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Acquisition Finance: Risk assessment and risk division between the parties in Leveraged Buyout Transactions

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Abstract

The purpose of the Thesis is to identify the main risks in leveraged buyout process and analyze different risk assessment between the parties. In addition, the paper concentrates on comparison between UK and US common law systems and Finnish civil law systems where due to different jurisdictional characteristics treatment of LBO transactions is different. The emphasis is also put on analysis from the perspective of legislation and court practice what needs to be taken into account in conducting successful LBO transaction.

As LBO transactions have their roots in the US system and it is more commonly used in US based acquisitions, more weight is given on the analysis from the perspective of US legislation. In addition, due to confidential nature of LBO transactions and as majority of agreements restrict that claims are solved in arbitration there is lack of available case law. This is why I am concentrating more on the US system and case law that is publicly accessible. Furthermore, this research also concentrates on comparison and identifying differences and similarities between different common law systems and Scandinavian civil law system. Scandinavian system is analyzed from the Finnish perspective since there has been hot debate related to Finnish more restrictive approach to legislate LBO transactions. Finally, it is also interesting to take into comparison other common law system, UK where national legislation varies from the US system in great parts. The paper brings out the main characteristics in these systems and tendencies to manage risks from the perspective of national laws and legal practice.

Risks in the LBO process range from choosing the right parties, risks related to the negotiation process and different contractual risks. In addition, there are issues related to different national and EU law provisions that parties need to take into account. In this research is covered step by step the whole acquisition transaction and analysis on different risk assessment tools and how parties seek to divide and mitigate their risks. In addition, the perspective of academic writers is taken into account in the analysis to see what kind of risks and risk division is seen as ideal in practice. Finally, relevant case law is analyzed from the perspective of which kind of situations may lead to unsuccessful deal and how these conflict situations are solved in practice.

Leverage and more specifically the debt level have an essential role in LBO transactions. The whole transaction process has various steps from choosing the right target company and parties to the transaction, negotiating the deal and loan agreements and finally completion of the deal.

Keywords

Acquisition, Leveraged buyout, risk assessment, buyout process, deal structure, debt level

UNIVERSITY OF HELSINKI

Acquisition Finance: Risk assessment and risk division between the parties in Leveraged Buyout transactions

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Master's Thesis
International Business Law
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Abbreviations

ARA	Additional rights agreement
EU	European Union
LBO	Leveraged buy-out
LOI	letter of Intent
MAC	Material Adverse Clause
MBO	Management buy-out
PE	Private Equity
PTP	Public to Private
UK	The United Kingdom
USA	United States

1 Introduction

1.1 Background

Companies have different reasons to make structural changes. Corporate transactions are always unique and done to achieve different goals. Transaction tools are chosen depending on the purpose what the company is trying to achieve. The main reason for structural change can be for instance improving general efficiency of the company or better coordination of resources. One form of making structural change that this paper concentrates on is corporate acquisition with leveraged buyout (LBO) transaction.¹

Leveraged buy-outs have been a trend in the credit markets for a longer period of time. It seems that it is not merely U.S phenomenon, but more like a global thing. Public-to-private LBO transactions in different countries are legislated in different manner and they are influenced by the ability to squeeze out minority shareholders. The United States, United Kingdom, and Ireland have taken less restrictive approach. On the other hand countries such as Italy, Denmark, Finland, and Spain tend to be far more restrictive.² Legislative differences bring legal uncertainty which increases the risk level in LBO transactions.

Bain & Company is one of the leading consulting firms in the world. According to company's 2013 Global Private Equity Report three years have passed since the global collapse of credit markets. Through this period private equity transactions seems to have been stuck, but in the end of 2012 they have shown recovery. As credit markets are now healthier, they are open to finance again new leveraged buy-outs.³ Therefore, the matter is current at the moment and as legislation changes all the time, parties need to be constantly aware of the possibilities, limits and risks that are included in this form of finance.

¹ Immonen Raimo, Yritysjärjestelyt, Talentum Media Oy, 2011, p. 14-19

² DePamphilis, Donald M. / 2012 / 6th ed, Focal Press, Mergers, acquisitions, and other restructuring activities: an integrated approach to process, tools, cases, and solutions, available at <http://www.sciencedirect.com.libproxy.helsinki.fi/science/article/pii/B978012385485800013X>, Last visited November 23, 2013

³ Bain & Company, Global Private Equity Report 2013, p. 1-2, available at <http://www.bain.com/consulting-services/private-equity/index.aspx>, Last visited November 23, 2013

Leveraged buyouts have become favorable investment form among venture capitalists and it serves as an important channel of finance for small and medium-sized enterprises. The reasons why this form of activity has increased rapidly can be explained with the structure of current financial market. Many times a company that is seeking a capital investor has no other forms of finance available. This is due to bank regulations which do not allow loans that are tied with equity. Therefore, venture capitalism is also one of the future forms of investment which has become filling the gap between the capital needs of different industries and available forms of finance in the market. ⁴

1.2 The purpose and limits of research

The purpose of the Thesis is to identify the main risks in the leveraged buyout process and analyze different risk assessment between the parties. In addition, the paper concentrates on comparison between UK and US common law systems and Finnish civil law systems where due to different jurisdictional characteristics treatment of LBO transactions is different. The emphasis is also put on analysis what needs to be taken into account in conducting successful LBO transaction.

In finding relevant research results as sources I have used first of all relevant legislation, more specifically national legislation that regulates LBO transactions and EU law provisions in this regard. In addition, this paper includes analyses from academic writers and available negotiation practices to find answer how the negotiation process is structured and what different risks have effect on the successfulness of the deal. Finally, relevant available case law is analyzed for the purposes of understanding what kind of risks there are included and how these matters are dealt in practice in different jurisdictions.

The Thesis demonstrates different legal risks that are included in leveraged buyout transactions. There are several parties included and these are highly risky acquisition forms which require carefully planned execution. The seller and the buyer, whether they are then business corporations or financial investors need to take into account several things in the beginning and when the whole acquisition process is going on.

⁴ Korhonen Ville, Pääomasijoittajan irtautuminen Exit-Lausekkeilla, Edita Publishing Oy, 2003, p. 4 available at <http://www.edilex.fi/opinnaytetyot/768.pdf>, Last visited November 23, 2013

In addition, there are included banks and other institutions to finance the deal which make the financial structure more complicated. Failure of adequate investigations before engaging into negotiations or lack of professional help may result as unfavorable agreement with risks that the other party would not have wanted to bear on their selves. The Thesis underlines the importance of duly planned deal-structuring process and correct division of risks where possible future events and other risks are taken into account.

In this essay I am covering acquisitions, especially Leveraged buyouts where private equity investors are involved and more specifically where public companies' structure is changed to private so that public companies' registration requirements based on law cease to exist. To understand how LBO deals are structured, the whole acquisition process and the division of different risks that there might be in the whole process are identified in this essay. Many times it takes a long time for the acquisition to be completed and therefore, there are many different factors that the parties need to take into consideration when negotiating agreements.

In the second chapter is covered essential terms related to leveraged buyouts. This chapter defines both private equity buyout and leveraged buyouts even though they are sometimes used as meaning the same thing. For the purposes of this research it is necessary to treat separately risks that are related to private equity formed transactions meaning the vehicle which is chosen as an acquisition form and on the other hand to leveraged buyouts meaning the form of finance and risks related to the debt level. In addition, this chapter explains general history of buyouts and their use and spread in different jurisdictions. Furthermore, term debt is defined so that it is understood from the perspective of the target company's risk assessment, how much debt the deal has capability to take. Finally, this chapter covers the process what is happening inside the target company and the purpose what the parties are aiming to achieve with the structural change.

Third chapter introduces relevant legislation that is applicable to acquisition transactions. More specifically this part explains legislation first of all, from the viewpoint of the United States Legal system which legislation needs to be applied in domestic and international buyout transactions. Secondly, UK section introduces the essential legislative sources that need to be taken into account when a target

company is residing in the UK. Finally, Finnish legislation section brings out the Scandinavian perspective to regulate buyouts and its special features that need to be taken into account when the target company is Finnish.

European Union competition rules and national legislation set certain restrictions on how LBO's can be managed in practice. This legislation is essential from the perspective that the transaction can succeed in practice and the deal is accepted by the European Union authorities. It has been necessary to limit research primarily on national provisions and in certain jurisdictional differences. This is why relevant European legislation is introduced only from the essential parts of the community law. Therefore, the main purpose is to concentrate on national provisions related to contractual relationships in the LBO process and risks that parties seek to mitigate in this transaction.

As LBO transactions have their roots in the US system and it is more commonly used in US based acquisitions, more weight is given on the analysis from the perspective of US legislation. In addition, due to confidential nature of LBO transactions and as majority of agreements restrict that claims are solved in arbitration, there is lack of available case law. This is why I am concentrating more on the US system and case law that is publicly accessible. Furthermore, this research also concentrates on comparison and identifying differences and similarities between different common law systems and Scandinavian civil law system. Scandinavian system is analyzed from the Finnish perspective since there has been hot debate related to Finnish more restrictive approach to legislate LBO transactions. Finally, is also interesting to take into comparison other common law system, UK where national legislation varies from the US system in great parts. The paper brings out the main characteristics in these systems and tendencies to manage risks from the perspective of national laws and legal practice.

The fourth chapter is the heart of the whole paper. This chapter covers the whole acquisition process and risk assessment. The section starts with identification of risks that need to be taken into account already at the preparatory level of the whole process. These risks range from choosing the right parties in the first place, the bid process that needs to comply with domestic legislation and tax considerations. In addition, different risks related to the negotiation process are explained. Risks that

are related to the terms of the acquisition agreement itself are an essential part of the risk division between the buyer and the seller. These are explained and analyzed in more depth in this research. One of the significant risks included in leveraged buyouts are related to the value of the company. It is rarely easy to estimate the correct value of the company and errors in pricing can have tremendous effects on the successfulness of the deal as whole. Related to the value estimation, also the payment form needs to be decided for the purposes of benefits that the deal is seeking to achieve. Finally, where the term leverage is related to the significant debt level in these transactions, it is relevant to cover risk analysis on how much debt a successful buyout transaction can take.

In the fifth chapter is introduced some case law related to unsuccessful buyouts which means that there has raised a dispute and a case has ended up in a court. First of all is covered a case in Ontario Court of Appeal, where also the United District Court needed to consider, if the courts of California had exclusive jurisdiction. The case covers matters related to the interpretation of different contracts signed in the process and specific terms which were related to negotiating with good faith and arbitration. Secondly, from the UK perspective is introduced a case *Harman LBO*. In this case the question was about unsuccessful leveraged buyout due to reasons that the target company was not suitable for the transaction. Harman did not meet the requirements so that the structural change would have made the company more profitable and this is why parties erred in choosing the target company. Finally is covered one case from the Finnish Supreme Court and consideration related to situations in which a seller can have liability of the defects in the deal or defects of the target company itself.

Finally, chapter six is the conclusion. The conclusion covers the main research results and sums up risk evaluation in this paper. This section covers in essential parts the main steps in the acquisition process and provides consideration on risk assessment between the parties.

2 Leveraged buyouts: Definitions and history

2.1 General

Business is company's dynamic activity. Company's operational environment may change for various reasons. This might lead to a situation in which business structure is impractical and might endanger competition in the market. This is why company's structure needs to be changed. Also different company buyouts are treated as structural transactions.⁵

There are various reasons for engaging into acquisition transactions; financial and non-financial. Management in the majority of European companies has given more weight to strategic and operational reasons than pure financial ones. First of all, economies of skills have played a major role in acquisition process. Secondly, there have been motives to expand the company and economies of scale which have driven companies towards acquisition. Thirdly, growth market has had an essential role, which has led companies to seek cross-border acquisition possibilities in developing markets. Therefore, as we can see, main reasons from the perspective of the acquired company are not financial, but the decision has been usually made on the basis of improving the company's standing.⁶

In the following are explained essential definitions related to one specific form of acquisition, Leveraged buyout. To understand ways and the structure how the process is constructed, first needs to be defined what is meant with private equity buyout, which is sometimes used in a similar meaning with leveraged buyout term. However, I am explaining these terms separately, first defining private equity as a vehicle to formulate the transaction and leverage buyout referring to the use of debt in the transaction. Even though these terms are treated separately, for the purposes of this research, with leveraged buyout transaction is meant the use of private equity to structure the deal.

2.2 Private equity Buyout

There are different possibilities to make private equity (PE) investment. Payment tools are covered in more detail later in this essay, but one of the investment possibilities is funds. Funds that have pooled money from investors are usually managed by management companies. Furthermore, institutional investors such as

⁵ Ibid; Immonen Raimo, p. 2

⁶ Jagersma, Pieter, Cross-border acquisitions of European multinationals, Journal of General Management Vol 30 No 3 Spring 2005, p. 17-18

insurance companies and pension funds, but also individuals can provide money for private equity investments. In a typical situation, private equity fund acquires control of the company using Portfolio Company to finance the deal.⁷

Typically, a private equity firm is organized as a partnership or limited liability corporation. Private equity firms in the first 1980 wave were criticized of being too small and decentralized, with relatively few professionals, but nowadays the amount of private equity professionals has increased. Today companies that invest are bigger, but the target companies are usually relatively small.⁸

Private equity funds are vehicles used in LBO transactions in which investors are committed to provide a certain amount of money to finance investments. The capital is raised by a private equity firm through these funds. As already mentioned, these funds are usually organized as limited partnerships, which mean that general partners manage the fund and limited partners provide essential amount of the capital. The private equity firm is a general partner of the fund providing 1 percent of the capital itself.⁹

Fund is established on a fixed duration which is usually ten years, but the time can be extended with additional three years. On the other hand, private equity firm itself invests typically its capital for five years in the fund. After this it has five to eight years' time period to return capital back to investors. Limited partners have not much to say after capital is committed, but general partners have the power to deploy the investment fund. From the legal perspective, common covenants in the agreement include restrictions on the amount of capital that can be invested in one company and the types of investments that can be made.¹⁰

Where LBO transaction is quite risky way of changing company's structure, successful completion of the deal in practice requires that investors who have limited rights in the deal should draw their covenants carefully. When their capital is on the hands of general partners, they should secure that their investments are duly balanced

⁷ Meyerowitch, Steven A, Structuring Private Equity Transactions, Banking Law Journal, Vol 126, Issue 3 March 2009, p. 196, available at http://www.heinonline.org/HOL/Page?handle=hein.journals/blj126&div=27&collection=journals&set_as_cursor=0&men_tab=srchresults, Last visited November 24, 2013

⁸ Kaplan, Steven N, "Leveraged Buyouts and Private Equity", Working paper, National Bureau of Economic Research, July 2008, p. 4

⁹ Ibid; p.4

¹⁰ Ibid; p. 5

from every angle and possible risk factors of the LBO transaction which are further explained, are all taken into account.

In the private equity transaction, the consent to buy a company comes from the private equity firm. Usually premium paid by the firm is from 15 to 50 percent of the current stock price. The deal is typically financed with 60 to 90 percent of debt, where the term leveraged buyout comes, which is explained in more detail later. Also senior and junior debt formed loans are part of this finance and they are covered later.¹¹

In private equity buyout where the aim is to go private, the purpose of the whole transaction is to remove the target company from the equity trading market. The deal is structured by a limited partnership, which means the buyout fund and it is organized by a private equity firm, usually referred as the buyout firm. The main task of the buyout firm is to act along with the buyout fund in choosing the target firm and taking the role as a supervisor. The buyout fund means the purchasing entity which has derived its risk capital from institutional investors. As the buyout firm's incentive is purely financial, it has full motivation to supervise that there are neither free riders nor conceptual problems which could have negative effect in the deal negotiation process.¹²

As private equity buyout may provide an efficient solution in unifying ownership and managing with control problem, one of the main issues in these equity transactions is finance. Institutional investors demand assurance for their investment and they provide capital for the transaction on an indefinite time period. Private equity contract includes provisions which limit the buyout fund's duration and sets the buyout firm under strict conditions after which cash is distributed when this period has passed.¹³

Whether the investor is institutional or individual, there are several things that one needs to bear in mind when structuring a private equity transaction. If there is international investment in question, both the investor's and the portfolio company's

¹¹ Ibid; p. 6

¹² Bratton, William, Private Equity's Three Lessons for Agency Theory, Brooklyn Journal of Corporate & Commercial Law, Vol 3, Issue 1 (Fall 2008), available at http://www.heinonline.org/HOL/Page?handle=hein.journals/broojcfc3&div=4&collection=journals&set_as_cursor=0&men_tab=srchresults, Last visited November 23, 2013 p. 2

¹³ Ibid; p. 3

national legislation needs to be taken into account. As the purpose of the transaction is to acquire the company, try to add its value and then sell it further through public offering or to other private equity investor, there are several issues that need to be taken into account. First of all, it is essential to cover tax matters. If there is high tax rate imposed on the sale of local portfolio company, this can be eliminated by forming holding company to a country which has an income tax treaty with the portfolio company's country. In addition, there is a possibility to form a holding company into a tax haven, such as the Cayman Islands. Secondly, there also also different no-tax related issues such as be legal requirements or other restrictions arising from either the investor's or the portfolio company's country.¹⁴

What is also worth of consideration in private equity buyout is the exit from the deal. As it has been stated, most private equity funds have a limited contractual lifetime. For these reasons it is essential to determinate how and when the exit is done in practice before closing the deal. One of the most common exit routes is to sell it to a strategic buyer. Another mostly used is a sale to another private equity fund. Finally, initial public offering where the company is listed on a public stock exchange comes on the third place.¹⁵

2.3 Leveraged Buyout

Leveraged buyout is one of the acquisition forms, where an entire company or part of it is delisted and financed usually with significant portion of debt. In a typical LBO, the buyer is usually private equity fund. In the process the sponsor provides debt to finance the essential part of the purchase price and uses fund to contribute its part of the deal.¹⁶ Furthermore, it means a sales process where a company finances its own purchase by granting liens on its assets and taking debt to finance the transaction. In this process there is high risk of insolvency which has effect on how much debt the company is able to take. Creditors of the company are in worst positions since throughout the risk they are not gaining any compensation from the deal. In the

¹⁴ Ibid; Meyerowitch, Steven, p. 197

¹⁵ Ibid; Kaplan Steven, p. 10

¹⁶ Ebo, Espen, Thorburn Karin S, "Corporate Restructuring: Breakups and LBOs", Handbook of Corporate Finance: Empirical Corporate Finance, Volume 2, May 2008, p.34

opposite, parties in the buyout, meaning buyer, seller and lender are driven towards the deal with great expectations of high profits.¹⁷

In the LBO transaction where the buyer is private equity fund, it usually pays only a minority of the purchase price. In the process the target company itself borrows the money and uses leverage to attain greater purchasing power than its own investment has. The party responsible for the debt is solely the target company, not the buyer and its assets are given as a security for the debt. Even though target company is a party to the LBO, it has a poor position in the negotiations. Terms of the deal are primarily negotiated between the buyer, the lender and selling shareholders. In a friendly environment though, the management and board of directors can be allowed to participate. Therefore, LBO is simply a capital structure change of the company where on the other side stands the fear of high risks and on the other the possibility of high profits.¹⁸

Leveraged buyout transaction can be divided into three different parts. First is leverage, which means that the acquirers borrow the substantive portion of publicly traded company's value. Secondly, there is the role of control which refers to acquirers taking key role in the management and finally, third element of taking the target company off from public market to private (PTP).¹⁹

In the process the equity is injected to a shell company which bears the debt and acquires the target. The sponsor is relying on the company's cash flow to service the debt. The incentive in this deal is to improve operating efficiency of the company during short time period from three to five years and then divest the company. During this time period the debt is paid down and returns are accrued to the equity holders. When it comes to exit, it can be for instance sale to another strategic buyer or another LBO fund.²⁰

¹⁷ Ginsberg John H., Burgess M. Katie, Czerwonka, Daniel R., Caldwell, Zachary R., Befuddlement betwixt Two Fulcrums: Calibrating the Scales of Justice to Ascertain Fraudulent Transfers in Leveraged Buyouts, American Bankruptcy Institute Law Review Vol 19, Issue 1, Spring 2011, p. 72, available at http://www.heinonline.org/HOL/Page?handle=hein.journals/abilr19&div=6&collection=journals&set_as_cursor=0&men_tab=srchresults, Last visited November 23, 2013

¹⁸ Ibid; p. 74-76

¹⁹ Damodaran, Aswath, professor, New York University, The Anatomy of an LBO: Leverage, Control and Value, p. 1, Electronic copy available at <http://ssrn.com/abstract=1162862>, Last visited November 23, 2013

²⁰ Ibid; Ecko, Espen p. 34-35

One of the essential matters in leveraged buyout is the amount of debt and the form of payment. When we compare UK and US types of leveraged buyouts, there is considerable difference in the amount of debt taken to cover the deal. It seems that in US debt amount is far higher than UK types of buy-outs and it creates different risks like insolvency and requires different planning how the deal should be constructed.²¹

2.4 Parties

In LBO types of transactions, venture capitalists are investors who seek to obtain certain profit on their investment and they are evaluating expectations based on the deal in question. The purpose of venture capitalists is to reorganize resources and performance of the company and to make the company more beneficial. They seek to increase stocks value and beneficially exit the whole deal. Profit gained by venture capitalists consists of dividends, loan interests and other returns during the investment period.²²

Venture capitalism is an essential part of the LBO deal. It is one form of acquisition finance in which venture capitalists have a role as financiers of the deal in a company which is not publicly traded and which has good future prospects. Such investments are primarily made through equity. Venture capitalists are active investors who in a co-operation with other owners seek to enhance the company's business prospects.²³

There are three differences compared with other forms of finance that it worth to make notion. First of all, is already mentioned active participation in monitoring and restructuring the target company after the investment is made. Secondly, these investments are always made for a certain time period, so they are time-limited. Usually fixed term is from 10 to 13 years. Third separate factor is related to restricted liquidation. This means that venture capitalists usually always invest into unlisted companies, either by investing into new innovations after which they are practicing

²¹ Martynva Marina, Renneboog Luc, A Century of Corporate Takeovers: What Have we Learned and Where Do We Stand?, *Journal of Banking and Finance* Volume 32, Issue 10, October 2008

²² Lauriala Jari, *Yritysjärjestelyiden rahoitus*, No 6/2009, p. 952, available at http://www.edilex.fi/defensor_legis/6682.pdf, Last visited November 23, 2013

²³ *Ibid*; Korhonen Ville, p,7

rights in the target company, or then new unlisted company is structured to perform the deal.²⁴

Another party to LBO transaction is creditors. It is riskier to invest in a leveraged buyout structured transaction than to invest directly to the company. The process as whole is more vulnerable and riskier and cash flow of the company is more insecure. After the transaction the credit worthiness from the perspective of creditors is lower and there are risky elements related to the future of the company.²⁵

Third party in the LBO is the management of the company. After the deal, compensation structure is different in relation to venture capitalists. Target company's management is committed to the deal usually with its own capital so that more incentive end could be achieved. In addition, exit from the property ownership is usually under strict provisions that certain objectives need to be achieved before it is possible.²⁶

2.5 Definition of Debt and comparison with the use of equity

For the purposes of understanding the whole structural change of the company, it is necessary to define term "debt" within the meaning of LBO process. It can be too narrow to measure debt only from the balance sheet of the company as many analysts do. According to Aswath Damodaran there are three different criteria in categorizing financing as debt. First of all, when there is debt, there are also contractual obligations that need to be met despite the company was living its good or bad times. Secondly, payments of this kind are usually fixed and tax deductible. Finally, if the company fails to meet its commitments, this can lead to loss of control of the company.²⁷

When these criteria is being used, term company debt can include both all interest-bearing debt, whether it was then long or short term but not non-interest bearing obligations, meaning for instance accounts payable or supplier credit. In addition, if there is no explicit interest payment, it cannot be considered as debt within this meaning. Furthermore, some other items in the balance sheet should be also

²⁴ Lauriala Jari, "Instrumentointi ja Liquidation preference –rakenne pääomasijoituksissa", Edita Publishing Oy, 2004, available at <http://www.edilex.fi/artikkelit/1178.pdf>, Last visited November 24, 2013, p. 4

²⁵ Ibid; Lauriala Jari, Yritysjärjestelyiden rahoitus, p. 952

²⁶ Ibid;

²⁷ Ibid; Damodaran, Aswath p. 4

separated and treated as debt. This means for example long term leases and other commitments where a payment is tax deductible and where nonfulfillment of commitments leads to negative consequences.²⁸

Another way of making difference with the accounting balance sheet is to set up a financial balance sheet. According to this division, on the assets side there is only assets in place meaning investments that are already made and growth assets that are investments expected in the future. On the other side are liabilities which include debt and equity.²⁹

There are two positive sides on the use of debt for the deal when it is compared with the use of equity that is explained above. First of all, the interest paid on debt is tax deductible, where cash flows to equity are not. This means that the higher the amount of debt is the greater is the tax benefit. Secondly, the use of debt as a form of finance is more subtle. This means arguably of course, that it induces managers to be more disciplined in project selection. This can be explained better with comparing this with the use of pure equity financing, where cash flows are strong and this could lead to laziness. Where an equity –financed project could be hidden from the investors under the cash flows of the company, deb –based project failures are usually not left unnoticed.³⁰

To discover the best balance in the company's structure, it is necessary to compare also of the disadvantages on the use of debt with the use of equity. First is related to an expected bankruptcy cost. One of the components is that as debt increases, probability of bankruptcy does too. The other is the cost of bankruptcy which can be divided into two subparts; direct costs including legal fees and court cost and on the other hand the effects it has on the operational part of the company.³¹

Another disadvantage in the use of debt is that agency costs arise from the competing interests between equity investors and lenders. These differences of course come from the characteristic diversities between investors readiness to take more risks than lenders. Equity investors' tendency to risk taking is higher than lenders would be willing to allow and this can lead to altering the terms of the loan agreement. One way in which lenders can protect themselves is to add covenants to these agreements,

²⁸ Ibid; p. 4-5

²⁹ Ibid; p.5

³⁰ Ibid; p. 6

³¹ Ibid; p.7

which is dealt later. The other is to start charging higher interest against investor's games to meet possible future losses.³²

Finally, where companies borrow more money today, they might lose the ability to tap this borrowing capacity in the future. If the company loses its financing flexibility, it might be unable to make investments it would have wanted to make due to financial reasons.³³ This is true and may have significant effect on the company's operation as whole. If the company makes bad decisions and it has too heavy loan burden, it might end up into a very difficult financial situation. Therefore, in every case, the debt and the level of debt compared with equity is an essential question to be solved in the entire LBO process.

2.6 History of buyouts

Corporate studies reveal that acquisitions come in waves. There can be separated five different periods that literature has been studied; of the early 1900s, the 1920s, the 1960s, the 1980s and the 1990s. In the recent wave, European countries became more active participants along with US and UK.³⁴

Two important latest buyout cycles were in the 1980 and the last in 1990s which reached its peak in the first half of 2007 and then started to decline. Michael Jensen has analyzed how optimal management performance could be achieved by correction through capital market intervention. Companies were making unproductive investments on plants and value-reducing acquisitions which meant that shareholders were not paid any profits. This created conflict between the management and shareholders. Leveraged buyouts were seen as a tool to solve the conflict situation when shareholders were paid a premium over the market. Therefore, this offers an explanation why LBOs became so popular among other corporate restructuring models.³⁵

In the US there were extensive amount of hostile takeovers and restructuring. According to Jensen who has studied corporate takeovers, LBO's functioned as necessary catalyst to reduce this form of takeovers. The extensive growth of US

³² Ibid;

³³ Ibid; p. 8

³⁴ Ibid; Martynva Marina, p. 3

³⁵ Ibid; Bratton, William p. 4-5

going-private buyout market is explained better in numbers, since it developed in 1979 from less than one billion dollars to more than sixty billion dollars in 1988. Of course, we need to bear in mind that LBO wave was associated with many bankruptcies and also changes in the legislation, such as anti-takeover legislation. It is argued that today these kinds of deals are not necessary anymore because the focus on shareholder value has become institutionalized afterwards. However, there has been still seen rise from 1997 onwards in the use of PTPs in the USA.³⁶

In the UK LBO activity can be spoken on a smaller scale, but there the first wave culminated at the end of the 80's, in 1989. There was public controversy regarding increased hostility in transactions that year which made the Panel on Takeovers and Mergers to adopt new rules regulating the PTP procedure. As in the US, it seemed that PTP's were only used for a short time period, but in 1997 came a second wave which can be explained with increased presence of private equity and debt financiers. Reasons why small companies were driven into the arms of private equity firms was mainly financial. There was lack of liquidity and for instance LBO deal offered a solution in a difficult situation.³⁷

In the Continental Europe the situation was different in 1980, because the use of PTP was very low during that decade. However, the situation changed and it was more used in the second wave if so to speak in the late 1990s. European market regarding PTP is still quite small because of various reasons. First of all, in the continental Europe there are less listed companies than compared to US for instance. Secondly, there are also fewer private equity houses that see the worthiness of taking highly risky and costly PTP. Thirdly, European financial market seems to be more sophisticated and the culture has a role to play in these kinds of transactions. Finally, when compared with the UK, the legal and fiscal infrastructure has its drawbacks in continental systems which make it less attractive from the viewpoint of investors.³⁸

What might happen in the future is that private equity firms may not be so fortunate anymore. One of the problems could be bidding wars. Nowadays buyouts are larger and buyout funds more extensive, so the likelihood has increased for equity firms ending up bidding against each other to buy the same targets. When there becomes

³⁶ Ibid; Martynva Marina, p. 4

³⁷ Ibid, p. 4-5

³⁸ Ibid; p. 5

contest in the same target, an equity firm might end up paying too much. In addition to bidding contests, there are stock market trends that might change. Furthermore, directors and shareholders might drive prices up dangerously when the profitability of LBO deal is suffered.³⁹

2.7 Company's structural change

A public company reorganizes its capital structure for the purposes of avoiding its public recording requirements. According to U.S law Securities and Exchange Act of 1934 a company is treated as public when it is listed on a national securities exchange, it has registered a public offering or it has five hundred shareholders and ten millions dollars of assets.⁴⁰ The same conditions are also defined in Finnish Companies Act and UK Companies Act 2006.⁴¹

When the company reduces the amount of its record shareholders to less than three hundred and delists securities from any national exchange, it can escape from its recording requirements. This means also that at this point the company is considered privately-held and it may choose whether to file public reports anymore.⁴²

These capital structure changes going from public to private can be done in several ways. One way is that a public company buys back its own stock or mergers with its own subsidiary. By doing this the amount of its shareholders can be reduced and it gains private characteristics. The change can also be made so that another independent company acquires the other. In practice this happens so that privately-held company buys a publicly-traded company. In this case the privately-held company is considered as a strategic buyer in case it is another operating company and as a result the privately-held acquiring company becomes a newly-formed subsidiary of the financial buyer.⁴³

Acquisitions in which financial buyer is known as private equity fund or buyout fund showed an increasing trend in the early part of this decade. The element that financial

³⁹ Cheffins, Brian, Armour, John, "Eclipse of a private Equity", The Delaware Journal of Corporate Law, Vol 33, Issue 1, 2008 p. 43 available at http://www.heinonline.org.libproxy.helsinki.fi/HOL/Page?handle=hein.journals/decor33&div=6&collection=journals&set_as_cursor=24&men_tab=srchresults#13 ,Last visited November 23, 2013

⁴⁰Ibid; Immonen Raimo p. 54-55

⁴¹ Finnish Companies Act and UK Companies Act 2006

⁴²Ibid; Immonen Raimo, p. 55

⁴³Ibid; p. 55-56

situation is only made for a certain period of time requires well planned execution. When the buyout fund is capitalized, the management firm's task is to find a suitable target company and then continue to negotiate acquisition. After this a sell company is created and this is the operating vehicle for the whole acquisition. The purchase is funded by the target company's securities, the buyout fund's cash capital and borrowings from other possible financiers. The sell company is acquiring in the process majority of the voting shares and the control of the target company. Shareholders of the target company have the cash and the buyout fund and the target company itself becomes a portfolio company of the buyout fund.⁴⁴

These portfolio companies are kept a short time period with incentive to gain high profits. The time period of keeping money in these investments is usually between five and seven years. After this the buyout fund resells the portfolio company through public offerings to private buyers or other strategic buyers. As a result in the sale the buyout fund usually receives substantially enhanced value of the purchased portfolio company.⁴⁵

There can be considerable risks here from both the side of the buyer and the target company. When structuring the deal, the target company needs to take into consideration that the buyer is not making any essential changes for the business itself or employees, in case it wants the business to remain the same. These kinds of financial investment situations can be very risky, since investors are aiming at gaining high profits and the ways in which these are done, are not always the most favorable to the acquired company itself.

3 Legislation

3.1 The United States

In general foreign companies acquiring US businesses are treated similarly as domestic acquisitions in the USA. The US Government offers incentives to foreign-based companies providing different tax and other benefits. There are though certain exceptions where foreign investors are treated differently from US investors. These

⁴⁴Ibid; 56-57

⁴⁵ Ibid; Immonen Raimo p. 57

restrictions are usually related to national security issues, because in general US Government seeks to boost country's economy by allowing foreign investors similar access to US investments.⁴⁶

The Sarbanes-Oxley Act has essential role in the US buyouts. The Act came into force in July 2002 introducing changes regarding regulations related to corporate governance and financial practice. The name was given according to its main drafters Senator Paul Sarbanes and Representative Michael Oxley. The impact of the Act was remarkable since it set a number of non-negotiable deadlines for compliance. The Act itself contains eleven titles of which few sections are the most vital ones from the perspective of buyout transactions.⁴⁷

In section 302 corporate responsibility regarding Periodic statutory financial reports is more restricted. It requires that the signing officers have above all seen the report, any negative impacts to internal control is informed and it does not contain any misleading information and that all the information given is duly presented.⁴⁸ As the Act defines the requirements related to financial reports clearly, it is not possible to commit omissions without liability by saying that persons involved were not aware of the reports or that they did not actually see what they contained.

In section 404 the scope and adequacy of the internal control structure and procedures for financial reporting need to be published by the issuers. In section 409 is the requirement to inform publicly of all major changes in financial conditions and of all major operations that the company gets involved into. Section 802 covers fines and penalties for falsifying documents or destroying some essential records.⁴⁹ When we think about leveraged buyouts and risks that are related to financial situation of the target company, these requirements have great significance. Transparency of company's current situation brings more certainty for buyers and more trust on the exchange of documentation. Therefore, the Act is essential from the point of view of clarifying responsibilities and liabilities between the parties in buyout transactions.

⁴⁶ Baker and McKenzie, A Legal Guideline to Acquisitions and Doing Business in the United States, Cornell University ILR School, 2007, p.14, available at <http://digitalcommons.ilr.cornell.edu/cgi/viewcontent.cgi?article=1037&context=lawfirms>, Last visited, November 23, 2013

⁴⁷ Sarbanes-Oxley Act 2002, available at <http://www.soxlaw.com/s302.htm>, last visited 24 November, 2013

⁴⁸ Ibid;

⁴⁹ Ibid;

The Williams Act was passed by the US Congress to amend the Securities Exchange Act of 1934. The purpose of the Act is first of all to require that offerors disclose information about the offer and secondly, to establish procedural requirements to govern tender offers. This means that the primary purpose of the Act is to protect shareholders and make them familiar with the relevant facts which affect on their decision. If an acquirer is seeking to obtain more than a specified percentage of shares, certain information on the offeror's background and the source of funds should be included. Therefore, the Act serves as a minimal source of requirement on acquiring corporations when they are making a tender offer.⁵⁰

There are 50 different jurisdictions in the US and the sources of law are different. For this reason federal regulations have only a small role in regulating buyouts. Delaware Court of Chancery's decisions have become often used also outside the state's borders. For instance in hostile takeovers the "intermediate standard" of review which was developed by the Delaware Supreme Court have had influence in the court practice in other states.⁵¹

State Anti-Takeover Statutes serve as one legislative source in buyout transactions preventing certain hostile takeovers. These statutes are divided into three different generations. First provisions provided protection for in-state corporations in a case where the acquirer comes out of the state. In case law, such as in *Edgar v. MITE Corp.* the Court has though invalidated statutes which have discriminated acquirers from other states and these statutes have been judged as unconstitutional. In the second generation weight was given on disclosure-oriented protection as in case *CTS Corp. v. Dynamics Corp. of America*. In addition, fair price statutes where approval by a supermajority of shareholders was requirement for the transaction were established. Third generation statutes went far more protective prohibiting mergers within five years after the acquisition had been completed unless the transaction was approved by the company's director's before completion.⁵²

⁵⁰ Magnuson William J, Takeover Regulation in the United States and Europe: An Institutional Approach, February 2008, p. 11-13, available at http://works.bepress.com/cgi/viewcontent.cgi?article=1000&context=william_magnuson, Last visited November 23, 2013

⁵¹ Ibid; p. 13

⁵² Ibid; p. 16-17

As it has been said earlier, there are only few occasions where US Government interferes more strictly in transactions by non-US companies. One of the exceptions where US is restricting foreign investors is regulated under the Exon-Florio provision of the 1988 Omnibus Trade and Competitiveness Act. The Act gave the president of the United States powers to review certain acquisitions and in specific circumstances capacity to block the transaction if there is significant evidence that a foreign company exercising powers over the company has a purpose to cause threat to national security.⁵³

Secondly, it is worth mentioning that there are certain restricted industries where a foreign buyer needs to exercise even more care when planning a leveraged buyout transaction. These industries range from banking, insurance and fishing to television broadcasting. Banking for example is regulated by both the state and federal laws.⁵⁴ This sets certain limitations how a structural change can be executed in practice. Therefore, it is essential that there are used experts that are fully aware of specific legislative features of that exact country where above all the leveraged buyout transaction is planned, but also in those countries which parties are connected to process.

3.1 The United Kingdom

Legislation that applies in the UK public to private transactions is found in the City Code on Takeovers and Mergers. Public and private companies are treated differently because public companies usually have multiple owners and the bid process is public. In May 2006 UK law adopted the EU Directive on Takeover Bids which is an essential development, because it gave to the City Code first time a statutory basis. This is of course to the extent that it is derived from the Directive.⁵⁵

The City Code on Takeovers and Mergers defines the scope of the Code which applies first of all to all companies that are listed on the Main Market of London Stock. Secondly, the Code uses more general applicability to all public companies that are residing in the UK, Channel Islands and the Isle of Man. This is for the

⁵³ The Exon-Florio provision of the 1988 Omnibus Trade and Competitiveness Act

⁵⁴ Ibid; Magnuson William J, p. 16

⁵⁵ Speechley Tom, Acquisition Finance, Tottel Publishing Ltd 2008 p. 467

reason that buy-outs of public companies are treated differently under UK law due to various owners that are protected.⁵⁶

Another possibility is that the transaction falls under the Companies Act 2006 where disagreements are solved in court. Companies Act applies to both public and private companies and for this reason serves as an essential legislative base for buy-out transactions also. Some of the provisions that are explained in the following apply particularly to public-to private transactions.⁵⁷

First of all, financial assistance rules apply to a public company in accordance with the 2006 Act as long as the company has not re-registered as a private company. This is an essential feature from the point of view of acquisition financiers. In addition, whitewash provisions do not apply to public companies and this is absolute. From the point of view of taking company private, there is no possibility to upstream credit support, but guarantees and loans from target group companies can be taken only afterwards the target company has been re-registered as private. This has an essential meaning for financiers who are left unsecured for certain period after funding and before the stage is completed. This brings more security to financiers as there is a possibility to register the target company as private.⁵⁸

Secondly, there is statutory procedure established by Companies Act 2006 which is called scheme of arrangement. These provisions provide basis for the arrangement that the company can make with its members. It includes the purposes of a takeover bid and detailed statutory requirements that must be obeyed. Where the Code does not regulate how the bid is launched and on its execution, legally effective bids are set out in the Companies Act.⁵⁹

Thirdly, the 2006 Act includes provisions which provide the bidder under traditional takeover offer to squeeze-out shareholders. There is a requirement of 90% acceptance to make it possible. In this way the bidder acquires 100% ownership of the target company.⁶⁰

⁵⁶ Ibid; p. 465

⁵⁷ Ibid; p. 471

⁵⁸ Ibid; p. 471

⁵⁹ Ibid; p. 472

⁶⁰ Ibid; p. 472

Takeover offers and Schemes of arrangement are the alternatives according to which a public company can be acquired in the UK. A takeover offer is a direct offer to the shareholders of the target company to acquire their shares and it is made by the bidder. Usually acquisition financiers require much more than 50% of the voting share capital of the target company because they want to secure that minority shareholders do not later block the possibility to obtain loans, guarantees and security by the target group. A scheme of arrangement enables a structure where a company can make an arrangement with its shareholders or creditor, or class of them. The arrangement is wide including terms such as restructuring of debts and reorganizing capital.⁶¹

In addition previously mentioned Code and Act, there are other regulations that apply to UK leverage buyouts. Listing rules and the Disclosure and Transparency Rules of the Financial Services Authority must be applied. In addition, the Model Code on Director's Dealings applies to the target company and its directors. Furthermore, as there are different statement given in the process, criminal liability is considered in accordance with the rules under the Financial Services and Markets Act 2000.⁶²

3.2 Finland

According to Finnish law and the principle of freedom of contract recognized by the law, Finland allows various different methods for a Finnish private limited liability company to finance the purchase of shares. This means that in these situations the financing situation is more dependent on what the parties agree and how they negotiate their deal. There are though several mandatory and non-mandatory provisions which may have to be applied or which may become applicable in certain financial transactions regarding drafting and documentation matters. Most of these provisions are included in the Finnish Companies Act, the Contract Act and the Finnish Sale of Goods Act and the Promissory Notes Act.⁶³

When Finnish legislation regarding venture capitalism is compared with the US and the UK systems, there is no specific legislation that would regulate venture capitalism. This means that the operation of funds and financial instruments are

⁶¹ Ibid; Speechley Tom, p. 474

⁶² Ibid; Speechley Tom, p. 472

⁶³ Griffiths, Gwendoline, International Acquisition Finance, Oxford University Press, 2006, p. 226-227

regulated under Finnish Companies act. One solution would be to regulate with legislation only framework and the code of conduct. In this way also Finland would maintain its flexibility to adopt and act in different market situations. This is how problems related to acquisition finance have been solved in the UK and USA. For instance, in the US public power has had a significant role in information and infrastructure projects by supporting venture capitalism.⁶⁴

There has been public discussion in Finland that there has not been taken necessary efforts to remove obstacles of venture capital funds. As it has been earlier indicated that tax benefits have an essential role in LBO transactions, Finland has not made legislative changes to allow tax exemptions on Finnish Income Tax for non-tax Treaty countries. In addition, there has been discussion to eliminate PE risks in Finnish fund investing and mutual recognition of fund structure in general, but so far no changes in law has been made. As it has been already said, that there are no available court cases related to court proceedings related to acquisition agreement itself, there is though published Supreme Administrative Court cases related to venture capitalism activity.⁶⁵

In general Finnish legal and tax legislation that applies to Finnish venture capital funds is satisfactory. Finnish limited partnerships are suitable for venture capital activities since legislation does not restrict how profits can be allocated and distributed or how the business is structured. There are though matters related to interpretation that bring uncertainty. Mandatory provisions of law should be investigated by the parties to the transaction, so that uncertainty does not endanger the deal.⁶⁶ Uncertainties also effect on the desirability of foreign venture capital investors to invest in Finnish based funds due to permanent establishment requirements and Finnish Income Tax legislation. Finnish government has started to take efforts to boost Finnish economy and certain steps needs to be taken to simplify

⁶⁴ Korhonen Ville, p. 16

⁶⁵ Nordic Innovation Publication 2011:3/ November 2011, Obstacles to Nordic Venture Capital Funds, Promoting a common Nordic venture capital market, p, 31 available at <http://www.nordicinnovation.org/Documents/Attachments/Obstacles%20to%20Nordic%20Venture%20Capital%20funds%202011.pdf>

⁶⁶ Ibid; p. 32

current legislative position. It will be seen in the future, which reforms the Government will make.⁶⁷

Finnish law covers many provisions that are required to be taken into consideration when acquisition agreements are drafted. When Finnish agreements are compared with U.K system, they are shorter and more concise. Usually financing and the completion of share purchase goes hand in hand and there is no point in negotiating them separately, since the financing will not be satisfied if the share purchase is not completed. Finnish law also defines requirements for conditions precedent that all the information is up-to-date and it is kept by the Finnish Trade register.⁶⁸ Therefore, the Finnish Trade register and legislation brings more certainty for the buyer, since all the required documents and information of the target company are updated and the risk of misleading or inaccurate information is diminished.

Typical covenants that are used in Finnish market range from debt-equity ratio and gearing ratio to operating profit. These are often used in purely domestic transactions. From the lender's perspective, also negative pledge and antidisposal type of covenants are of particular importance. When parties draft covenants, it is possible, though quite rare that they can be adjusted by Finnish courts in accordance with the Finnish Contracts Act. This means that the evaluation of a certain covenant and its reasonableness is based on the entire agreement, the status of the parties, circumstances during the time when the agreement was concluded and other similar factors.⁶⁹

When Finnish law and liability of defects in the LBO transaction, especially related to Due Diligence is taken into consideration, provisions are found mainly from the Finnish Sale of Goods Act. From the quality perspective, the acquisition agreement serves as an essential role to determinate if there is an error in the target of the deal. If the target company does not meet the requirements and qualities that the agreement defines, there can be a concrete error in the target. To analyze this requires

⁶⁷ Pohjanpalo Kati, Finland Turns to Venture Funds to Rescue Economy: Nordic Credit, April 5, 2013, Bloomberg.com, available at <http://www.bloomberg.com/news/2013-04-05/finland-turns-to-venture-funds-to-rescue-economy-nordic-credit.html>

⁶⁸Ibid; Griffiths p. 232

⁶⁹ Ibid; Griffiths, p. 235

the set of so called normal standard, which can be difficult to be defined in practice.
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According to the principle of freedom of contract, parties can agree on the negotiations regarding many terms of the contract. However, the Finnish Sales of Goods act includes both indispositive and dispositive provisions. Parties can agree in their contract that the Sales of Goods Act is not applicable, but they cannot be absolutely certain that only the acquisition agreement between the parties would be only taken into account when possible disagreements are solved. This means that the acquisition agreement is not completely independent agreement from other indispositive regulation. Therefore, when possible disputes arise, always the purpose behind the agreement is an essential source where to start. ⁷¹

3.3 The Europe

The European Union limits concentrations between undertakings that might have the effect on endangering or distorting competition in the European internal market. Council Regulation (EC) No 139/2004 of 20 January 2004 on the control of concentrations between undertakings (the EC Merger Regulation) and its Article 8 defines that the Regulation applies to significant structural changes which are incompatible with the Treaty. ⁷² In addition, Commission Regulation (EC) No 802/2004 of 7 April 2004 implementing Council Regulation (EC) No 139/2004 on the control of concentrations between undertakings serves as a regulatory base. ⁷³ Therefore, this regulation and its Implementing regulation need to be taken into account when buyout transactions are planned in the European area.

In the European Union the situation is similar to the United States as there are several different jurisdictions. The EU has adopted Directive 2004/25/EC of the European

⁷⁰ Mäkelä Joni, Virhevastuu yrityskaupoissa erityisesti ostajan suorittaman Due Diligence – tarkastuksen näkökulmasta tarkasteltuna, Referee-artikkeli, Marraskuu 2011, Edilex, available at http://www.edilex.fi/acta_legis_turkuensia/8323.pdf, Last visited 14 September, 2013p. 124-125

⁷¹ Tast, Taneli, ”Kaupan kohteen tarkastus yrityskaupoissa”, Edita Publishing Oy, 20013, available at <http://www.edilex.fi/opinnaytetyot/1133.pdf>, p. 35

⁷² Council Regulation (EC) No 139/2004 of 20 January 2004 on the control of concentrations between undertakings (the EC Merger Regulation), available at <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=CELEX:32004R0139:EN:NOT>, Last visited 23 November, 2013

⁷³ Commission Regulation (EC) No 802/2004 of 7 April 2004 implementing Council Regulation (EC) No 139/2004 on the control of concentrations between undertakings, available at <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=CELEX:32004R0802:EN:NOT>, last visited 23 November, 2013

Parliament and of the Council of 21 April 2004 on takeover bids. The takeover directive is quite comprehensive and governs essential elements of a tender offer. The main objectives of the Directive are first of all, to promote legal certainty and transparency of takeover bids. Secondly, it seeks to protect the interests of shareholders through information and transparency rights. Thirdly, it provides more protection against the potential events which could lead to frustration of a bid. Finally, the purpose of the Directive is also to enable movement of capital in the EU. There are four essential parts in the acquisition process that needs to be heard in mind when parties seek to start the process; the mandatory bid rule, the board neutrality and the breakthrough rule.⁷⁴

3.4 Other risk management tools

3.4.1 Shareholder's Agreement

Even though shareholder's agreement is not part of the legislation, it serves as an essential tool in risk management in leveraged buyout transactions between venture capitalists and the target company. Shareholder's agreement is a deal between the company and the company's shareholders on their roles as company's share owners and board members. It is used as a way of cooperation to cover shareholder's relations towards each other's and the company where they are not able to organize business operation in a wishful manner. Therefore, the purpose of this contract is to change and fulfill the completed network of norms that company already has.⁷⁵

In LBO transactions this contract form has an essential role. If the contract is well drafted, it serves as an excellent risk management tool. In addition, detailed contract also secures different interests of the parties to the transaction. When risks are divided and identified, it is also possible to find tools how to avoid and control them. With the contract and with a specific term it is possible to plan and direct future events. This is why this contract needs to be drafted in a way which clearly brings out the needs of both the target company and the venture capitalist. Usually these

⁷⁴ Directive 2004/25/EC of the European Parliament and of the Council of 21 april 2004 on takeover bids, available at <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=CELEX:32004L0025:EN:NOT>, Last visited November 24,2013

⁷⁵ Ibid; Korhonen Ville p. 17

contracts are specifically detailed, multi-page contracts with different contractual penalties.⁷⁶

Usually parties agree in the shareholder's agreement on the use of rights related to owners of shares of the company, organizing the business, governance, ownership of shares and the sale of shares. In contract law the agreement has an essential role on directing legal dispute solution. When it is speak about the purpose of the agreement, by this question is meant the purpose of the parties and those aims that they seek to achieve with the agreement. When venture capitals are investing on the Target Company, it is usually made in the form of shareholder's agreement.⁷⁷

3.4.2 Senior Syndicated Facilities Agreement

If a transaction is small and there is only one bank providing the senior loan facility, the agreement is usually very short and based on the bank's standard form. On the other hand, if a transaction is larger, it often requires more specific terms. This document is called syndicated facilities agreement and it is generally governed by English law. There is a standard form that the Loan Market Association (LMA) in London has provided to cover the essential terms in leveraged finance transactions. The purpose of the standard form is to standardize certain so called 'boilerplate' mechanical terms but it is excluding other more commercial definitions and terms.⁷⁸

The content in standard form agreement is divided into two different parts. First of all, there are clauses. Clause part of the agreement includes for instance, essential definitions and terms related to the payment and interest calculations. Essential from the point of view of acquisition are clauses which define acquisition forms that are accepted by the guarantor of the loan and terms of the acquisition agreement that the purchaser is allowed to include in an acquisition agreement. In this way the bank or other provider wants to ascertain that the borrower does not engage into other commitments than those defined in the agreement. This is because it could be too

⁷⁶ Ibid; Korhonen Ville p. 17

⁷⁷ Ibid;

⁷⁸ Ibid; Griffiths p. 16

risky to give the party too much discretion over its business behavior during that time when a bank has financial interests over the company.⁷⁹

In addition, what is essential in these agreements is a possibility to include material adverse effect. Or this can also be called as material adverse clause (MAC). Material adverse effect means a situation, in which the target company's performance and ability to pay are disturbed due to certain reasons. This clause seeks to mitigate the possibilities under which a party may escape from liability if it is not performing the payment schedule in accordance with the agreement. Usually finance providers seek to keep these situations as narrow as possible and so wide events such as terrorism are not allowed in the agreement. Therefore, MAC clause has an important role in defining the situations under which only, the borrower may escape from the duty to perform the agreement.⁸⁰

4 Risk consideration

4.1 Risks before entering into negotiations

4.1.1 Bid Process and choosing the party

It is more flexible for both parties if there is only one buyer and seller negotiating from the deal. It is easier to agree on the schedule and different phases that the transaction includes. Direct negotiations are taking place typically from the buyer's initiative, but they may weaken the seller's position, especially if there is insecurity of the sale of the target company. If there is significant competition situation, also restricted auction and open auction have become more common options.⁸¹

In a restricted auction there is a selection of small amount of potential buyer candidates who are offered to buy the company. These candidates need to fulfill certain requirements and they are all accepted as parties to the first phase of the process. The amount of candidates is reduced according to the prices that they are offering. There is a specific structure in rules and timetable related to this kind of

⁷⁹ The Consensus Group, Official web page, Senior Term facilities Agreement, available at <http://www.consensusgroup.com/previews/376091/>, last visited November 27,2013

⁸⁰ Ibid;

⁸¹ Ibid; Katramo Mikko, p. 61

auction. On the other hand, open auction means that all optional buyers are accepted in the first round of the auction. Open auction guarantees the highest price for the deal. One of the negative sides is though that confidential information might end up to competitor's hands. This may have crucial effect on the target company's business. Open auction can be divided into four main stages, where at first target company's business is clarified. In the second stage sale strategy and material that are necessary for the sale are prepared. Thirdly, chosen candidates are contacted and they are provided with the sale material. This includes due diligence inspection and selection of most potential buyers. In the last stage final offers are delivered and these offers are analyzed carefully to choose the best offer and the buyer.⁸²

Bid process has become of significant importance in the buy-out process. Because of the high level of competition between private equity providers, auction process where seller invites multiple private equity houses to compete against each other's has become more common.⁸³ Irrevocable commitments are recognized especially in the UK's City Code on Takeovers and Mergers and the law requires private actions before the bid is announced. The importance of requiring irrevocable commitments can be explained by the high risk of failure in these kinds of transactions. Engaging into PTP negotiations take time and costs of failure to complete the transaction can be relatively high, even up to 10 % of the total transaction value.⁸⁴

The division of finance in PTPs is usually organized with a small amount of private equity and substantial amount of leverage. If the bidder is left as a minority holder, there has been a bid failure meaning that the bidder faces difficulties in repaying the debt. For this reason irrevocable commitments have essential role in the beginning of the sales process.⁸⁵

According to UK takeover regulations taking company private requires that bidder holds 75 % of the equity. If the amount is less, one is not able to declare the bid unconditional. In general the requirement is over 90 % because it enables the bidder to purchase also the minority shareholdings. However, minority shareholders have a

⁸² Ibid; p. 62-64

⁸³ Private Equity Transactions: Overview of a Buyout, International Investor Series No. 9, p. 2, available at www.ashurst.com, Last visited April 17, 2013

⁸⁴ Wright Mike, Weir, Charlie, Burrows Andrew, Irrevocable Commitments, Going Private and Private Equity, European Financial Management, Vol 13, No.4 2007, p.760-761

⁸⁵ Ibid; p. 761

possibility to decline going private first of all, when at least 5 % in nominal value of the issued stock or at least 50 members apply the cancellation of the resolution from the court. Secondly, when a dissentient minority has over 25 % of the common stock, they can block the process of going private.⁸⁶

In the beginning of the bid process the bidder is sending a signal to other non-committed shareholders informing of the quality of the deal. In this way the bidder gains irrevocable commitments. In addition, this might have positive impact on other potential bidders to refrain from contesting the bid, which should be done within 21 days from the first bid. However, there can be various factors which might have influence on receiving irrevocable commitments. These reasons range from the quality of the transaction and the reputation of private equity financiers to the accounting performance of the target company.⁸⁷ Therefore, as we can see, irrevocable commitments are important from the point of view of the successful bid but also when thinking about the success of the actual final deal.

One impact on the level of irrevocable commitments is bid value. If the company's size is large, it might be difficult to gain support from the substantial amount of shareholders. Another factor what matters is return on assets. If it is unlikely that a company would have capital gain or dividend to be paid, existing shareholders might be looking a different way, such as management buy-out (MBO) as a way to exit. Furthermore, one crucial effect for the choice of private equity provider is its reputation. Private equity firm with good reputation and record of successful purchases can persuade shareholder's to commit to a buyout bid more easily because shareholder's might feel that the funding of the deal is more secured.⁸⁸

4.1.2 Taxation

Transaction might face structural difficulties when all different tax, legal and business considerations are taken into account from the perspective of different investors but also from the point of view of the portfolio company. The primary goal in deal structuring for investors is the exit, but terms and the structure of the deal

⁸⁶Ibid;

⁸⁷Ibid;

⁸⁸Ibid; 763-764

needs to be also accepted by the potential buyer. As private equity transactions often involve substantial debt leverage, tax planning is of great significance.⁸⁹

Tax planning starts with ensuring that the portfolio company is at present taking advantage of tax benefits that are offered in the jurisdictions in which the company is operating. For these purposes, the business can be reorganized or relocated. Furthermore, the investor needs to investigate if there are available deductions against operating income and credits at the portfolio company which can be claimed. In addition, there are interest deductions which play an essential role in these kinds of transactions where the debt level is high. Finally, there is also tax efficiency from the perspective of investors that needs further consideration.⁹⁰

There might be difficulties in finding the golden line taking into account both portfolio company's standpoint, but also from the investor's in maximizing tax efficiency. Investors can directly feel the impact of unsuccessfully planned deal. Usually it is more favorable to ensure that at least most of the exit is paid to investors as capital gain rather than ordinary income.⁹¹

In certain jurisdiction, such as Anglo-American, the public corporations seem to have more advantages compared with private ones. Throughout, after the 80's public to private transactions became more and more used because of different benefits that this form of corporate structure had to offer. Even though public companies have different range of advantages from stock listing and separation of ownership to risk diversification by owners, it also has its drawbacks. If the company has unaccountable management, this can create substantial agency costs which may lead to decreased corporate value.⁹²

As it earlier had been said in the Finnish Legislation part, Finnish limited partnerships are suitable for venture capital activities⁹³, but there are certain matters related to interpretation that might have effect on the deal. In the current situation foreign venture capital investors may face difficulties related to Finnish tax legislation. When Finnish Income Tax Legislation requires permanent establishment,

⁸⁹ Ibid; Meyerowitch, Steven, p. 198

⁹⁰ Ibid; p. 198

⁹¹ Ibid; p. 199-200

⁹² Renneboog, Luc, Simons Tomas, Wright Mike, "Leveraged Public to Private Transactions in the UK", Working Paper N 78/April 2005, p. 2

⁹³ Ibid; Nordic Innovation Publication

a private equity fund that is situated in a country which has not tax agreement with Finland, may face heavy tax burden. These matters both parties need to take into consideration before entering into further negotiations, as the whole deal can become unprofitable due to inability to benefit from tax deduction.

When it comes to Finnish taxation matters, taxation is one of the major concerns related to leveraged buyouts. As Finland is a country of high tax rates, consideration of tax issues play an essential role in all aspects of acquisition financing transaction. From the perspective of Finnish borrowers, it needs to be ascertained that payments made to the lenders are tax deductible for Finnish income tax purposes. There is a risk in the lack of thin capitalization rules in Finland, that Finnish tax authorities' apply general anti-avoidance provisions to the acquisition financing and reclassifies interest as dividends. Therefore, lenders and companies planning acquisition techniques need to concentrate on careful planning, especially in situations where they intend to finance it with longer and shorter period loans. As these loans could be made for the purposes of tax avoidance, tax authorities might tax parties more heavily in these circumstances.⁹⁴

Tax deductions seldom are the only motivation for acquisitions, but in LBO structured capital changes tax reasons are one of the essential ones.⁹⁵ Even though majority of the tax related questions need to be answered before the parties even start negotiating the deal, tax considerations are covered in this section. Taxation is one of the parts in the LBO process that are related to the financing and structuring the whole deal. Taxation can have effect on three levels in the LBO process, from the investor's point of view, the seller and the buyer.⁹⁶

The current situation of LBOs is that it is not anymore so attractive for private equity investors. Due to more restricted legislation it has become more unfavorable to creditors, who earlier were given full protection in form of different requirements by

⁹⁴Ibid; Tast Taneli p. 239-240

⁹⁵Mergers and Acquisitions Basics: Negotiation and Other Deal Structuring Activities An Integrated Approach to Process, Tools, Cases, and Solutions (Sixth Edition), 2012, Pages, p. 449-483, available at <http://www.sciencedirect.com.libproxy.helsinki.fi/science/article/pii/B9780123749499000051>

⁹⁶ Ossa, Jaakko, "Yrityksen myynnin verokohtelu", lakimies 7-8/2011, available at <http://www.edilex.fi/lakimies/8405.pdf>, p. 1524

the acquired companies to for example maintain adequate capital. Financial assistance (FA) laws have needed to develop due to the popularity of LBOs.⁹⁷

U.S approach to leveraged buyouts is looser when compared with stricter European system. Reasons for their difference lie on the origin of leveraged buyouts. As the LBO structure is developed in the United States where there are neither financial assistance laws nor any restrictions on company's ability to give financial support, later migration to European area has not been that unproblematic. Where the US system gives similar tax treatment to foreign investors, the situation in Europe is different. In certain European countries such as Finland, the capital structure change is distressed by the century-old restrictions which purpose is to secure creditors. Therefore, the flexibility and benefits of leveraged buyouts can be sometimes be frustrated in the European area for regulatory reasons.⁹⁸

It has been seen from the news that LBO's as private investors have become less attractive due to publicity in media especially related to taxation matters. It will be later seen, in which way the use of LBO will develop or which other investment or acquisition structures will be favorable and used in the future.

4.1.3 Commitment of Parties

Before parties start negotiating the actual acquisition agreement, there are certain steps that need to be taken. In the first discussions, the buyer needs to have some kind of idea about the value of the target company. There is a range of possibilities how the value can be determined and at this point also the buyer needs to have some indication about it, or otherwise the seller might refuse to provide necessary proprietary information. Where for example target firm's shares are in question, the price can be either determined by target's standalone or present value. In calculation of present value different factors need to be taken into account. First of all, current value of a firm based on its expected future cash flows, secondly, the risk associated with those cash flows, and finally, financial rates of return on alternative investments exhibiting similar risk. On the other hand, the standalone value is the cost a business

⁹⁷King, Brett W , Past Its Prime [article] ,International Financial Law Review, Vol. 26, Issue 9 (September 2007), pp. 28 Int'l Fin. L. Rev. 28 (2007), available at http://www.heinonline.org/HOL/Page?handle=hein.journals/intfinr26&div=250&collection=journals&set_as_cursor=9&men_tab=srchresults&terms=LBO&type=matchall, Last visited September 8, 2012

⁹⁸Ibid;

would command if its projected cash flows would reflect fully all revenues and costs at market values.⁹⁹

If the target firm at least to some extent agrees with the buyer's proposal, certain preliminary documents need to be negotiated. First of all, confidentiality agreement, which is mutually binding covers all parties to the transaction. At this stage certain data such as historical audit is requested by the buyer, but also seller may want to have some proof of buyer's financial credibility. What is worth notion is that the agreement should cover only information that is not available in public and should have a reasonable expiration date.¹⁰⁰

At this stage also term sheet and the letter of intent (LOI) needs to be signed. In the term sheet primary terms with the seller are outlined and they are often also a basis for more detailed letter of intent. It often includes consideration of the purchase price, indicates what is being acquired and it includes different prohibitions against the potential buyer using data it has received.¹⁰¹ In my opinion these first steps are of essential importance and need to be negotiated with care. In addition, both parties should have skillful legal help, so that all the necessary things are taken into consideration and continuation of negotiations can be guaranteed.

Letter of intent can be a valuable tool at this phase, because the parties might have already had successful negotiations in certain areas, but in certain things they might have significant disagreement. All these can be identified in the letter. The main purpose of LOI is to implicate the reason for the agreement and major terms and conditions.¹⁰²

After this parties enter into negotiations which are essential stage before signing the acquisition agreement. At this stage the parties aim to achieve consensus regarding material areas as a purpose to gain agreement on the purchase of the target firm in question. Parties may have to make some concessions, but they need to also think

⁹⁹DePamphilis, Donald M, Mergers and acquisitions basics : negotiation and deal structuring, available at <http://www.sciencedirect.com.libproxy.helsinki.fi/science/article/pii/B9780123749499000014>, Last visited November 24, 2013

¹⁰⁰Ibid, Damodaran, Aswath

¹⁰¹Ibid;

¹⁰²Ibid;

carefully all the risks related to for example taxation matters and other possible future events that may occur before the purchase is completed.¹⁰³

4.2 Risks in the Negotiation process

4.2.1 Contractual risks

Document that is drafted in the buy-out process is called acquisition agreement. It contains contractual obligation on the seller to sell and on the other hand on the buyer to buy the target company in question. It depends, whether it is the sale of shares or assets that have been agreed to buy or sell which the other party then acquires as a result of the transaction.¹⁰⁴ In the following, I am first concentrating on a share sale and purchase agreement and secondly, to business transfer agreement. In addition, different parts of the agreement are analyzed from the perspective of risk management in the process.

The share sale and purchase agreement includes several different provisions. First of all, it includes an agreement where parties agree to buy and to sell the shares of the target. One of the essential provisions is consideration which indicates the purchase price of the target business. Usually this means a fixed cash sum by reference to the amount of the target's current net asset when compared to the position at the time of the completion. An additional possibility could be that the buyer and the seller agree a fixed price based on a balance sheet. This needs to be drawn up and agreed one day before signing.¹⁰⁵

The agreement also includes conditions precedent to completion. This part includes any regulatory approvals or approvals from any other authorities such as domestic or European Union competition authorities.¹⁰⁶ Because different restrictions may vary depending on the country according to which legislation the buy-out is conducted, it is essential that there are different experts and professionals involved in the drafting of the agreement.

¹⁰³Ibid;

¹⁰⁴Speechley, Tom, Acquisition Finance, Tottel Publishing Ltd 2008, s. 72

¹⁰⁵Ibid;p. 73

¹⁰⁶ Ibid;

Completion mechanics part indicates whether the agreement is subject to any fulfillment of specific conditions, or whether the completion occurs immediately after signing. This term indicates what parties require before the deal is concluded such as delivery of stock transfer forms, share certificates of the target firm's shares, statutory books, title deeds to Target Company's property and title documents regarding the assets which are not transferable by the delivery.¹⁰⁷

Parties need to review carefully the completion conditions to guarantee successful deal. They need to be sure that all parties to the agreement fully understand specific conditions or consents that are required before the acquisition is completed. There are two scenarios where buyer's 'outs' may become real. First of all, requirement of regulatory consent from the authorities which application for consent will be made at signing. Secondly, especially in case of larger deals which include more complex legal planning, a two stage process including 'out' for a buyer to pull the deal may become an option.¹⁰⁸

Continuation promise means a commitment that the buyer requires from the seller that it continues the business in the ordinary manner until completion. If this clause was not included, there could be a danger that before the whole buy-out process is completed, the company would have decreased value or its business might have endangered somehow. In addition to specific completion mechanics, the agreement might contain general post-completion undertakings which mean protection after the completion has occurred. This can include release of guarantees which the buyer has required from the target company and processing of insurance claims that have arisen prior to completion.¹⁰⁹

When we are thinking about for example investment funds such as Triton and its targets which the company has acquired recently, they vary from different business sectors. There have been companies such as OBH Nordica and Suomen Lähikauppa, so the products that these companies produce or services that they sell may be very different.¹¹⁰ Therefore, risks related to possible insurance claims and liabilities are very different and it is important that each acquisition agreement is drafted carefully

¹⁰⁷ Ibid;

¹⁰⁸ Ibid; p. 79

¹⁰⁹ Ibid;

¹¹⁰ Triton, Official web site, available at <http://www.triton-partners.com/en/investments>, Last visited November 24, 2013

taking into account all the possible claims that may arise in the future but which have arisen from the decisions that company's management has made before the completion of the buy-out or which are related to products that have been produced during that time.

If the business is for example a part of a larger business meaning that it is to some extent dependent on other companies, the agreement should include transitional services agreement. This guarantees that the buyer may use the central functions of the company for a certain transitional period. This requirement is essential for the maintenance of the business because the buyer needs usually few months to place new arrangements.

Non-competition clauses are very important so that there would be no risk by the seller to compete against the buyer after the target company has been acquired. This restriction may contain prohibition of using trading names of the target by seller. In addition, it may prevent seller from taking target company's customers and employees.¹¹¹ These non-competition agreements are essential from the continuity perspective of the target company's business after the completion of the buy-out deal. If the agreement is missing adequate competition clause, the value of the company might be decreased or the whole business endangered when the seller would set up new competing company with target company's clients and employees.

One of the key provisions of the acquisition agreement is warranties and indemnities which are usually required from the seller. Indemnity relates to events arising prior to completion but which may have effect after the purchase is completed. This is an assurance from the seller to the newco and financial parties to compensate loss if certain circumstances or eventualities arise.¹¹²

On the other hand, seller warranties include a schedule pointing out detailed warranties in relation to the target and its business. Warranty means a statement of fact that the other party to the transaction gives and on which the other party relies on. If the statement later occurs to be incorrect the party that has relied on it may

¹¹¹Ibid; p. 73

¹¹² Ibid;

raise a claim for loss it may have suffered. Warranties may include disclosure of facts for preventing claims for breach of warranty in certain circumstances.¹¹³

There are usually included in the agreement also provisions related to especially seller protection. These contain limitations that the buyer may not make claims for breach of warranty. So it is possible to add these protection clauses in addition to specific disclosure of facts to protect seller against random claims. Finally, the agreement may contain guarantee from the seller's parent. This is only needed if there are doubts of the creditworthiness of the seller because first of all, it has no other assets than the target business and secondly, there is concern that it would not be able to meet a claim against it by the breach of warranty.¹¹⁴

As we can see, there are many risks that different parties need to take into consideration when negotiating acquisition agreement. The time period for negotiations can last for a long time and the conditions can change during this time. Therefore, the parties need to manage their risks and negotiate which risks they are ready to assume on their selves and which are more accurate to try to pass on the other party.

4.2.2 The preparation stage

4.2.2.1 General

Acquisition transaction requires careful planning. This includes investigation of possible market risks, taxation and accounting practices such as IFRS. Finance is in an essential role when these kinds of transactions are planned. It is pertinent that the buyer is aware of all the investment needs in the target company's concern structure and capital structure. Due planning requires vision of the future development of turnover and profitability, meaning how company's profits are dealt between its owners.¹¹⁵

There are many negotiations taking place between the beginning and the end of the transaction. Usually seller and buyer are on equal stand, but if the target company is in a poor financial situation, the buyer might have a stronger position. On the other

¹¹³ Ibid; p. 76

¹¹⁴ Ibid; p.76

¹¹⁵ Ibid; Katramo p. 46

hand, it goes also the other way round, if the target is profitable and there is high demand and several buyer candidates, the process usually progresses to auction. Therefore, it is typical for LBO transactions that they are time consuming which means that negotiations can take months.¹¹⁶

From the efficiency point of view it is necessary that the buyer takes care of that it is negotiating with a party that has competence to decide on the sale of target company's stocks. In addition, representatives of the target company need to have authorization from the shareholders to negotiate the terms of the deal and if necessary, to conclude the agreement. In public companies party to the negotiations is often management of the company or the board of directors.¹¹⁷

Before entering into negotiations, exchange of information has an essential role in the preparation stage. Both academic researches and empirical investigations made by consultant companies have revealed that majority of buyouts have not succeeded in the way as they were planned. Most common reason has been that a buyout has not been successful in a sense that it did not actually increase the value of the company. In contrast, the value of the company had diminished in many cases after the deal had been closed. Academic statistics reveal that the level of unsuccessful deals has been between 35 to 65 percent.¹¹⁸

4.2.2.2 Due Diligence and risk of defects

Term due diligence is a business related term which means a process that parties are required to complete successfully before engaging into buyout negotiations. The purpose of due diligence is to investigate beforehand the target firm. The primary reason is to give to the potential buyer clear picture of the firm that is a target to the transaction, information regarding its value and reduce risks related to unknown responsibilities.¹¹⁹

¹¹⁶ Ibid; Katramo p. 47

¹¹⁷ Katramo Mikko, Lauriala Jari, Matinlauri Ismo, Niemelä Jaakko, Svennas Karin, Wilkman Nina, Yrityskauppa, WSOYpro Oy Helsinki, 2011p.47

¹¹⁸ Hallila, Hanna-Reetta, ”sallittu ja kielletty tietojenvaihto kilpailijoiden välillä erityisesti Yrityskaupan Valmistelun yhteydessä”, Pro gradu Tutkielma Tammikuu 2010, available at <http://www.edilex.fi/opinnaytetyot/8448.pdf>, Last visited November 23, p. 21

¹¹⁹ Ibid; Katramo Mikko, p. 50

Due diligence is one of the most essential part in acquisition transaction. Both parties want to ascertain that there are no problems arising from the potential acquisition agreement. The purpose of due diligence is connected with corporate financial matters, such as checking the numbers, making sure that the company is correctly valued and checking if the assets are overstated or understated. Due diligence takes place before parties engage into the official acquisition negotiations.¹²⁰

Usually due diligence is kind of a pre-investigation procedure of the target company and risks that the deal might include. It also ascertains potential buyer of its own assumptions and provides information if the deal is beneficial and how it should be structured. Throughout it is usually made in the beginning of the process, it can also follow through the whole acquisition transaction. It is possible that it is divided into different stages where in the last phase the seller hands out the most intensive information.¹²¹

Persons that are usually in response of the investigations at this stage are lawyers and accountants. They should take into consideration and research all the possible search engines. Therefore, in addition to company data, also all kinds of news and company background should be searched via internet. The research aims at finding answers where the company in question is going and to some extent what has happened in the past that has significance on the deal. Everything that might happen in the future can have effect on the value of the company and how risky the whole acquisition process could be.¹²²

One of the essential features of due diligence is also related to environmental aspects. If the company practices industry, it is significant to investigate risks related to the company that might have dangerous consequences on the nature and its contamination. In addition, competition law aspects are essential at this stage of the process. Furthermore, financial and legal aspects are of course essentials of the deal, but also in bigger transactions it is important to inspect the production of the target

¹²⁰Ojala, Marydee, Due Diligence Research, published at the dollar sign, March 1, 2006, p. 44 available at <http://web.ebscohost.com/ehost/pdfviewer/pdfviewer?sid=68ec3e3f-5727-484d-8b2b-135788d6f05e%40sessionmgr110&vid=2&hid=125>, Last visited April 7, 2013

¹²¹ Ibid; Katramo p. 51

¹²² Ibid p. 44-45;

company and its compatibility with the needs of the buyer or its company. This includes inspection of the markets and synergy benefits.¹²³

In addition, lately also other softer financial aspects have become part of due diligence. This means personnel, management and organizational culture of the target company. It is good that these aspects are taken into consideration too since they affect directly on the company's purchase price and its value after the deal is closed. This part of investigation has also been one of the most challenging parts in practice when the integration process has been accomplished.¹²⁴

As the media and other instances, such as investors are usually curious and well aware of companies' financial situations, this public research is one of the important phases in the beginning of the whole acquisition process. As a commitment into due diligence is done where there is serious intention to acquire the company, it should be done with true care, so that possible problems and other inconveniences could be avoided. It is true that possible future events weight more, but still the past should not be forgotten. Therefore, parties should take the time and carefully fulfill their duties at this stage, so that the acquisition process would be successful.

Comprehensive research takes time and requires deep planning. According to Paul Engle, management consultant with an MBA in finance certain checklist should be followed. In the course of due diligence, first of all, management requires inspection. If a company is performing poorly, it means also a high-risky acquisition. Secondly, the industry, customers and competitors play an essential role. At this stage both external and internal data may uncover possible risks and provide information regarding company's competitiveness, trends, growth and other significant features. Thirdly, business processes and technology needs to be evaluated. This may reveal if the company has failed in executing its strategic business plan and whether any infrastructure investments or other improvements are required. Finally in the checklist is finance. It is important to evaluate and test companies audited statements by comparing them with competitive financial results, if these are available. Once

¹²³ Hallila, Hanna-Reetta p. 24

¹²⁴ Hallila Hanna-Reetta, p. 24

these steps have been taken, the results will be provided to management for further evaluation.¹²⁵

Buyer is required to careful due diligence meaning a thorough evaluation and inspection of the target company taking into account various sectors of the deal. The purpose is to first of all, identify the factors that may have influence on the legal and economic security of the buyer. Secondly, to manage and avoid risks that may occur in the course of acquisition process. In the inspection other than those liabilities that are identifiable from the public material needs to be taken into account. Therefore, due diligence is for the buyer above all risk control and way to secure its own position if any legal disputes arises in the future. Buyer fulfills its requirement of duty of care by doing necessary inspection and performing its task in this manner. To sum up, if there are any errors in the future and buyer has performed its due diligence well, it has good opportunities to succeed in legal proceedings against the seller.¹²⁶

Due diligence gives a total picture of the target company's operative business and its assets. It needs to give an answer to the most important question in buyout process; whether the target company is desirable and rationalized. In addition, it reveals, whether it is possible to achieve goals that the deal is seeking, which means that the transaction is actually increasing the value of the company. Therefore, due diligence can be held as a backup procedure to evaluate the company and a helpful tool in the acquisition process.¹²⁷

Also the seller wants to fulfill its own due diligence by making efforts to discover all the needed material that it is required and asked to present for the buyer. In a situation where the seller is not familiar with the target company, the negotiations may fall for the lack of knowledge from the seller's side. The seller is responsible of giving warranties and valid information and in any case this given information binds him regardless of its validity.¹²⁸

¹²⁵Engle, Paul, Doing Due Diligence, *Industrial Engineer: IE*, September 2011, Vol 43 Issue 9 p. 20, available at <http://web.ebscohost.com/ehost/pdfviewer/pdfviewer?sid=03793a1b-e0c2-4577-8d4a-fefff651d809%40sessionmgr111&vid=2&hid=125>, last visited April 7, 2013

¹²⁶Leinonen, Mikko, Legal Meaning of Due diligence in Corporate Acquisitions, 2006, p. 28 available at <http://www.edilex.fi/lakikirjasto/4016.pdf>, Last visited September 7, 2012

¹²⁷ Ibid; Katramo p. 52

¹²⁸ Ibid; Leinonen Mikko, p. 51

The fulfillment of due diligence seems to be one starting point for the negotiations and acts as a base for them. Where both parties have the necessary amount of knowledge, they are first of all aware of the target company's financial position and may openly engage into discussion regarding the important thing; price. In addition, there might be pending legal proceedings or other events that need to be taken into consideration when evaluating the value of the company. It is easier to negotiate successfully, where both parties have done their investigation properly and there are no surprises which could interrupt negotiations or worse, give a start to court proceedings.

What is important to note is that the requirement of due diligence and how it is treated in different legislations might vary essentially. When the United States and the European countries such as the United Kingdom are compared, privacy reasons restrict certain company data from being publicly available in the UK. Therefore, for example LexisNexis which was United States response to European anti-money laundering legislation and provides company profiles, news and PEP data can only be used by the customers in the U.S, not in the UK. ¹²⁹

Due diligence tries to minimize all the possible risks that acquisition process might include. Such risks can be paying too much, managing the newly acquired company and avoidance of other surprises. One of the major challenges is related to satisfying the buyer's expectations. Buyers might have too rosy picture of the transaction as whole and they might have lost their objectivity on their way towards the agreement. Usually the success or failure of the deal emerges later even after five years after signing and the reality can be many times crucial. ¹³⁰

4.2.3 Different forms of Finance

4.2.3.1 Methods of Finance

As it has been already said in previous discussion, LBO transactions include significant risk level. Usually these risks are related to realization of the arrangement, to the target company or other insecurities related to negotiating parties. The target company may be a party to a legal dispute which might impair company's future. On

¹²⁹Ibid;

¹³⁰Ibid;

the other side, the buyer may have difficulties to finance the deal which would lead that there would substantially negate the whole deal. Throughout well planned transaction, all risks can never be eliminated. Some of the factors are also outside the control of the parties themselves. Insecurities that remain are primarily related to raising the company's value.¹³¹

Structuring the deal and legal considerations related to it are essential things in the acquisition process. Deal structure defines the rights and obligations in the acquisition that both parties have. The way in which acquisition agreement is negotiated is called deal-structuring process. In the process parties aim at satisfying their primary objectives and determining how risks should be shared. Seller's motivation towards the deal is driven by the wealth maximization purposes. There might be though also other considerations which may have effect on the maximum price, such as easiness of doing the deal itself, desire to obtain a tax-free transaction and softer values such as obtaining employment contracts for their key employees.¹³²

Risk sharing matters in LBO are related to division of risks between acquirer and the seller, which risks the acquirer is assuming and on the other hand which liabilities or events are too risky to assume purely on one party. The deal structure is appropriate when it satisfies both parties and they are ready to accept the level of risk and its division. The difficulty of the process is fully dependent on the transaction itself and the co-operation between the parties.¹³³

When the acquisition form, also known as acquisition vehicle is chosen, whether it is the acquisition by private equity or another form, taxation matters are important to be considered. If target shareholders are able to deduct taxes, it is likely that the purchase price will be increased so that it would compensate the target's shareholders' tax liabilities. This may have effect on the form of payment, to what extend more debt or installment payments are used to cover the total sale price.¹³⁴

¹³¹ Ibid; Katramo p. 59

¹³² DePamphilis, Donald M, *Mergers and Acquisitions Basics: Negotiation and Other Deal Structuring Activities An Integrated Approach to Process, Tools, Cases, and Solutions* (Sixth Edition), 2012, Pages, p. 55, available at <http://www.sciencedirect.com.libproxy.helsinki.fi/science/article/pii/B9780123749499000051>

¹³³ Ibid; DePamphilis

¹³⁴ Ibid; DePamphilis p.55

There are various tools available and these new methods have made debt financing in the Europe more complex and diversified. Senior debt has been one of the most favorable forms of finance in leveraged buyouts, as it offers a cheap and flexible way to structure the deal. Even though senior debt is still one of the more often used methods, it has evolved too. Today, it can generally be divided into three different classes; TLA, TLB and TLC.¹³⁵

One of the possibilities is to use mezzanine, which seems to have become in fashion again. Also this form of finance has changed slightly because of the pressure from cheaper high yield products and second liens. In addition, of being straight bank debt, it has changed to include mezzanine bonds.¹³⁶ Mezzanine is used also during times when there is limited access to high yield debt and bank loans. It can replace or subordinate high yield bonds. This finance form is individually negotiated and it is sold as a private placement to funds and institutions. The structure of the agreement is debt contract or equity. This type of finance is mostly used in Europe than in the United States.¹³⁷

High yield debt is one of the newest forms of acquisition finance. Its use in LBO transactions is dependent on market conditions that have influence on pricing and purchase attraction.¹³⁸ High yield debt is usually bonds and it is unsecured debt. It has fixed interest rate which is based on a spread to treasury bonds and it varies depending with the credit quality. It is typical that high yield bonds are sold to the public in a 144A offering. This form includes a requirement of road show and it is taking time to close.¹³⁹

Usually LBO's capital structure is a mix of different bank loans, high yield debt, mezzanine debt and private equity. Bank debt is senior debt in the capital structure and it is secured. The interest rate in this form of debt is floating and it is secured. In addition, it is always shorter than junior debt and taken normally for the period from

¹³⁵ Wells, Clive, Latest Tools –How New Products Have Made the Debt Financing of European Buyouts Increasingly Complex and Diversified, *The International Financial Law Review*, September 2006, p. 38, available at [http://www.heinonline.org/HOL/Page?handle=hein.journals/intfinr25&div=196&collection=journals&set_as_cursor=15&men_tab=srchresults&terms=\(Covenants AND LBO\)&type=matchall#584](http://www.heinonline.org/HOL/Page?handle=hein.journals/intfinr25&div=196&collection=journals&set_as_cursor=15&men_tab=srchresults&terms=(Covenants AND LBO)&type=matchall#584), Last visited 12 June, 2013

¹³⁶ Ibid; Wells

¹³⁷ Ibid; Ecco, p. 37

¹³⁸ Ibid; Wells

¹³⁹ Ibid; Ecco p. 36

five to eight years.¹⁴⁰ According to certain experts the optimal use of a mixture of both ex ante and ex post capital guarantees the best deal. This way the capital structure maximizes the value of investments.¹⁴¹

It is surprising, that where equity market itself is a topic that has been written about, there is not much information regarding the capital structure of the deal. There can be various incentives which drive parties to choose the essential one to cover their deal, but there is not much statistics available which would actually reveal, how the deal should be constructed for it to be successful in specific circumstances and depending on the details of the deal in general. On the other hand, as we have seen, use of high debt ratio and high risk finance methods can always have its possible negative effects, which may lead to unsuccessful deal.

In the United States the choice between different acquisition forms depends on the company and business that are involved in the transaction. In leveraged buy-outs the possibilities range between a combination of senior and junior debt. In larger transactions finance structure can be built up with both combination and debt securities, as usually is the case in LBO.¹⁴²

Senior financing in the USA can be part of finance in larger transactions together with a bank loan facility. This package is consisted of a bank loan facility and sometimes debt securities. This means that bank loan facility has a senior right towards other debt forms regarding the right of payment. If the borrower is not an investment grade company, the bank facility shall be secured by the assets of the company. In majority of cases including both bank loan and senior debt, the debt securities are usually the ones that are left unsecured.¹⁴³

It depends on the deal structure, whether also the component of junior debt is needed for the acquisition package. Usually this form of debt is both unsecured and subordinate with respect to payment rights. This type of finance is called generally as subordinated debt and it might include different layers. The structure of the debt is dependent on different circumstances and of the borrower. In LBO transactions

¹⁴⁰ Ibid; Ecto, p. 36

¹⁴¹ Axelson Ulf, Strömberg Per, Weisbach Michael S., "Why are Buyouts Levered? The Financial Structure of Private Equity Funds", December 14, 2007, p. 2-3

¹⁴² Ibid; Griffiths, p. 602

¹⁴³ Ibid; Griffiths p. 602

where the purchase price is financed partly by equity, it is usual to finance the debt as deeply subordinated debt.¹⁴⁴

These finance forms are also available in the European markets, so it is not necessary to explain these terms from the perspective of Finland and UK. In the following is concentrated on risks related to different forms of finance and how parties seek to mitigate these uncertainties.

4.2.3.2 Risks related to different forms of Finance

When it comes to the acquisition agreement, it should include certain securities from the perspective of the bank as a borrower. As already has been said that representatives and warranties are part of the acquisition agreement, these are also important and required by banks too as risk management tools. Even though terms of the agreement are negotiated between the seller and the buyer, banks may require more extensive representations to secure the debt in cases where credit is based in large part on the value of certain assets of the acquired business.¹⁴⁵

After the private equity boom banks and private equity funds have needed to develop new methods of finance and as private equity buyout has its special risks related to finance, the way how the terms are negotiated is essential. In the US one of the used forms has been covenant-lite financing. This means a combination of bank loan and high yield bond. There are competing interests in this form of finance, from the other side private-equity funds which are seeking small number of profitable companies and on the other banks seeking lucrative transaction fees.¹⁴⁶

The incentive in this form of finance from the perspective of the target company is to pressure buyers into accepting limited financing condition protections. On the other hand, the private equity clients have a burden to bear on the banks to provide them with finance that meets their requirements on the wanted terms. What is essential to note, is that this arrangement offers greater flexibility with floating interests but decreases risks related to possible court proceedings as lenders have difficulties to

¹⁴⁴ Ibid; Griffiths p. 603

¹⁴⁵ Ibid; Griffiths p. 604

¹⁴⁶ Great Inventions M&A Review, US Acquisition Finance, International Financial Law Review, 2008, p. 22, available at [http://www.heinonline.org.libproxy.helsinki.fi/HOL/Page?handle=hein.journals/intfinr25&div=298&collection=journals&set_as_cursor=0&men_tab=srchresults&terms=\(leveraged buyout\)&type=matchall#818](http://www.heinonline.org.libproxy.helsinki.fi/HOL/Page?handle=hein.journals/intfinr25&div=298&collection=journals&set_as_cursor=0&men_tab=srchresults&terms=(leveraged%20buyout)&type=matchall#818), Last visited November 11, 2013

press claims. In practice, the deal is structured using as a basis the standard bank credit agreement. What is different in this agreement is that maintenance covenants are not replaced with incurrence covenants but they are written to include so called carve-out possibility. This enables borrower to increase debt level provided that certain financial ratios such as leverage test are maintained. Therefore, the deal allows the borrower greater control over the debt and more flexibility as there is no need to substantially change the loan documents.¹⁴⁷

As the loan terms and the amount of debt level itself have an essential role in leveraged buy-outs, this seems to be a good way to maintain borrower a greater control over when they raise money. On the other hand, when certain financial ratios are required, it prevents borrowers taking too big risks and engaging into bigger leverage which could endanger the successfulness of the deal. In addition, as borrowers are able to take high yield loan when it is necessary and target companies are not able to raise claims, it brings more flexibility and legal certainty in this manner.

Buyer might want to include a financing condition in the agreement. This clause means that buyer's obligation regarding the purchase of the target company is conditioned on its ability to secure financing prior to closing. Furthermore, the purpose is to avoid obligation to close the deal, if the buyer is not able to secure financing on satisfactory terms. Sellers seek to resist such a term because by this condition the financing risk is assumed on the seller. The use of this clause is dependent on the reputation of banks and the buyer that is involved in the transaction. Therefore, financing condition is always dependable on the circumstances of the transaction, on the structure how it is made and of the parties involved.¹⁴⁸

It raises controversial rights and expectations from the perspective of both the buyer and the seller to include such a term in the acquisition agreement. It must be beard in mind that LBO transactions are always a risky way to make structural changes in the company. Many times the deal includes high risk level and when it is done in combination with private equity, there are many investors that are behind the deal as participants in investing on funds. This means that there are several parties with

¹⁴⁷ Ibid; Great Inventions M& A Review

¹⁴⁸ Ibid; Griffiths p. 605

conflicting interest. Now, if some party in the financing chain fails to meet the commitments and the deal is endangered or left without closing, it leaves the seller in too risky position. Therefore, from the perspective of the seller, this is highly not recommended to include in the agreement and understandable that they tend to avoid this situation.

In the US there is no legislation that would set any commitments on the parties before making an offer to purchase shares of a company. Throughout, buyers are often seeking certain degree of certainty for their ability to fund the deal when they close. In the bid process, as is explained earlier in this essay, this certainty for funding also effects on the attractiveness of the buyer. At this stage of the process buyers usually seek to obtain a commitment letter from banks in which they commit to fund the deal. This letter includes pricing, tenor, prepayments, covenants and collateral. In addition, the letter limits the extent of bank commitments on funding.

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This commitment letter can have an essential role in the LBO process where the parties seek to gain certainty on the terms of the debt and assuring the levered structure in their deal. Badly negotiated and unsecure loan terms could have negative effects on the success of the closing the deal, but also on gaining profits from the exit. Therefore, it is important that buyers seek assurances and detailed terms from banks so that unwanted surprises could be avoided before signing the final agreement.

In the UK, the most popular finance methods in buyouts have been senior debt, use of mezzanine and high yield debts. Senior lenders have usually low risk level which means also lower rewards and they gain typically profits in terms of interest rate margins and fees. In the ranking list they are above all other types of debt financiers involved in the deal, but among themselves differentiations may be made. These lenders do not necessarily participate in all types of facilities which the syndicated facilities agreement may provide. Factors that have effect on this decision are financial and related to which kind of risk these investors are willing to take.¹⁵⁰

Mezzanine lending includes higher risk which typically also means higher profits. As already said, these lenders came after senior lenders, but they rank higher than other

¹⁴⁹ Ibid; Griffiths, p. 605

¹⁵⁰ Ibid; Griffiths p. 11

subordinated debt, debts due to trade creditors and equity finance. Senior lenders can also be this type of lenders if they diversify their risks and rewards in this manner, but usually mezzanine lenders are different specialist lenders, funds and insurance companies. The terms in the agreement between mezzanine lenders and the seller are similar to senior facilities agreement. There can be though differences which reflect the commercial position of these types of lenders and a separate warrant instrument.

¹⁵¹

Debt securities and more specifically high yield bonds have become recently one of the most used types of finance in the UK. However, there are both advantages and disadvantages related to this type of financing. From the perspective of the purchaser, they are issued with maturities longer than syndicated loans with a bullet repayment at the end. In addition, the overall cost can be lower when compared with mezzanine loans for instance. Finally, covenants in these loans usually only restrict the issuer from taking certain actions instead of including maintenance covenants.¹⁵²

4.2.4 Risks related to the debt capacity

One of the risks related to leveraged buyouts is the debt capacity. Determination of how much debt the deal can take is estimated on the basis of comparing the firm's internal and external repayment capabilities to scheduled principal and interest payments. Operating cash flow is derived when earnings before interest, taxes, depreciation and amortization are decreased with cash taxes, capital expenditures and working capital increases. This operating cash point is the start when internal debt capacity is under estimation. What effects on additional debt capacity is asset sales and refinancing.¹⁵³

The reason for choosing debt to finance acquisition transaction lies above all in the deductibility of interest payments. If there are two companies competing against each others of which the other would finance the acquisition with debt and the other purely with equity, the debt financier is in more favorable situation. The

¹⁵¹ Ibid; Griffiths p. 11

¹⁵² Ibid; Griffiths p. 12-13

¹⁵³ Rizzi, Joseph, How much Debt is Right for Your Deal, Commercial Lending Review, Vol 22, Issue 4, (July—August 2007), p. 13, available at http://www.heinonline.org/HOL/Page?handle=hein.journals/cmlrv22&div=35&collection=journals&st_as_cursor=0&men_tab=srchresults, Last visited April 18, 2013

competitiveness of the offer does not lie only on the price that is being offered, but how the deal is structured. That company which has possibility to cover all finance with debt compared to equity transaction has more advantage because of tax returns. This means that usually the company can also beat the maximum price that private equity investor has offered. Therefore, we can say that there is significance to a larger extent how the offer is structured ¹⁵⁴

When we think about the offer and the structure of an acquisition deal, we cannot say that a deal including the biggest debt level would be always the best choice, or that companies would always choose the contracting party in this manner. Even though statistics tell that structuring the deal with debt has its advantages, real life has shown the opposite. Where the motivation of taking company in this sales process is to increase its efficiency, it has been said that the company offering the best price has also the best ability to do this in practice. ¹⁵⁵

I agree that the role of tax deductibility has an essential role in many financial transactions. But when we think about how legislative changes and tax planning has become under more strict surveillance and rules, the amount of debt and its advantage might be different in different countries. In addition, we cannot say that the level of debt would guarantee the performance of the company but perhaps past records provide more information regarding it. Furthermore, as acquisition transaction itself contains several risks from the point of view of economical and contractual considerations, it would be too blind to rely on the payment structure lonely. Therefore, where the acquisition party is being chosen and different offers considered, target company should concentrate on the whole picture, balancing between the price, the structure of payment and the reputation of the company to achieve the best resolution which would benefit the company most.

There can be different tools to assess the amount of debt in particular situations. First of all, the cost of capital approach suggests that when debt-to-equity ratio is optimal, it has minimizing effects on company's cost of capital. This requires that company's

¹⁵⁴ Bartlett, Robert, Taking Finance Seriously: How Debt Financing Distorts Bidding Outcomes of Corporate Takeovers, *Fordham Law Review*, March 2008, p. 1993-1994, available at http://www.heinonline.org/HOL/Page?handle=hein.journals/flr76&div=64&collection=journals&set_as_cursor=0&men_tab=srchresults, Last visited April 19, 2013

¹⁵⁵ *Ibid*; p. 1999

cash flows are kept fixed and only the debt level decreases or increases the cost of capital. Therefore, by minimizing this cost we are actually maximizing the company's value.¹⁵⁶

In the enhanced cost of capital approach indirect bankruptcy costs are included in the analysis. When this is the case, optimal debt ratio is created from a combination of cash flows and cost of capital that again has the positive effect on the company's value. This means that the cost of capital is equal to interest rate at zero level risk added with premium for business risk and premium for financial risk.¹⁵⁷

Final approach is adjusted present value approach in which debt is separated from operations and the company is valued without taking the debt into account. In this approach the first step is to estimate the value of unlevered firm. This happens by discounting the expected free cash flow to the firm at the unlevered cost of equity.¹⁵⁸

These kinds of calculations which include various variables are always complicated and calculations alone include risks related to wrongly calculated results. If there is a failure in making adequate risk assessment on how much debt the deal can take and parties have failed to estimate the correct debt capacity, this may lead to unsuccessful deal and in the worst scenario to insolvency proceeding in the target company.

4.3 Other risks

4.3.1 EU Competition Law

It is significant to mention that European Union legislation and competition rules restrict negotiations already in the very beginning, regarding when and what kind of information can be exchanged. Companies might change confidential information illegally, if this is done between two competitive enterprises, even though they did not begin to complete the transaction. In the negotiation phase competition law aspects are one of the essential to bear in mind because if this information is used wrongly for the purposes of reducing competition in the market, the whole transaction can break down.¹⁵⁹

¹⁵⁶ Ibid; Damodaran p. 8

¹⁵⁷ Ibid; Damodaran p. 8

¹⁵⁸ Ibid; Damodaran p. 8

¹⁵⁹ Ibid; Hallila, Hanna-Reetta, p. 65

There is case law regarding restrictions on competition law where competition authorities have tried to deny certain transactions. One case *MAO:449/11* concerned a prohibition by Finnish Kilpailuvirasto according to which NCC Road should be denied to buy Destia Ltd's and Destia Kalusto Ltd's business. The claim by Finnish Competition authority did not succeed in the Finnish Market Court on grounds that in general the deal was not in a violation of competition law, but the Market court set certain conditions which the company should satisfy in the transaction so that competition interests were satisfied.¹⁶⁰

Another case where Finnish Competition Authority failed to prevent company buyout is *case MAO:228/13*. The Finnish Competition Authority argued that competition was endangered in certain market areas, more specifically in certain plastic pipe industry where the company was performing. The Market Court ruled that the Finnish Competition Authority had not reasoned sufficiently its decision to permit this buyout transaction and judged that it did not have the effect of impairing market in this area.¹⁶¹

It is essential therefore, that legal experts are taking part in the negotiations right from the beginning of the first phases. Familiarizing with national and EU or other international provisions are vital if parties want the deal to be successful. Even though negotiations otherwise were successful from the perspective of the parties, they might be endangered if accurate instances such as national authorities are not willing to accept the deal. If the deal for these reasons is left without closing, there has been resources and money wasted for nothing.

¹⁶⁰ *MAO:449/1*, available at <http://www.markkinaoikeus.fi/fi/index/paatokset/kilpailuasiat/kilpailuasiat/56499.html>, Last visited 14, September 2013

¹⁶¹ *MAO:228/13*, available at <http://www.markkinaoikeus.fi/fi/index/paatokset/kilpailuasiat/kilpailuasiat/62307.html>, Last visited September 14, 2013

5 Case Law

5.1 The United States

There is one case *Key Brand Entertainment Inc., SFX Theatrical Group, Inc. and others v. Dancap Private Equity Inc., Ed Mirvish Enterprises Ltd., Ontario Court of Appeal, C49360, 13 February 2009* which was about a dispute related to jurisdictional matters. There was an issue about the correct forum where the dispute should be solved, but also about the interpretation of a preliminary agreement on acquisition.

Dancap Private Equity (Dancap) had headquartered in Ontario, Canada and Key Brand Entertainment Inc (Key) its principal business in New York, USA. Parties signed a preliminary term sheet on Dancap's acquisition of an equity interest in Key. This terms sheet included first of all, participation of Key's board of directors and secondly, Dancap's right to manage some of the Key's Canadian theatre assets. In addition, parties signed also additional rights agreement (ARA), which contained terms on good faith negotiations but also an arbitration clause. This arbitration clause stated that any dispute arising related to ARA (other than claims on injunctive or equitable relief) should be determined in accordance with the JAMS International Arbitration Rules. Furthermore, a forum selection clause that ARA included referred the exclusive jurisdiction to the courts of California.¹⁶²

Despite the fact that Key had closed the transaction with Dancap, prior to the finalization of the management agreement, Key had sold its theatre assets to a third party, Mirvish Enterprises Ltd (Mirvish). As a consequence, Dancap brought an action against Key and Mirvish seeking damages for instance for the breach of contract and duty of good faith, since Key lacked contractual right to manage the theatre assets when the deal between Key and Mirvish was closed. Key was

¹⁶² Key Brand Entertainment Inc., SFX Theatrical Group, Inc. and others v. Dancap Private Equity Inc., Ed Mirvish Enterprises Ltd., Ontario Court of Appeal, C49360, 13 February 2009, available at [http://www.kluwarbitration.com.libproxy.helsinki.fi/document.aspx?id=ipn91385&query=AND\(content%3A%22acquisition%22,content%3A%22private%22,content%3A%22equity%22\)](http://www.kluwarbitration.com.libproxy.helsinki.fi/document.aspx?id=ipn91385&query=AND(content%3A%22acquisition%22,content%3A%22private%22,content%3A%22equity%22)), Last visited September 15, 2013

unsuccessful in seeking for a stay of action under the UNCITRAL Model Law on International Commercial Arbitration.¹⁶³

The Ontario court judged that dispute was only covered by the term sheet and that Dancaps action fell outside the scope of the arbitration and forum selection clauses included in the ARA. The United States District Court in California provided K an order according to which Dancap was required to submit to the arbitration, whether Key had the right to terminate any of the management rights that Dancap arguably had under the term sheet and the ARA.¹⁶⁴

Key's appeal to the Ontario Court of Appeal regarding the stay was successful. The appellate court noted that a stay should be granted in a situation where it was arguable that a dispute falls within the terms of an arbitration agreement. In addition, the court stated that where the dispute was not clearly outside the terms of arbitration agreement and both were parties to this agreement the case should be left to be resolved by the arbitrator himself. The issue on the appeal was therefore, if the motion judge had erred in refusing to grant a stay even though there was an agreement between Key and Dancap which included arbitration and forum selection clauses.¹⁶⁵

From the contractual point of view, it was essential that Dancap and Key had signed a preliminary sheet which outlined the general terms of a participation agreement related to Key's acquisition of theatrical assets. In addition, the sheet contained provisions on Dancap obtaining equity position in Key and right to manage these specific theatres in accordance with the separate management agreement which was to be concluded in the future.¹⁶⁶

According to the term sheet: "Dancap Productions will manage the Canadian Assets pursuant to the Dancap Management Agreements. This agreement (sic) will contain terms customary in such agreements, including without limitation, customary representations and warranties, mutual indemnities and other provisions consistent with normal business practices in the Theatre industry." In addition, the term sheet specified some of the terms that the Management Agreement would contain and

¹⁶³ Ibid;

¹⁶⁴ Ibid; case

¹⁶⁵ Ibid; case

¹⁶⁶ Ibid; case

termination clause on which grounds parties had right to terminate the agreement within six months' notice time.¹⁶⁷

As I have earlier in my essay in the negotiations section indicated the importance of the first steps in the negotiations phase, we see from this case how essential it is in practice that first draft agreements are made with care. With this I refer to the term sheet which actually serves as a basis to more detailed letter of Intent, which on the other hand has quite a controversial role regarding how the promise to buy or sell should be interpreted if a dispute arises. In addition, as the term sheet can already include consideration of the purchase price and some more specific terms indicating the terms of the acquisition agreement itself, it requires careful consideration and expert involvement. Therefore, as in this case, parties had already included very detailed terms about the rights of the parties, how the acquisition would be structured through equity and what would be the legal standing of the parties after the agreement, I would already call it as a binding agreement to sell and buy the target company.

In the following, certain agreement terms are covered in more detail to see first of all, what kind of provisions parties seek to include in the first draft agreements and secondly, how the court tends to interpret these terms. The ARA between the parties included the following clause, which was requested by Dancap; "Dancap and Key Brand intend to the enter into Management Agreements in accordance with the terms of the Term Sheet dated November 7, 2007 among the parties hereto and Dancap and Key Brand will continue to negotiate in good faith towards executing Management Agreements which have terms consistent with the terms set forth in such Term Sheet. The Management Agreements shall include a right of Key Brand to terminate the Management Agreements if Dancap ceases to own any common stock of Key Brand." ¹⁶⁸

¹⁶⁷ Ibid; case "Dancap Productions will manage the Canadian Assets pursuant to the Dancap Management Agreements. This agreement [sic] will contain terms customary in such agreements, including without limitation, customary representations and warranties, mutual indemnities and other provisions consistent with normal business practices in the Theatre industry." (9)

¹⁶⁸ Ibid; "MANAGEMENT AGREEMENTS. [Dancap] and Key Brand intend to the enter into Management Agreements in accordance with the terms of the Term Sheet dated November 7, 2007 among the parties hereto and [Dancap] and Key Brand will continue to negotiate in good faith towards executing Management Agreements which have terms consistent with the terms set forth in such Term

This agreement term and the ARA in general which included important clauses regarding the jurisdiction and arbitration was passed over by the motion judge due to reasons that the term sheet was the starting point for the claim.¹⁶⁹ At the time where parties have signed the term sheet, they can choose to include also other agreements to define their legal relationship. By treating these agreements separately, we end up into problems, since the whole picture of what parties have intended during the negotiations becomes unclear. From my point of view parties intended with this detailed term sheet to enter into the stage where the complete deal would be concluded. Therefore, ARA should not be separated and the term sheet treated as an only starting point to the claim.

The ARA contains an “entire agreement” clause providing that it “supersedes all prior agreements, negotiations and understandings concerning the subject matter hereof” and that it “shall supplement each of the Management Agreements and the Shareholders Agreement of even date”. The entire agreement clause further provides that “if there is a conflict between this Agreement and ... the Management Agreements, this Agreement shall control and provide Dancap with the additional rights granted ... under this Agreement.”¹⁷⁰

This clause also indicates the importance of the ARA agreement and why it should not have bypassed in the investigation of the motion. Even though the management agreement which was to complete the whole equity transaction obviously would have included small-detailed terms, the intend was that ARA would be an additional agreement besides that to cover both legal disputes arising from other agreements that parties have signed, but also the ARA itself. We can draw a conclusion here, that it seems that ARA was intended to cover earlier agreements, such as the term sheet and possible future agreements and therefore, also jurisdiction and arbitration clauses should have applied to this case.

Sheet. The Management Agreements shall include a right of Key Brand to terminate the Management Agreements if [Dancap] ceases to own any common stock of Key Brand.” (12)

¹⁶⁹ Ibid; case (23)

¹⁷⁰ Ibid; “The ARA contains an “entire agreement” clause providing that it “supersedes all prior agreements, negotiations and understandings concerning the subject matter hereof” and that it “shall supplement each of the Management Agreements and the Shareholders Agreement of even date”. The entire agreement clause further provides that “if there is a conflict between this Agreement and ... the Management Agreements, this Agreement shall control and provide [Dancap] with the additional rights granted ... under this Agreement.”

According to the United States District court, which took also into account Ontario litigation, the conclusion was that Key Brand was not entitled to arbitration in all claims advanced by Dancap. It held though that on one specific issue the arbitration should be compelled. The issue was following: whether Key “has the right to terminate any management rights to the Theatres that Dancap may have obtained under the agreements upon the sale of the Theatres” and whether either party has breached the agreements.” An appeal from the District Court’s judgment has not been yet heard but parties have exchanged their pleadings in the California arbitration.¹⁷¹

It will be seen in the future, how the arbitral tribunal will decide on the matter and to what extent the solution becomes public. The right to terminate the rights and possible breach by either party is a key question in this case, because it provides an answer, whether Key was acting wrongfully when selling the assets to a third party. The arbitrator needs to take into consideration the term sheet and other agreements that parties had concluded before the dispute arose. This should include consideration about to what extent the parties have intended to be committed to conclude the final management agreement in the future and what kind of events could have justified Key’s sale to a third party. In addition, the arbitration panel needs to decide, whether Dancap has suffered any additional damages related to unclosed deal and the negotiation process. To sum up, the case reveals what kind of contract terms parties request at the beginning of the negotiation process and the importance of such contract terms in the event that dispute arises. Therefore, it is essential that parties are fully aware what the terms should mean, they should be detailed and defined if possible so that these kinds of proceedings and sale to other parties could be avoided.

In case *Boyer v. Crown Stock Distrib., Inc.*, No. 09-1699 the trustee in bankruptcy filed an adversary action against the corporation and its shareholders for violation of Fraudulent Transfer Act. The Crown, a designer and manufacturer of machinery for cutting and bending tubes was sold to Smith, which was a newly formed company also under name Crown Unlimited Machine, Inc. The loan was secured by all

¹⁷¹ Ibid; “has the right to terminate any management rights to the Theatres that Dancap may have obtained under the agreements upon the sale of the Theatres” and whether either party has breached the agreements.” (25)-(27)

Crowns' assets, but the interest rate still exceeded 9 percent. The price of the deal was divided into \$3.1 million in cash and a \$2.9 million promissory note¹⁷²

Terms of the promissory note included, that it was payable on April 1, 2006 with the interest at an annual rate of 8 percent. The new corporation was required to pay annually only \$100,000 which is remarkably small amount taking into consideration that interest expenses themselves were \$ 232,000 a year. Despite the fact, that the interest rate was 1 percent lower than the interest on the bank loan and although it was well secured, there was a little chance that the note would ever be paid by the new corporation.¹⁷³

Just before the deal was closed, old Crown transferred \$ 590,328 to a separate bank account for the purposes of dividend distribution to shareholders. After the closing the old Crown distributed then agreed cash amount of \$ 3.1 million to its shareholders and ceased to be an operating company. Soon it was revealed that the new Crown was a flop. The company declared bankruptcy in July 2003 and its assets were sold for \$ 3.7 million to a new company of which president is Smith now.¹⁷⁴

The significant question raised in the case was, if the acquired company should be doomed to go broke after and because of the debt level was too heavy for the company reasonably survive from the payment to shareholders and if this is deemed as a fraudulent conveyance because it merely increased the debt of the company instead of providing value for the company.¹⁷⁵

Experts in this area analyze that the court ruling in this case is noteworthy for several reasons. First of all, the court did not apply the reasoning of cases that have earlier expressed reservations about applying fraudulent transfer laws. LBOs are seen as beneficial transactions with the changes in corporate control and increasing the efficient use of capital but the court considered this case was different from a conventional transaction. This was for the reason that the transaction was highly likely to take the company into bankruptcy. Secondly, in the future the length of time between the LBO and the bankruptcy may become a problem for defendants in

¹⁷² *case Boyer v. Crown Stock Distrib., Inc.*, No. 09-1699, available at <http://caselaw.findlaw.com/us-7th-circuit/1499251.html>, Last visited November 11, 2013

¹⁷³ *Ibid*;

¹⁷⁴ *Ibid*;

¹⁷⁵ *Ibid*;

fraudulent transfer actions. Defendants often use the length of the interval between an LBO and a bankruptcy to back up their claim as evidence that a company was not inadequately capitalized after a completed transaction.

In addition, the court in this case rejected analyses of some previous courts that the passage of as little as 10 or 12 months is sufficient to create the presumption that LBO was not the ultimate cause of the company's bankruptcy. Companies have ability to manage quite a long time if it is able to raise money to pay its debts as they come due or when their creditors are willing to forbear on exercising their rights. In this case three and half years had passed between LBO and New Crown's bankruptcy for which reason the court ruled that the transaction was fraudulent in the light of the fact that shareholders were unable to prove how the new Crown could have survived from the terms how the LBO transaction was structured.¹⁷⁶

It has been argued that this court decision may have the effect that unsecured lenders in LBO transactions seek more often to secure their interests by applying fraudulent transfer laws more aggressively in the future.¹⁷⁷ This apparently discourages LBO financing and the use of LBO transactions in general. Deeper analyze related to fraudulent transfer actions is not meaningful from the purposes of this essay, but the reasoning behind this judgment may show how the use of LBO's and the amount and nature of court proceedings might change.

5.2 The United Kingdom -England

To understand more the anatomy of leveraged buyout and the possible risks that are included in the process, it is essential to cover example case of a deal that has been unsuccessful. As it has been earlier said that there are three components in leveraged

¹⁷⁶ Ibid;

¹⁷⁷ Guisado Angelo, Revisiting the Leveraged Buyout: Is Constructive Fraud Going Too Far, p.429-432, John Marshall Law Review 46 J. Marshall L. Rev. (2012-2013) Issue 1 - Fall 2012, available at [http://www.heinonline.org.libproxy.helsinki.fi/HOL/Page?handle=hein.journals/jmlr46&div=15&collection=journals&set_as_cursor=10&men_tab=srchresults&terms=\(leveraged buyout\)&type=matchall#494](http://www.heinonline.org.libproxy.helsinki.fi/HOL/Page?handle=hein.journals/jmlr46&div=15&collection=journals&set_as_cursor=10&men_tab=srchresults&terms=(leveraged%20buyout)&type=matchall#494), Last visited November 11, 2013

buyout, first, the leverage, second, control and thirdly, going private. In the following is examined deeply the Harman LBO case.¹⁷⁸

As a background, Kohlberg Kravis Roberts & co (KKR) and Goldman Sachs withdrew from a leveraged buyout in September 2007. Therefore, this is not a case about unsuccessful results in increasing the company value after the deal and gets the benefits from it, but this is an example of a situation where due to different reasons the deal itself was never closed. This case is a good example also, because it demonstrates that even smart and well-experienced investors sometimes end up making bad decisions and have failures in their actions. This explains also, why these deals need to be negotiated well and take all these essential factors into account.

According to the New York University's professor Aswath Damodaran reasons for unsuccessful acquisition transactions have been a failure to treat all these three different parts independently. Research has revealed that several companies that were chosen to be acquired would not have had to be managed differently nor they were appropriate candidates to be taken into private in the first place. When it comes to Harman, Damodaran argues that first of all, the company had no characteristics of which the investors could take advantage of regarding these three components. In addition, there was no need for the company to be managed differently. Finally, flaws that happened in the process of constructing the deal were of a kind that was common to other unsuccessful deals in the same year.¹⁷⁹ Therefore, we can say that one of the essential roles in the successful acquisition process itself is the choice of the right target company.

The financial structure before the transaction was divided into 5,5 billion dollars in publicly traded equity and only 371 million in debt, mostly leases. As a result, the amount of debt-to equity-ratio was less than 7%. Goldman Sachs and KKR were joining to finance the deal by arranging LBO with a total value of 8 billion dollars. Therefore, the intention was to buy out existing equity investors with 2 billion dollars. When Harman was taken private, the capital structure of the company would have been of 50 percent debt and 50 percent equity.¹⁸⁰

¹⁷⁸ Ibid; Damodaran Aswath p. 1

¹⁷⁹ Ibid; p. 2

¹⁸⁰ Ibid; p. 3

What is worth of consideration, is first of all, where is the increase of over 2 billion dollars coming from. Secondly, if Harman is able to carry a mix of roughly equal amounts of debt and equity. Finally, to discover what were the reasons for taking Harman private in the first place.¹⁸¹

When it comes to differences in the amount of debt and equity, it is arguable whether it has the effect of altering the value of the business. The definition of debt is covered earlier in this paper and it is essential term to be understood in this context. This definition works as a tool in discovering, whether changes in the mix of debt and equity in a company can actually have effect on the value of the company.¹⁸²

When debt assessment tools that have been defined earlier are considered from the perspective of optimal debt ratio, these approaches all rely on sustainable cash flow. This means that they do not rely on market value or growth expectations. Furthermore, stable and predictable cash flows have the impact on increasing the company's optimal debt ratio. In addition to this, as the most significant benefit of debt is the tax benefit, higher tax rates will lead to higher debt ratios. Therefore, when good candidates for high risk LBO transactions are being considered, best suitable companies are companies with relatively large reliable cash flows.¹⁸³

Second component that needs further investigation is value of control. It is one of the essential factors when company's value is estimated. As the objective of LBO deal from the perspective of investors is that they assume they run the business better and gain profits in this manner. There are two variables in which value of control can be divided, first, the value that is gained by changing the company's operational tendencies and second, the probability of succeeding in changing them.¹⁸⁴

Investors value control and are ready to pay to acquire it and there is evidence about it in practical business behavior of investors. In theoretical terms, the control is the difference between the current value of the company and its optimal value. This means that when a company is poorly managed, the premium is larger and in well-managed companies it is smaller. In addition, there is not only one way to estimate the premium, but it varies across companies. Furthermore, when there are

¹⁸¹ Ibid; p.4

¹⁸² Ibid; p. 17

¹⁸³ Ibid; p. 17

¹⁸⁴ Ibid; p. 18

uncontrollable external factors that may have effect on the company's performance, the premium is lower than when the cause of bad performance is a result of bad management. Finally, the amount of control premium is also affected by the actions which need to be done to ease the problems, whether they are easily remedied or not.

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When it comes to Harman case and the value of control, Harman did not meet the requirements to be a good target company for LBO. This can be explained in numbers. First of all, Harman's stock should have been underperforming in its sector. Secondly, its margins should have been lower than similar companies in the same sector. Thirdly, its returns on equity and returns on capital should have lagged its costs of equity and capital. Finally, the company was not badly managed and did not meet the requirements to be repaired in this way.¹⁸⁶

As we can see, value of control and estimating it has an essential role in the selection of target company for LBO. Furthermore, if experts and investors taking part in the negotiations fail to make correct risk analysis on the value of control, it can have tremendous effect on the success of the deal as whole. For this reason the target selection should be carefully planned and the company's performance should be deeply investigated and predicted before entering into deal making. Therefore, it can be said that as Harman did not meet these requirements, investors made a mistake in treating it as a suitable candidate for LBO.

Third component that has effect on the value is the element of taking company private. There are several reasons to make private company public, such as raising capital, monetize the value of the company and bearing the risk more efficiently. But taking company from public to private is done for different purposes. When we think about Harman case, there can be identified four reasons to do this. First of all, agency issues which mean that where managers of publicly traded companies are not using their own money, they might have poor incentives to manage the company well. Secondly, due to disclosure costs publicly traded companies have to meet more requirements than private firms. Thirdly, private companies have possibility to make

¹⁸⁵ Ibid; p. 18-19

¹⁸⁶ Ibid; p. 21

more long-term decisions. Finally, public pressure by financial press or investors may drive management of the company to make a decision for LBO.¹⁸⁷

The decision in going private costs a lot for the company and in Harman case, the estimated loss in value by going private is approximately 2,5 billion dollars. There are different steps that a company can take to reduce these costs. Firstly, acquirers may hold a portfolio of private companies. Secondly, going private can be only a temporary arrangement and the higher cost of capital applies only during that time. Finally, the private equity investor can make the decision of going public which reduces its residual risks.

If we look once again criteria that a company should meet to be suitable candidate for LBO, there needs to be certain characteristics to be met. First of all, managers of the target company are not significant stockholders in the company. Furthermore, actions that would be needed to correct the company's problems should be of a kind that they are actualized in a short term, such as factory shutdowns. Finally, analysts of the company are only providing credit for near term actions. What is worth of notion is that once again, Harman did not meet these criteria because its management had been very active since the company had founded and Harman family itself owns large portion of the company stocks. In addition, the decisions made in the company are made on a long-term basis. Therefore, there has been no specific goal to be achieved in Harman's going private.¹⁸⁸

When we combine all these separately discussed components that has the effect on the value of control in LBO transaction and effect on how the target company can perform in the deal, we can come up to a solution that there is a possibility that them all can interact with each other's. First of all, when considering leverage from a lender's point of view, newly constructed company becomes healthier and reduces its default risks. This requires though monitoring from the lender's side, so that assets securing their loans are not eliminated in the process. Secondly, when the company has gone private, the managers are now its owners. This means that they unlikely take aggressive risks that could endanger their wealth and concentrate more likely on good management. Finally, after the process lenders have the advantage in personally

¹⁸⁷ Ibid; p. 23

¹⁸⁸ Ibid;

liable owners of the company and they should use this as their own benefit when negotiating loan terms.¹⁸⁹

Taking Harman as a target for LBO was not a good decision for several reasons. Which has been established in the analyze above, is that each of the three components of an LBO, leverage, control and privatization may effect on the company's value in two ways, either negatively or positively. Furthermore, these components are separable and should be treated as such when choosing the best target company. Finally, there are companies that can take advantage of one of the components and only few companies own the characteristics with a combination of two of these three components.¹⁹⁰ Therefore, I would say that both financiers of an LBO transaction but also sellers of the target company should carefully consider all these separate elements and try to find at least one of them to justify the decision to go private. If there are no such characteristics that would guarantee successful deal, either getting the deal closed in the first place, but also by getting wanted profits out of it, there is no sufficient requirement met to take the company in this process.

5.3 Finland

There is no available case law in Finland that would cover claims that have arisen between parties after the completion of leveraged buyout through private equity transaction. In the following, I am analyzing Finnish national legislation from the perspective of buyout process and more specifically related to due diligence requirements in the buyout process. As it has been earlier said that due diligence has an essential role in the buyout process managing risks, here is some case law where Finnish Courts have needed to interpret if a party may successfully rely on the defects after the deal has been completed.

There are two different views which lead into two different ends when liability of defects in corporate acquisitions is estimated. First of all, some experts argue that Finnish Promissory Notes Act is applicable. In practice this would lead to a situation where the seller would be exempted from liability of any defects in the buyout deal.

¹⁸⁹ Ibid; p. 25

¹⁹⁰ Ibid;

Second, perhaps more certain option is that the Finnish Sale of Goods Act is applicable, because it applies to the sale of property, not goods.¹⁹¹

In case *KKO: 2001:36* Rinvest Ltd and Ekomen Ltd had negotiated an agreement to buy Instinct Ltd.'s shares and on the increase of share capital.¹⁹² From the viewpoint of due diligence, it is not just errors in the statements of the board of directors which may lead to liability of defects in the deal, but liability can extend also to faults made by the accountants. Instinct Ltd.'s estate of bankruptcy sought compensation of damage from the board of directors of these two companies.¹⁹³

As a background, within a short period of time after the agreement had been closed both Rinvest Ltd and Ekomen Ltd were bankrupt. Later it was revealed that subsidiaries of Ekomen Ltd. were not transferred to Instict Ltd. in accordance with the drafted agreement, but they were left as guarantee for Ekomen Ltd.'s loans. Accountants and Director's of Ekomen Ltd. had signed a statement in which they testified that the increase of share capital was in the possession of the Company and that regulations related to the payment had been followed.¹⁹⁴

In the judgment the Court interpreted that Finnish Companies Act had not been applied in the form of payment and the court held the chairman of Instinct Ltd.'s board, Ekomen Ltd.'s chief executive and accountants personally liable for the defects in the process where the aim was to obtain benefit for the owners of the company. They were entitled to pay damage that Instinct Ltd. had suffered from the fact that the shares were not correctly pledged and the company was not able to use them for its own business activity.¹⁹⁵

As it has been stated that Finnish Contract law to large extend dispositive and there is a freedom of contract in Finland, parties can quite flexibly agree on the terms of the acquisition agreement. The acquisition agreement and terms that have included in the contract serve as a basis in interpreting errors in leveraged buyouts transactions. Where the agreement itself does not contain an answer and there is error in the

¹⁹¹ Ibid; Mäkelä Joni, p.113

¹⁹²KKO:2001:36, available at

[http://www.edilex.fi/kko/ennakkoratkaisut/20010036?offset=1&perpage=20&phrase=Apportti&sort=timedesc&typeIds\[\]=5&searchKey=156864](http://www.edilex.fi/kko/ennakkoratkaisut/20010036?offset=1&perpage=20&phrase=Apportti&sort=timedesc&typeIds[]=5&searchKey=156864)

¹⁹³ Ibid; KKO:2001:36

¹⁹⁴ Ibid;

¹⁹⁵ Ibid;

object, meaning the target company itself, the court uses abstract defect evaluation where it uses so called normal standard consideration.¹⁹⁶

In leveraged buyout transactions in accordance with the Finnish legislation, there are certain risks that the seller especially needs to bear in mind. Court practice has established that when Finnish Sales of Goods Act applies to the dispute in question, the seller can be held liable of defects in the deal. This means that the seller needs to make efforts and try to avoid this risk with the acquisition agreement. As parties can freely agree on the terms of the agreement, they need to be drafted as clearly as possible. As we have seen, where the dispute arises and there is controversy on how certain terms should be interpreted, the claim is made and the Court decides how to interpret the agreement. In addition, there can be other errors that are related to the target company itself. This means that the seller needs to make all the efforts in giving correct information regarding the company's situation as is possible. Also the buyer has responsibilities in this regard and finally the court decides if the requirement of due diligence from both parties has sufficiently completed.

6 Conclusion

As it has been seen leverage and more specifically the debt level has an essential role in LBO transactions. The whole transaction process has various steps from choosing the right target company and parties to the transaction, negotiating the deal and loan agreements and finally completion of the deal. The whole process is easily disturbed and needs careful planning with involvement of experienced experts so that the transaction can be completed successfully. Successful performance of the deal means beneficial deal from the perspective of all parties. This means that parties meet their expectations regarding profits and that creditors are paid in accordance with the loan agreements but also that there are no transaction costs or inconvenience from any legal disputes. Therefore, the successful LBO transaction includes first of all, carefully planned deal, secondly, maintenance period when loans are paid and the company managed by its new owners and finally beneficial exit from the deal.

¹⁹⁶ Ibid; Mäkelä Joni, p. 124-125

Parties need to bear in mind different legislation in different jurisdictions. When a buyer is seeking to invest in a company residing in a country like the United States, which Government allows the benefits and incentives also to foreign investors these are not available everywhere. This is the case when a party is dealing with LBO transaction that has relations to Finland for instance. Certain countries have more restrictive approach to legislate leveraged buyouts and the current national legislation is an essential starting point in each transaction.

One of the significant risks in the process is to choose a wrong target company. The presented case law has shown that there are certain characteristics that a target company should have so that it would be suitable for LBO transactions. If there is no need to manage the target company and there are no possibilities to increase company's productiveness, it is not a suitable candidate for LBO. In addition, the decision to go private costs a lot for the company and there needs to be certain benefits that are achieved in doing this. Finally, if the debt element in the transaction does not have the positive impact on reducing company's default risk and on increasing its healthiness, the candidate is not suitable for LBO.

In the LBO transaction there are always competing interests and the parties have different standing on how their position is secured in the process. In addition, there are different expectations what parties are seeking in these arrangements. This constitutes a complex situation where parties try to protect their interests with different terms in the agreement, whether they were then for example covenants in acquisition agreements, special terms in shareholder agreements or terms restricting the loan agreements from the creditor's point of view. For this reason it is essential, that agreements are drafted as clearly as possible and parties interest in risk management are taken care of satisfactorily. This would decrease the possibility of legal disputes and conflicts related to the interpretation of the terms in the acquisition agreement.

The acquisition agreement itself contains several provisions which purpose is to divide risks between the parties. From the perspective of different national legislation, it is essential that the deal is subject for regulatory approval by national authoritative before the completion is final. Continuation promise has an essential role in the agreement preventing the decrease of the company's value by fraudulent

seller. In addition, indemnities and warranties have a significant purpose in the agreement providing legal safety for parties if the other party's statement occurs to have been incorrect. Warranties given by the target company's management can easily lead into conflict situations, if they reveal to be incorrect in any manner. It is helpful that there are certain standard contract forms today which parties can use as a basis in their negotiations. This helps in practice otherwise quite complex set of different terms that can be included in the agreement. However, depending on the nature of the company and the area where the target company is operating, parties need to balance their risks on a deal-by deal basis. Therefore, successful acquisition agreement seeks to mitigate risks with clear division of duties and rights in accordance with parties objectives so that any possible future event has been tried to be taken into account.

One of the risks lies on the determination of the company's value and achieving consensus in this regard. Value estimation can be achieved in several ways such as from the target's standalone or present value. What is essential though, is that the buyer itself needs to have its own indication about the value before the seller is willing to reveal proprietary information. Failure in the adequate calculation of the value could lead to unsuccessful deal and failure to meet the expectations. If value of the company is considered too high and the amount of leverage in the deal is substantial, this can lead to bankruptcy of the target company in situations when the LBO transaction does not improve the performance of the company. Therefore, the value of the company also serves as an essential starting point in the negotiations and it has significant influence on the successfulness of the deal in general.

At the preparation stage different preliminary documents such as confidentiality agreements and letter of intent have an essential role. Confidentiality agreement already gives certain expectations that the final agreement will be signed in the future. The significance of LOI on the other hand is to define the purpose where the negotiations are heading and what have been achieved so far. These both letters of commitments can have a significant role, if either of the parties chooses to refrain from further negotiations. This means that in situations where there is a dispute about parties' intentions in the negotiations, these documents can serve as an essential source where to start interpreting the conflict situation. Therefore, where parties start

planning and preparing LBO transactions it is preferable to draft first agreements in written, because these have an essential role on the determination of arising legal disputes in practice.

Exchange of information has a special meaning before negotiations start and when they are going on. There can be identified legal and economic uncertainties that need to be avoided with due inspection. As there is high risk that a buyout is not actually succeeding and a possibility that parties fail to meet their expectations, information exchange between the seller and the target company is essential. Due diligence is one part of the information exchange and should be made with true care, not only from the buyer's but also from the seller's side. This investigation gives answers first of all to the buyer, what it is expected to gain in the process and what are the possible risks. Secondly, it is valuable for the seller also in showing the buyer's potentiality to conclude the deal successfully. If there is a failure from either party at this stage, one might be not be able to show in the future that it has actually suffered damage by signing a deal which later revealed to be something else than a party expected. Furthermore, though parties need to actively try to gain all necessary information, they need to be aware of possible competition and national privacy rules that might restrict access and acceptability of certain information exchange. This means that parties need to take into consideration national rules related to company's privacy matters, but also EU and national competition rules which may endanger the whole deal. Therefore, due diligence is a significant risk management tool in leveraged buyout process and failure to complete this stage with due care may lead to serious consequences.

Taxation has a key role in the beginning of the whole acquisition process. As the purpose of leveraged buyout from the buyer's point of view is to gain tax deductions from the interests of the loan, it is important how the payment of the deal is structured. In addition, a party that is seeking a target company needs to be aware of national legislation that might prevent certain arrangements or negate the planned tax benefit. Usually parties choose to bear tax questions as their own risks but as the purchase price and the level of leverage are in the key roles in LBO transactions, this question needs to be answered in the very beginning of the whole process. Therefore, the question of taxation needs to be solved before parties enter into actual

negotiations, so that the chosen payment form and buyout vehicle does not meet any unwanted surprises when parties have already concluded the deal.

There are different ways how to manage risks related to different methods of finance. These different forms have highly different risk levels and parties to the agreement seek to mitigate possible losses in different ways. Buyer might for instance seek to mitigate risks with requiring a financing condition in the agreement. From the perspective of a seller this condition is unfavorable because in this way the risk on the successfulness of the deal is tied on finance with satisfactory terms and the risk is assumed on the seller. Choosing the finance form itself includes different risk levels, depending on what kind of finance arrangement a party wants to make. It is essential to negotiate clear loan terms that the deal does not meet any surprises later. In addition, when it comes to different finance providers, the security of the loan is usually tied on the profits. This means that the more profits a party is seeking to gain, the riskier is the loan form. Therefore, it is essential that also loan providers are ready to assume the risks and choose the right way to finance the deal that they are ready to take.

Debt capacity and determination of how much debt the deal can take is of great significance in LBO transactions. It can have tremendous consequences from the point of view of successfulness of the deal if there is a failure in making adequate risk assessment on how much debt the target company has ability to take. If parties have failed to estimate the correct debt capacity, this may lead in the worst scenario to insolvency proceeding in the target company. There are different ways how to calculate the debt level for the deal, but calculation methods include so many different variables, that there is high level of risk that the result is incorrect. Even though there are experienced professionals engaged in the process, practice has shown that many times debt level has been too high and the deal has not been able to take it successfully. Therefore, parties need to take into consideration that there are certain risks that sometimes cannot be managed and as the whole LBO process is very risky especially from this debt perspective, these calculations need to be done carefully and consider if parties can rely on them, or if the debt level should be less.

In the end, we never know if the case ends up in the court, how the dispute will be solved and what will be the judgment. As we have seen, there are various things that

parties need to bear in mind when they are planning leveraged buyout transactions and seeking to mitigate possible risks related to the process. It is impossible to cover all the future events, but planning and involvement of experienced experts usually guarantee the best solution. In addition, it is helpful to follow certain checklists and use available risk assessment tools such as draft contract forms in mitigating risks in the first steps of the preparation stage. Even though parties have sought to organize the division of risks in correct way, there are always changing variables that may have effect on the deal. Therefore, parties need to keep in mind that there is always high risk probability included in the process and the only possibility to try to avoid errors in the deal successfulness, is to follow each of these separate steps carefully and try to mitigate liabilities with contractual terms.

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