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**USING CONTRACT LAW IN THE NEGOTIATIONS OF MERGERS &
ACQUISITIONS**

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ABSTRACT

Companies use mergers and acquisitions as a strategic tool in order to carry out their economical and organizational goals. Mergers and acquisitions are often extremely long and complex processes that involve negotiations in a number of subjects. Success in the negotiations require a lot of expertise and input. The thesis focuses on the negotiations conducted in mergers and acquisitions and operating in them. The research problem is the following: which aspects of contract law can the negotiating parties use on in order to achieve the best possible outcome.

The theoretical frame of reference the thesis focuses on is mergers and acquisitions in general, the legislation concerning them and their negotiations as well as proceeding in them from both the buyer's and the seller's point of view. Mergers and acquisitions as terms are multi-dimensional, but in this thesis, they mainly refer to either the transfer of the business or shares. Regarding the legislation affecting mergers and acquisitions the thesis focuses on the norms affecting the negotiation phase and the contracts agreed in it. The negotiations are studied observing the process possibilities of them and by analysing the most important contractual instruments used in the negotiations and the benefits of them. The research material used in the thesis is mainly Finnish legal literature, but literature specific to the field is also studied and utilized.

Behind a merger or an acquisition can be a variety of reasons and aspirations that all affect the negotiations that take place in them. Mergers and acquisitions can have different forms as can the negotiations. There is a variety of process possibilities for conducting the negotiations that affect both the phases of the negotiations and the benefits gained in them. Non-disclosure agreements, preliminary contracts, and the due diligence investigations rise above others with their importance within the instruments of contract law. By using these, as well as the other contract tools, and acknowledging the boundaries set by contract legislation, the negotiating parties can reposition themselves in the negotiation proceedings with the goal being the best possible final contract for an individual.

KEYWORDS: Mergers and acquisitions, contract law, negotiations

1. INTRODUCTION

1.1. Area of study

The terms mergers and acquisitions are widely used in the business world, but they can mean a variety of things. For example, they can be used together to describe the whole process in which the ownership of companies or their operating units are transferred or consolidated with other entities. They can also be used separately, merger meaning the consolidation of two entities into one whereas an acquisition is a transaction where one entity takes the ownership of another entity's stock, equity interests or assets. Sherman defines the terms as follows: "A merger is a combination of two or more companies in which the assets and liabilities of the selling firm are absorbed by the buying firm. Although the buying firm may be a considerably different organization after the merger, it retains its original identity. An acquisition, on the other hand, is the purchase of an asset such as a plant, a division, or even an entire company"¹. This thesis focuses more heavily on the acquisition part but discusses also mergers as they are a vital part of the big picture which is why the term in use will be mergers and acquisitions. Furthermore, from a negotiations point of view the process is fairly similar which highlights the need to address both of the transaction types.

Companies use more and more mergers and acquisitions in order to grow in size, move to new market areas or otherwise carry out their economic and strategic objectives. In 2016, the number of mergers and acquisitions grew thirty percent compared to the previous year. The reason for this, amongst other things, was that loaned funds were becoming easier to gather and some of the bigger age groups were reaching retirement age². A company may also find themselves in a situation where they realize they cannot grow internally in order to keep up with the market. In these kinds of situations mergers and acquisition can offer a solution. Still, only a couple of thousand mergers and acquisitions are made yearly in Finland altogether. Between 2010 and 2011, the number was 1629. By

¹ Sherman 2010

² Valtanen 2016

contrast, in 2008 the number was less than a thousand. According to Lehtonen, Nordea made 30 percent more mergers and acquisitions in 2018 than the previous year. This demonstrates the trend companies are steering into. Lehtonen says the majority of the mergers and acquisitions made in early 2018 were done by private equity investors and nearing the end of the year, by industrial entities³.

Even though the number of mergers and acquisitions that are carried out rises by the day, it is worth noting they still are highly complex arrangements where large amounts of assets, for example trade secrets and properties, are transferred from the seller to the buyer. The effects of a merger or an acquisition, especially a large one, can be enormous for the parties involved, but also to the markets that they operate in. If a company grows to a certain size, it can gain control of the whole market. These types of deals require almost meticulous precision and preparation in order to be successful.

In order to carry out a merger or an acquisition, special competence and large investments in its every subarea are naturally needed, especially in the negotiations. Contract law plays a vital part in this phase, both directly through the different agreements the parties usually enter into during said negotiations, but also due to the responsibilities and obligations that participating such negotiations inflict on the parties. According to statistics however, companies have been using mergers and acquisitions successfully to move in the markets⁴. This study concentrates on the negotiations phase of mergers and acquisitions and the issues one must pay attention to during them concentrating on the contractual legalities and their effects. With the right approach and choices made during the negotiations of a merger or an acquisition, a company can substantially affect their position at the negotiations table as well as gain advantage over the opposing party and through it, reach a deal that can have enormous effect on the success of the company.

³ Nordea 2019

⁴ Finnvera 2017

1.2. Research problem

No merger or acquisition is like the one before it, which is why there is no specific formula or standardized form for the negotiations either. The negotiable issues and the order they are addressed is also unique to every merger and acquisition, although some regularities can be found. Furthermore, the generic responsibilities that arise from conducting negotiations overall are present in practically every merger and acquisition. However, it is common for the negotiations to take a long time, often several months. For instance, the negotiation process for large gas-, oil- and mining projects take at least half a year⁵. Similar timeframes can also be found in other industries.

The possible long duration of the negotiations and the complexity of them make it difficult for the parties involved to reach an optimal contract that would also benefit both parties after the deal is done. This forms the research problem: how and with what instruments of contract law can a company affect the final sales contract in the negotiations phase and achieve the best possible outcome. Also, what are the benefits of acknowledging all the responsibilities and liabilities participating in negotiations overall. The objective is to portray which aspects of contract law are more useful to either of the parties as different instruments are more useful for the buyer than the seller and vice versa. Some responsibilities and liabilities have also greater effect on one party compared to the other. In practice both of the parties have a common goal, but it is important that the sides are aware of the elements they need to be focusing on during the negotiation process to effectively improve their negotiating position. This is underlined especially when conducting an auction type of a merger or an acquisition, whether it is an open or a closed one.

⁵ Kirvesniemi 2015

1.3. Focus and sources

This research focuses mainly on analyzing the different stages of mergers and acquisitions negotiations, as well as moving forward in them, and on the instruments used in the negotiations from a contract law point of view. In addition, the different responsibilities and liabilities relating to contract law and their effect on the parties are analyzed. As said before, negotiations regarding mergers and acquisitions can be highly complex transactions and even small details in different parts can play a vital role. The importance of the different stages of negotiations and the effects they have on each party, benefits of the variety of contractual instruments to be used in the negotiations and the possible ways to conduct the trade have been raised regarding both negotiating parties, approaching them from a contract law point of view. Different responsibilities as well as liabilities both brought forward and inflicted by the negotiations have also been studied. In the beginning, the concept of mergers and acquisitions as well as their versatility are opened up and explained to help the reader see the bigger picture of mergers and acquisitions. Understanding the context provides the tools to see the connection of different ways mergers and acquisitions can be conducted in and the related negotiations.

The sources used are both domestic and international, meaning mainly Finnish and European, sources of law and legal literature. Also, literature specific to the field, most of it American, has been utilized. The negotiations themselves, the information they consist of and the progression of them regarding mergers and acquisitions are almost always under a non-disclosure agreement, which is why hardly any detailed and practical information is available. Furthermore, there are few legal cases explicit to the field since the disputes occurring in mergers and acquisitions are often handled in arbitration proceedings. Rulings from the court of law, as well as specific information regarding a contract between two companies, for example parties of the case, cannot be found. However, the general aspects of contract law regarding mergers and acquisitions and their negotiations have been studied and these studies have been utilized in this research. Also, a number of the Finnish Supreme Court's rulings relating to other

fields have been analyzed as the subjects are similar to ones that occasionally emerge in mergers and acquisitions too.

1.4. Structure of the thesis

In the beginning of the thesis, in the introduction chapter, the area of study is explained and addressed. Some timely information and statistics are provided to show how the subject is occurring in practice. The research problem is also formulated and described as are the objectives to solve it. This is done by first explaining the complexity of the subject and the problem arising from it, and then addressing the means to resolve the problem. The focus and the different sources used, as well as the structure of the thesis, is also outlined in the introduction chapter.

In the second chapter, the concept of mergers and acquisitions is explained as are the different ways of dividing them. The division can be made either based on the strategy behind the transaction or the execution method. The different forms of mergers and acquisitions have an effect on the negotiations and therefore they are addressed. Different legislation also applies, depending on the form of the transaction. These are also explained. This helps the reader to understand the context and see the connections that the different forms have on the negotiations and furthermore, on the outcome of the deal.

In the third chapter, the reasons why mergers and acquisitions are carried out in the first place are studied. The transaction can either make or break a company's future and require a vast amount of resources, which is why the reasons behind the decision have to be adequate. The reasons also vary which is why they are addressed. The focus is then aimed on the buyer and the seller individually, and their most common motives in entering the world of mergers and acquisitions. The approach of the buyers and the sellers naturally differ from each other, as do

the goals of entering into the process, thus the separate analysis. After the motives of both the buyers and the sellers have been resolved, the different process possibilities of merger and acquisition negotiations and their effect on the parties is studied.

The fourth chapter focuses on contract law and its provisions that affect mergers and acquisitions and especially the negotiations that are conducted in them. The focus is on Finnish and European contract law and norms, which in part overlap with each other, but also other legislative literature has been studied. Contract law provides a basis as well as guidelines for the different instruments used in merger and acquisition negotiations, but also for the negotiations proceedings themselves, regardless of the contracts the parties may or may not agree upon. The chapter breaks these aspects down and discusses their effects on the parties but more than that, how the opposing parties can use these for their advantage. As mentioned before, every merger and acquisition is different which means that every transaction does not include the exact same contracts or inflict the same responsibilities and liabilities. As a result, the research focuses on the ones that surface in most cases and play the biggest role.

Next, the research discusses what goes on in merger and acquisition negotiations more in practice and portrays the negotiations almost as a timeline. The fifth chapter goes through how the negotiations start and what the parties should take into consideration when getting into merger and acquisition negotiations. The chosen type of process that the transaction is carried out in, has the most effect on the contracts that the parties agree on early on, as well as the whole beginning of the negotiations. This is also discussed in the chapter. In addition, the goals and aspirations that both of the parties have in the beginning are showcased as they too have an effect on the ignition of the negotiations.

In the sixth chapter, the focus shifts on the latter stages of the negotiations and which elements of contract law play the biggest role and what instruments are the most important during this phase. When merger and acquisition negotiations have reached this stage, the involved parties have already built some trust

between each other and are ready to agree on certain parts of the proposed transaction. However, there is still a lot to be done in order to be able to reach the final contract. More and more information is shared between the parties which means the risks grow bigger. Both parties can and want to protect themselves and this is mostly done by a number of significant contractual instruments. The structure of the chapter is built around these instruments, which are used in practically every merger and acquisition. How the parties can use them in their favor and what kind of effects they have on the path to the finalization of the deal have been addressed.

In the seventh and last chapter, the conclusions of the research are made. The fact that the studied transactions and their negotiations are highly complex proposes a lot of problems, especially from a contract law point of view. However, there are steps and tools that the involved parties can consider and use in order to reach the optimal deal. This chapter summarizes the means and ways the parties negotiating on the merger or acquisition have at their disposal and how to make the most of them.

2. MERGERS AND ACQUISITIONS

2.1. Strategic division

As mentioned before, there are almost always strategic reasons behind mergers and acquisitions for both the buyer and the seller. Mergers and acquisitions can also be divided by strategy, with each strategy type creating a different approach to the deal itself, influencing also the negotiations and the instruments used in them. The four different strategies mergers and acquisitions can be divided into are called horizontal, vertical, concentric and conglomerative transactions. The most common types are horizontal and vertical which are also the most likely to be successful. The base for the division is a participating party's aspiration to affect their stance either regarding competition and customers or the chain of processing and distribution⁶.

In a horizontal merger or acquisition the buyer and the seller operate in the same field, compete in the same markets and are on the same level of production stage. This can be compared to an industrial acquisition scenario. The purpose of a horizontal merger or acquisition is to achieve as big of a market share as possible by buying a straight competitor out of the market and by doing so limiting the competition. Buying a competitor out of the market decreases the number of companies in the market which then brings scale advantages and increases ones power in said market. The risk in these kinds of mergers and acquisitions are possible cartel formations, which are illegal, and different kind of price agreements⁷. In Finland, the formation of cartels and price agreements are regulated by the Competition Act⁸.

A company can also widen its product portfolio and geographical coverage through horizontal mergers or acquisitions. Companies can also have similar

⁶ Katramo, Lauriala, Matinlauri, Svensnas, Wilkman 2013

⁷ Tenhunen & Werner 2000: 13

⁸ Competition Act (948/2011)

operational functions but in different countries which means, if the goal of one of the companies is to move to new markets, a horizontal merger or acquisition can prove to be an effective way to achieve this. If realized, a horizontal merger or acquisition brings significant benefits through the increase in market share, making scale advantages possible as well as other synergy benefits⁹. According to research, horizontal mergers and acquisitions have the best success rate due to the markets, products and the business practice being familiar. In consequence, the preparation and advancement in the contract negotiations are also easier, as the buyer already has market specific information and is familiar with the company at sale. Furthermore, it makes the sellers process more simpler as it can trust the buyer has a deeper knowledge level than in other types of transactions.¹⁰

A merger or an acquisition is vertical when the buyer is seeking after businesses inside its own value chain. In other words, both the buying and the targeted company operate in the same field but in different stages of the manufacturing, processing or distribution chain¹¹. In these cases, the goal is usually to gain control of the parts that the company could not earlier control. A vertical merger or acquisition can be executed both up and down the production ladder. When a company acquires another company beneath it in the production chain the goal is usually, according to Katramo et al., to secure the access and supply of products and a better control of the whole production stage. When buying a company higher up the ladder, the aim is to acquire marketing and distribution channels and through them gain cost savings and a better market control. This way a company can also defend itself more effectively against competitors. An example of a vertical purchase is a company that is specialized in product development and wants to acquire a distribution channel and does this by buying a company that is focused on distribution. Through the purchase the development company can save in distribution costs and make sure their products are marketed and the customers managed in the correct way¹².

⁹ Katramo et al. 2013

¹⁰ Tenhunen & Werner 2000: 13

¹¹ Tenhunen & Werner 2000: 13

¹² Katramo et al. 2013

According to Katramo et al., vertical mergers and acquisitions have grown more common as several large companies have bought new distribution companies to their network in order to concentrate more on the control of their distribution chain. In other words, vertical mergers and acquisitions enable value development in the whole manufacturing process and on every level of the value chain due to the contact interface focusing on customers being in the control of the company itself. In some vertical mergers and acquisitions the goal can also be to benefit from common infrastructure, reputation or brand that is to be taken to a new field. In these types of strategies there are also benefits to gain from risk allocation and a better capability to adapt to possible cyclical fluctuations¹³. The aforementioned issues and aspirations can be of utmost importance to a company, which can lead it to be more accommodating in the negotiation proceedings and be prepared to pay a higher price on the company or a part of it that they are targeting.

In concentric mergers or acquisitions the field the targeted company is operating in is different from the buyer's field, but the companies have similar markets as well as marketing and distribution channels, or the same type of technology and research and development operations. In other words, the companies are close to each other structure wise, but operate in different fields¹⁴. A conglomerative merger or acquisition means a situation where a company acquires another company that is specialized in a completely new markets and products. When the two companies operate in different fields the goal is the expansion of either market area or product line. This can also mean an acquisition by a private equity investor. This way it is possible to balance out the fluctuations of operational incomes and thereby reduce risks, but also acquire market share. Either way, the more familiar the market area, products and the line of action of the targeted company are the easier the negotiations and the issues arising in them, making the transaction more likely to be completed successfully. The further the fields of operation of the two companies are from one another, the more the transactions need careful analysis, for example through the due diligence investigation¹⁵.

¹³ Katramo et al. 2013

¹⁴ Katramo et al. 2013; Tenhunen & Werner 2000: 13

¹⁵ Katramo et al. 2013

2.2. Division by execution method

Above mergers and acquisitions were divided by strategy and the parties' operational objectives for the transactions were discussed. Mergers and acquisitions can also be divided concerning their method of execution. This affects, amongst other things, the completion of the final deal, the negotiations that precede it and the laws and norms applicable to the negotiations. According to Katramo et al., the execution methods of mergers and acquisitions can be divided into two main groups, which are an asset deal and sale of shares and partnership shares. The most notable distinction between these groups are the tax consequences that occur from the deal, which play an important part when negotiation the details of the deal. In principle, a limited company can decide to carry out the transaction in either way, in other words either by selling a part of its assets or by selling the company shares. When a merger or an acquisition is a part of a bigger transaction entirety, for example the beginning or the end of one, divisions and transfer of business can also be added to the list but in this thesis, they are left out of the discussion¹⁶.

In an asset deal the transaction usually includes the transfer of an individual entirety, for example a profit center or a production line. In other words, it includes both tangible and intangible factors of production that construct an entirety or a substance. In an asset deal the subject of the deal can also be the whole business of the company, including its assets and liabilities. In this instance the company can be a private business, a partnership or a limited company. The business form of the company has a big impact on the premise of the trade negotiations and for example, who is the person sitting in the negotiations table. According to Manninen, in an asset deal the seller is always the company itself, but for example in a private company the entrepreneur and the company is juridically the same thing¹⁷. From a legal point of view an asset deal is a purchase of goods regarding the business assets and a real estate deal concerning the immovable property. Thus, it usually includes, in addition to the general

¹⁶ Katramo et al. 2013

¹⁷ Manninen 2001: 273

agreement that is considered as the main sales contract, a deed of conveyance for the possible immovable property, as dictated by the Land Law Code¹⁸.

When selling a limited company, the subject of the trade is the shares that entitle to ownership of the company. It can also be the purchase of one's own shares, which is a transaction that carries a risk applying the rules of veiled distribution of profits. That being said, the purchase of one's own shares is allowed, for example, in a situation where a shareholder gives up their whole ownership of the company¹⁹. The shares of a company are considered as goods, so the sales contract does not have to be done according to the norms of the Land Law Code. The trade can also be agreed either in writing or orally, though a written contract is recommended for the possible need of verification later on²⁰. A limited company can also be sold in pieces. For instance, the buyer can first acquire a specific portion of the shares and after a few years the rest of them. The selling party can decide which of the shares acquired at different times are to be sold, as long as they are not a part of the book-entry system²¹. The trade can also be carried out as an exchange of shares where a limited company acquires such portion of another limited company's shares, that it generates over half of the number of votes that all of the shares generate. As compensation for this the company gives the other company's shareholders new shares that it has issued into circulation²².

In a transaction where the company being sold is a partnership, whether it is an open partnership or a partnership company, the subject of the trade is partnership shares. It can also include separate asset deals in order to benefit from old deferred losses, as a sale of partnership shares could result in the loss of them. The conveyance of partnership shares can happen in three ways: a partner can transfer their shares to another partner, an outsider or the company can claim them. Each of these ways mean, in practice, that the partner resigns from the

¹⁸ The Land Law Code (12.4.1995/540)

¹⁹ Manninen 2001: 295-296

²⁰ Manninen 2001: 298

²¹ Manninen 2001: 300

²² Manninen 2001: 302

company. In order to protect the other partners, the conveyance of partnership shares requires the consent of the other partners, assuming that the partnership agreement does not say otherwise. The conveyance of said shares is also considered from a legal point of view as a trade of goods even if the company would only own immovable property which means the sales contract does not have to be done according to the rules of the Land Law Code.²³

2.3. Norms regulating mergers and acquisitions

As discussed before, mergers and acquisitions are complex processes regardless of the goals behind them or the form that they are carried out in. There are also several laws and norms regulating mergers and acquisitions and the different stages of them. All laws and norms regulating mergers and acquisitions connect to each other and affect one another and therefore have an effect on the negotiations as well, naturally depending on the situation at hand. This includes the non-contractual law norms as well as the different parts of contract law.

In Finland mergers and acquisitions are trade deals of personal equity regardless if the transaction is an asset deal or a trade of shares or partnership shares and thus, the Sale of Goods Act applies to them. The Sales of Goods Act includes, for example, sections for handing over the item or equity, what properties the tradable object must have and the consequences of a faulty object and the responsibilities and liabilities of both the seller and the buyer. Regarding the trade of real estate, the Land Law Code are also usually applied²⁴. The concept of a trade is an agreement where the seller “conveys the ownership of an object to the buyer against a pecuniary compensation”²⁵. A merger or an acquisition is also a trade between two businesses, in other words a business trade. The specification is necessary as it enables the possibility to demand the parties

²³ Manninen 2001: 286-287

²⁴ Immonen 2014

²⁵ Hemmo & Hoppu 2006

precise and quick proceedings and requires knowledge of the fields business practices. However the Sale of Goods Act can only be partly applied to mergers and acquisitions as their character is so complicated and special. In addition, the Sale of Goods Act consists of dispositive norms, and therefore will not be applied if the parties agree so which is usually the case²⁶.

Mergers and acquisitions are also regulated by antitrust legislation regarding merger control, which can complicate or at least prolong the transaction in hand and its negotiations²⁷. According to Finnish regulations, the Competition and Consumer Agency must be informed of a merger or an acquisition before the completion of the transaction if “the combined turnover of the parties involved exceeds 350 million euros and the combined turnover generated from Finland of at least two parties exceeds 20 million euros”²⁸. The parties planning and conducting a merger or an acquisition can prepare themselves and possibly make necessary restructuring actions in order to meet these restrictions. This can also be used as a bargaining chip in the negotiation proceedings.

When the conditions mentioned above are exceeded, the Market Court can, following the recommendation of the Competition and Consumer Agency, impose certain conditions for the realization of the transaction or even forbid the deal from happening or alternatively order the deal to be dismantled. The reason for this is the possibility of the transaction to essentially prevent effective competition from happening in the Finnish market or a relevant part of it especially due to the deal formulating a decisive market position or enforcing one. The primary goal in such a situation is however, to negotiate the terms and modify them if by doing this, there is a possibility to prevent the negative effects of the transaction. One such term could be for example, that the buyer sells a part of its existing business or promises to sell onwards a part of the purchased business. According to Hoppu and Hoppu, a party involved in the transaction

²⁶ Hoppu & Hoppu 2016: 108-110, 130

²⁷ Hoppu & Hoppu 2016: 449

²⁸ Government Decree on the Calculation of Turnover of a Party (1011/2011)

does not have to accept these terms. In such case, the party that is not content with the suggested terms can exit the negotiations.²⁹

The supervision of mergers and acquisition is also active on the European Union level, which in fact the Finnish supervisions parameters are based on. The supervision is a part of European Union's competition law. It is mandated in the Fusion Supervision Statute which was renewed in 2004 and is nowadays generally known as the EC Merger Regulation³⁰. According to the statute, mergers or acquisitions exceeding certain turnover limits must be informed beforehand to the competition authorities, as is also required in Finnish legislation which was addressed in more detail earlier. In addition to the threshold values, the merger or acquisition must have union-wide effects in order to be included in the supervision regarding competition-effects. Being included in the supervision does not, however, automatically mean that the transaction is not allowed. The merger must significantly restrict competition in the union for the competition authorities to be able to restrict the deal from happening. The evaluation consists of comparing the situation after the transaction to one which would likely take place without said transaction³¹.

When a merger or an acquisition is targeted by the supervisory authorities of mergers and acquisitions, one of the factors they consider is the market power of the companies. This can be for example, large gross margins on sales, stable and high market shares and stable concentration levels. Horizontal mergers and acquisitions are especially important when defining the effects regarding Competition Act. This is because in horizontal mergers and acquisitions the products and services of the companies are in competition which means the price determination effect of the deal is more relevant compared to other transactions³². In the analysis of market power a central aspect is also a dominant position on the market, which is considered as the "critical meter" in the supervision of mergers and acquisitions. The generation of a dominant position

²⁹ Hoppu & Hoppu 2016: 449

³⁰ Council Regulation (EC) No 139/2004 of 20 January 2004 on the control of concentrations between undertakings (the EC Merger Regulation)

³¹ Huimala, Huimala, Leivo, Leivo, & Väisänen 2012: 1129

³² Aalto-Setälä, Aine, Lehto, Petäjaniemi-Björklund, Stenborg & Virtanen 2008: 131, 356

on the market is the most common competition problem considering mergers and acquisitions that the supervising authority can use to restrict the deal from the parties' point of view. The authorities can also interfere such transactions that would decrease the competition pressure between the parties and through that, cause competition problems³³.

The analysis of the antitrust legislation is one of the most important analyses to be carried out in the beginning of the transaction process, especially considering larger mergers or acquisitions, according to Katramo et al.. The same analysis should also be done in the case of smaller transactions, for example if the buying party does business in several countries. Even a small business in some country can lead to the obligation to make a regulated report of said transaction to the officials of Supervision of Mergers and Acquisitions³⁴. The analysis is vital because it can either make or break the deal.

When the company being bought is a publicly listed company, more regulating laws come into question. The Securities Market Act and the instructions of the finance supervisor that supervise said law, regulate the purchase offer, process of the sale and the stages within it. The security markets law instructs in making a public purchase offer and the finance supervisors instructions adds to and interprets it, as well as concretizes the principles regarding making a purchase offer, manners of proceeding, compensation and informing about the offer. According to the Finnish Securities Market Act, the decision made of a public purchase offer has to be published without delay and be informed to the target company. The publication must mention the amount of securities the offer refers to, the period of validity and the offered compensation, as well as other essential conditions the offer may have. The offer may be disclosed when the Financial Supervisory Authority has accepted it³⁵. If the issuer of the public purchase offer neglects the obligation to disclose the offer made, they may be issued a fine.

³³ Huimala et al. 2012: 1126-1127

³⁴ Katramo et al. 2013

³⁵ The Finnish Securities Market Act (14.12.2012/746)

According to Katramo et al., the statute given out by the Finnish Ministry of Finance on the contents of an offer document is also an important ordinance when trading on publicly listed companies.³⁶ The statute stipulates that the purchase offer must be available to the public free of charge and the offer must be published before it comes into force. The purchase offer must also disclose the name or names of the offerors as well as their place of residence³⁷. The Finnish Securities Market Association has also issued a statement, “The Helsinki Takeover Code”, with the purpose of unifying market practices in making a public purchase offer as well as promote good market practice. The statement itself is not imperative, however good practice according to the Finnish Financial Supervisory Authority’s standard demands complying to it³⁸.

Different tax laws regarding tax planning and some elements of company law affect going into a merger or an acquisition, the matters agreed in them and the realization method of the transaction. Issues regarding tax law come into assessment for example when deciding between an asset deal and the sale of shares as the decision can have an impact on the profitability of the deal as well as the transfer of liabilities and responsibilities. Katramo et al. state that the sale of shares is usually seen as the more profitable alternative for the seller, and vice versa for the buyer. This is because turning over shares is usually a tax-free proceeding³⁹.

However, if the conveyance is unprofitable for the seller, that may not be the case as the loss of agreement is usually not deductible in taxation. There are conditions to be met for the turning over of the shares to be tax free. The shares must be a part of the company’s fixed assets, the shares have to be owned for at least a year and be over ten percent of the whole share stake. Before these conditions are met, the share turnover will not be tax free even if the transaction is done through a

³⁶ Katramo et al. 2013

³⁷ Decree of the Ministry of Finance on the content and publication of the offer document and the derogations therefrom and the mutual recognition of the offer document accepted in the European Economic Area (1022/2012)

³⁸ The Helsinki Takeover Code 2014

³⁹ Katramo et al. 2013

sale of shares. Also, the company cannot be a real estate company or a housing association. The purchase of shares can also be preferable for the buyer as the company's liabilities and responsibilities do not usually transfer with the shares as they are owned by the company, not the shareholders.⁴⁰

Regarding legislation regulating companies involved, it is worthwhile to check if there is a redemption or a consent clause in the articles of association, if there are different kinds of shares in the company and for example the possible existence of a shareholder's agreement in the company as far as it affects the seller's right to sell. Furthermore, the company structure of the seller is to be considered and possibly modified during the transaction, especially if the buyer is a private equity investment firm⁴¹. Immonen adds that the jurisdiction of the seller to conduct the transaction, the pricing of the deal and the shareholders right to know of certain ventures the company is planning on participating in is dictated in the company law⁴².

⁴⁰ Katramo et al. 2013

⁴¹ Katramo et al. 2013

⁴² Immonen 2014

3. MOTIVES AND DIFFERENT NEGOTIATION PROCESSES

3.1. Reasons behind mergers and acquisitions

According to Katramo et al., the motives of mergers and acquisitions differs case-by-case but usually they include creating new business or, for example, speeding up the growth of an existing company. In addition to these, change of generation or owners bring up the need of mergers and acquisitions. The restructuring of the economy can also create the need to resort to mergers and acquisitions for smaller companies that cannot compete in the international competition, mainly because of their size. This occurs especially in the fields that are going through a period of transition⁴³.

Sherman adds to these with a list of general motives to conduct mergers and acquisitions. They include aspects such as restructuring the industry value chain, revenue enhancement, responding to competitive cost pressures through economies of scale and scope, pressure from the investors, underutilized resources, a desire to reduce the number of competitors, improving process engineering and technology, a need to gain foothold in an new geographic market, increasing the scale of production in existing product lines, a desire to diversify into new products and services, finding additional uses for existing management talent, redeploying excess capital in more profitable and complementary uses and obtaining tax benefits⁴⁴.

As a whole, mergers and acquisitions are a multiphase chain of events with their base goals and global markets where the negotiations part play a huge role. To understand the full context of the negotiations that take place in different stages of the process, the instruments used in them and the laws and regulations that affect them, the motives of mergers and acquisitions must be addressed first.

⁴³ Katramo et al. 2013

⁴⁴ Sherman 2010

3.2. Motives of the buyer

There can be a variety of reasons and goals behind mergers and acquisitions that all affect the negotiations process and the set of documents needed to complete the possible transaction. According to Katramo et al., there are two types of corporate buyers in practice, industrial buyers and private equity firms, behind of which the goals and as a result also the issues to be discussed differ from one another. A merger or an acquisition is industrial when the buyer operates in the same field as the target company and the purpose of the transaction is to attach the purchased company as a part of the business of the buyer. As so, in industrial mergers and acquisitions the goal is the synergy benefits that come from the integration of the company that is the target of the purchase. Synergy benefits are, amongst other things, growth in business, scale advantages, better steering of resources, increase in profitability or gaining a bigger market share⁴⁵. Other benefits can be for example increasing the efficiency of the whole entity or removing overlaps in a company's operations⁴⁶. In industrial mergers and acquisitions the rate of return is based on the risk premium which then is based on the subjective valuation of the buyer. The period of ownership is usually long or even indefinite with industrial buyers which means the time to benefit from the future cash flows is longer⁴⁷. These issues are highly relevant and need to be taken into consideration and stressed in the negotiation phase.

The motives behind mergers and acquisitions carried out by private equity investment firms have more to do with increasing the profitability and expanding the operations of the company through the transaction. In these cases, the private equity investment firm invests according to the terms of equity and evaluates the target company with the total profit of the period of investment as the starting point. The goal can be for example the possible value increase of the share capital and a profitable breakaway of the investment through reorganizing the operations, management and recourses of the target company⁴⁸. According

⁴⁵ Katramo et al. 2013

⁴⁶ Immonen 2014

⁴⁷ Katramo et al. 2013

⁴⁸ Katramo et al. 2013

to Immonen, the goal of re-grouping an entity is to make investing in the company's shares more desirable. This arrangement is called focusing. On the flip side, the goal can be to even out the risks by making the company more multisectoral. The profit of private equity investment firms consists of dividends, interests, returns and the possible value increase of the share capitals of the company. Thus, the role of the management, their experience and know-how are a vital part of the process. In situations like these, the re-distribution of the power of decision and the increase in the management's efficiency are usually tried to obtain by a business transfer⁴⁹. The aforementioned goals of reorganization and increase of efficiency are important parts of the negotiations of the transaction and can be controlled different ways.

Industrial buyers and private equity investment firms compete in the same merger and acquisition markets with the same investment targets even though they often have different motives planning the transaction. In situations like this, private equity investment firms usually have an advantage due to professionalism and financing, which can be seen for example when the merger and acquisition negotiations are conducted in the form of an auction. On the other hand, industrial buyers have deeper knowledge and understanding of the subject than private equity investment firms have. This means they do not have to perform as thorough due diligence investigations as private equity investment firms do⁵⁰. This can be a vital factor in the negotiations and a compelling aspect for the seller as it decreases the burden to give more specific information and the need to explain it. Different process possibilities of mergers and acquisitions as well as due diligence investigation and its different forms are discussed further on in the thesis.

The reasons behind conducting a merger or an acquisition as a buyer can also be divided in other ways. Immonen, for example, divides the reasons to internal and external. According to the author, internal motives can be the character of a company, structure of a company's ownership or personnel, willingness to expand, capital structure, level of production technology as well as allocation

⁴⁹ Immonen 2014, Katramo et al. 2013

⁵⁰ Katramo et al. 2013

possibilities of resources and financing possibilities. External reasons are for example the conditions of competition in general and especially regarding market shares, availability of labor and the circumstances of the financial markets⁵¹. Karppinen, Leppiniemi, Mattila and Pipatti have a few additions to the list. According to the researchers behind a company's desire to buy can be, amongst other things, investing surplus liquid assets as profitably as possible, "all of" technique where a company tries to make use of its market power as broadly as possible, or the pursuit of an independent position from a current supplier. In addition to these, a company can enter the merger and acquisition markets with the intention to carry out its growth targets when it feels that the field in question is not growing at a satisfying rate⁵².

A company may also want to obtain specific attributes or properties of a company in sale, such as patents, legal rights, models, expertise of the personnel, business location, production machinery, customer relations, marketing channels or a supplier. The reason behind a merger or an acquisition can also simply be the desire to increase the authority of a company and its management⁵³. The reason behind a buyers approach also have an effect on merger or acquisition negotiations. The type and quality of information may be different depending on what the buyer considers valuable and the issues the buyer wants to agree on during the negotiations can differ as well. Also, the willingness to participate in an auction, whether an open or a closed one, may depend on the motives behind the desire to buy a certain company or a part of it.

Mergers and acquisitions are always strategic decisions regardless of the background of the executer. They also always demand a lot of resources and when planning on carrying out one, it is worthwhile to contemplate, whether the transaction is necessary or even possible⁵⁴. Sherman divides the strategic growth options to organic, inorganic and external means. Organic means are, for example, hiring additional salespeople, developing new products and expanding

⁵¹ Immonen 2013

⁵² Karppinen, Leppiniemi, Mattila, Pipatti 1985: 16

⁵³ Karppinen et al. 1985: 16

⁵⁴ Katramo et al. 2013

geographically. External revenue growth opportunities include franchising, licensing, joint ventures and strategic alliances, among others. Merges and acquisitions fall to the third and last category, inorganic growth⁵⁵. Often however, the decision includes for example detecting a threat or a possibility in the operational environment of the company. Tenhunen and Werner call this a strategic problem situation. This can be, for example, a sudden decline in turnover in a specific market which forms a threat or a cease of operations of a company in a special market area leaving the market free to enter which forms a possibility. Thus, when planning a merger or an acquisition a company has to resolve how the possible transaction connects with the buyer company's strategy and if it possibly changes it⁵⁶.

Alternatively, a company's strategy can be to expand its operations in which case interesting targets for purchase are sought after actively. Whether or not this is the case, the company that is being purchased or consolidated should be analyzed in a way that compares the strengths and possibilities it brings, which can be then compared to the corresponding ones of internal development. It is also essential to perceive the focal internal strengths and weaknesses of the buyer company as well as the company being purchased and what kind of added value there is to gain from them – if any⁵⁷.

Sherman completes the list with ten key reasons merger and acquisition deals are made. The first one is the fact that mergers and acquisitions are the most effective way to enter a new market, add a new product line or increase distribution reach. A key trend within a certain industry may also drive companies to conduct mergers and acquisitions. This may occur as a rapidly changing technology, fierce competition, changing consumer preferences, the pressure to control costs or a reduction in demand. Some transactions are motivated by the need to transform a firm's corporate identity. The fourth key reason, according to Sherman, is the need to spread the risk and cost of developing new technologies, such as in the communications industries, research into new medical discoveries,

⁵⁵ Sherman 2010

⁵⁶ Tenhunen & Werner 2000: 11

⁵⁷ Tenhunen & Werner 2000: 61

such as in the medical device and pharmaceutical industries as well as gaining access to new sources of energy, such as in the oil and gas industries. Global markets have also forced many companies to explore mergers and acquisitions as a means of developing international presence and expanding their market share. Some companies recognize the need of a complete product or service line if they want to remain competitive or to balance seasonal and cyclical market trends. Many companies also calculate that it is less expensive to buy brand loyalty and customer relationships than it is to build them. Several mergers and acquisitions are conducted out of competitive necessity, as in order to prevent a competitor from acquiring said business. Sherman also mentions plain and simple survival as one of the reasons of mergers and acquisitions. The final key reason is the willingness of a company to transform itself entirely, as well as diversify and refocus on higher-margin and value-added revenue streams⁵⁸. All of these situations add their own twist to the negotiations and affects the stance of the buyer and indirectly the seller also.

A merger or an acquisition should not be the endgame in itself rather the possible benefits should always be compared to the company's own business and the strategy it has implemented in it⁵⁹. The negotiations of mergers and acquisitions require a lot of resources and often personnel away from their normal tasks, which should be also considered. The technical aspects of contract law strongly depend on these issues the contract contains and for example, with some contractual instruments it is possible to reveal the attributes of different sections of the target company. There are also exceptions where a merger or an acquisition is not a strategic decision. They can for example be inevitable ways to expand due to an increase in the competitions challenge in a field or because the possibility to establish an own manufacturing or marketing unit is eliminated due to markets downsizing too much⁶⁰.

⁵⁸ Sherman 2010

⁵⁹ Immonen 2014

⁶⁰ Katramo et al. 2013

3.3. Motives of the seller

The motives and reasons behind selling a company are also strategic but differ a lot whether the seller is a private person or a conglomerate selling a part of its business. If the seller is a private person, usually meaning an entrepreneur, the internal willingness to sell the company can be due to retirement and thus a change in generation, taking up on a suitable selling opportunity if an appropriate follower cannot be found or, for example, due to clear synergy benefits for both parties⁶¹. An entrepreneur can also be pushed into selling the company if the company's own resources, such as know-how of the management, are not enough to ensure the continuity or growth of the company. Sherman agrees with this by saying one of the motivators behind selling can be the inability to compete as an independent concern. In addition to this they mention other key motivators such as the need or desire to obtain cost saving through economies of scale and access to the greater resources of the acquiring company. Other common seller motivators, according to Sherman, are business adversities, inadequate distribution system, to eliminate personal guarantees or other personal obligations, no ability to diversify, irreconcilable conflict among owners and losing key people or key customers⁶².

Tenhunen and Werner add to the list an entrepreneur becoming so sick that they have to sell their company and the desire to realize one's lifework as reasons behind the sale of a company. Even though these are rare occasions, they affect the seller's position in the negotiation proceedings and the goals of the negotiations as much as the other reasons do. The most important external reason to sell a company is, that the company has ended up in a strategic situation where an external possibility or threat forces the company and its owners into considering selling the company. An external threat can be, for example, losing the most important sales channel to a competitor, whereas an external possibility can be acquiring a new manufacturing technique or patent through the transaction or gaining a substantial additional contribution to a business idea⁶³.

⁶¹ Katramo et al. 2013

⁶² Sherman 2010

⁶³ Tenhunen & Werner 2000: 66

Other external reasons are, amongst other things, allocation of business responsibilities, market conditions such as interest rates and availability of financing as well as the company's industry's and the national economy's growth prospects⁶⁴. In a situation where the seller is forced to sell the company, the selling party has a poor starting point going into the negotiations, especially if the buyer candidate is aware of the situation. On the other hand, if the company on sale is thriving and profitable but on sale for example due to retirement and the absence of a suitable follower, the selling party has a good stance going into the negotiations and can make use of the instruments much more easily.

When a conglomerate or a concern wants to sell a part of their business, the reason can be for example the desire to get rid of a unprofitable business component, the willingness to free resources and funds in order to strengthen and centralize other business areas, debt relief and risk management optimization. When a concern is the selling party, the buyer can sometimes be found from the management of the business unit. This is referred to as a so called MBO or management-buy-out transaction. A company can also be forced into selling the whole entity or a part of it due to legislation controlling mergers and acquisitions or because of tax based reasons⁶⁵. According to Tenhunen and Werner, two companies can also seek to change businesses with each other, strive for a controlling market position through mergers or acquisitions, or make use of the synergy possibilities between the two companies. Ending up in a reorganization situation can also trigger the need to sell a company or a part of it⁶⁶.

⁶⁴ Katramo et al. 2013

⁶⁵ Immonen 2014

⁶⁶ Tenhunen & Werner 2000: 67

3.4. Approach and process possibilities

3.4.1. Approach

The process of mergers and acquisitions usually depends on who initiates the merger or acquisition negotiations but in practice there are three possibilities: direct negotiations, a restricted auction and an open auction. The latter two are usually associated with a trade initiated by the seller⁶⁷. Both the buyer and the seller may also use proxies or representatives to issue the deal or alternatively act on their own behalf. According to Frankel and Forman, the initial approach should be a simple and functional event where either the buyer or the seller suggests a potential transaction and the counterpart expresses interest in said transaction and they start negotiating the deal. However, the style and method of the initial approach can have a great effect on the possible negotiation or if there will even be one in the first place. The basic principles of making a first impression apply also on merger and acquisition negotiations, that is to say that the initial perceptions and impressions are hard to change later on. The side making the initial approach has to try to bring forward the right impressions of both the deal and themselves to the other party⁶⁸.

There are a number of ways for making the initial approach with some of them being more straightforward and others a little less direct and formal. However, if a company is using a proxy having some kind of a relationship with the other party, the medium of approach is less important. A direct approach can be less formal, by e-mail or a direct call, or more formal, as in by letter. The party making the initial approach ought to keep in mind that a written approach is not only more formal but also more intimidating. For example, for publicly listed companies with disclosure requirements, the more formal the approach is, the more likely it is to trigger a requirement to make a statement to the company's investors. In addition to that, a written approach does not give the author an opportunity to clarify intents and meanings after the fact. For example, a phone

⁶⁷ Katramo et al. 2013

⁶⁸ Frankel & Forman 2017

call allows a more loose atmosphere where questions can be asked by both parties and any unclear subjects to be clarified⁶⁹.

If the selling party is the one making the approach to a potential buyer or buyers, they face a problem of perception as the first reaction of any potential buyer to an unsolicited offer could easily be that of a skeptical one. Thus, the seller needs to succeed in communicating the inherent value and strengths of the business, even though they are the one initiating the deal. According to Frankel and Forman, one considerable option for explaining the situation is to be forthcoming from the start and quickly identify the reason for the willingness to sell. Communicating this reason to the buyer upfront could help allay any fears the potential buyer may have. This also helps advancing in the negotiation proceedings as the facts are laid out already at the beginning and unnecessary confusion is cleared. If the seller does not provide a clear reason for the proposed sale, the potential buyer will likely assume there is something wrong with the business in question. It is also vital to the seller to try to communicate their intent on being a reasonable and accommodating negotiating partner. This is the case especially with privately owned companies, not to mention when the founder is selling the company, as the buyer may be concerned that negotiating with these individuals may be complex and difficult. This is due to possible emotional interest in the business that may lead to irrational and unreasonable expectations for the negotiations.⁷⁰

When the initial approach is made by the buyer, they also have to succeed in communicating certain aspects. Firstly, they need to communicate their genuine seriousness in the proposed deal. Since transactions such as mergers and acquisitions and related negotiations usually require the seller to disclose certain confidential and possibly highly valuable information about its business, the seller must be convinced, that the potential buyer is not going on a “fishing expedition” by proposing a deal only to gain access to competitive information. Secondly, merger and acquisition negotiations also require a vast amount of resources, especially from the seller, in terms of disengaging senior management

⁶⁹ Frankel & Forman 2017

⁷⁰ Frankel & Forman 2017

and employees from the main business operations. As a result, it is highly important for the buyer to communicate a significant level of seriousness on the proposed deal.⁷¹

Like the buyer, the seller may also have concerns about ending up in negotiations with an unreasonable or irrational counterparty. Even though buyers rarely personalize a transaction, according to Frankel and Forman, they can still be difficult to negotiate with. For example, some buyers make high initial offers to open up the discussion, but then drastically reduce the bid once the negotiations have gone further. This is where the instruments that the thesis addresses later on, such as a letter of intent or a preliminary contract, come in handy. It is beneficial for the buyer to also try to anticipate some of the seller's specific needs and concerns and try to address them during the approach. Such a topic can be, for example, the protection of the employees in any possible deal. If this is the case, the buyer could make a point upfront that they plan on offering protection higher than normal to the seller's current employees, which can be a strong motivator for the seller to begin negotiations.⁷²

3.4.2. Direct negotiation

According to Huhtamäki, the process of mergers and acquisitions is usually carried out through direct negotiations when the trade process is started by a buyer⁷³. Frankel and Forman agree by stating that direct negotiations with only two parties, which is the most basic form of a sales process, appeal to the buyer as it eliminates the danger of a competitive bidding process happening. However, this does not mean the buyer has all the power at the negotiations. The seller can always break off negotiating with a certain party and enter into a competitive process with another potential buyer. However, as long as the one-on-one negotiation is ongoing, all the buyer has to reach is a set of terms that is

⁷¹ Frankel & Forman 2017

⁷² Frankel & Forman 2017

⁷³ Huhtamäki 2014: 282

acceptable for the seller without having to worry about an outbidding offer from another buyer⁷⁴.

Direct negotiations can also be the chosen process for a trade initiated by the seller if, for example, the trade or the intention of selling is wanted to be kept a secret or if the target of the trade contains some special features. The reason for direct negotiations can also be that the selling party believes the demand for the trade will be low because of poor profitability. As a process, direct negotiations are also more confidential and possibly a cheaper way for the seller to carry out the trade compared to the different auctions⁷⁵. This is also beneficial for the buyer.

According to Frankel and Forman, direct negotiations with two parties are usually a fairly fast process and one that increases the likelihood of getting the deal done, which of course is something the seller is looking after. This is due to the fact that the parties can quickly determine whether a deal is likely to happen or not, since both of the parties need to put their proposed terms on the table in a timely manner. However, a seller might be hesitant to get into a direct negotiation with only one party as it eliminates the opportunity to play off one buyer against another through a bidding process to maximize value, although the seller could try to use the initial bid and the entity that made it as a “stalking horse”. However, this is a risky maneuver and might end up in losing the original offer. The one-on-one negotiation situation also creates a risk for the seller that it may have to start over and try to find another buyer if it does not reach terms with the partner at hand⁷⁶. Katramo et al. agree that direct negotiations are only beneficial for the seller if it makes the process quicker or increases the selling price compared to a trade carried out through an auction. On the flip side, direct negotiations can lead to a weaker competitive situation for the seller and through that to worse trade conditions⁷⁷.

⁷⁴ Frankel & Forman 2017

⁷⁵ Katramo et al. 2013

⁷⁶ Frankel & Forman 2017

⁷⁷ Katramo et al. 2013

As with any sales process, there are no hard rules on how direct negotiations in mergers and acquisitions need to be conducted. According to Frankel and Forman, the first step is to establish contact and determine the level of interest of both parties for the possible transaction. This can be done by either of the parties. The party initiating contact will usually propose quite general and rough terms to attract the interest of the other party. If the party making the approach is the buyer, it can be as simple as communicating an interest in buying the company. When the seller initiates the contact, the interest in selling is usually coupled with some basic information, a “teaser”, especially if the company is not publicly listed⁷⁸. As said before, the process of direct negotiations between two parties is naturally a more flexible one than the process of an auction with many participants and leads more often to a letter of intent agreed by the parties. The timetable and the phases are freely agreeable and the issues rising during the negotiations more easily solved. The private equity investment firms favor direct negotiations when buying companies but prefer to give them up through an auction as the competition is tougher⁷⁹.

Once a mutual interest in discussing a possible transaction is established with the two parties, non-disclosure agreements, in other words confidentiality agreements, are usually signed. This document protects primarily the seller as they are the one giving out more information but is also beneficial to the buyer. When the non-disclosure agreements are signed, the seller often provides more extensive information, including more detailed financial data among others, in the form of an information or offering memorandum. The information memorandum can also be considered as a precursor to a full due diligence investigation. Once the buyer has had the chance to familiarize themselves with the target company, they are usually asked to provide an indicative and non-binding price offer, in practice a letter of intent. In some cases this requires the seller to agree to an exclusivity agreement for a certain period of time. It is important to note that all negotiations ultimately come down to direct negotiations with two parties. The key aspect is whether the seller decides to start

⁷⁸ Frankel & Forman 2017

⁷⁹ Katramo et al. 2013

there or go through an auction process⁸⁰. All of the contractual instruments mentioned are addressed in more detail further in the thesis.

3.4.3. Restricted auction

A merger or an acquisition initiated by the seller through an auction process can be carried out either through an open auction that any willing potential buyer can participate in or a restricted one that is aimed at only buyers filling certain criteria⁸¹. This process should end with a direct negotiation with the most potential buyer who will give the seller the best terms. However before that, an auction can help the seller to recognize potential buyers and test their level of interest as they may need to participate in various stages throughout the process⁸². According to Huhtamäki and Katramo et al., a restricted auction starts off with the selling company giving an investment bank advisor, or a similar entity, the assignment to identify, for example, five to twenty buyer candidates from different areas of business and to find out their interest in buying the company on sale, its business or a part of it⁸³.

Frankel and Forman agree and state that the need to use an investment bank advisor is due to the process requiring a lot of networking and communication with the potential buyers, as well as the complexity and workload of it. The inquiry normally happens through a sales brochure or a teaser, similar to the one used in direct negotiations. When the pool of bidders is reduced based on the interest shown, the negotiations for increasing the amount of information given out and the contracts ensue⁸⁴. According to Frankel and Forman, the identity of the seller is usually told to the potential buyers, but in some cases, it is kept

⁸⁰ Frankel & Forman 2017

⁸¹ Katramo et al. 2013

⁸² Frankel & Forman 2017

⁸³ Huhtamäki 2014: 285; Katramo et al. 2013

⁸⁴ Frankel & Forman 2017, Huhtamäki 2014: 285; Katramo et al. 2013

confidential. This is due to the sellers will to keep the possible sale out of the public knowledge, though this gets harder the further along the process goes⁸⁵.

According to Katramo et al., a restricted auction has a clear schedule and structure as well as rules which help the seller to increase the competition and the value of the company even more⁸⁶. Frankel and Forman agree and add that the bidders in a restricted auction process are usually given a formal timeline and general outlines of the process. The researchers say that there is no “magic structure” to a restricted auction process but there are some common steps. After receiving the teaser, the bidders are usually asked to confirm their level of interest. Next, they will be asked to sign a non-disclosure agreement after which they will receive a full information memorandum. Because of all the work coordinating all of this requires, the bidders will usually then be asked to sign a letter of intent, which helps to winnow the group of bidders down to a smaller number. After the letter of intent, the seller can either choose one party to start the direct negotiations with or continue advanced talks with multiple potential buyers⁸⁷.

During an auction, the seller can also smoothly change the party they are negotiating with, without delaying the process significantly if the negotiations with a specific party are not going the way the seller had hoped for⁸⁸. The risk in such transaction is that the switch of the negotiations partner signals the other buyers that the seller may be in a weak position, which damages the seller’s standing in the negotiations. However, the seller can use negotiating with multiple parties to increase the value of their offers by setting them up against each other. As the auction proceeds, the seller can also officially inform all the potential buyers that there are minimum terms necessary in order to be able continue the process. With these, the seller can strengthen its position in the negotiations proceedings⁸⁹. Katramo et al. say a restricted auction is the best

⁸⁵ Frankel & Forman 2017

⁸⁶ Katramo et al. 2013

⁸⁷ Frankel & Forman 2017

⁸⁸ Frankel & Forman 2017, Katramo et al. 2013

⁸⁹ Frankel & Forman 2017

process option if the company for sale is expected to raise interest in several buyers. In a restricted auction the confidentiality is also higher compared to an open auction. The risk is not choosing a significant buyer candidate that could have maximized the price paid for the company⁹⁰.

3.4.4. Open auction

Katramo et al. state that an open auction, and to some extent a restricted one also, is a time-consuming process and relatively expensive⁹¹. According to Blomquist et al., beginning an auction can be justified for example with maximizing the selling price or another trade term. If this is the case however, the business must be a notable one. According to the researchers, an auction can also be the chosen trade process for the sale of a “big family company or a startup -company that has gone past the first stage”⁹². As said before, in an open auction every willing buyer candidate is accepted to the first round. This is to achieve the highest possible selling price but at the same time, the owner’s intention to sell becomes public which can affect the company’s relationships as well as its personnel. The risk of sensitive information ending up in the hands of wrong entities is also present⁹³.

Katramo et al. recognize four different main phases in an open auction. The first phase is establishing what the business or the company for sale is comprised of and what the possible trade circumstances could be. In the second phase the seller draws up the strategy, prepares the material needed and begins marketing. Before the last phase the chosen buyer candidates are contacted, the selling material is sent to them and the best candidates are picked. In the fourth and last phase the buyer candidates deliver their final bids, based on which the buyer candidate to get into the final negotiations with, is chosen⁹⁴.

⁹⁰ Katramo et al. 2013

⁹¹ Katramo et al. 2013

⁹² Blomquist, Blummé, Lumme, Pitkänen, Simonsen 2001: 13

⁹³ Katramo et al. 2013

⁹⁴ Katramo et al. 2013

Selling a company through an open auction requires a great number of external experts, for example investment bankers, but also a big input from the company on sale and its management. In other words, the management cannot focus on the day-to-day business operations with its full capacity. However, it is an excellent way of maximizing the price payed in the merger or acquisition by inviting multiple different buyer candidates to compete on the target company. From the buyer's point of view, the auction process is not usually the best option due to its competition set-up, the obligation to be flexible and the unsure outcome. The expenses are also higher compared to, for example, direct negotiations.

4. CONTRACT LAW IN MERGERS AND ACQUISITIONS

4.1. Norms regulating contracts and contract negotiations

Mergers and acquisitions and the related negotiations involve a number of contracts straight from the beginning of the process all the way to making the final sales contract and these contracts are regulated by different laws and regulations. These contracts also bring a variety of responsibilities and obligations upon the parties and they affect the negotiations, going forward in them and the issues agreed during them. There is a strong contractual freedom in the Finnish contract law and its sub-categories, but they have certain preconditions, especially regarding mergers and acquisitions where the process is so complex and the amounts of money usually growing to high numbers. The freedom of contract gives the parties a variety of possibilities to affect their position in the negotiation proceedings but they have to keep in mind that certain actions can have consequences.

The structure of a merger or an acquisition transaction is a contract and in addition to that, during the negotiations there is a number of contractual instruments in use to carry out the deal, whether the chosen process is one-on-one negotiations, a restricted auction or an open auction. Both auctions usually require more contracts to be concluded comparing to a one-on-one negotiation, which can be fairly straight forward in some cases. In auctions, teasers, as well as information memorandums are usually required in order to proceed in the negotiations. This is mainly because of the seller's will to protect its sensitive and valuable information, but also to get a picture to what extent the potential buyers are actually interested in the company. This means contract law and its paragraphs are strongly present during the negotiations and the phases before the actual negotiations even begin.⁹⁵

⁹⁵ Hoppu & Hoppu 2016: 62

Simply put, a contract is a legal act between two parties which “requires a consistent declaration of intent from two persons”. As so, Hoppu and Hoppu state that the legal effect is formed when the parties agree on the wanted change in the legal state⁹⁶. The basic provisions which govern concluding a contract can be found in the Finnish Contracts Act. According to the act, a binding contract is formed by an offer and an accepting answer to that offer. However, the offer must be formed so that it can be given an accepting or a rejecting answer. In an offer there is also usually a time limit that the answer must be given in and even if there is none, the offer should be answered accepting it “in a time that the offeror could have reasonably calculated to take to give the answer when making the offer”. If the accepting answer does not arrive in the time limit or in a reasonable time or it is a rejected answer the offeror is freed from his commitment to the offer⁹⁷. An accepting answer that arrives late is however considered as a new offer that the original offeror has a chance to answer to. There is however, exceptions to this rule⁹⁸.

A contract can also be formed through negotiations and this is usually the case with mergers and acquisitions. According to Hemmo, in contract negotiations the parties make preliminary suggestions as to the contents of the contract, pose questions, gather information and go through possible contractual stipulations. In mergers and acquisitions, these can be for example, the included share of the company that is in question, in which form the transaction could take place or what are the responsibilities and liabilities of the parties. This exchange of information and suggestions happens without legal liability. However, negligent actions can lead to liability for damages for unnecessary expenses and equivalent damages occurred to the opposing party⁹⁹.

As said before, there is a strong principle of freedom of contract in the Finnish legislation of contracts. According to Saarnilehto, freedom of contract has originally meant a freedom of choice as well as the ability to form and use one’s

⁹⁶ Hoppu & Hoppu 2016: 62

⁹⁷ Contracts Act (13.6.1929/228)

⁹⁸ Hoppu & Hoppu 2016: 63-64

⁹⁹ Hemmo 2008: 85-86

own legal will but nowadays, characteristics regarding risk allocation are linked to it too. With a contract and the freedom connected to its contents the parties allocate the risk between themselves in order to reach a common goal¹⁰⁰. This is strongly present in mergers and acquisitions. The buyer wants the seller to ensure the information given is accurate and truthful and the seller may, for example, want a guarantee from the buyer of the ability to pay the agreed fee. Because of the freedom of contract, there is no mandatory method in allocating these risks so the parties can negotiate them between themselves.

Both Hemmo and Saarnilehto list different elements of freedom that can be included into contractual freedom. The elements are the freedom to decide, freedom of choice, freedom of content, freedom of form, freedom of type and the freedom to terminate. The freedom to decide means the parties have a freedom to do or not to do contracts in general. The freedom of choice gives the parties the freedom to choose their contract partner, the freedom of content the freedom to choose on which terms the contract is to be made, the freedom of form the freedom to determine in which form or order the contract is to be made. The freedom of type gives the parties the freedom to choose the type of contract they want to make and the freedom to terminate the chance to any of the parties to withdraw from the contract within the law. The parties have also the freedom to agree on the regulating law and the method of resolving disputes¹⁰¹.

Out of these elements of contractual freedom, especially the freedom of content and the freedom to agree on the regulating law are applicable to mergers and acquisitions and the contracts made during their negotiations. A merger or acquisition contract does not have any legal obligations content wise, with the exception of property, so the parties can negotiate the content to suit them as perfectly as they can. In international mergers and acquisitions, which most of said transactions are, the parties have a possibility to choose which countries national regulations shall apply and whether any possible disputes emerging will be resolved in an arbitrary or in a public forum. Also, the other elements apply, as in any contract. For example, even if a party is conducting negotiations,

¹⁰⁰ Saarnilehto 2005: 37

¹⁰¹ Hemmo 2008: 64-65, Saarnilehto 2005: 37

they can decide to not enter into a contract if they consider the terms not to be acceptable. However, if they act in a way that the other party can assume a contract will be agreed, they can be liable for damages as will be shown later on in the thesis. Also, the seller has a choice to make on the partner they want to engage in the transaction with, especially in an open or a restricted auction. On the other hand, the freedom to terminate cannot usually be applied to the contracts made in merger and acquisition negotiations, even though it would be possible from the legal point of view¹⁰². The reason for this is the amount of expenses put to the negotiations being so large, the parties usually want to include the liability for damages for at least the resources used on the negotiations.

Agreeing contracts and negotiating them includes also different responsibilities and liabilities that are applied, either directly or when agreed upon, to the negotiations at hand and acting in them. This is also the case in mergers and acquisitions. The so-called responsibility of negotiating instructs the contract negotiations themselves, although as a general rule negotiations do not inflict legal validity. The responsibility of negotiating does not appear in the Finnish legislation itself, but it is applied in practice through the responsibility of acting to conclude an agreement that includes, for example, the termination of the contract negotiations or the invalidity of the contract. The basis of the responsibility, in this case, is acting to make a contract which is also known as the doctrine of "culpa in contrahendo"¹⁰³.

The questions of law regarding the responsibility of acting to make or conclude a contract can be divided into three main groups, according to Hemmo and Hoppu. They are continuing the negotiations for an extended time, an unacceptable negotiation action and special contracts about the contents of the negotiations. In the first one, the responsibility and through that the liability for damages arises when the negotiations proceeded to a stage where the opposite side has with good reason trusted that a contract will be formed and the freedom to terminate the contract negotiations cannot be used as an excuse anymore.

¹⁰² Hemmo & Hoppu 2006

¹⁰³ Hemmo & Hoppu 2006, Hemmo 2008: 121

Hemmo and Hoppu describe this situation as one where the negotiating partner has been given “an over optimistic understanding of the probabilities of concluding a contract”. This is strongly present in mergers and acquisitions, especially as the negotiations usually take a long time and the expenses grow to significant numbers. Also, a similar situation may incur during mergers and acquisitions if the negotiations have reached a stage where a letter of intent has been signed, but a negotiating party suddenly wants to revisit certain terms of the contract that were already agreed on¹⁰⁴. In a case in the Finnish Supreme Court, number 2009:45, the following ruling was made:

“A limited company had negotiated with a property owner about renting a commercial hall from the owner’s property. After almost a year of negotiations, the limited company retracted from the negotiations. Because the limited company had acted in a way in the negotiations that it had formed reasonable expectations of concluding the rental contract in the property owner, the limited company was charged to compensate the property owner those rental incomes that it had lost after declining to continue a previous rental relationship trusting that the negotiated contract would be agreed. The limited company was also charged to pay for the reconstructions made in the property that were demanded by the limited company.”¹⁰⁵

According to Hemmo, an unacceptable negotiation action refers to a situation where one of the parties has begun preparing actions without a real intention to conclude the contract or has presented false information during the negotiations, pressured the opposite side or otherwise acted inappropriately. Hemmo and Hoppu add that neglecting a party’s obligation to disclose information can also be, and usually is, an unacceptable negotiation action. Considering mergers and acquisitions, in such cases there usually incurs additional sanctions as the information handled and its completeness is so vital for valuing the transaction¹⁰⁶. Negation to mislead and a certain type of protection of confidence as manners of negotiations appear in the Finnish Supreme Court ruling 1999:48. In the statement of reasons the following was mentioned as general statements:

¹⁰⁴ Hemmo & Hoppu 2006, Hemmo 2008: 123

¹⁰⁵ Finnish Supreme Court ruling 2009:45

¹⁰⁶ Hemmo & Hoppu 2006, Hemmo 2008: 123

*“It is not allowed to proceed in contract negotiations so that the opposite side becomes misled or otherwise sustains damages. The side whose confidence and reasonable expectations generated from the contract negotiations has been offended is entitled to a compensation due to the offence to conclude an agreement. The compensation depends on the nature of the offence and how far in the agreement conclusion the parties had progressed”.*¹⁰⁷

In the third type of the responsibility of negotiating, the parties may have agreed on something special about the principles of the competition bidding or following other manners of proceeding or, for example, the division of the negotiating expenses. In addition, forming a negotiations contract that clarifies the methods to be used forms the responsibility of negotiating.¹⁰⁸

Saarnilehto presents another obligation that applies to contract negotiations and acting in them: obligation of loyalty. In the Finnish contract legislation, the obligation of loyalty refers to “the obligation to take the opposite sides interests into consideration to a reasonable extent without endangering one’s own contractual rights unreasonably”¹⁰⁹. Hemmo and Hoppu agree, and describe the responsibility as one that forbids a party in a legal act to solely pursue their own interests and that at the same time they also need to take into consideration the opposite sides rights and benefits. According to the researchers, the instance is also usually expressed in a way that considers the contract to be a common agenda for the parties, regardless of their opposing interests, and that both of their interests need to be taken into consideration evenly¹¹⁰.

According to Saarnilehto, a breach in the obligation of loyalty is seen as a restricted contractual offence and sometimes even as fraud. In a broad sense the obligation of loyalty appears in the contract negotiations, when fulfilling the

¹⁰⁷ Finnish Supreme Court ruling 1999:48

¹⁰⁸ Hemmo & Hoppu 2006, Hemmo 2008: 124

¹⁰⁹ Saarnilehto 2000: 129

¹¹⁰ Hemmo & Hoppu 2006

contract as well as evaluating a contract offence¹¹¹. This obligation can also come into consideration when interpreting mergers and acquisitions and the negotiations held on related contracts. After all, the transaction that is being negotiated is usually of such importance that it can affect the party's business and its success greatly. In addition, if a party, whether it is the seller or the buyer, acts against the obligation of loyalty, they set themselves in a position where their reputation as a negotiating party can be inflicted. This can affect their future business dealings.

In mergers and acquisitions the parties are usually expected to be equal and sensible negotiators that operate according to their own motives within the freedom of contract. Thus, the obligation to investigate and to disclose are imposed on them, the former to the buyer and the latter to the seller¹¹². Both are usually realized during the due diligence investigation. Mergers and acquisitions being primarily a purchase of goods, both the obligation to investigate and to disclose are applied according to the law regulating the purchase of goods. According to Blomquist et al., the obligation to investigate generally means "the buyers obligation to inspect the target of the purchase in such a capacity that the buyer can lose their right to appeal to a mistake in the target of the purchase due to not carrying out an investigation despite the chance to do so or otherwise inspect the target of the trade". Therefore, it is comparable to the demand of a justifiable sincere mind where the subject of investigation is whether "a person had known or should have known" about an issue affecting the deal or the target of the trade¹¹³. In the Finnish Sale of Goods act, Section 20, the following is stated:

*"The buyer cannot claim a matter to be a fault if they ought to have known of the fault while making the deal. If the buyer has inspected the item before the deal or without an acceptable reason neglected the sellers recommendation to inspect the item, they cannot claim a matter to be a fault that they should have detected during the investigation, assuming the seller has not acted in a way that is contrary to honor and without dignity."*¹¹⁴

¹¹¹ Saarnilehto 2000: 129

¹¹² Blomquist et al. 2001: 14

¹¹³ Blomquist et al. 2001: 14

¹¹⁴ Sales of Goods Act (27.3.1987/355)

In mergers and acquisitions the obligation to investigate is primarily considered to be fulfilled if a thorough person familiar with the field has decided to buy, after considering all issues affecting the deal. Neglecting the obligation to investigate does not impose sanctions to the buyer, but by neglecting the obligation, the buyer takes a conscious risk that “the deal binds them as it is regardless of a possible mistake”¹¹⁵.

The buyers obligation to investigate the target of the trade, usually in mergers and acquisitions to make a due diligence investigation, can be fulfilled in different ways. Blomquist et al. list five of these ways. The first way for the obligation to be fulfilled is through the buyer’s independent investigation. The second way is through the seller’s invitation to the buyer to inspect the target. The invitation can be either individual or general. This can be abdicated with an “acceptable reason” stated in the Finnish law of the purchase of goods but rarely comes into question in mergers and acquisitions. There are exceptions however, according to Blomquist et al., for example if the seller gives extensive guarantees and warranties or otherwise restricts the investigation. The obligation can also be fulfilled only by a chance given by the seller to carry out said investigation. However, the buyer can experience that they did not have “a real opportunity to carry out an investigation on the target of the trade” and later on appeal to the matter. Such circumstances restricting a real opportunity to carry out an investigation can be for example limited time available. A real opportunity to carry out an investigation is evaluated case-by-case. The fourth way for the obligation to be fulfilled is the buyer’s doubt of a breach of contract. In these cases, however, there must be a specific reason for the investigation. The fifth and last way for the obligation to be fulfilled is due to trading practice or an express stipulation¹¹⁶. As a result of the aforementioned issues, investigation of the target of the trade has become a main rule in the contract practices regarding mergers and acquisitions.

¹¹⁵ Blomquist et al. 2001: 15

¹¹⁶ Blomquist et al. 2001: 15-16

According to Blomquist et al., the seller's obligation to disclose means primarily that the opposing side has to be given accurate information on all issues affecting the deal that have significance to the opposing side and that can be presumed to affect one's decision to make a contract or fulfilling an obligation relating to it. Abdicating the obligation to disclose means either giving inaccurate information or withholding it. In addition, Blomquist et al. state that the more detailed the information the seller gives to the buyer about the target of the trade the more significance it has when evaluating the fulfillment of the buyer's obligation to investigate¹¹⁷.

However according to Annola, the use of superior knowledge is not always reprehensible. There is a chance to make use of the imbalance of information in contractual relations under certain circumstances. Annola mentions market economy as an example. It is built on the basis that everyone operating in it is pursuing the best possible contract from their point of view¹¹⁸. This is also the case in mergers and acquisitions and the related contracts in their negotiations. This should be evaluated together with the obligation of loyalty presented by Saarnilehto and find a balance between the two. Hemmo adds that the obligation to disclose information usually means that either the deal or the negotiation circumstances become more unfavorable to the one disclosing the information, in mergers and acquisitions the seller, than they would be without the obligation. However, failing to disclose information, especially of a significant type, can break the trust between the parties, so giving out the necessary information is usually the better option for the seller¹¹⁹.

The selling party in a merger or an acquisition is also considered to have complete information about the company's wealth and business, according to Blomquist et al.. Therefore, the buyer usually has the right to presume that the seller informs them about any deviating properties in the target of the trade. In addition to this, in mergers and acquisitions the seller is often considered to have an "active obligation to disclose concrete issues regarding the target of the

¹¹⁷ Blomquist et al. 2001: 16

¹¹⁸ Annola 2005: 67-68

¹¹⁹ Hemmo 2003: 276, 278

trade”¹²⁰. However, general praise of the company, the seller’s opinion or inexact or indistinct information does not usually cause the seller to be liable for the error. In other words, the context and circumstances affect the buyer’s right to trust the information given out by the seller¹²¹.

Blomquist et al. state that if the seller urges the buyer to investigate the validity of the information given by the seller while giving out said information, regardless of how concrete or detailed it is, “neutralizes the given urge to investigate the meaning of the information given in relation to the guarantees and warranties of the seller and thus their liability for damages”. Holding the information available is usually not enough though. In mergers and acquisitions the seller can also have, in addition to the active obligation to disclose, an obligation to correct information deemed inaccurate given to the buyer or the buyers incorrect impression about the target of the trade. However, the obligation to correct is conditioned on that the seller knows about the inaccuracy of the information they have given or about the incorrect impression the buyer has.¹²²

4.2. Application order of the norms

Most of the legislation considering business agreements are optional noncompulsory rules. This is also the case in mergers and acquisitions. This means that the negotiating parties can displace the legislation impacting said legal relationship with contract stipulations and terms. The regulations of law apply only if nothing else has been agreed. Because of the practical impossibility to create such legal provisions that would make effective and appropriate acts possible in every sections of business, the Finnish legislators have only enacted laws considering business deals that are general, and have left the rules affecting

¹²⁰ Blomquist et al. 2001: 16

¹²¹ Annola 2005: 67-68

¹²² Blomquist et al. 2001: 17-18

specific lines of businesses to be considered through contract practice in said line of business. Mergers and acquisitions are one such line of business. However, if certain contract stipulations have not been taken into consideration in a business deal, optional non-compulsory legislation come into effect.¹²³

There are several norms applied to mergers and acquisitions and their contracts, which usually have different content and therefore are in contradiction with each other, as addressed before. In order for a company to be able to make effective use of the concluded contracts as risk management, they must recognize the order in which the norms are applied to the contracts. First is the imperative legislation, which precedes everything else. As so, imperative legislation cannot be substituted with contract stipulations. If there is contradiction between the two, the contract stipulations are ignored, and the imperative provisions shall be applied instead.¹²⁴

However, as mentioned before, there is usually no imperative legislation in contracts concluded in business, as the parties are usually equal in power and position or at least so close to each other that one does not have an overwhelming power over the other. This is true to mergers and acquisitions. In practice, almost any legislation impacting the transaction can be substituted with contract stipulations and terms. This includes everything from the Sale of Goods Act to the Contracts Act. However, if a dispute between the parties arises, there are certain provisions that apply, for example provisions considering liability for damages.

Next in the order of application is contract stipulations agreed by the contract parties involved. They can displace anything else, except for imperative legislation, as was demonstrated above. Parties of a business negotiation have the freedom to draw up the contract stipulations applied to their legal relationship. This can be clearly seen in mergers and acquisitions as the final contract itself and the ones agreed before it vary in form, content and legal

¹²³ Hemmo & Hemmo 2006

¹²⁴ Hemmo & Hemmo 2006

liability among others. If a dispute between the two parties proceeds all the way to a court or arbitrary, as is usually the route in mergers and acquisitions, the contract stipulations agreed by the parties are applied as the norms regulating the case instead of any optional non-compulsory legislation. This way a company can significantly affect their legal position in their business environment¹²⁵. This is highlighted in mergers and acquisitions where the impact of the deals are usually highly significant both for the parties as well as the market they are a part of. An active negotiating party can make use of the freedom and increase their stakes in given situations.

Third in line in the order of application are established practices between the parties, which displace optional legislation and its norms. The idea behind established practices is that the parties would not have to specifically agree on certain manners of proceedings during the contractual relationship, rather it could be formed into a norm during the legal relationship through the adopted established practices¹²⁶. This, however, does not apply very well into mergers and acquisitions as the contractual relationship is usually a non-recurring transaction. One situation that can be an exception is where the parties have made similar deals in the past, for example a company acquiring another in sections or during a long period of time. In such case the same parties may agree similar contracts and divisions of liabilities and responsibilities multiple times which can mean the formation of an established practice between the two parties. This can, however, be hard to prove afterwards.

After established practices, in line is trading practice prevailing in the field. However, a trading practice must be generally known in the field and established in order to be considered as a source of law. In mergers and acquisitions these are for example the due diligence investigation and the different non-disclosure-agreements. Sending out an information memorandum to auction members and agreeing on a letter of intent can also be considered as trading practices of the field in question. If either one of them are excluded from the process, there is usually a specific reason for this. All the above are discussed in more detail in the

¹²⁵ Hemmo & Hemmo 2006

¹²⁶ Hemmo & Hemmo 2006

next chapter. Trading practices can be deviated with contractual stipulations. In practice it is possible to appeal to a trading practice, especially when there is no specific legislation regulating the contract type in use. In such cases the contractual relationship is evaluated based on general contract law principles and trading practices.¹²⁷

The last one in line in the application order of norms applied to contracts is optional non-compulsory legislation, according to Hemmo and Hoppu. In most contract types concerning business, there is no optional noncompulsory legislation but concerning mergers and acquisitions there is some¹²⁸. These are for example the Sale of Goods Act and the Contracts Act. As mentioned before, the parties can substitute these with contract stipulations and terms, but they can also be explicitly included in contracts so that they cannot be substituted. Some terms in said legislations can be highly useful for a negotiating party and in consequence, they may want to include them so that they come into application. The reason can be anything from gaining advantage or just a party wanting to protect themselves from possible risks and liabilities. In addition to the legislation, stipulations and practices mentioned above, legal practice or case law as well as the application of principles of contract law from laws specifically mandated to certain contract types can be used as sources of law, also in mergers and acquisitions and related negotiations.

¹²⁷ Hemmo & Hemmo 2006

¹²⁸ Hemmo & Hemmo 2006

5. STARTING THE NEGOTIATIONS

5.1. Negotiations of mergers and acquisitions in general

Mergers and acquisitions usually include rather long negotiations before concluding the final sales contract and the actual transaction taking place. Both the seller's and the potential buyer's position depend heavily on the target of the trade and the chosen process form of the transaction. In the beginning of the negotiations, a buyer tries to position itself regarding the other potential buyers with different kind of contracts, while the seller wants to protect its trade secrets from leaking to competing companies. In addition to this, the buyer wants assurance that it has a real possibility to actually see the finalization of the transaction and justify their usage of resources to the negotiations. The seller, on the other hand, wants to be sure that the potential buyer is in fact serious with their claims, and tries to maximize their profit from the deal. According to Katramo et al., in this stage the parties try to unify their views so that the possible due diligence investigation can even come into question¹²⁹.

If the parties have advanced to the stage that the buyer or buyers are to begin the due diligence investigation, they have almost certainly already invested a significant amount of resources to the process. In addition, executing a due diligence investigation, even a light one, requires more resources. This is why it is important that the parties have as unified views of the potential trade taking place as possible and that the buyer candidate or candidates are in fact, the best ones.

The best buyer candidate for the seller is determined, amongst other things, through the price of the trade, the financial capacity of the buyer and other terms agreed in the negotiations, according to Katramo et al.. These can be, for example, the division of liabilities and responsibilities after the trade or the pace of the

¹²⁹ Katramo et al. 2013

process. The position of the seller is improved if they can deduce at an early stage if the buyers pricing is based on synergy benefits, as discussed earlier, or if they can utilize some kind of debt leverage in the transaction at hand. Finding out the motives of the buyer gives the seller a view of the mind of the buyer which can help them during the negotiations¹³⁰. Frankel and Forman agree and say that determining a list of potential buyers can be difficult. The researchers say that the seller will usually first turn to its direct competitors, which is natural, however the best candidate may be from a completely different line of business. Therefore, the seller needs to consider potential buyers from several industries with which it is not necessarily familiar with. It also needs to consider all the different reasons that a company may have in order to do the deal, this is to say if the motive is synergy benefits or just profits, as mentioned also by Katramo et al.¹³¹.

In addition, Frankel and Forman mention the way the potential buyer is going to integrate the seller's business to its own as a factor the seller may want to consider. This happens usually when the seller is the original owner and founder of the company and the company holds a sentimental value to the seller. A company considered only with maximizing the shareholders' value will simply choose the buyer that is prepared to pay the highest price for the company. Lastly, the researchers mention that it may be more beneficial for a seller to choose a buyer that is experienced in mergers and acquisitions and uses them as a strategic tool, although it is always possible to deal with a first-time buyer¹³². Dealing with an experienced party can decrease the expenses of the negotiations by speeding up the process and increase the trust in the buyer, however it can also mean harder negotiations for the seller as the buyer will know what they are doing and what instruments to use to their advantage.

From the buyer's point of view, the value of the target of a successful trade is determined during the negotiations. It is affected by both the targets individual capability of making a profit as well as the synergy benefits from the trade. These

¹³⁰ Katramo et al. 2013

¹³¹ Frankel & Forman 2017

¹³² Frankel & Forman 2017

are determined with the different contractual instruments used in the negotiations, with which the negotiating parties gather information of each other and increase their trust in one another through dividing liabilities and agreeing on different terms. This means, according to Katramo et al., that a successful negotiation process needs elaborate preparation, right analysis of the given information, a clear negotiations tactic and an understanding of the other party's strategic and tactical goals. An open and trusting atmosphere furthers an efficient negotiations process.¹³³

In the trade negotiations the negotiating parties have different kinds of contractual instruments to use in different stages in the negotiations. With them they can position themselves juridically, control the risk arising from the transaction and its contracts and aim to the best possible contract from their point of view. The contractual instruments applied to the negotiations that can be used differ from one process form to another.

5.2. In the beginning of the negotiations

As merger and acquisition negotiations are almost always a significant and expensive process for both parties, it is usually wise to enter into a negotiation contract in the beginning of them¹³⁴. A negotiation contract can be used in any form of merger or acquisition and all of the process possibilities, even though in deals concluded by auction it usually comes into question when the negotiating parties have been limited to one or in some cases, a few candidates. According to Hemmo, a negotiation contract does not have an independent commercial meaning, rather it serves as a tool in the pursuit of the actual trade contract. A negotiation contract also decreases the legal uncertainties during the negotiation phase¹³⁵.

¹³³ Katramo et al. 2013

¹³⁴ Hemmo & Hoppu 2006

¹³⁵ Hemmo 2008: 616

Terms that can be included in a negotiation contract are for example the previously mentioned principles guiding the negotiations or the division of the expenses occurred during the negotiations in case the negotiations do not lead to a trade contract. This is especially useful and important for the party that is required to invest more resources to the transaction, in the form of investigation for example, than the counterparty. A negotiation contract can also focus on the way the contract should be agreed, the process of solving a dispute, exclusivity or the terms of confidentiality¹³⁶.

Exclusivity can already be agreed on in a negotiation contract, as per Hemmo and Hoppu, or later on during the negotiations as Hemmo suggests¹³⁷. Regardless of the timing, an exclusivity contract commits the other participant, in this case the seller, not to enter into negotiations regarding the same deal with outside sources. This especially is in the interest of the buyer. According to Hemmo, with an exclusivity contract the buyer can for example “buy time” in connection with a purchase offer as the elimination of other competing offers increases the motive to invest in the negotiations process. An exclusivity contract is also a useful contract instrument when a final trade deal is likely to be agreed on and the participants want to decrease the amount of uncertainties around the negotiations¹³⁸.

Hemmo adds however, that an exclusivity contract does not in its basic form eliminate the right of a participant to withdraw from the negotiations with the other contract partner, and later on enter into negotiations with a third party. The author states that the issues of liability regarding an exclusivity contract usually revolve around the compensation of negotiation expenses deemed unnecessary¹³⁹. Miller and Segall go as far as to say that especially the seller should not in any case agree to an exclusivity contract or term that limits the flexibility to terminate the engagement¹⁴⁰. However, agreeing to an exclusivity contract increases the trust between the partners which increases the chances of

¹³⁶ Hemmo & Hoppu 2006

¹³⁷ Hemmo & Hoppu 2006; Hemmo 2008: 619

¹³⁸ Hemmo 2008: 619

¹³⁹ Hemmo 2008: 620

¹⁴⁰ Miller & Segall 2017

arriving to a mutually beneficial final contract, which is why it can also be seen as a useful contractual instrument for the seller. Frankel and Forman explain this by stating that some buyers will exit the process if they cannot get the seller to agree to exclusivity¹⁴¹.

Confidentiality can also be agreed in connection with a negotiation contract but in mergers and acquisitions it is beneficial, especially to the seller, to separate it from other contracts or agreements to highlight its importance. Miller and Segall say that in mergers and acquisitions, the issue of confidentiality is “extremely important and delicate”¹⁴². A confidentiality agreement, or a non-disclosure agreement, is a contract usually included in the early stages of a merger or acquisition. The contract is used in every form of mergers and acquisitions and all of the process possibilities almost without exceptions¹⁴³. In direct negotiations a non-disclosure agreement is made at the latest before the investigation of the company to be bought is allowed, whereas in auctions it is usually signed before the sales brochure alias the information memorandum, is done¹⁴⁴. Whichever the case is, the obligations of a non-disclosure agreement are realized at the latest when the buyer candidate or candidates proceed to go through their investigation of the target company, in other words the due diligence process¹⁴⁵.

A non-disclosure agreement and the secrecy obligation coming into effect because of it can cover the fact that negotiations are being held as well as the concealment of trade secrets or other similar information gathered during said negotiations, according to Hemmo¹⁴⁶. Miller and Segall agree and say that a non-disclosure agreement, in essence, says two things: firstly, that the recipient of the confidential information agrees to keep the information confidential and not to disclose it to anyone other than on a need-to-know basis and to only those who themselves have signed the actual non-disclosure agreement, and secondly, that the recipient agrees not to use the confidential information for any other purpose

¹⁴¹ Frankel & Forman 2017

¹⁴² Miller & Segall 2017

¹⁴³ Miller & Segall 2017, Katramo et al. 2013

¹⁴⁴ Katramo et al. 2013

¹⁴⁵ Huhtamäki 2014: 276

¹⁴⁶ Hemmo 2008: 618

than in connection with the proposed transaction¹⁴⁷. Vapaavuori states that a non-disclosure agreement is a quite standardized contract, especially in mergers and acquisitions, even though the terms can vary case by case if need be. The author generalizes five different parts that can be found in almost every non-disclosure agreement. The parts are party information and opening phrases as well as the scope of application, the definition of confidential information, obligations of secrecy and usage restrictions and their exceptions, measures to ensure confidentiality and lastly, terms regarding special issues and ending phrases¹⁴⁸. A specific ending phrase in non-disclosure agreements used in mergers and acquisitions is often the means to resolve a dispute, which almost always is arbitration¹⁴⁹.

According to Vapaavuori, questions regarding secrecy obligations do not differ that much whether the transaction is a stock trade or the purchase of business. The most notable difference is that the parties may be different legal subjects. When a business is purchased the seller is the company in whose name the non-disclosure agreement is also made. When trading stocks, the sellers are the target company's stockowners. In this instance, the non-disclosure agreement may be made both in the name of the company as well as the said stockowners personally¹⁵⁰. The parties ought to also think who they can share the information at hand with, Hemmo adds. Different commercial, legal and technical advisors are commonly used in mergers and acquisitions and it is important to outline their right to use the confidential information¹⁵¹.

As addressed before, in mergers and acquisitions the buyer candidate is usually a competitor to the seller, for instance in industrial mergers and acquisitions. Therefore it is in the interest of the seller, in addition to protect the information from ending up in the hands of outsiders, to prevent the exploitation of the information by a competitor. Mergers and acquisitions can break down due to a variety of reasons and in such instance depending on the negotiation phase, a

¹⁴⁷ Miller & Segall 2017

¹⁴⁸ Vapaavuori 2005: 187

¹⁴⁹ Katramo et al. 2013

¹⁵⁰ Vapaavuori 2005: 141

¹⁵¹ Hemmo 2008: 618

different amount of trade secrets and other useful information might be at the hands of a competitor¹⁵². Due to this, a breach of contract -clause is usually added to a non-disclosure agreement. Usually the clause is formed so that the party that has experienced a loss is “to be reinstated to a state where they would be if the breach of contract would not have occurred”, according to Katramo et al.¹⁵³.

However, no non-disclosure agreement can compensate the significance of protecting one’s trade secrets, which is why the seller should give out information and material in phases as the negotiations proceed and the trust between the parties grows stronger and thus, the probability of the finalization of the transaction increases¹⁵⁴. Miller and Segall agree to this and add that especially the seller must realize that even the tightest non-disclosure agreement is “just a piece of paper” and that if the agreement is violated by a potential buyer in situation where the transaction falls through, the fact may not ever become apparent and even if it would, it would be extremely difficult to prove it¹⁵⁵. The Finnish legislation has addressed this problem and in 2018, the Law of Trade Secrets was passed, which specifies the circumstances which are to be considered as a breach of confidentiality in trade secrets and defines the sanctions applied in such situations¹⁵⁶.

Vapaavuori adds that a strict confidentiality agreement can also be in the interest of the final buyer. For example, in a merger or an acquisition made through auction there are several buyer candidates and the seller usually discloses sensitive material to all of them. In such instance, a strict confidentiality agreement can protect the “losing” candidates’ possibility to exploit the information and secure the competitive advantage that the buyer sought after through the transaction in the first place¹⁵⁷. Frankel and Forman agree and add that while a non-disclosure agreement primarily protects the seller, it also provides some protection to the buyer during the negotiations, as the buyer also

¹⁵² Hemmo 2008: 618; Vapaavuori 2005: 140

¹⁵³ Katramo et al. 2013

¹⁵⁴ Miller & Segall 2017, Vapaavuori 2005: 140

¹⁵⁵ Miller & Segall 2017

¹⁵⁶ Law of Trade Secrets 595/2018

¹⁵⁷ Vapaavuori 2005: 141

may need to disclose some sensitive information about its business to the seller. In addition, the intention of buying the targeted company itself is valuable information from the buyer's part as it is an indication of its motives on the market which it may want to keep quiet during the negotiations¹⁵⁸.

A non-disclosure agreement has a particular purpose if one or both negotiating parties is a publicly listed company. According to Katramo et al., the knowledge of the possible merger or acquisition or the negotiations regarding them can be considered as insider information that is to be included in a non-disclosure agreement. That being said, in an instance where only the buyer is a publicly listed company, it may be in its interest to agree on a non-disclosure agreement in order to prevent the leaking of information regarding the possible trade to the public from the seller's part¹⁵⁹. Huhtamäki agrees and emphasizes the significance of a non-disclosure agreement regarding publicly listed companies as "market rumors" can have considerable effect to the merger or acquisition parties' market value¹⁶⁰.

According to Katramo et al., in mergers and acquisitions made through auction, both restricted and open ones, the seller usually draws up a sales brochure, in other words an information memorandum, after the initial confidentiality agreement. The purpose of an information memorandum is to present the target company to the participants of the auction and wake their interest towards said company. It can include among other things a description of the company's business, products, customers, markets or for example financial success.¹⁶¹

Frankel and Forman state that an information memorandum can be, and usually is, also used in one-on-one negotiations. The contents of an information memorandum does not have a prescribed form, however it usually includes more detailed financial data and an overview of the business and operations as

¹⁵⁸ Frankel & Forman 2017

¹⁵⁹ Katramo et al. 2013

¹⁶⁰ Huhtamäki 2014: 276

¹⁶¹ Katramo et al. 2013

well as the company's key assets. In a way, an information memorandum serves as a precursor to a full due diligence investigation. Although an information memorandum does not usually contain any sensitive information, a confidentiality agreement, as addressed above, is usually demanded before a participant can familiarize themselves with the document¹⁶².

An information memorandum can also be understood to be a part of the marketing material, although it can also affect the responsibilities of the trade and its parties, according to Katramo et al.. In the Finnish Sale of Goods Act it is stated that there is a fault in the object of the trade if the object of the trade does not reflect the information that the seller has given out about its attributes or usage and the information is assumed to have affected the trade. A similar interpretation can be made if the seller neglects their obligation to disclose such information about the attributes of the object of the trade that can be assumed to affect the trade and which of the seller ought to have known about and the buyer could have assumed to be informed about¹⁶³. However, according to Blomquist et al., the seller often refuses the responsibility regarding the information memorandum as the buyer candidates themselves have the chance to check the company and its attributes by completing a due diligence investigation¹⁶⁴. That being said, in order to avoid these responsibilities the seller has to urge the buyer candidates to a certain type of inspection, as mentioned before.

Even before the signing of a confidentiality agreement and giving out an information memorandum to the selected party or parties, when the seller is the one making the approach to the potential buyers, they usually send out a document called a teaser. The purpose of the teaser is to inform the recipients of the seller's intentions of selling. A teaser is usually a one- to two-page document that includes some basic information about the business and gives a "very high level" description of the business that is for sale.¹⁶⁵

¹⁶² Frankel & Forman 2017, Katramo et al. 2013

¹⁶³ Sales of Goods Act (27.3.1987/355)

¹⁶⁴ Blomquist et al. 2001: 13

¹⁶⁵ Frankel & Forman 2017

6. LATTER STAGES OF THE NEGOTIATIONS

6.1. Letter of intent

As the negotiations have proceeded from a negotiation contract and a confidentiality agreement, among others, to a situation that the parties can for some parts agree on the possible final result, it is common in mergers and acquisitions to form a letter of intent. The purpose of a letter of intent is for the buyer to express their willingness to buy the target company and define some main features of the possible final trade contract. A letter of intent can also be used, to the advantage of the potential buyer, as a tool to prevent the seller to “shop” the company to other candidates. This means that the seller cannot seek or enter into discussions with other bidders or potential buyers for a specified period of time¹⁶⁶. However, in order for this term to come into effect, it must be explicitly mentioned in the letter of intent.

A letter of intent is not, however, a contractual instrument that binds the parties to agree to complete a final trade contract such as the preliminary contract, although its interpretation can lead to the compensation of expenses used on the negotiations of a possible trade that ultimately broke down¹⁶⁷. In addition, in a letter of intent the parties can also agree on the extent of the sellers contribution to research and negotiation expenses, for example in an instance where negotiations are being held with multiple buyer candidates and the deal is not made with the other party of the letter of intent, says Katramo et al.. This commitment to compensate a losing candidates expenses used for the negotiations decreases the threshold to take the risk of expenses and encourages to continue said negotiations even though succeeding in merger and acquisition negotiations is uncertain¹⁶⁸.

¹⁶⁶ Miller & Segall 2017

¹⁶⁷ Hemmo 2008: 150

¹⁶⁸ Katramo et al. 2013

The contents of a letter of intent is agreed on case by case, although according to Katramo et al., there are a few terms that are usually included in the contract. The first thing in a letter of intent is often a description of the company, which is the target of the merger or acquisition. An initial price is also usually included in a letter of intent. The price is based on previously mentioned matters that the two parties have already agreed on. The negotiations period of validity, in other words, the date that the final trade contract can be signed, is also written in a letter of intent. The negotiating parties usually agree the transaction to be conditional to a due diligence investigation. This can be mentioned in a letter of intent. The method to resolve disputes as well as various liabilities to damages may be agreed on in the terms of a letter of intent¹⁶⁹.

In conclusion, the more there is information and terms already agreed in the letter of intent, the more trust it builds and therefore can help the process to evolve. This can be useful and even vital, particularly to the seller. Miller and Segall point out that in their view, the seller should try to get as much information and detail into the letter of intent as possible. This means key economic points as well as legal aspects. There is a lot of potential pitfalls in the process of mergers and acquisitions and often the seller's strongest point of leverage is at the beginning of the negotiations as it has the most information and the power to use it. Here, a definitive letter of intent serves as a considerable tool¹⁷⁰.

However, the negotiating parties have to be careful not to include all elements and terms of a binding contract in a letter of intent, or at least the full unanimity between the two parties of the subjects mentioned above if they want to preserve aspect of inconclusiveness associated with the letter of intent. In the Finnish Supreme Court's decision number 1996:7, a document intended to be a letter of intent was seen as a binding preliminary contract in a sale of a company's shares, as it included some of the aforementioned elements:

"The letter of intent agreed between the parties was unambiguous and highly detail oriented. The contract text consisted of all essential

¹⁶⁹ Katramo et al. 2013

¹⁷⁰ Miller & Segall 2017

terms of the trade. The target of the trade was precisely identified and the trade price as well as the time of the trade was determined. Furthermore, the target and the terms of the rental agreement in the letter of intent was identified with details in the contract. Considering this, as well as the fact that there was a trade contract with all its terms attached as an appendix in the contract, it can be determined that the contract was, based on the wording, a unambiguously binding preliminary contract of a share deal.”¹⁷¹

Annola, however, sees the lack of commitment regarding a letter of intent a problematic attribute in certain situations, as it can create mistrust even though the purpose is fulfilling the obligation. In response, the author has sketched an interesting contract instrument to be used in the negotiations phase of a trade which purpose is “to help reach the main contract through supporting the negotiations”. The meaning of the instrument is to create trust between the partners through sharing information and creating tools to support the negotiations. Consequently, a binding contract is not needed in order to reach a trusting relationship between the parties. To entities negotiating about a merger or an acquisition, this is instrumental. Annola has named the contract instrument as Relation Plan Document, alias RPD. The tools of the RPD include the main contracts core conditions which are in the center. The center is surrounded with the shared vision of the parties, individual overall arrangement and operating environment which form the surroundings of the coming main contract as well as the terms that regulate the negotiations.¹⁷²

According to Annola, the RPD’s core conditions and the visions interaction form its central dynamic as they indicate the starting point of the negotiations and the goal of them. However, a contract is always evaluated as a part of its environment. In the RPD this is done by including the document with clauses that support the content creation of the main contract. In turn, the clauses are formed in relation with the operating environment as well as the individual overall arrangement formed by the contract¹⁷³. By using the mentioned tools together, the transaction negotiating partners have a possibility to picture the final main contract without actually committing to signing it. This can act as an

¹⁷¹ Finnish Supreme Court ruling 1996:7

¹⁷² Annola 2016: 6-8

¹⁷³ Annola 2016: 8-9

encouraging element to continue the negotiations and striving for the final contract.

6.2. Preliminary contract

A merger or an acquisition can also be made in two phases. In this case, the negotiating parties form a so-called preliminary contract in which they agree to form the final contract. The reason behind the willingness to make such a contract is, for example, that the negotiating parties want to ensure that the final contract will be made even though all the information needed is not available. The seller of the company can also be hesitant to let the buyer candidate to make the due diligence investigation if the preliminary contract is not signed. If the buyer candidate has signed a preliminary contract, they have forfeited the right to refuse the purchase of the company, assuming that the investigation does not bring forward any extraordinary information that could affect the trade¹⁷⁴.

The preliminary contract is also a contractual instrument that reduces the uncertainty caused by the negotiations. The parties may have a need to undertake actions that create costs. This is where a preliminary contract can be used to commit the other party to pursue the final contract. In this instance, the topics already agreed upon considering the final contract can be included in the preliminary contract, even though the parties are not yet ready to enter into the final contract with all its details. The responsibilities of a party that has entered into a preliminary contract are not restricted to only the negotiation costs, in the case they refuse to agree the final deal. The party that has been refused of the final contract is also eligible for “the financial benefit that the final contract represents”¹⁷⁵.

¹⁷⁴ Hemmo & Hoppu 2006

¹⁷⁵ Hemmo 2008: 142

As mentioned before, a preliminary contract is binding and as such, a stronger contractual instrument than a letter of intent. Consequently, a preliminary contract is formed with just one buyer candidate either in straight negotiations or when the participants of an auction have reduced to one instance. A preliminary contract must also have a specific enough description of the contents of the final contracts that is targeted. According to Saarnilehto, a preliminary contract is not binding if it does not portray what kind of a contract the two parties are striving for. A preliminary contract is also not binding if it is dependent on a condition, for example acquiring funding for the merger or acquisition, and the condition is not fulfilled¹⁷⁶. This is a highly useful instrument, especially for the buyer as it promotes trust between the parties but is not absolutely binding.

According to Hemmo however, the obligations that a preliminary contract brings to the parties can have two problem areas. First of all, a preliminary contract can be made on a precondition concerning the future, for example gathering funding as mentioned above, that may not be fulfilled for a variety of reasons, as discussed above. Secondly, the negotiating parties may not arrive to an agreement of the remaining contractual factors that were left open. In such case, the contract either becomes void due to the lack of mutual understanding or it is supplemented with terms decided with another instance than the parties themselves. In principle, the effects of the terms not being fulfilled in a preliminary contract do not vary much from the effects of any other contract's binding factors, but Hemmo states that the practical relevance can be bigger due to the higher number of details left open. Changes to the preconditions must also be significant to have effect on the obligations, as contracts normally include a reasonable amount of risk. This is the case especially in mergers or acquisitions. In addition, the lack of consensus of certain details does not prevent the parties from forming the final contract. In such instance, according to Hemmo, the centrality of the open details and the possibility of supplementing the contract based on optional provisions comes into consideration.¹⁷⁷

¹⁷⁶ Saarnilehto 2005: 70-71

¹⁷⁷ Hemmo 2008: 143-144

If a preliminary contract is made binding and the other party refuses to fulfill it voluntarily, the other party can either demand fulfilling the contract, a settlement based on the preliminary contract or compensation of damages. However, a negotiating party cannot always demand any of the above, for example when the nature of the contract is such that the other party cannot be forced to act according to the contract. Commonly such case is solved with the compensation of damages, as is done in mergers and acquisitions, even though it can also be used as an additive to other claims.¹⁷⁸

6.3. Due diligence investigation

The due diligence investigation is one of the most important and largest individual instruments in the negotiation phase of a merger or acquisition and an established custom regarding mergers and acquisition, even though executing it is not regulated by any individual law or provision. In practice, a due diligence investigation is performed through interviews and turning over information in the so called "data room", in other words a location online where electronically saved documents can be read. According to Katramo et al., the purpose of a due diligence investigation for the buyer is the ascertainment of the presumptions regarding the target company and its operating environment that can affect the terms of the merger or acquisition and in certain situations, the finalization of the whole trade¹⁷⁹. Blomquist et al., phrase that its primary purpose is "to give the buyer a clear picture of the target company and its value as well as decrease the risk possibility of unknown responsibilities"¹⁸⁰.

Usually the due diligence investigation is a preliminary examination of the target of the merger or acquisition but it can also be divided into several phases. As the process moves forward, the seller turns over more information in general and with more details about the company being bought. Katramo et al. state that a

¹⁷⁸ Saarnilehto 2005: 71

¹⁷⁹ Katramo et al. 2013

¹⁸⁰ Blomquist et al. 2001: 18

due diligence investigation is more concise if the transaction is a simple business purchase compared to an inspection regarding an international conglomerate¹⁸¹. According to Blomquist et al., the size of the company being bought can also have a contrary affect. When the company being investigated is small, the buyer is assumed to execute a more detailed due diligence investigation than a buyer acquiring a large company¹⁸². Certain lines of businesses can also presuppose a more in-depth inspection, for example due to intellectual property or environmental factors. These types of business lines can be for example high technology fields or industries handling chemicals¹⁸³.

The extent of due diligence investigation is also dependent on whether the transaction is a business purchase or a stock trade and the type of the buyer. According to Bäck et al., when the buyer is a private equity investment firm, the due diligence investigation is usually more comprehensive and standardized as to an inspection performed by an industrial buyer. An industrial buyer has a deeper knowledge of the field at hand and its risks, markets, customers as well as the suppliers and as a result, the buyer can identify more specifically which areas the inspection ought to be focused on. In a merger or acquisition made through a stock trade the due diligence investigation is usually also larger compared to an inspection made regarding a business purchase which is almost always more concise.¹⁸⁴

As mentioned before, a due diligence investigation can cover different areas of a company and the segments investigated vary from transaction to transaction. According to Bäck et al. however, four of the most usual segments investigated can be identified. These are financial, tax, commercial and legal aspects. The purpose of the financial due diligence investigation is to ensure the accuracy of the financial information the seller has provided as well as to seek specificity and a more in-depth understanding of said information to help make the purchase decision and to proceed in the negotiations. In a financial due diligence

¹⁸¹ Katramo et al. 2013

¹⁸² Blomquist et al. 2001: 21

¹⁸³ Katramo et al. 2013

¹⁸⁴ Bäck, Karsio, Markula, Palmi 2009: 60-62

investigation the buyer examines, among others, critical subjects affecting the trade and the value determination, funding needs of the target and the trade, subjects that have to be considered in the final contract as well as issues affecting the seizure and integration.¹⁸⁵

The purpose of a tax due diligence investigation is to gather a representation of the tax position of the company in order to determine its ability to make profit as well as its value. A well performed tax due diligence investigation gathers useful information about the tax position of the target and its situation regarding payment of taxes, possible tax risks and the possibilities to perform tax planning. The goal of a commercial due diligence investigation is to determine the target company's operating environment and the market position in it from a business point of view. According to Bäck et al., in practice this means analyzing the turnover in order to understand the risks of its development.¹⁸⁶

In a legal due diligence investigation, the buyer determines the rights, responsibilities and obligations regarding the target company and the possible factors restricting their transfer. The possible obstacles of the trade are also determined in a legal due diligence investigation. Also, subjects regarding the determination of the target, information affecting the purchase price as well as issues affecting the negotiation position are sought after¹⁸⁷. According to Katramo et al., a legal due diligence investigation consists of familiarizing with, for example, the board of directors and the organization, company law documents, contracts and obligations, intellectual property rights, staff subjects, juridical proceedings and their threats as well as conditions regarding competition law¹⁸⁸.

The information gathered from the aforementioned parts of the due diligence investigation can also be divided into four general groups according to their importance to the merger or acquisition and their negotiations. The first group is

¹⁸⁵ Bäck et al. 2009: 59, 64

¹⁸⁶ Bäck et al. 2009: 79, 96

¹⁸⁷ Bäck et al. 2009: 92

¹⁸⁸ Katramo et al. 2013

the so called “deal breakers”, which mean the issues that can endanger the whole transaction. The second group consists of issues that “in essence affect both the determination of terms in negotiations as well as the price”. The third group is the issues that affect the structure and the last group the things that affect the sales contract¹⁸⁹. The division can help the instance executing the investigation to analyze the gathered information and through that, position themselves better in the negotiations.

A due diligence investigation can also be conducted by the seller. This is called a vendor due diligence and its popularity has risen in Finland during the last 10 years. A vendor due diligence investigation is an investigation performed by the seller that is given out to the buyer candidates that have advanced in the auction process, although it can also be useful in direct negotiations. The primary purpose of the investigation is to speed up the merger or acquisition process and to increase the trade price. The authors state that the benefits of a vendor due diligence investigation include a better preparation to the critical questions from the buyers, the possibility to fix issues rising up during the inspection before contacting the buyer candidates, a better ability to compare different purchase offers as well as a better control of the selling process. It can shorten the selling process and decrease the burden on the seller’s organization inflicted from the merger or acquisition process.¹⁹⁰

The buyers aforementioned obligation to request information comes to realization during the due diligence investigation as the buyer familiarizes themselves with the target of the company basically without limitations. According to Blomquist et al., a due diligence investigation has been seen to mean “at least that the buyer has in fact detected what he was ought to detect according to the Sale of Goods Act”. A well-executed due diligence investigation increases the buyers awareness and decreases the sellers liability for errors¹⁹¹. A possible vendor due diligence investigation conducted by the seller has the same affect. In addition, the non-disclosure agreement’s terms come into realization in

¹⁸⁹ Blomquist et al. 2001: 19

¹⁹⁰ Bäck et al. 2009: 114

¹⁹¹ Blomquist et al. 2001: 22-23

connection to the due diligence investigation. Because of this, Katramo et al. emphasize that the investigation should contain only the information that is needed to make a purchase offer, and any unnecessary trade secrets should not be revealed as it could cause harm to the company. This can be protected with the non-disclosure agreement¹⁹².

In practice the due diligence investigation is a contractual instrument that supports decision making and one that helps determine the target company's value and its attributes, but it can also serve as a tool for the seizure of the trade and its integration. The investigation is present almost all the way of a merger or an acquisition process as it generates more information the further the negotiations go. The execution of a due diligence investigation usually begins when the negotiations process has proceeded to a preliminary agreement of the final sales contract or, after a letter of intent if a preliminary contract is not deemed necessary. According to Katramo et al., after a due diligence investigation the only thing left to do is to sign the final contract, as long as the effects of the subjects risen up in the inspection have been addressed and the possible consequences agreed on¹⁹³.

¹⁹² Katramo et al. 2013

¹⁹³ Katramo et al. 2013

7. CONCLUSIONS

A merger or an acquisition is a functional way for a company to complete their financial and strategic goals in their respective field, whether it is a case of a private equity investment firm driven purchase, industrial expanding or selling a unit deemed unnecessary. They are a great and often faster alternative to internal growth targets and offer a number of different possibilities to companies that choosing to take part in them. They are also a sufficient way of letting go of a business when a traditional change of generation is not possible for some reason. Because of this, in recent years the number of mergers and acquisitions carried out in Finland, as well as internationally, has grown significantly.

However, a merger or an acquisition is practically always a long and complex process which needs to be addressed appropriately to ensure its success. The transactions can be quite different in form and the parties participating may come from a variety of backgrounds. Thus, the strategic views behind them also differ. The goal can be to grow in size and gain synergy benefits or one of making profit in a more timely manner. Also, whether the transaction considers the shares or only business, is an aspect that needs to be considered. There can also be a variety of motives and prospects behind the transaction, which means the company has to compare the possible transaction at hand to other alternative plans and investments before getting into it¹⁹⁴.

The motives of the buyer and the seller differ as the buyer usually sees a merger or an acquisition as a way to grow, expand to different areas or to make a profit. A company can also get into a merger or an acquisition in order to get a hold of a patent or trade secret. The seller on the other hand, is usually in a position where they need or want to separate themselves from an unprofitable entity or do not see themselves capable of developing the company anymore and receive an offer worth considering. A company can also be offered for purchase if the current owners are ready to separate themselves from the company but cannot

¹⁹⁴ Karppinen et al. 1986: 118

do it through a change of generation. If however, the decision to get into the transaction is made, the progression of the chosen process and consequently the outcome can be greatly affected through the negotiations phase.

The motives of both the buyer and the seller as well as the entity making the approach decide the chosen process to carry out the transaction in. This has an enormous effect on the negotiations and how they are conducted, especially to the first stages of them. The process can be one of three possibilities: direct negotiations with two parties, a restricted auction or an open auction. When the buyer is the one initiating the proposed deal, the negotiations are usually conducted as direct negotiations. This is due to the fact that there is no competition, as the targeted company has not made itself publicly open for purchase or actively searched for a buyer to take over the company. Direct negotiations are usually also lighter and more flexible from the contract law point of view, as fewer instruments are used. In direct negotiations, the responsibilities and liabilities also arise earlier than in auctions. This is also beneficial for the seller. The potential seller can, however, use the proposal of direct negotiations as a possibility to convert the situation into an auction of some sorts, as it can usually increase the trade price through the competition generated from an auction.

Because of the possible advantages, when a company offers itself for purchase, they usually do it by some sort of auction. In a restricted auction the potential seller can choose who they approach and thus, gets the possibility to learn more about the company. This is a good way of maintaining a higher level of protection and decreasing the risk of someone exploiting sensitive information about the seller's company. On the other hand, if the process of choosing the candidates is not properly executed, the most profitable buyer can be ignored by accident. In an open auction, whoever can participate in the bidding process. However, an open auction is an expensive process and not necessarily the best option. An auction also offers its possibilities to the potential buyers. They can evaluate the market and the competition by assessing the progress of the auction and how the competition acts in it. In addition, contract law offers tools to make one stand out

in the crowd. Concentrating on, for example, a letter of intent and its content can make a huge difference even though it does not bind the buyer to anything.

When starting and proceeding in merger or acquisition negotiations, a company must keep in mind all of the laws and statutes that govern the transaction. The legislation affecting mergers and acquisitions is widely spread from EU regulations to domestic laws of real property and these also affect the negotiations phase but the biggest effect to the negotiations comes from the elements of contract law. Governing laws can be viewed as a burden or a restricting factor, but they can also be used to gain advantage and to better one's position in the negotiation proceedings.

First of all, the elements of contract law as well as the contractual instruments that it provides for the parties involved can be used to protect one's trade secrets as well as other valuable and sensitive information. The responsibility of negotiating, liability of loyalty and the obligation to disclose play a huge role during the negotiations and act as the determining factors if any disputes on, for example, compensation of damages come into question. Secondly, the buyer and the seller can use the different aspects and tools that contract law offers to change their standing against the competition or regarding the opposing party while striving to reach the optimal deal for them. The buyer benefits from the seller's obligation to disclose, whereas the seller benefits from the loyalty that the buyer has to show during the negotiations. In Finland, there is a great freedom regarding contracts meaning the responsibility of conducting in them and the content of them is largely at the parties discretion, which is why the terms of the contract play a vital role in the negotiations and are the main source governing the relationship between the parties.

In the beginning stage of merger and acquisition negotiations the parties must have in mind what they are trying to achieve through the transaction and approach the negotiations accordingly. In an auction, the buyer wants to be the one chosen for the following one-on-one negotiations but at the same time, not to overpay for the targeted company. The seller wants to maximize the value they

are receiving from the company, but they should restrain themselves from just seeking for the highest price. The party offering the highest price beforehand may not be the most reliable negotiating party afterwards. Using contract law and its elements, the parties can decrease the risks and uncertainties arising from the negotiations. The most important contractual instrument for the seller in the early stages is the non-disclosure agreement. Without one, a seller should never disclose any remotely sensitive information to a potential buyer, let alone trade secrets. The non-disclosure agreement is also useful to the buyer. When in an auction, the fact that the other competing buyers that ultimately failed to get the deal had to sign the same non-disclosure agreements as the chosen buyer, prevents them from using the information given out also in the buyers disadvantage. Without this, the deal could end up being worth a lot less than the buyer had imagined.

When the negotiations proceed, the trust between the parties grows stronger and the parties can begin to trust that a deal will be made. The seller gives out more and more crucial information about the company and the buyer continues using its resources in order to maximize the chances of the deal actually happening. The importance of the liability of loyalty to the opposing party increases. At this stage, the parties have already come to agreement on some aspects of the deal even though there are still open issues to be addressed. In this situation a letter of intent is a useful tool to put the agreed subjects to writing and to establish the common goal of agreeing on a deal. A letter of intent is not a binding contract so the parties do not agree on anything determining, even though the letter of intent can be used to evaluate the possible need to compensate one's negotiations expenses, if the negotiations are broken off. A letter of intent is a good way for both of the parties to see if they are near each other valuation wise and if there is a possibility of coming to an agreement on the final contract.

A preliminary contract contains much of the same information as a letter of intent, but the legal validity of it is significantly different. A preliminary contract is a binding contract that the parties can use to commit one another to the negotiations and the finalization of the deal. This lowers the threshold for both the parties to allocate more resources and to undertake cost causative actions in

the negotiations. If a party breaks off the negotiations after signing a preliminary contract, they may have to positively compensate the suffering party for not concluding the transaction. Thus, a preliminary contract should not be signed unless the parties are certain that the final contract will be agreed upon if nothing extreme does not surface, for example in the due diligence investigation. This can be included as a stipulation in the preliminary contract and is a viable option for the buyer to use during the negotiations. In these cases, the preliminary contract can even be formed as the final contract, but with the contingency of completing the due diligence investigation without anything significant surfacing.

The due diligence investigation is the most important element of contract law and contractual instrument for the potential buyer. This is the phase where the buyer gains access to all of the necessary data and information about the buyer that it needs to make a decision to continue the negotiations at all and the price they are willing to pay. During the due diligence investigation, also the sellers obligation to disclose is implemented. In addition, the buyers right to appeal to a defect in the object of the purchase terminates. Therefore, the due diligence investigation should be conducted with care and concentration, as the ramifications of a poorly executed due diligence investigation can be severe. The different parts inspected during the due diligence investigation vary from transaction to another according to the motives and background of the buyer, but financial, tax, commercial and legal due diligences are practically always included.

As shown above, by using contract law the parties involved in merger and acquisition negotiations can greatly affect the starting point of the negotiations and what to consider when initiating them as well as their positioning when proceeding in them. There is a large number of contracts included in most of the merger and acquisition negotiations which all play a vital role when proceeding in the negotiations but also responsibilities and liabilities that have effect on them. Concentrating on the right contracts and acknowledging the benefits of the different responsibilities and liabilities, the parties can arrive to an outcome that satisfies both of them and does not prompt any aftermath, causing additional costs.

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