

Legal Risks and Regulatory Suggestions for Cross-Border Leveraged Buyouts

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Abstract. Leveraged Buyout (LBO), which emerged in the United States in the 1960s and 1970s, is a corporate acquisition method in which the acquiring party uses financial leverage to increase the debt-to-equity ratio in the purchase of the target company's equity. LBOs utilize the principle of financial leverage and have the dual characteristics of high risk and high returns. On the one hand, as a mechanism based on the market allocation of resources, LBOs affect the entire social and economic system, continuously promote the development and improvement of corporate governance systems and structures, and accelerate the progress of enterprises. On the other hand, it often has a high-risk nature, and the excessive use of leverage may cause financial disorder and turbulence in capital markets. Based on the typical case of Geely's acquisition of Volvo, a multinational LBO, as well as the relatively mature legal and regulatory practices in the United States, this article analyzes the problems existing in the LBO process, such as high leverage ratios and complex structures of acquisition funds, inadequate information disclosure, and difficulties in protecting the rights and interests of small and medium-sized investors, as well as the legal risks that may be faced by companies' financing, shareholder rights, and creditor rights. Suggestions are made from three aspects: emphasizing information disclosure, improving judicial remedies, and strengthening financing supervision.

Keywords: Leveraged Buyout (LBO); legal risks; financing tools; information disclosure; protection of investors' rights and interests.

1. Introduction

The acquisition of Volvo by Geely is a typical case of LBOs. During the acquisition process, Geely's own funds accounted for only 25% of the total acquisition funds. When Ford acquired Volvo in 1999, the transaction price was approximately \$6.5 billion. In 2010, with the help of Rothschild Bank, Geely successfully lowered the acquisition price from the \$6 billion proposed by Ford to the final transaction price of \$1.8 billion, less than a quarter of the price from just 10 years ago. Such a difference is due to the use of leverage tools.

LBO refers to the behavior of an enterprise using the assets and future earnings of the acquired enterprise as collateral, raising a large amount of debt to purchase the equity of the target company from its shareholders, and repaying the debt and interest with the monetized value of the target company's future earnings or assets. The acquiring company does not have to have a large amount of capital but can merge companies of any size by using the assets and income of the target company as financing guarantees or repayment sources for the borrowed funds.

The history of corporate mergers and acquisitions was thoroughly changed by the emergence of LBOs. In the 1980s, the success of KKR's massive LBO in the United States marked the beginning of this acquisition method. The scale of enterprises also expanded rapidly under this acquisition method, promoting the historical development of enterprise mergers and acquisitions. However, the rise of high-risk and high-yield LBOs also brought many contradictions, such as the abuse of leverage by companies and conflicts of interest between management and shareholders.

2. Problems during the process of LBOs

2.1. High leverage and complex structure of acquisition funds

In general, for a regular acquisition, the acquirer's own funds account for a large portion of the required funds. However, LBO is essentially a type of acquisition that relies heavily on external financing, using high financial leverage and substantial debt to acquire the target company. Approximately 60%-70% of the funds needed for the acquisition are raised through the collateralization of the assets of the acquired company and borrowing from commercial banks or other financial institutions. This type of financing capital has priority repayment rights over the company's assets. The remaining 20%-30% is raised by issuing high-yield bonds, convertible bonds, and other financial instruments on the market [1].

In the case of Geely's cross-border leveraged acquisition of Volvo, on the one hand, the process of cross-border LBOs is complicated and involves different national entities with differences in legal regulations, market supervision environments, and cultures. Therefore, it is highly risky, and the operational process requires strict requirements. Any slight negligence may lead to the failure of the acquisition. On the other hand, due to the substantial external financing of LBOs, companies have a high debt-to-equity ratio and face significant debt repayment pressure. This huge debt is repaid through the future cash flow of the acquired company, which has greater uncertainty. Once there are adverse changes in the market or the acquired company's operations are not performing well, the company may face difficulties in meeting its debt obligations, which may even result in bankruptcy. Therefore, the complex structure and high-risk nature of LBOs present significant challenges to corporate management.

There are also related issues of strong tax avoidance ability. Companies can reduce their taxable income by deducting the interest expenses generated by the substantial debt incurred through LBOs, thereby reducing their tax burden. In addition, cross-border LBOs involve multiple national entities with different tax systems. Companies can fully understand and use tax incentives to reasonably avoid taxes, thereby reducing their tax costs.

2.2. Inadequate disclosure of information

Insufficient information disclosure is due to information asymmetry, which makes it difficult to obtain complete and accurate information. During the preparation stage of a LBO, the acquirer's access to reliable information about the target company is limited, and they can only rely on the target company's publicly available financial reports or stock price reactions to gain an understanding of the target company's true and complete situation. If the target company intentionally conceals negative news about its financial assets or operations, or falsifies financial reports, it will further increase the information risk. In particular, in cross-border LBOs, there are issues of insufficient understanding of information related to legal regulations, markets, and culture in multiple countries, which will exacerbate information asymmetry risk. Incomplete information gathering and investigation by the acquirer will affect the valuation of the target company, leading to a significant increase in the cost of the acquisition [2]. Some listed companies selectively disclose information, deliberately concealing risk information related to LBOs, so that the high risks of LBOs are not noticed by the public, especially significant information such as leverage ratio, funding sources, acquisition purposes, and repayment arrangements.

Most of the acquisition information relies on voluntary disclosure by both parties, and investors are in a passive and weak position in terms of information, which limits the amount of acquisition information they can obtain. Investors are important participants in the capital market, and their investment choices and judgments rely on sufficient and accurate market trading information; otherwise, they will suffer losses. Acquirers may deliberately conceal or fabricate important transaction information to attract investors to participate, confuse the public's vision, lower their risk awareness, and lure a large number of ineligible investors into the LBO market. Without sufficient

and accurate market trading information, investors will find it difficult to make rational value judgments and investment decisions, and are likely to suffer losses.

2.3. Small and medium-sized investors have difficulty obtaining effective protection

The LBO market has a large number of small and medium-sized investors, whose legitimate rights and interests are facing multiple threats and who are the main buyers of the acquisition risk. Due to the high risks and insufficient disclosure of information in LBOs, small and medium-sized investors are in a clearly disadvantaged position in the acquisition market, and their legitimate rights and interests are difficult to effectively safeguard, with little possibility of legal remedies after their interests are damaged [3].

Firstly, the right to information of small and medium-sized investors is difficult to protect. In order to attract investors to participate, some individual acquisition entities conceal or fabricate false information to hide the true risks of the acquisition. Small and medium-sized investors are in a position of information disadvantage, and in most cases, they are unable to obtain true information about the LBO transaction. Furthermore, small and medium-sized investors lack the professional expertise and risk identification ability to detect and evaluate investment risks in LBOs.

Secondly, some investors suffer serious losses. LBOs themselves are high-risk investments, and once the acquisition fails, investors may suffer significant losses or even lose all their investment. The complex capital structure and the risk of insufficient disclosure of information are the main hidden risks of LBOs, highlighting the speculative intentions of the acquisition entities. Driven by speculative motives, LBOs may become a game of capital speculation rather than normal investment, and investors' rights and interests are difficult to effectively protect. In addition, the range and number of investors involved in LBOs are wide, and the period and difficulty of seeking legal remedies are long, making it difficult for ordinary investors to exercise their rights to compensation [4].

Small and medium-sized investors are in a naturally disadvantaged position in terms of information acquisition, risk tolerance, and self-protection. Without strengthening the institutional construction of protecting the legitimate rights and interests of small and medium-sized investors, their interests will continue to be violated. Especially during the LBO process, the stock price of the target company fluctuates frequently, and the frequency of sudden rises and falls continues to increase. During this period, a large number of small and medium-sized investors are prone to suffer losses due to judgment errors.

3. Legal risks in acquisitions

3.1. Legal risks in company financing

Financing is a crucial step for companies in cross-border leveraged acquisitions, and whether the financing is successful or not is closely related to the smoothness of the subsequent acquisition process. The size of financing risk is influenced by various factors such as financing structure, financing method, financing timing, and financing interest rate. High leverage financing can make enterprises bear huge debt repayment pressure. Once the company's operation is in poor condition, it will affect the credit rating evaluation of financial institutions on the enterprise, leading to obstacles in the company's subsequent refinancing channels, increased difficulty in financing, and the formation of a vicious cycle. The vast majority of funds for corporate leveraged acquisition financing are obtained through borrowing, and generally, the loan funds account for 70% to 80% of the total acquisition funds, with the remaining portion being the acquiring company's own funds for merger [5].

Firstly, there is a legal risk for "bridge loans". From the principle of LBOs, the acquirer will only use the debt financing method to pay off the "bridge loan" after the acquisition is completed, and the "bridge loan" provided by investment banks, together with a small amount of the acquirer's corporate funds, ensures the success of the acquisition process. Therefore, obtaining "bridge loans" plays a very important role in the success of LBOs. However, due to the segmented management of China's

capitalist market finance, it limits the behavior of non-bank institutions such as securities companies and insurance companies in providing loans. Only a small number of financial institutions such as commercial banks and trust investment companies have the right to provide commercial loans, making it very difficult to obtain "bridge loans" from investment banks. Secondly, there is a legal risk for private equity financing. Private equity funds are funds that are raised for specific targets in a non-public manner, managed by professional fund managers, investing in target companies' equity, and then exiting at opportune times within specified time frames. The most significant problem with private equity funds is that there are no standard legal provisions that restrict the development of private equity funds, thus failing to guarantee the legitimate rights and interests of investors and provide them with legal protection.

3.2. Insufficient protection of certain shareholders' rights and interests

Firstly, the rights and interests of small and medium shareholders are easily infringed. The controlling shareholder's advantage in terms of the shareholding proportion inevitably gives them strong control over the company's management and operations, and the rights and interests of small and medium shareholders are easily subjected to the domination of the controlling shareholder. After the company becomes the target of acquisition, it is difficult for the small and medium shareholders of the target company to obtain specific transaction information between the acquirer and the controlling shareholder, which makes it difficult to accurately judge the trading market of the company's stock and grasp the timing of the transaction. In some equity acquisitions, most acquirers only purchase the shares from the controlling shareholder, which not only means that some shareholders cannot obtain equal treatment and a premium for selling their shares, but also may result in a discount when selling their shares. The controlling shareholder of the company not only infringes the interests of small and medium shareholders in the acquisition activity through non-collusive means but also may infringe their interests through collusive means. Equity acquisition can also be conducted through private placement or the issuance of new shares through public offering. That is to say, the target company issues securities to specific individuals in a non-public manner through the board of directors and shareholder resolutions. Due to the closed nature of private equity acquisitions, the rights and interests of minority shareholders are more likely to be infringed due to inadequate disclosure of the private equity content [6].

Secondly, there may be conflicts of interest between shareholders and creditors in asset distribution during simultaneous acquisitions. Geely's acquisition of Volvo may face the "fraudulent transfer" rule, which refers to the transfer of assets by a company at a price lower than the fair market value of the assets. When a company transfers assets at a price lower than the fair market value, the assets available for debt repayment are correspondingly reduced, which harms the interests of creditors. When the company's assets are greater than its liabilities and its ability to repay debts is strong, the reduction of such assets is not very serious for the creditors; but when the company's assets are not enough to cover its liabilities or is on the brink of insolvency, the improper reduction of such debt repayment assets will seriously affect the interests of the creditors.

3.3. Risks to the rights and interests of existing creditors

LBOs can not only harm the interests of shareholders but also significantly impact the interests of existing creditors. Generally, creditors consider multiple factors such as the debt level, profitability, business strategy, and corporate reputation of the target company before lending money. Based on their assessment of the risk, they determine the loan amount, interest rate, and loan term. In a LBO, however, as the target company is being acquired, these factors undergo significant changes. Firstly, the debt level of the target company will increase substantially as the acquirer typically invests only a small portion of their own funds, and the rest is obtained by mortgaging the assets of the target company. Secondly, the acquirer's use of funds for the buyout rather than for investment in production and operation makes it difficult to improve the target company's profitability. Moreover, during the initial period of integration between the target company and the acquirer, the profitability of the

enterprise may even decrease. Thirdly, in terms of business strategy, the acquirer may adopt more aggressive strategies to repay the huge debt burden, deviating from the target company's previously prudent operating strategies, and hoping to achieve high returns by operating high-risk projects. Lastly, the change of shareholders and potential changes in management may cause different degrees of instability, thereby reducing the market's confidence in the target company [7]. In general, LBOs may have a negative impact on the risk profile of the target company, resulting in a significant adverse impact on the interests of creditors.

4. Improve the legal regulatory system for leveraged buyouts

4.1. Optimize the information disclosure system

Strengthen the disclosure obligations of acquisition entities regarding financial information, including acquisition funding sources, amounts, and investor status. According to China's current acquisition regulatory rules, a detailed equity change report must be prepared and disclosed, including information on funding sources, industry competition and related transactions, and arrangements with concerted actors, once the acquirer's shareholding ratio reaches 20% or more. Prior to this, regulatory agencies and investors had difficulty obtaining such information to identify and prevent risks associated with acquisition activities, making it challenging to take appropriate regulatory measures and make rational investment decisions. For LBOs with high leverage ratios and complex financing structures, timely disclosure of relevant information is beneficial for investors to make rational decisions based on their risk tolerance and to prevent significant loss of benefits in the event of a risk outbreak, reducing the legal risks of the acquiring entity. For initial disclosures of shareholding behavior aimed at acquisitions, stricter information disclosure standards should be set, not limited to a 20% shareholding ratio.

From the perspective of shareholding influence, a higher shareholding ratio does indeed have a significant impact on the target company, but the shareholding ratio is not the only important factor. Non-controlling shareholding behavior, even if the shareholding ratio is higher, may not have greater influence than acquisition behavior with a lower shareholding ratio. It is suggested that different information disclosure obligations be established for general investment behavior and acquisition behavior based on the purpose of shareholding. The emphasis should be on strengthening the information disclosure requirements for acquisition behavior to prevent risk accumulation and spread. In 1968, the *United States amended the Securities Exchange Act* of 1934 to add Section 13(d) of the *Williams Act*, which triggers a disclosure obligation for shareholdings of 5% or more, requiring detailed information disclosure, including the acquirer's basic information, funding sources and amounts, investment arrangements for the held securities, and the purpose and plan of controlling the target company. Subsequently, in 1990, the *United States enacted the Foreign Investment and Disclosure Act*, which again amended the Securities Exchange Act, adding Section 13(j), which strengthens the disclosure requirements for foreign investors and substantial holders of stock [8]. These information disclosure requirements only apply to shareholders with an acquisition purpose, while for shareholders without an acquisition purpose, the required disclosure information only includes the holder's identity, residence, and the number and type of shares held, without detailed information on funding status and investment arrangements.

An effective information disclosure mechanism not only protects the basic rights of investors who are in an information disadvantage due to agency relationships but also constrains the behavior of market participants. To prevent acquirers from deliberately avoiding strict disclosure standards when determining the purpose of shareholding, daily supervision and law enforcement inspections should be strengthened based on the contents of the equity change report published by listed companies, specifically determining whether there is an acquisition purpose among the shareholders of the listed company at present or in the near future. Clarifying the consistency between the benefits and risks behind the use of leverage between investors and managers, from a regulatory perspective, whether

it is hostile acquisitions in the secondary market or friendly acquisitions through agreement transfers, as long as they are carried out according to the rules, they are spontaneous market behaviors.

4.2. Construct a comprehensive judicial relief system

In the process of LBOs, in addition to pre-emptive measures such as legal regulations and administrative supervision, sound post-remedies such as judicial relief should also be established. The judicial relief system includes dispute resolution channels and the choice of applicable law.

Regarding dispute resolution methods, in the typical Chinese case of the "Baowen Dispute," dispute resolution relied more on administrative supervision measures, and the legal issues involved in its various leverage methods should be under the supervision of the People's Bank of China, the China Insurance Regulatory Commission, and the China Banking Regulatory Commission. Improving the judicial relief system requires a reasonable division of responsibilities between administrative and judicial organs and allowing judicial organs to appropriately join the regulatory team for acquisition behaviors. It is necessary to rely on strict legal regulations and to give the parties involved in hostile takeovers the right to sue, appeal, and accuse in court. In situations where legal constraints and administrative supervision are not effective, judicial means can be used to protect the legitimate rights and interests of the victims.

Regarding legal regulation, as early as 1890, the *United States promulgated the Sherman Act*, which used legally mandatory regulations to restrict corporate mergers and acquisitions [9]. The law clearly stipulated that any contract between individuals or companies through special forms to implement any behavior of merger, monopoly, or trade restriction constitutes an illegal transaction. In 1984, the *Model Business Corporation Act* stipulated directors' duty of care and the business judgment rule, explicitly requiring company management to fulfill their duty of diligence and faithful management, protecting the legitimate interests of the company and shareholders from infringement.

In the process of resolving disputes, it is essential to respect the choices of both parties and suggest that the dispute resolution mechanism be clearly defined in the merger agreement. Strict compliance with legal regulations and acceptance of supervision by various departments are necessary. It should be diversified and have judicial means as the ultimate channel. Regarding legal application, it is based on the agreement between the acquiring and acquired companies, but at the same time, exceptions should be specified (such as when acquisition behavior severely infringes the national security of the country where the acquired company is located). The national law of the acquired company's country should be directly applicable.

4.3. Improve the regulatory system for financing

LBOs and financing tools have a two-way interactive relationship. LBOs constantly stimulate the innovation of financial products and financing tools in the capital market, and financial market innovation also promotes new features in LBOs. Financing risk is the main source of risk in LBOs, so regulating the financing method is an important link in controlling the risk of LBOs.

In LBO stock pledging financing, funds flow between different financial institutions, creating a bridge between the securities market and the money market. According to China's current regulatory model, the China Banking and Insurance Regulatory Commission supervises fund providers such as banks and insurance companies, and when funds flow to the acquirer, it falls under the regulatory scope of the China Securities Regulatory Commission.

LBOs originated earlier in the United States, where the capital market is more mature and the legal system is sound. The United States is the birthplace of private equity funds, and the rapid development of its private equity funds is mainly due to its sound legal system. This is demonstrated in its regulatory focus on qualified investors and private placements, innovative organizational forms, tax incentives, and a lenient legislative orientation. For preferred stock, according to Section 6.01(a) of the U.S. Model Business Corporation Act, the types and names of stock categories should be determined in the company's articles of incorporation, and the restrictions, benefits, and related rights of the stock should also be clearly defined. From these provisions, it can be inferred that the issuance

of preferred stock needs to be clearly specified in the company's articles of incorporation, and in addition, it should have equal rights with other preferred stocks and not be discriminated against. As part of the New York Code, the New York Business Corporation Law specifically regulates the system of issuing preferred stocks in Section 502 of "Corporate Financing [10]."

Firstly, as a special financing method, LBO stock pledging financing requires a large amount of financing funds. Only by allowing bank funds to participate in LBO financing activities and smoothing financing channels can we fundamentally prevent acquirers from raising acquisition funds through improper channels, ensure the standardization of financing activities, avoid liquidity risks of financing funds, and fundamentally prevent systemic financial risks. Secondly, using financial technology to innovate the regulatory method of LBO financing and incorporating the financial risks of LBO financing into the entire regulatory process can not only save regulatory costs, but also improve regulatory efficiency [11]. Finally, improving the legal system of preferred stocks and high-yield bonds, as well as the legal system of private equity funds. Introducing the preferred stock system at the legislative level enables the full play of the role of the company's articles of incorporation and establishes a preferred stock pricing issuance mechanism. At the same time, appropriately relaxing the scope of information disclosure for private placement bonds, establishing a sound qualified investor system and a private equity fund exit mechanism, and establishing a regulatory system for private equity funds. This continuously improves LBO financing and contributes to the development and growth of enterprises.

5. Summary

LBOs are a value-neutral acquisition method. Legitimate LBOs not only enhance market financing efficiency and improve corporate governance but also benefit industry competition and M&A upgrades, thus optimizing resource allocation in the entire capital market. While LBOs bring unlimited development potential to companies, they also conceal risks behind them. The use of leverage in the acquisition and operation of US companies is one of many initiatives for financial capital utilization. The moderate combination of financial and industrial capital can bring more vitality to industrial capital.

This study provides a superficial analysis of some problems and legal risks of cross-border LBOs and proposes practical suggestions. The use of LBOs paves the way for overseas expansion of enterprises. It is crucial to conduct in-depth research on related risks in LBOs. The author has a positive outlook on the development prospects of cross-border LBOs.

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