

THE DARK SIDE OF LBOS. PRIVATE EQUITY INVESTORS BE FOREWARNED!

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Abstract

The institutional environment regulating mergers and acquisitions (M&A) is crucial for the private equity industry, especially for leveraged buyout (LBO) transactions, which are currently at the center of an intensive debate in the US, as seen in many European countries over the last decade. One of the most controversial issues of an LBO deal is associated with its ultimate economic result, often perceived as an indirect and fraudulent example of financial assistance provided by the acquired firm for the purchase of its own shares, to the detriment of its assets and stakeholders. Given the potential damage to the target's stakeholders, LBOs have been strongly debated and even prohibited in Italy. The institutional uncertainty surrounding the legitimacy of LBOs had a negative impact on the Italian private equity market. Recently, Italy issued an innovative corporate governance reform which offered a more favorable legal environment to this type of transactions and represented an important turning point for the domestic private equity market. The institutional change, induced by the above reform, provides scholars and policy makers with guidelines on how PE transactions may be spurred with an appropriate regulation aimed at legalizing LBOs, as well as protecting the interests of the target firm and its stakeholders. Notwithstanding the new reform, several issues remain unsolved and the admissibility of certain types of LBOs is still under debate. The purpose of this paper is two-fold: a) to shed some light on the debate on the legitimacy of LBOs by emphasizing, from an economic and financial point of view, the critical features of this class of transactions, and b) to highlight unsolved problems associated with the new LBO reform, particularly with reference to the investors' liability. The Italian buyout market, whose transactions were previously prohibited and only recently legalized, offers a unique example in order to better understand the current international debate on the admissibility of LBOs and the related consequences for the target's stakeholders.

Keywords: Private Equity, Leveraged Buyouts, Regulation, Financial Assistance, Governance.

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1. Introduction

For the purpose of this paper, a leveraged buyout (LBO) represents a particular financial technique used to accomplish the acquisition of the equity capital of a company (target) by another company (newco). The transaction is financed with a large amount of debt relative to the asset value of the acquired company (Axelson *et al.* 2007 b, Kaplan 1997, Jensen 1989).³

Recently, several empirical studies (such as Bottazzi *et al.* 2007 a, Kaplan *et al.* 2006, Lerner and Schoar 2005, Caselli and Gatti 2005, Capizzi 2005 a, b) and policy makers (such as the UK Financial Services Authority) have emphasized the importance of the institutional and regulatory environment for the

private equity (PE) industry, especially with reference to leveraged buyout transactions.

When evaluating the opportunity to invest in the buyout industry, especially in certain European countries, one of the most critical issues for entrepreneurs, managers and investors is the legal environment associated with private equity and LBO transactions which may have a strong impact on the investors' behavior (Bottazzi *et al.* 2007 b, Cumming *et al.* 2006 a, b, Kaplan *et al.* 2006, Lerner and Schoar 2005) by affecting the related transactional risk.⁴ This risk is especially relevant in countries, such as Italy, where LBOs have often been criticized by legal

³ See Cumming *et al.* (2007) for an up-to-date literature review of buyouts. See also: Axelson *et al.* (2007a). For a discussion on the determinants of the buyout investment process, see Ljungqvist *et al.* (2007).

⁴ For a discussion on the impact of the legal system and corporate governance on the financial behaviour of private equity investors, in the spirit of La Porta *et al.* (1997-1998), see also: Allen and Song (2003).

scholars (doctrine) and courts (jurisprudence).⁵ Interestingly, over the last decade the domestic buyout market followed a puzzling trend⁶, alternating dramatic decreases in the number of deals with impressive increases in the buyout frequency. This trend seems to be associated with a series of changes and restrictions involving the Italian regulatory environment.⁷ Cumming and Zambelli (2007) show that the introduction of restricting or prohibiting regulations on LBOs does not necessarily protect the interest of the acquired firm, but rather has a negative impact on the private equity industry as a whole.

Despite the growing literature on the effects of LBOs, especially in terms of performances of target firms (see among others: Cumming *et al.* 2007, Renneboog 2007, Nikoskelainen and Wright 2007, Cao and Lerner 2006⁸), relatively little attention is dedicated to the effects of LBO regulations (Cumming and Zambelli 2007), which might be introduced by legislators around the world with the aim of preventing potential opportunistic behaviors by management to the detriment of the target's stakeholders (Ferran 2007, Enriques and Gelter 2006). The main purpose of this paper is to contribute in bridging this gap by discussing the critical features of the Italian LBO regulation, from an economic and financial point of view, especially with reference to the consequences for investors involved.

At present, the admissibility of leveraged buyout transactions is at the center of an intensive debate in the US, as seen in many European countries over the last decade.⁹ Private equity investors, who finance

these transactions, have even been defined as asset strippers.¹⁰ Recently, critics in the US have argued that LBOs should be prohibited, given the potential side effects on the target's stakeholders.¹¹ As highlighted in Cumming-Zambelli (2007), LBOs have been often accused of a) increasing the probability of default of the target company, b) involving a lack of full disclosure, against the interests of pre-existing creditors and shareholders, and c) promoting a conflict of interests between newco's managers and the target's shareholders, so that the former have a greater incentive to undertake opportunistic behaviors and to violate their business duties towards the company's stakeholders.¹² Furthermore, the ultimate result of an LBO transaction is sometimes interpreted as an example of financial assistance provided by the target for the acquisition of its own shares, which in some European countries (such as Italy) is strictly regulated or even prohibited (financial assistance ban). In Europe, the financial assistance prohibition was originally introduced by article 23 of the Second European Commission Directive on Corporate Law 77/99/EC (the Second Directive hereafter), under which a company cannot grant loans or provide guarantees for the purchase of its own shares.¹³ Each European Member State has interpreted and implemented such financial assistance provision in a different way. On the one hand, some countries (such as the UK and Germany) have created exceptions to the financial assistance rule, imposing the ban to listed companies only. Hence, private companies are generally allowed to provide guarantees for the acquisition of its own shares. On the other hand, other countries (such as Italy) have interpreted the financial assistance rule quite broadly, by prohibiting any kind of financial assistance provided by public companies or private firms, and extending the prohibition to LBO transactions as well.¹⁴

⁵ See Bernardi and Bernardi (2006) and Silvestri (2005). General overviews of the Italian debate on LBOs are also available at the following websites: <http://www.altassets.com/casefor/countries/2005/nz6460.php>. <http://www.altassets.com/casefor/countries/2004/nz4561.php>;

<http://www.altassets.com/casefor/sectors/2003/nz3097.php>; <http://www.altassets.com/casefor/countries/2002/nz3432.php>. With reference to Italy, see also: Pegorano (2005), available at: <http://www.soldionline.it/a.pic1?EL=018AB94977B13CE9C1256FD600399AFF>.

⁶ The evolution of the Italian buyout market will be discussed in section 2.

⁷ Cumming and Zambelli (2007) empirically analyze the impact of changes in legal environment on the frequency, structure and organization of buyouts deals. They highlights a statistically significant relationship between the legal environment and the frequency of buyouts in Italy. The changes occurred in the Italian legal environment will be summarized in section 2 and discussed in greater detail in section 3.

⁸ See also: Guo *et al.* (2007), Cressy *et al.* (2007), Wright *et al.* (2006), Chou *et al.* (2006) Holmstrom and Kaplan (2001), Opler (1992), Kaplan (1989).

⁹ For a summary of the most debated issues on LBOs in Europe, see: Ferran (2007), Silvestri (2005), Cleary Gottlieb Steen Hamilton European M&A Report (2003, 2004). For a general overview of the LBO-debate in the US, see among others: Stein (2006), available on line at the following website:

<http://www.nytimes.com/2006/09/03/business/yourmoney/03every.html?ex=1314936000&en=6679077c5af5c4a6&ei=5088&partner=rssnyt&emc=rss>.

¹⁰ See for example: <http://news.bbc.co.uk/2/hi/business/6221466.stm>.

¹¹ For further information, see Cumming and Zambelli (2007) and Stein (2006), available at: <http://www.nytimes.com/2006/09/03/business/yourmoney/03every.html?ex=1314936000&en=6679077c5af5c4a6&ei=5088&partner=rssnyt&emc=rss>.

¹² See also Kaplan (1997) and Holmstrom and Kaplan (2001) for an overview of the buyout-activity in the United States that emphasizes the critical features of LBOs.

¹³ "A company cannot advance funds, nor make loans or provide security for the purchase of its own shares by a third party"

¹⁴ As a consequence, several LBO transactions have been accused of violating the financial assistance prohibition and declared void. The consequences and the legal debate on the legitimacy of LBOs will be discussed in greater details in the following sections 3 and 4.

In 2004, Italy anticipated the European corporate governance trend¹⁵ by introducing an innovative corporate law (corporate governance reform), which legalized LBOs despite the financial assistance rule.¹⁶

Prior to this reform, the legitimacy of LBOs was uncertain and strongly debated in Italy, especially over the 1999-2000 period. Several LBOs were invalidated by Italian Courts because considered examples of financial assistance fraudulently provided by the target for a share buyback purpose (Montalenti 1996).¹⁷ The debate intensified in 2000, when the Italian Supreme Court further deemed the LBO scheme illegal.¹⁸ Relevant criminal consequences were also applied to the directors involved in the transaction, who ran the risk to be punished with a sentence of up to 3 years of prison.¹⁹ The Supreme Court's decision increased the debate on the legitimacy of LBOs in Italy, rather than solving it. The legal risk associated with these types of transactions raised concerns among private equity investors, and probably diminished their incentive to undertake buyout deals, as well as affected the Italian private equity market.²⁰ By looking at the Italian case law, it is interesting to notice that LBOs were carried out anyway, despite the legal uncertainty and the Courts' prohibition, especially in the form of large-

mega deals²¹ and multi-layer transactions (with a pyramidal ownership structure²²).

The new corporate law, applicable as of January 2004²³, clarified the legal status of LBOs and decreased the uncertainty surrounding their legitimacy. This probably encouraged a more rapid growth of the buyout industry in terms of number of deals. Additionally, the new corporate governance reform diminished the incentive to use complex pyramidal LBO-structures, at least for a legal purpose.²⁴ Notwithstanding the introduction of the new corporate governance reform, important issues remain unsolved: is the debate on the admissibility of LBOs finally over and, if not, what are the consequences for investors of undertaking them?

Given the negative effects that a prohibiting or uncertain regulation on LBOs might have on the entire private equity industry, this paper intends to shed some light on the reasons underlying the past and current international debate on the legitimacy of this class of transactions and the consequent risks run by the investors involved. In line with the current international criticism on LBOs, the purpose of the paper is two-fold:

1. It discusses the reasons why the admissibility of LBOs was highly disputed or even prohibited in Italy prior to 2004 by analyzing, from an economic and financial point of view, the critical features of LBOs and the related case law. Understanding the roots of the past debate is crucial in order to better evaluate the transactional risk that might affect the validity of LBOs in the future;

2. It highlights the new requirements for the legitimacy of LBOs in light of the new Company Law Reform. Despite the enactment of the new corporate legislation, several issues remain unsolved. The paper therefore evaluates unsolved problems that might affect the validity of LBOs in the future, especially with reference to the private equity investors' and directors' liability.

The Italian buyout market, whose transactions were previously prohibited and only recently legalized, offers a unique example in order to better understand the current international debate on the admissibility of LBOs and the related consequences for the target firms and their stakeholders. Additionally, the innovative Italian LBO reform provides scholars and policy makers around the world

¹⁵ In order to harmonize the different company law regulations, the European Union recently reformed article 23, introducing a more favourable legal treatment to the financial assistance event. See: article 23, European Directive 2006/68/EC. According to the new formulation of article 23, the financial assistance shall now be permitted if certain conditions are satisfied, such as the shareholders' approval. Hence, each Member State will have two options: a) to maintain the existing general prohibition on financial assistance, or b) to introduce new principles in order to apply the new formulation of article 23, allowing financial assistance under certain conditions.

¹⁶ We refer to the Legislative Decree 6/2003, applicable as of January 1, 2004, which will be discussed in greater detail in section 4. For an outline of the corporate law reform see Montalenti (2004).

¹⁷ The LBO scheme was in fact perceived as a financial instrument accused of fraudulently allowing the target to provide a guarantee for the acquisition of its own shares, in contrast with the Italian law. See Montalenti (1990).

For a discussion on the criticism surrounding LBOs in Italy over the last decade, see section 3 of the present paper. For a literature review of scholars against leveraged buyouts see: Bruno (2006), Fava-Fuschino (2003).

¹⁸ The Supreme Court's decision will be discussed in section 3. The original wording of the decision is also reported on line at: http://www.diritto.it/osservatori/diritto_fallimentare/corte_cass2000.html#sent5503_2000

¹⁹ We refer to the previous version of article 2630 Civil Code, modified with the Legislative Decree 11/4/2002, number 61. See Accinni (2001).

²⁰ See Cumming-Zambelli (2007) for an empirical analysis of the impact of LBO regulations on the Italian private equity market. See also Enriques (2002) for a discussion on the general impact of corporate law Judges.

²¹ Large-mega deals are transactions characterized by a size greater than 150 million Euro. Considering the high risk of illegality over the last decade, it seems that investors were willing to run this risk only for relevant deals, in terms of size and expected returns.

²² The typical multi-layer buyout deal was characterized by having more than one newco firm, and locating the primary holding newco abroad. See section 3.1.2 for further discussions on these complex buyout structures.

²³ Legislative Decree 6/2003, applicable as of January 1, 2004 which will be discussed in greater detail in section 4.

²⁴ The LBO structure will be discussed within section 3.

with guidelines on how the private equity industry may be spurred with an appropriate regulation aimed at legalizing LBOs, as well as protecting the interests of the target firm and its stakeholders.

This paper is organized as follows. The following section describes the puzzling evolution of the Italian buyout market in relation to the most recent changes in the institutional environment. The third section highlights the critical features and financial implications of LBO deals by analyzing the reasons underlying the past debate on their admissibility. It also discusses, from an economic and financial point of view, the relevant case law especially the "D'Andria case" paradox (Supreme Court's Decision 5503/2000). The fourth section describes the new regulation of LBOs by discussing the requirements for their legitimacy, as well as emphasizing unsolved issues. The last section highlights concluding remarks.

2. Leveraged Buyout Transactions in Italy: The Market Puzzle

As anticipated, a buyout represents the acquisition of the equity capital of a firm (called target) by another company (called newco). Buyouts can be classified according to the party that originates the acquisition process. This results in the following types of buyouts:

a) The Institutional Buyout (IBO), which refers to the acquisition of part or all of the equity capital of a company by an institutional investor.

b) The Management Buyout (MBO), which is the acquisition of a company by its own management.²⁵

c) The Management Buyin (MBI), which is the acquisition of a company by an outside management team.²⁶

d) The Buyin Management Buyout (BIMBO), which refers to the acquisition of a company by both outside and inside managers.

e) The Management-Employees Buyout (MEBO), which refers to the acquisition of a company by its own employees.

f) The Turnaround Buyout, which occurs when outside investors acquire a company in financial crisis.²⁷

The term leveraged buyout describes a particular method of financing and structuring the acquisition, and can occur in conjunction with any of the above buyout types.²⁸ In an LBO, the acquisition of the target company is financed with a large amount of

debt relative to the asset base of the acquired company. Following the acquisition, the newco and the target are merged and the new combined firm has a higher leverage ratio (total debt over total assets) than the target firm had before. LBOs differ from other leveraged acquisitions because the debt is ultimately secured by the acquired company and not by the buyer.

Leveraged buyouts are relatively new in Italy. The concept was developed in the United States²⁹ in the 1970s, and imported into the Italian financial system during the 80's. Since then, buyouts have played a crucial role within the private equity (PE) market. As shown in Figure 1, the total amount invested in buyout deals during 2006 was 2,444 million Euro, representing 66% of entire PE industry. In terms of number of deals, buyouts covered 34% of the industry.

Exhibit 1 provides some information on the frequency of buyouts in Italy over the period 1998-2006. It also shows the evolution of the large-mega deals (whose size is greater than 150 million Euro).³⁰ During the 1998-2006 period, the number of LBO transactions increased dramatically from 38 (representing a total invested capital of 242 million Euro) to 100 (for a total invested capital of 2,444 million Euro).

According to data collected by the Italian Venture Capital Association (AIFI), both the volume and the average value of buyouts carried out in Italy over the last decade increased sharply until 1999.³¹ Subsequently, the Italian buyout market followed a puzzling trend, alternating dramatic decreases in the number of deals (such as in 2000 and 2001)³² with periods characterized by relevant increases in the buyout frequencies, as seen after 2004.³³

²⁵ For a discussion on the basic characteristics of the MBO deal see: Wright et al. (2001), Kriegeri (1994), Ferrario (1991), Smith (1990), Kaplan (1989).

²⁶ See, among others, Wright et al. (1992).

²⁷ Also other types of LBOs exist, such as Family Buyouts. See Pencarelli (1993) for a discussion on the characteristics of family buyouts.

²⁸ See among others: Capizzi (2005), Bertini (2000), Altman and Smith (1993), Grande Stevens (1990), Gambino (1990), Cantoni (1989).

²⁹ See: Holmstrom and Kaplan (2001) for a discussion of buyouts in the US.

³⁰ The term mega deals instead refers to those buyout transactions whose invested amount is greater than € 300 million

³¹ See the statistic reports by Italian Venture Capital Association (AIFI), available at: <http://www.aifi.it>, AIFI Yearbook (various years, 1990-2000), Capizzi (2004, 2005 a, b).

³² The frequency of buyout transactions diminished by 18.46% (over the period 1999-2000) and by 43% in the following Year (2001), while the average amount invested increased in both Years. Over the same period, the buyout market has been characterized by "mega deals" such as Piaggio's 780 billion Lira deal and Fiat Lubrificants' 430 billion Lira deal, both in 1999. See: AIFI (2001), pp. 53-54.

³³ The evolution of the Italian buyout market will be discussed in section 2.

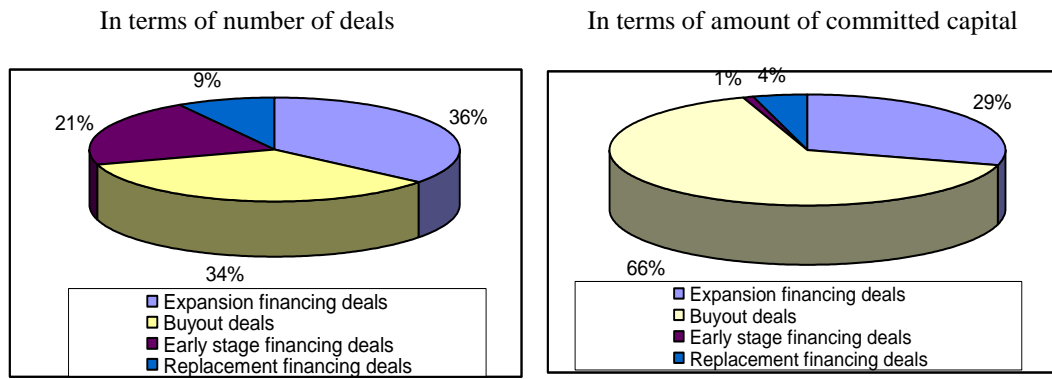


Figure 1. Relative weight of buyouts within the private equity market in 2006, in terms of number of deals and amount of committed capital

Source: Elaboration from the author on data from Aifi Yearbook (2006)

Exhibit 1. Size and frequency of buyouts (1998-2006)

Size	1998	1999	2000	2001	2002	2003	2004	2005	2006
Total invested Amount (€ mln)	242	878	1363	1014	1550	2258	916	2401	2444
Average deal size (€ mln)	6.4	13.5	25.7	33.8	20.4	38.3	19.1	32	15.1
Amount invested excluding mega deals (< 300,0 € mln)	242	594	431	303	797	543	581	1495	na
Amount invested in mega deals (> 300,0 € mln)	0	284	932	711	753	1715	335	906	na
Frequency	1998	1999	2000	2001	2002	2003	2004	2005	2006
Total number of buyouts	38	65	53	30	76	59	48	75	100
(Yearly % of change)		71	-18	-43	153	-22	-19	56	33
Number of large/mega deals (deal > 150,0 € mln)	0	2	8	2	4	7	2	4	na
Number of mega deals only (deal > 300,0 € mln)	0	1	4	2	3	4	2	na	na

Source: Elaboration from the author on data from AIFI Statistics Reports and Price Water House Coopers, various years.

One possible explanation of this trend could be associated with the recent changes in the legal environment experienced by the buyout industry, as summarized in Figure 2.³⁴

³⁴ Cumming, Zambelli (2007) empirically examine the effects of changes in the Italian legal environment on the buyout market, before and after the change in the corporate law reform (effective from January 2004). They demonstrate that legalizing LBOs increased the frequency

As shown in Figure 2, by the end of 2001 the Italian Parliament assigned the Government the task of reforming the corporate law according to some basic principles, as well as issuing specific provisions in order to legalize LBOs (Delegate-Law 366/2001, article 7, point d). This provided some hope for a new

and improved the governance of the target company. For a legal overview of the changes on the corporate governance law see: Bernardi (2006), Busani (2003).

more favorable legal treatment of these types of transactions. In 2002, a new criminal law reform came into force, introducing new crimes which were applicable to LBO transactions (Legislative Decree 61/2002). In 2004, a new Corporate Governance Law became effective (Legislative Decree 6/2003, article

2501 bis, applicable as of January 1, 2004). Among other things, it was aimed at legalizing certain types of LBOs. The recent corporate law reform clarified the legal status of LBOs and marked a milestone for the Italian private equity market.

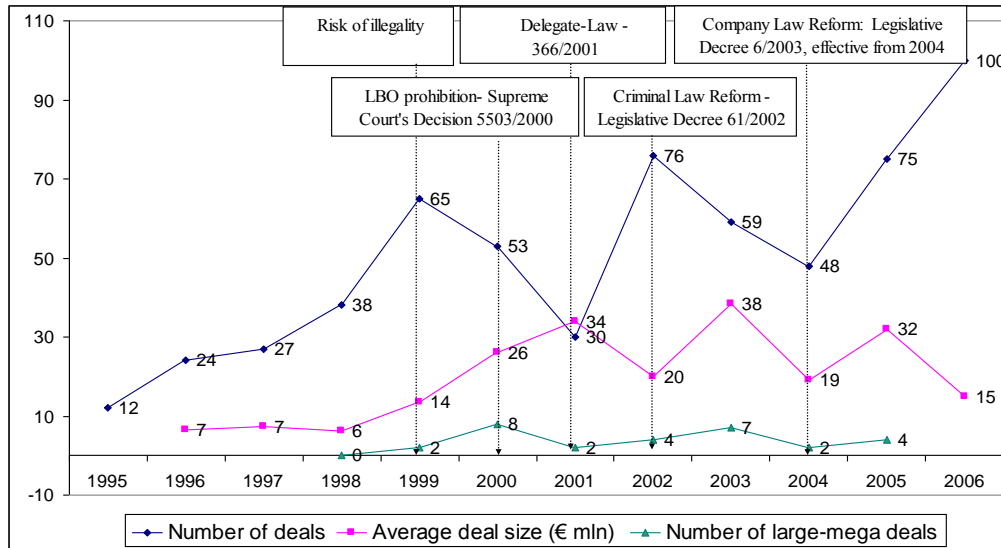


Figure 2. Number and average size of LBOs in Italy in relation to the changes in the merger and acquisitions (M&A) legal environment, over the period 1995-2006

Source: Elaboration from the author on data from AIFI Yearbook, various years

Further to the introduction of the new corporate governance reform, the frequency of buyout deals increased by 56% (in 2005) and by 33% (in 2006), as shown in exhibit 1. Similarly, the number of investors

actively involved in the buyout industry followed a positive trend and rose from 30 in the year 2004, to 54 in 2006 (Figure 3).

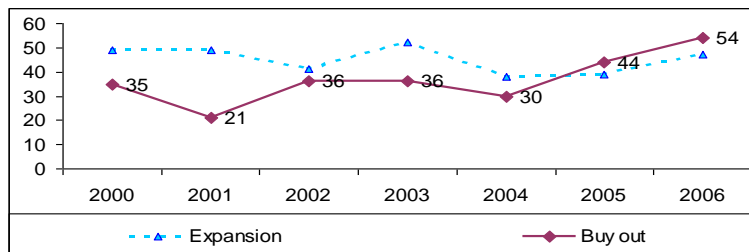


Figure 3. Number of active investors in the buyout industry, compared with those active in the expansion financing sector (2000-2006)

Source: Elaboration from the author on data from AIFI Statistics Reports, various years

In Italy, an especially popular transaction combines a management buyout, initiated by the management team of the target company, with a leveraged buyout as described above. The resulting Leveraged Management Buyout (LMBO) is currently the most frequent buyout transaction in Italy. This is demonstrated by a recent survey conducted by Carlo Cattaneo Castellanza University –Liuc- together with INSEAD and AIFI.³⁵ Most of the examined buyout

transactions (93%) were initiated by the management team of the target. Moreover, 92 % of the examined transactions were leveraged buyouts (Figure 4).

Exhibit 2 shows the evolution of the leverage ratio (Debt/Equity ratio) resulting from MBOs-MBIs in Italy over the period 1992- 1999. It demonstrates that the Debt/Equity ratio has increased slightly from 1.6 in 1993 to 2.2 in 1998³⁶, approaching an average level of 1.86, similarly to what happened in 2006.

³⁵ This study refers to a questionnaire response by investors who realized a buyout acquisition in Italy during the period 1998-2000. The sample consists of 400 deals corresponding to 203 target firms. For details see: AIFI, INSEAD, Università Cattaneo Castellanza (2001).

³⁶ The decline to 1.7 in 1999 was due to an increase in interest rates which affected the entire Euro area.

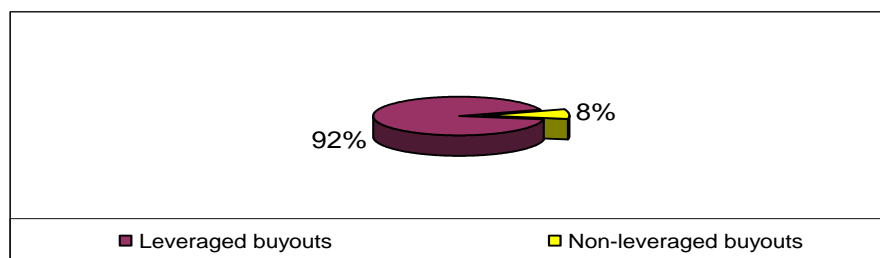


Figure 4. Percentage of Leveraged Management Buyouts in Italy

Source: Elaboration from the author on data from AIFI (2001) Aifi, Insead, Università Cattaneo Castellanza (2001).

Exhibit 2. Average Leverage Ratio (Debt/Equity) of MBO/MBI transactions in Italy (1992-1999)

	1992	1993	1994	1995	1996	1997	1998	1999
Debt/Equity Ratio	1.9	1.6	1.7	1.8	2.1	1.9	2.2	1.7

Source: Elaboration from the author on data from AIFI (2001) and AIFI Statistics Reports, various years.

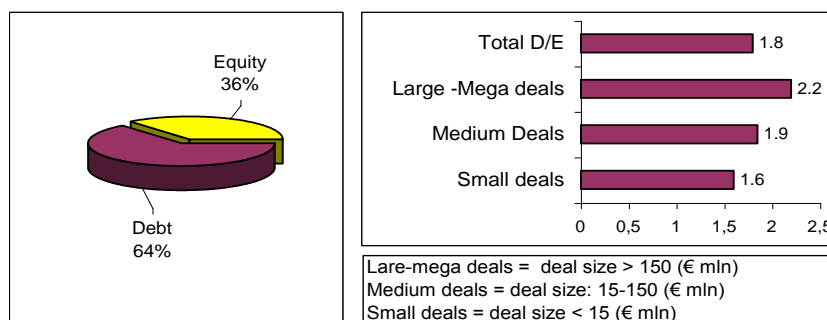


Figure 5. Debt/Equity Ratio in Italy (2006)

Source: Elaboration from the author on data from AIFI Yearbook (2006)

As shown in Figure 5, almost 64% of an Italian LBO deal is typically financed by debt and the remaining 36% by equity.³⁷ Large-mega deals (whose size is greater than 150 million Euro) usually are characterized by a higher Debt/Equity ratio than smaller deals. In 2006, large-mega deals on average applied a leverage ratio of 2.2 while the leverage ratio for small deals (whose size is smaller than 15 million Euro) was 1.6.

From a more general point of view, the majority of the target companies involved in buyout transactions in Italy have been closely held, unlisted and with a family ownership structure. The buyout technique seems thus well-suited to the Italian economic system which is characterized mainly by small private and family business. Exhibit 3 shows the distribution of buyout transactions across different

types of target companies.³⁸ In 54% of the cases, the target was a private and family-owned company and in 3% of the cases the target was a state-held company. In another 3% of the cases the target was represented by a listed company which needed to be restructured.

Moreover, according to the AIFI-INSEAD-LUIC survey 2001, the majority of target companies in Italy belong to traditional manufacturing sectors and are located in Northern Italy. Exhibit 4 presents the distribution of target companies across Regions.

From an economic viewpoint, LBOs tend to have a positive impact in Italy. On average, empirical evidence demonstrates that target companies grow faster and improve their overall economic performance after the change in ownership.³⁹ The

³⁷ In the US, the debt used to finance LBOs usually covers a greater percentage of the deal (Axelson et al. 2007 a, Jensen 89).

³⁸ See the survey carried out by Aifi, Insead and Liuc (2001).

³⁹ With reference to the Italian buyout market, several surveys demonstrate that buyouts improve the performances of the target companies, in terms of revenues and EBIT, with positive effects on the employment growth. See: AIFI,

high degree of leverage which characterizes most post-LBO firms has at least two effects. First, the presence of debt puts pressure on the management team and serves as a motivator and disciplinary device (Jensen 1989).⁴⁰ Secondly, the higher leverage ratio increases the firm's default risk, which tends to be especially high in case of a turnaround leveraged buyout.⁴¹ In this situation, it is essential to have a highly motivated management team with proven experience and skills. Moreover, LBOs may have a positive effect on the return on equity (ROE) and the firm value, by lowering the weighted average cost of capital (wacc).⁴²

3. The LBO Process: Legal and Financial Implications

Since leveraged buyouts might be performed through a merger between the newco and the target, understanding the legal environment that regulates mergers and acquisitions (M&A) is crucial for

PRICEWATERHOUSE COOPERS (2006) and AIFI, INSEAD, Università Cattaneo Castellanza (2001). A detailed analysis of the economic impact of LBOs in other countries is also presented in: Wright et al. (2006), Wright et al. (1996), Opler (1992), Smith (1990), Kaplan (1989).

⁴⁰ There is an extensive literature on the advantages and disadvantages of debt financing. See among others: Cornelli and Yosah (2003); Dessi (1999), Bolton and Sharfstein (1990); Harris and Raviv (1990); Sahlman 1990; Jensen (1989), Williamson (1988); Gale and Hellwig (1985).

⁴¹ One of the most successful examples of such a turnaround LBO in Italy is the acquisition of Ducati Motor by the Texas Pacific Group (TPG) in 1996. Texas Pacific Group is a private equity company based in San Francisco. TPG bought Ducati Motor in 1996 through a leveraged buyout alongside Deutsche Morgan Grenfell (now Deutsche Bank). Before the buyout transaction, Ducati was owned by the Cagiva Group, a private manufacturing conglomerate. In 1996, the Cagiva Group suffered a serious liquidity crisis which also affected Ducati's business, reducing Ducati's motorcycle production, sales and financial performance. Ducati came close to being declared bankrupt. Texas Pacific Group recognized the growth potential of Ducati's line of business and, following an accurate evaluation of Ducati's business plan, decided to acquire the company through a leveraged turnaround transaction. The process involved the following steps: In May 1996, "Ducati Motor Holding S.p.A." (DMH) was created by the Texas Pacific Group. DMH was a pure holding company with the aim to acquire the Ducati Business. In September 1996, after several difficult negotiations with the Cagiva Group which was reluctant to give up control of Ducati, TPG acquired 51% of Ducati Motor Holding together with Deutsche Morgan Grenfell Capital Italy (DMGCI). In 1998, DMH acquired the remaining 49% of the shares from Cagiva. Subsequent to the acquisition, Ducati implemented a successful turnaround program that substantially increased the production of motorcycles and unit sales. Finally, Ducati went public in March 1999. For details see: the Ducati's Initial Public Offering Prospect, published by CONSOB in "Archivio Prospetti", March 3rd, 1999, n. 4466.

⁴² See, among others, Cressy *et al.* (2007), Barzaghi (2002).

entrepreneurs and private equity investors.⁴³ Figure 6 summarizes the typical scheme through which a merger LBO transaction is undertaken.⁴⁴

Phase 1: Creation of a new company (holding company or newco)

A new company (newco) is established as special purpose vehicle (SPV), with the aim of acquiring a specific firm (target). The newco generally takes the form of an Srl (Limited Liability Company). The share capital of the newco is supplied by the initial buyers and by institutional investors, specialized in buyout transactions. The initial buyers are in many instances the management of the target company (MBO) or an outside management team (MBI).

Phase 2: Debt financing

In order to obtain the funds necessary to accomplish the acquisition, the newco generally requires debt financing (leverage). This debt usually takes the form of bridge financing and is collected from specialized financial institutions (mainly banks). The debt financing is often secured by pledging the shares or the assets of the target company.

Phase 3: Acquisition of the target

In a typical LBO, the newco acquires the totality (or majority) of the target's shares.⁴⁵ The target company has to repay the debt obligation with its future cash flows. Since the target firm bears most of the economic costs of its acquisition, the success of a LBO deal depends on the financial characteristics of the target, its growth potential, and its management team. An ideal candidate firm for a LBO acquisition should have some or all of the following features:

- A good and secure competitive position in its industry;
- A modest level of initial (pre-LBO) debt;
- A substantial level of assets suitable as collateral for the bank loan;
- An expectation of high and most importantly stable future cash flows to repay the principal and interest on the newly issued debt.

Phase 4: Merger

In most cases, the acquisition is followed by the merger of the target with the newco. After the merger, the bridge

⁴³ Usually the LBO acquisitions observed in Italy have not been hostile and the mergers proceeded with the approval of the target companies. An acquisition is termed "hostile" if it is opposed by the management team of the target company. In this case, the acquirer can attempt to take control of the target by buying a majority of the target's voting shares in the open market, usually through a tender offer. Given that most Italian companies are privately held and the shareholder structure of public firms is highly concentrated, hostile takeovers are extremely rare in Italy. For an overview of the Italian ownership structure and corporate governance, see among others: Enriques and Volpin (2007), Bigelli et al. (2007). For an empirical analysis of the impact of ownership structure on market opportunities see: uk (2005).

⁴⁴ For further discussions on the financial structure of LBOs in Italy see, among others: Forestieri (2007), Capizzi (2005 a, b); Caselli, Gatti (2005); Forestieri, Tasca (1994).

⁴⁵ In the majority of LBO deals completed in Italy so far, the newco has always acquired 100% of the capital of the target company. This simplifies the merger procedure following the acquisition. After the incorporation of the target into the NEWCO, the target's shares are cancelled. See: Aifi (2001), Mills and Seassaro (1990).

financing is generally replaced by a new medium or long-term debt, secured by the assets of the merged company.⁴⁶

Two types of mergers exist. In a forward merger, the target is merged into the newco, and consequently the target disappears. In a reverse merger, the newco is merged into the target, which will be the only remaining company. In both cases, as a consequence of the merger, the combined entity enjoys all the rights and it is subject to all the obligations that the two prior companies had before. In the end, the debt obtained by the newco is merged into the target's liabilities, and any claims by newco's creditors are transferred to the target's asset.⁴⁷

According to the current Italian law, the merger procedure subsequent to an LBO deal must follow several steps. First, the shareholders' meetings of both companies must approve the merger agreement specified in a letter of intent prepared by the firm's directors (article 2501 c.c.). Once the shareholders' meeting has approved the agreement, the merger decision must be published in the "Enterprises Book" (article 2502 c.c.). Subsequently, a waiting period of two months follows in order to give the creditors of both companies the right to oppose the merger (article 2503 c.c., paragraph 1). If some creditors oppose the merger, it is suspended. A court must then intervene and decide whether the merger is allowed to proceed, unless a bank guarantee is provided in favor of the opposing creditors (article 2503 c.c., III paragraph). According to the Law n. 287/90, each merger is also subject to the scrutiny of the Antitrust Authority

Figure 6. The typical LBO scheme

The critical features of an LBO that emerge from the above scheme are the following:

1. The debt financing is arranged by the newco and is ultimately secured by the assets of the firm that is being acquired.
2. The financing is obtained under the expectation that it will be repaid with the cash flows generated by the acquired company or by the sale of its non-strategic assets.
3. As a consequence, the target company effectively pays the economic price of its own acquisition. Critics⁴⁸ also argued that, in the end, the target appears to acquire its own shares or to provide a guarantee for this purpose through the intermediation of the newco and outside the limits and prohibitions specified by the law. This will be discussed in the next section.

3.1. The Past Debate on the LBO Legitimacy: A Critical Analysis from an Economic Viewpoint

As noticed, the legitimacy of LBOs has been strongly debated in Italy over the past decade. Divergent opinions between scholars (doctrine) and Italian

courts (jurisprudence) have characterized the debate.⁴⁹ Despite the intensive debate, none of the relevant cases included in the existing jurisprudence⁵⁰ directly addressed the issue of the legitimacy of LBOs or show a clear and consistent interpretation.⁵¹ The Court of Milan (civil and criminal sections) even issued contrasted decisions with reference to the same case.⁵²

The core of the LBO debate was focused on the interpretation of the ultimate economic result of the transaction.⁵³ The controversy surrounding several buyout transactions carried out in Italy led part of the doctrine and jurisprudence to believe that the overall LBO scheme was designed with the sole purpose of eluding Italian law, especially with reference to the provisions regarding the purchase of own shares by a company (articles 2357 – 2358 Civil Code –c.c.).⁵⁴

In particular, critics argued that the LBO process produces a result similar to what would happen if the target firm granted a loan or provided a guarantee to the newco for the purchase of its own shares.⁵⁵

⁴⁹ The authors arguing against LBOs are: Montalenti (1991, 1990), Apice (1990), Cottino (1999), Morello (1990), Grande Stevens (1990). The authors arguing in favor of LBO transactions are: Accinni (1996); Morano (1992); Gambino (1990); Calvello (1990); Marabini (1996).

⁵⁰ Examples of cases that are commonly considered part of the existing jurisprudence on LBOs in Italy are the following: Tribunal of Milan, May 14, 1992 (*Farmitalia case*); Penal Tribunal of Milan, June 30, 1992 (*Farmitalia case*); Tribunal of Ivrea, August 12, 1995 (*Cuorgnè case*); Tribunal of Brescia, June 1, 1993 (*Marzoli case*); Tribunal of Milan, May 4, 1999 (*Pepperland case*); Tribunal of Milan, May 13, 1999 (*Trenno case*); Supreme Court's decision 5503/2000 (*D'Andria case*). For an economic discussion of Court's decisions and on the doctrine concerned with LBO transactions see: Zambelli (2005). Legal reviews of the doctrine and jurisprudence concerned with LBOs are presented in: Fava and Fuschino (2003), Bruno (2006-2002), Varrenti (2000 a, b), Picone (2001), Frignani (1996), Desideri (1993), Preite (1993), Belviso (1993); Mills and Seassaro (1990).

⁵¹ Court decisions against LBOs are: Criminal Tribunal of Milan, June 30, 1992; Ivrea Tribunal, August 12, 1995; Tribunal of Milan, May 4, 1999; Supreme Court, February 4, 2000. Examples of Court decisions in favor of LBOs are: Tribunal of Milan, May 14, 1992; Tribunal of Brescia, June 1, 1993; Tribunal of Milan, May 13, 1999.

⁵² We refer to the buyout-transactions carried out by Farmitalia Carlo Erba SpA (*Farmitalia case*). With reference to this case, the Tribunal of Milan decided in favor of the legitimacy of LBOs on May 14, 1992. On the contrary, a month later, the Criminal Tribunal of Milan decided against the legitimacy of LBOs (Penal Tribunal of Milan, June 30, 1992).

⁵³ For a general legal review of the criticism surrounding LBOs over the last decade, see for example, Bernardi (2003, 2001), Picone (2001), Bentini (2000), Preite (1993), Pardolesi (1989).

⁵⁴ See: Montalenti, 1996.

⁵⁵ For more information from a legal point of view, see: Montalenti (1996, 1991, 1990), Morello (1990), Apice (1990), Mills and Seassaro (1990), Varrenti (2000 a, b).

⁴⁶ For a discussion on the merger effects, see: Spolidoro (2001, 2000).

⁴⁷ For a review on the effects of a merger in Italy, from an accounting point of view, see Caratozzolo (1989).

⁴⁸ See, among others, Montalenti (1996).

Exhibit 3. Target Companies in Italy (1999)

Family & Private	Local parent	Foreign parent	Privatization	Public to private
54%	26%	14%	3%	3%

Source: AIFI, INSEAD, LIUC (2001)

Exhibit 4. Geographical Distribution of target Companies

Lombardia	Piemonte	Veneto	Emilia - Romagna	Toscana	Friuli - Venezia Giulia
34%	16%	14%	13%	5%	5%

Source: AIFI, INSEAD, LIUC (2001)

The Italian Supreme Court decision (February 4, 2000, number 5503) confirmed this interpretation by declaring the LBO scheme illegal. Paradoxically, this decision intensified the debate surrounding the lawfulness of LBOs, instead of solving it.

3.1.1. The Limits of the Italian Law: Share-Buyback and Financial Assistance

A closer examination of Italian doctrine and jurisprudence⁵⁶ on LBOs reveals that three Civil Code (c.c.) provisions, which were commonly used to invalidate these types of transactions:

- Article 2357, which limits the purchase of own shares by a company;
- Article 2358, which prohibits the provision of guarantees by the target for the purchase of its own shares. This article represented the most invoked provision against the validity of LBOs;
- Article 1344, which invalidates any agreement whose primary goal is to elude imperative provisions of the law.

Article 2357 limits the purchase of own shares by a company. It defines a set of conditions according to which a company can repurchase its own shares. This can be accomplished only within the limits of the available net profits and only in case they are fully paid (see paragraph I). Furthermore, the purchase must be approved by the shareholders' meeting and the par value of the shares shall not exceed 1/10 of the entire share capital (see paragraphs II, III). These limits also apply to purchases realized through an intermediary or a fiduciary company (paragraph V). In case of a violation of these restrictions, the shares exceeding the specified limits must be sold within one year from their purchase. If this does not occur, the shares shall be cancelled and the book value of the share capital shall be reduced by a corresponding portion. Otherwise, a Court must intervene and order the reduction of the share capital (paragraph IV).

Article 2358 prohibits a company from granting loans or providing guarantees for the purchase of its own shares, either directly or indirectly through the intermediation of a third party (financial assistance prohibition). Before the introduction of the new Corporate Governance Law, a violation of this provision was punishable under criminal law with a sentence of up to 3 years of prison (according to article 2630 c.c., 1st paragraph, number 2)⁵⁷.

In order to invalidate the transaction, another legal provision (**article 1344** c.c.) was used in combination with the previously discussed article. Article 1344 c.c. declares invalid any agreement made with the intention of eluding imperative provisions of the law. Even though a specific transaction or financing arrangement might be legal, if the overall contractual scheme is designed with the purpose of eluding imperative rules of the law, then the transaction is considered illegal. The possibility of applying article 1344 to LBOs was based on the belief that the implicit purpose of the LBO scheme was to achieve the exact outcome that the lawmaker intended to prohibit through article 2358.⁵⁸

The following section intends to shed some light on the lawmaker's intentions behind the three relevant articles described above, and discusses their relationship to LBO transactions from a financial economic viewpoint.

3.1.2. LBOs as Share-Buybacks: An Economic Perspective

The rationale behind article 2357 (share-buyback ban) is to protect the target's paid-in share capital, avoiding a weakening of the guarantees granted to the target's creditors. In fact, the acquisition of own shares by a company, with funds other than current profits, would result in a partial reimbursement of equity capital to shareholders. Consequently, by draining funds from the company and increasing the leverage ratio, pre-existing loan obligations become more risky, to the detriment of the firm's creditors.

⁵⁶ For a summary on the basic jurisprudence and doctrine on LBOs see: Picone (2001), Bernardi (2001).

⁵⁷ This article was eliminated by the recent criminal law reform (Legislative Decree 61/2002).

⁵⁸ See, among the others, Grande Steven (1990).

According to a particular interpretation of the law⁵⁹, the result of an LBO transaction is considered similar to a situation in which the target company acquires its own shares through the intermediation of the newco, eluding the limits specified by article 2357 - paragraph V- (share buyback interpretation) as summarized in Figure 7.⁶⁰

The share buyback interpretation of LBOs does not seem justified from an economic viewpoint given the rationale behind the article as outlined before.

First of all, in a simple share buy-back by the target company (even through the intermediation of a third party) the final ownership structure does not necessarily change. LBO transactions, on the other hand, are fundamentally characterized by a change in ownership structure. The ultimate owners of the combined entity are the owners of the newco. Hence, the economic goal of an LBO is fundamentally different from the goal of a simple share buyback.⁶¹

Second, depending on the specifics of the deal, creditors may or may not be in favor of the buyout transaction. Does the protection of investors, and other parties with pre-existing contracts, justify the application of article 2357 to LBO transactions? Under the current Italian Law, creditors have the possibility to oppose any LBO transaction that appears to lower the value of their claims.⁶² The creditors' "veto right" opens up the possibility of mutually beneficial agreements between creditors, target company and acquirer, that would be ruled out by a broad interpretation of article 2357.

Another closely related argument, which received attention in the legal literature, is that the share repurchase may produce a "hidden" reduction of the firm's equity base, misleading investors and business partners. From a financial economic perspective, it is important to distinguish two situations. First, the repurchase of own shares is reported in the financial statements of the company. Hence, investors and other parties with an interest in the company should have little difficulty assessing the firm's true equity base from publicly available information. Second, only prior creditors and other parties with pre-existing contracts with the firm may be vulnerable to opportunistic reductions in the firm's equity capital, since they are unable to change their contract terms in face of the share repurchase.

Following a different line of reasoning, the LBO scheme was also perceived as example of financial assistance provided by the acquired firm for the

purchase of its own shares. Therefore, article 2358 c.c. was often invoked to invalidate the effects of LBOs in Italy, especially if carried out without a merger between the target and the newco.⁶³ From an economic viewpoint, the rationale behind the financial assistance prohibition is twofold:

– To avoid a deterioration of the target's assets and to protect the integrity of its net worth, to the benefit of its creditors, analogous to the rationale behind article 2357;

– To discourage opportunistic behavior by the target's management in the interest of the target's shareholders, e.g. to prevent them from taking over the company fraudulently through a hidden acquisition of its own shares and consequently influencing the company's ownership structure. If the actions described in article 2358 were permitted without restrictions, the directors could misuse the funds of the company by granting loans or providing guarantees to an outside party (trustee). This implies that, through the intermediation of that party, the management could indirectly take over the company and influence the shareholders' meeting.⁶⁴

Why were LBOs considered instruments adopted by investors to elude the financial assistance ban? According to a particular interpretation of the law ("financial assistance view"⁶⁵) the ultimate result of an LBO is to shift the debt obtained for the target's acquisition onto its assets, against the rights of preexisting unsecured creditors and minority shareholders. This was considered particularly evident in the case of non merger LBOs, where the target's assets often serve as a guarantee for the acquisition of its own share, against the prohibition imposed by article 2358. Moreover, the legal validity of a merger LBO was also highly disputed.⁶⁶ Critics argued that, as a consequence of the merger, the target's assets become a guarantee for the payment of the debt previously contracted by the newco.⁶⁷ The newco in turn was interpreted as an intermediary acting on behalf of the target company, and the merger was perceived only as an instrument to elude the law, especially in the case of a reverse merger LBO, where the target is the only surviving company⁶⁸ (Figure 8).

⁵⁹ This interpretation is defined as "substantial thesis" by the Italian doctrine. See: Montalenti (1996, 1990); Morello (1995); Apice (1990).

⁶⁰ Farmitalia case was accused to elude the provisions of article 2357 c.c. (Decision of the Tribunal of Milan, May 14, 1992). For a review of the related jurisprudence, see: Zambelli (2005), Fava and Fuschino (2003), Bruno (2002), Picone (2001), Scodditi (1993), Sorrentino (1992).

⁶¹ See the empirical research conducted by AIFI, INSEAD, Università Cattaneo Castellanza (2001).

⁶² Article 2503 of the Civil Code.

⁶³ A famous case accused to elude the provisions of article 2358 c.c. is represented by: Manifattura di Cuorgnè (Decision of Ivrea Tribunal, August 12, 1995). For more information see: Zambelli (2005), Fava, Fuschino (2003).

⁶⁴ For more information see: Cottino (1999), Montanari (2001), Molino (2000), Picone (2000), Morano (1992).

⁶⁵ The major authors embracing this view are: Grande Steven (1990), Montalenti (1996, 1991, 1990), Morello (1990), Apice (1990).

⁶⁶ Genovese (1997).

⁶⁷ See: Cottino (1999), Montalenti (1996, 1990), Morello (1990), Apice (1990).

⁶⁸ For a discussion on the reverse merger procedure in Italy, see Manzini (2000), Spolidoro (2000).

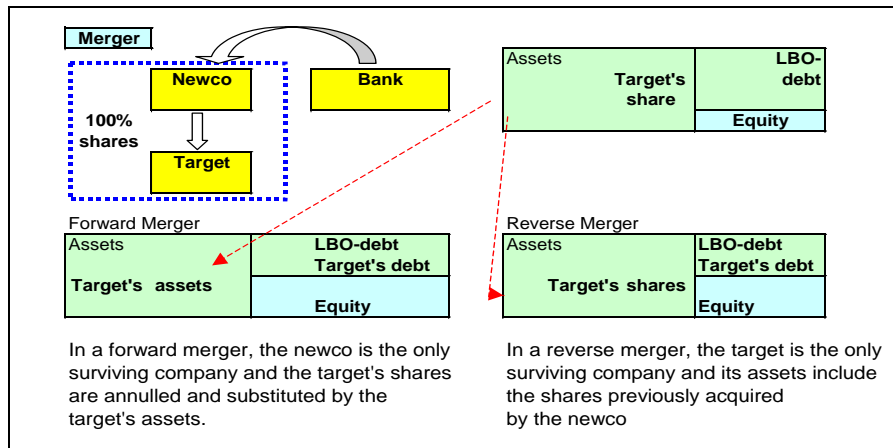


Figure 7. LBO scheme as an indirect share buyback

Critics argued that the LBO scheme produces the same results of a share buyback initiated by the target through the intermediation of the newco, eluding the Italian law limits (article 2357 c.c.).

In 2000 the Italian Supreme Court reinforced this view (Supreme Court's Decision n. 5503/2000, the D'Andria case) by declaring the LBO scheme illegal in Italy and prohibiting its adoption within the Italian context. In particular, the Supreme Court emphasized the interpretation of considering the LBO scheme as a fraudulent instrument adopted by the target's management with the sole intention of eluding the financial assistance provisions (especially article 2358) because the target in the end appears to provide a guarantee for the purchase of its own shares.

The Supreme Court's decision was severely criticized by legal scholars and investors.⁶⁹ This decision did not solve the debate on the legitimacy of LBOs. It only intensified the legal uncertainty surrounding the LBO admissibility and rose more concerns among private equity investors, probably preventing them from undertaking these types of transactions. In our opinion, the "financial assistance view" does not seem justifiable from an economic viewpoint: an LBO is merely a financial tool. Like any tool, it can be used properly or misused. This should not lead any Court to reject the LBO scheme in absolute terms since, when properly used, it allows a company to access alternative sources of finance.

The facts of the case judged by the Supreme Court, the related "financial assistance interpretation" and the subsequent market reaction will be discussed in greater detail within the next two sections.

3.1.3. The relevant Case Law and the D'Andria Case Paradox: A Critical Analysis from an Economic Viewpoint

The past case law on LBOs was characterized by inconsistent and ambiguous decisions, which did not

provide adequate interpretative guidance to legal scholars, entrepreneurs and investors. For example, in 1992 the Civil Court of Milan decided in favor of the legitimacy of an LBO transaction (the Farmitalia case) accused of having violated the limits regulating the share-buyback (Civil Court of Milan, 14 May 1992).⁷⁰ Surprisingly, a month later the criminal Court of Milan examined the same case and declared it illegal because perceived in contrast with the regulation limiting the acquisition by a company of its own shares (Criminal Court of Milan, 30 June 1992). In 1995, the Ivrea Court declared a leveraged buyout transaction (the Cuornè case) illegal because in contrast with the financial assistance prohibition imposed by article 2358 c.c. (Court of Ivrea, 12 August 1995). A similar decision of illegality was made in May 1999 by the Court of Milan, with reference to the Pepperland case (Court of Milan, 4 May 1999).⁷¹ The interpretation of considering the LBO scheme as illegitimate was not the only feasible one. Following a different line of reasoning, a decision by the Court of Milan, with reference to the Trenno case, declared that LBO transactions should be considered legal if they are supported by valid entrepreneurial and business reasons and are aimed at promoting the development of the company with a proper project (Court of Milan, 13 May 1999).⁷²

This implies that, in the absence of a valid business reason for the buyout or the merger, the whole transaction should be invalidated ("rule of reasons").⁷³

⁷⁰ For a legal discussion see: Scoditti 1993, Sorrentino 1992.

⁷¹ For legal discussions on the fact of the cases on LBOs, see Fava-Fuschino 2003.

⁷² Milan Tribunal, May 13, 1999.

⁷³ This decision followed a similar line of reasoning, emphasized more generally in a previous decision by the Brescia Court (criminal Court of Brescia, 1 June 1993, with reference to the Marzoli case).

⁶⁹ For a legal overview on the criticism related to the Supreme Court's decision, see: Fava – Fuschino (2003), Picone (2001), Accinni (2001), Varrenti (2000 b).

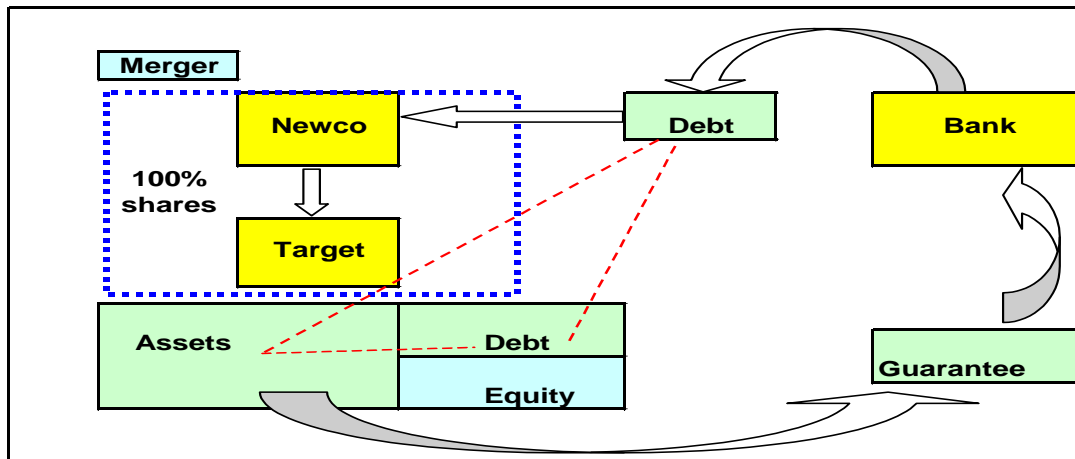


Figure 8. LBO scheme as a general breach of the financial assistance prohibition

The acquisition of the target's shares is generally followed by a merger between the newco and the target. Critics argued that, as a consequence of the merger, the target effectively offers its assets as a guarantee for the debt originally obtained by the newco. The effect of an LBO transaction is perceived similar to what would happen if the target granted a loan or provided a guarantee to the newco for the purchase of its own shares. This would be prohibited by article 2358 c.c. and the effects of the transaction would be invalidated according to article 1344 c.c.

Even though the above decision provided neither guidance nor examples of business reasons that could have been considered relevant for the legitimacy of LBOs, the decision on the Trenno case represented an important change of perspective for the Italian doctrine and jurisprudence on LBOs.⁷⁴

However, a year later, the Italian Supreme Court (Supreme Court's Decision 5503/2000, regarding the D'Andria case) declared the LBO scheme illegal.⁷⁵ It explicitly stated that the LBO scheme "cannot be imported into the Italian system because it is in contrast with article 2358 of the Civil Code".⁷⁶

In order to evaluate the general relevance of this decision, it is important to analyze the facts of the case that induced the Court to declare LBOs illegal (D'Andria case –Box 1). Box 1: The D'Andria case (Supreme Court, February 4, 2000, number 5503)

A group of companies collapsed into bankruptcy. Its director was accused of fraudulent bankruptcy because he financed the acquisition of several companies with the use of promissory notes guaranteed by the target companies. In the Court's opinion, he knew he could not honor these promissory notes since it was evident that he did not have the necessary funds to accomplish his stated goals. Given that several acquisitions involved a guarantee provided by the target companies, the Court saw an evident breach of the financial assistance rule (according to article 2358 of the Civil Code). After being accused of fraudulent bankruptcy, the director received an arrest order (July 7, 1999), against which he appealed. In the course of the appeal, the

defendant argued that the acquisitions followed "a modern but absolutely legal scheme of self financing, similar to a leveraged buyout". Only in response to this specific argument did the Supreme Court intervene and declare the LBO scheme illegal in Italy.

In our opinion, the facts of the case considered by the Supreme Court did not represent a reliable basis for resolving the issue of LBO validity in Italy.

First, the Supreme Court made the above statement on LBOs only indirectly, or better incidentally, with reference to a criminal law case of fraudulent bankruptcy. As shown in box 1, the legitimacy of LBO transactions was not the actual problem addressed by the Supreme Court and emerged only incidentally in the course of the appeal.

Second, the Court misunderstood the defining characteristics of LBO transactions, since the defendant improperly described the financing agreements signed by its client as an LBO. A closer examination of the financial transactions in conflict with article 2358 c.c. casts doubt on whether the case can even be considered close to an actual LBO transaction. In the case at hand, there is little doubt that the financial instruments used were illegal, and that the promissory notes were issued without the expectation that there would be sufficient funds to honor them. Furthermore, article 2358 c.c. describes a transaction scheme which is not used for most LBO transactions. It explicitly assumes that the target company plays an active role in the acquisition process, providing ex-ante guarantees or loans to the newco in order to facilitate the purchase of its own shares. This is what happened in the case considered by the Supreme Court. All target companies provided bank guarantees in favor of the newco, in order to facilitate the acquisition of their own shares. A part

⁷⁴ This decision, in fact, anticipated the future reform on the Italian corporate law that will be discussed in the next sections.

⁷⁵ For a legal review of the decision see, among others, Molino (2000).

⁷⁶ For more information see: Molino (2000), Picone (2000), Varrenti (2000 a).

from this particular situation, which is indeed prohibited by article 2358 c.c., it is inappropriate to consider all LBO transactions as illegal, as long as the target assumes a passive role and does not provide any formal ex-ante and specific guarantee to the newco.⁷⁷ The Supreme Court's decision seems unjustified even from an economic viewpoint. Not necessarily is there an ex-ante equivalence between LBO transactions and the acquisition by a company of its own shares through an intermediary.

In a typical LBO, the guarantee provided by the target company comes into effect only after the merger has been completed, i.e. after the ownership of the target has changed and the target's shares are annulled (in case of forward merger). Creditors will not be defrauded as long as they have the ability to object to any leveraged buyout which reduces the value of their claims. Furthermore, in the case of listed companies, LBOs are publicly announced and do not allow managers to take control of their own firms in a hidden manner. For the above reasons, the case considered by the Supreme Court could not represent a strong precedent for the Italian legal system.⁷⁸ The facts of the case at hand did not represent an appropriate picture of standard LBO transactions, which can be implemented in different forms. Whether or not any given transaction contrasts with article 2358 c.c. depends on the specific circumstances and details of each deal. The legal validity of each LBO deal should be evaluated on a case-by-case basis, taking into account the specific facts and circumstances that characterize each transaction.⁷⁹

3.1.4. The Market Reaction

The decision by the Supreme Court increased the debate and uncertainty regarding the legitimacy of LBOs in Italy, rather than solving it. It probably prevented entrepreneurs and investors from undertaking these types of transactions. From an empirical point of view, the number and the value of LBO transactions have significantly decreased in 2000 and 2001. For example, the number of LBO transactions declined by 18% in 2000 and by 53% in 2001.⁸⁰ An important contributing factor to this dramatic decrease was certainly the negative economic trend that affected the Italian private equity market at that time. However, according to the data collected by the Italian Venture Capital Association (AIFI), the frequency of LBOs diminished more than the decline in number of start-ups and expansion transactions. It seems reasonable to suspect that the uncertainty surrounding the legitimacy of this type of

transaction and its legal consequences has prevented investors from adopting this financial scheme.⁸¹

As noticed, if a Court perceived an LBO deal as a tool adopted with the sole purpose of violating the financial assistance prohibition, the legal consequences were quite relevant, both from a financial and legal point of view. The financing agreement and the subsequent purchase of the target's shares could have been considered null and void. A strong leverage ratio could have been interpreted as the cause leading to the insolvency status of the target and its subsequent bankruptcy declaration. Furthermore, if the integrity of the target's equity was damaged as a result of a breach of the financial assistance prohibition, the directors involved in the transactions ran the risk of receiving criminal sanctions (up to three years of prison⁸²).

In order to minimize the consequences of an illegitimacy declaration, the majority of buyout transactions carried out in Italy over the past decade were structured in a pyramidal form, as multi-layer deals, with more than one newco (Figure 9). As shown in Figure 9, newco 1 was usually set up abroad with the only purpose of acquiring 100% of the shares of newco 2 (located in Italy). The acquisition of newco 2 was accomplished thanks to a debt financing (D1) contracted by newco 1, which was then forwarded to newco 2, in the form of either high share premium or through a non interest bearing loan. Newco 2, in turn, was set up in Italy as a vehicle to purchase the majority of the target's share (T). Subsequently, newco 2 and the target merged. The share premium (or the non interest-bearing loan) was paid back to newco 1 through a loan agreement between them, and newco 1 could finally reimburse the original debt (D1).⁸³

⁸¹ Cumming, Zambelli (2007) empirically demonstrate a statistically significant relation between the legal uncertainty on the legitimacy of LBOs and their frequency in the Italian private equity market.

⁸² This criminal punishment was specified by article 2630 c.c., changed in 2002 (Legislative Decree 61/2002).

⁸³ Another solution, generally adopted to minimize the legal risk of an illegitimacy statement, was to acquire the target company with a short term bridge financing (D1), originally secured by newco shareholders only. Subsequently, newco and target merged. Following the merger, a new medium-long term financing (D2) was granted to the combined company, secured against the assets of the merged entity. De facto, the new debt (D2) was used to payoff the original debt (D1) contracted by newco. For more information on these complex deals, see for example: Silvestri (2005). See also: <http://www.altassets.com/casefor/countries/2002/nz3432.php>. For an overview of the pyramidal ownership structure in Italy see, among others, Bennedsen et al. (2007, 2006), Bigelli et al. (2007, 2004), Faccio and Lang (2002), Zattoni (1999).

⁷⁷ For more information see: Zambelli (2005), Accinni (2001), Filograna (2000), Frignani (1989), Varrenti (2000 a, b), Mills and Seassaro (1990).

⁷⁸ Varrenti (2000 a).

⁷⁹ Picone (2001).

⁸⁰ See Figure 1 of this paper and visit the website: www.aifi.it.

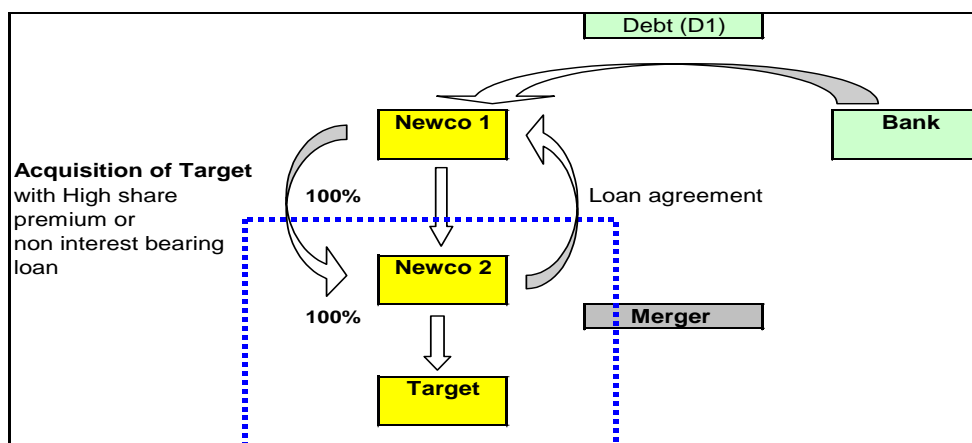


Figure 9. Multi-layer buyout deal

Despite these complex buyout structures, the illegality risk was not eliminated and a legal reform was still necessary. It came into force only in 2004.

4. The Current Regulatory Environment: New Requirements and Unsolved Issues

Recently, a new regulation was introduced with the aim of reforming the Corporate Governance law (Legislative Decree 6/2003, applicable as of January 1, 2004). Among other things, the new regulation finally clarifies the legal status of certain types of LBOs –merger LBOs.

This reform followed the guidelines indicated by the Italian Parliament in a previous bill of law (Law 366/2001), which clearly stated that LBO transactions should never be considered illegal (article 7 point d).⁸⁴ This law had only a formal efficacy, and therefore it was not directly applicable within the Italian legal environment. It was simply a “delegate-law” in which the Parliament assigned the Government the task of issuing, within 2002, one or more legislative decrees, in order to reform the Italian corporate law according to a set of principles and conditions. In 2003 the Government intervened and reformed the corporate governance law. A new article was introduced to regulate the legitimacy of LBO transactions (article 2501 bis).

However, instead of declaring that LBOs should always be considered legal, the Government preferred to specify a set of requirements that should be satisfied for the legitimacy of an LBO deal. In general, LBOs are presumed legal if certain conditions are satisfied, especially with reference to information disclosure, certification of fair deal and reasonable business plan. In particular, article 2051 bis states that mergers between a leveraged vehicle

(newco) and the acquired company (target), where the target acts as general guarantee for, or the source of reimbursement of, shall now be permitted subject to certain requirements, as discussed below.⁸⁵

1) First condition: **merger LBOs**, with no specific guarantees on the target’s assets.

Under the new regulation, only certain types of buyouts are legalized. Article 2501 bis applies only to those leveraged buyouts, which a) involve a merger between the newco and the target, and b) are characterized by the absence of specific guarantees (such as a pledge) on the target’s assets.⁸⁶ This implies that, in case of default the lender does not benefit from any particular preferential rights over a specific target’s asset. On the contrary, if the target provides a specific guarantee, the illegality risk remains and the transaction could be invalidated in light of the financial assistance prohibition, as already occurred in the past.

2) Second condition: **disclosure** on reasons, objectives and sources of funds.

Subsequent to the acquisition of the target’s share, the board of directors of each merging company must write a report indicating:

- The business reasons justifying the entire LBO transaction (not only the merger);

- A post-merger business plan, describing the objectives of the merger. The merger plan must contain information on the funding and a description of the expected financial resources that will be used by the merged company to satisfy its obligations. Furthermore, the plan needs to show the share exchange ratio of each firm. The aim of the merger plan is to demonstrate that:

a) The combined entity is able to meet all its financial obligations (including the debt originally

⁸⁴ Literally, article 7 (d) states: “The merger of two companies, one of which had received debt financing in order to acquire the control of the other, does not imply a violation of the prohibition to make loans or provide guarantees for the purchase or the subscription of own shares”.

⁸⁵ For a summary on the LBO requirements highlighted in the new corporate governance reform, see Portolano (2003).

⁸⁶ Article 2051 bis in fact states that mergers between a leveraged vehicle (newco) and the acquired company (target), where the target acts as general guarantee for, or the source of reimbursement of, shall now be permitted subject to certain requirements.

contracted by the newco for the acquisition of the target's shares);

b) No potential damage will be caused to minority shareholders and pre-existing creditors.

3) Third condition: **experts' appraisal and auditors' report**

An independent financial expert must attest the fairness of the financial resources and the assumptions made in the merger plan, especially with regard to the business plan and the share exchange ratio (fairness opinion).⁸⁷ Ultimately, if one of the merging companies is required to certify its financial statements, an external auditors' report must validate the content of the merger plan.

4.1. Unsolved issues

Article 2501 bis c.c. represents an innovative approach to the regulation of merger LBOs within the European Union. The corporate governance reform has definitely reduced the ambiguity surrounding the legal validity of LBOs in Italy. However, the debate is still open with reference to various issues:

1. The difficulty of justifying an LBO and its merger, with **valid business reasons**. In the worst-case scenario, in which a Court must intervene and judge the transaction, an open question remains unanswered: which reasons could be considered valid for the legitimacy of an LBO deal? The law does not provide any interpretative guidelines in order to evaluate the business reasons behind each LBO deal, and leaves this difficult task to doctrine and jurisprudence;⁸⁸

2. The difficulty of receiving an **assessment on the fairness** or reasonableness of the business plan, prepared by each merging company;

3. The legal status and consequences of **other types of LBOs**, which are not specifically regulated by the new reform. As noticed, the new corporate governance regulation applies to merger LBOs only, leaving out all the other kinds of LBO transactions. It does not even specify the type of merger (forward or reverse) that should be considered valid under the new law. Therefore, the legal consequences of reverse merger LBO transactions (which occur when the newco is incorporated into the target company) remain uncertain, for the same reasons emphasized in the past debate. In a reverse merger, the target is the only entity that remains after the merger. As emphasized in the past, the result of the whole transaction might be interpreted as a violation of the financial assistance prohibition and it could be invalidated by a Court, (according to article 2358

c.c.). The reverse merger LBO may also be perceived as an indirect instrument used by the target, in order to acquire its own shares, eluding the restrictions imposed by article 2357 Civil Code. Similarly, the legitimacy of other types of LBOs that are not specifically regulated remains doubtful, for example non-merger LBOs. It is reasonable to expect that the risk of illegality should be minimized if the new conditions introduced by article 2501 bis c.c. are satisfied (especially with reference to the disclosure requirements). This could be interpreted as proof of "good faith";⁸⁹

4. The **legal consequences** for the directors involved in the transaction in case of violations of the **financial assistance rule**. Under the new corporate law regulation, the financial assistance rule (described in article 2358 c.c.) still remains. However, it should be applied more cautiously to LBOs, and only on a case-by-case basis. In fact, by combining the corporate law reform (effective since January 2004) with a new corporate criminal reform (effective since April 2002)⁹⁰, a financial assistance violation will no longer automatically represent a crime, as it did in the past, under the previous provision of article 2630 c.c.⁹¹ However, new crimes have been introduced by a recent criminal reform⁹² and they may be applicable to LBOs if:

a) The acquisition of the target's shares damages the integrity of its equity to the detriment of its stakeholders;

b) The interests of preexisting creditors are negatively affected as a result of the merger between the newco and the target.⁹³

By combining the new crimes introduced by the recent criminal reform (applicable as of April 2002) with the new corporate law reform (applicable as of January 2004), we expect that the risk of receiving a criminal sentence should be minimal if the transaction is implemented by following the conditions introduced by article 2501 bis c.c. Anyway, the debate on the criminal consequence is still open, especially with reference to the directors' liability.

5. The fiscal implications concerning the deductibility of interests related to the debt financing drawn up by the newco. According to the Thin Capitalization Rule, introduced by the Legislative Decree 344/2003 (which has changed the

⁸⁷ Financial experts are chosen within a particular Register of Auditors.

⁸⁸ "It may prove difficult to ascertain a valid business reason for a merger in the case of a typical LBO carried out by professional investors such as private equity players, where a leveraged *newco* vehicle has been established solely for the purpose of the transaction", La Torre and Rio (2002).

⁸⁹ Portolano (2003).

⁹⁰ Legislative Decree April 11, 2002, number 61.

⁹¹ Under the past provision of article 2630 c.c., a violation of the financial assistance prohibition (article 2358) was automatically punishable as a crime. The new corporate criminal reform (Legislative Decree 61/2002) has eliminated this risk. Consequently, the risk for the managers involved in an LBO transaction to be considered reliable with a sentence of up to 3 years of prison does not exist anymore.

⁹² Legislative Decree, April 2002, number 61.

⁹³ For a general outline of the new crime-reform see, among others, Musco (2002).

Consolidation Act of Income Tax –TUIR), the tax shield associated with Debt Financing received by the newco may dramatically diminish.⁹⁴

At present, opinions with respect to the above issues appear to be contrasted. We shall wait for new jurisprudence.

Considering the past debate on the legitimacy of LBOs and the consequent legal risk, the new Italian corporate governance reform represents a crucial step forward, in line with the European Union's current intention of providing a more favorable legal environment to LBOs.

Contrarily to what happen in the past, the burden of proof is now reversed: if the new rules and the related requirements are satisfied, LBOs should be considered legal, unless proven otherwise. The risk of illegality should be minimal if the LBO transaction is implemented by adhering to the requirements specified by the new law. Complex multi-layer ownership structures (with more than one newco), typically adopted in the past to minimize the illegality risk of LBOs, are no longer necessary, at least from a legal point of view. This will hopefully contribute to improve the corporate governance of merging firms.

5. Discussions and Conclusions

As recently emphasized by the UK Financial Services Authority and several empirical studies (such as Bottazzi *et al.* 2007 a, b, Cumming and Zambelli 2007, Lerner and Schoar 2005), the legal environment regulating mergers and acquisitions is crucial for the private equity industry, especially for leveraged buyout deals.

Over the last decades, the Italian buyout market followed a puzzling trend, which seems associated with changes in the legal environment, alternating dramatic decreases in the number of deals (such as in years 2000 and 2001) with periods characterized by relevant increase in the buyout frequencies, as seen after 2004. By the end of 2001, a new law was introduced (Law 366/2001), according to which the Parliament delegated the Government to reform the Italian corporate and criminal law, thus providing some hope for a new more favorable regulation of LBOs. A few years later, the expected corporate law reform became effective. Among other things, it aimed at regulating the Leveraged Buyout process (Legislative Decree 6/2003, applicable as of January 1, 2004). The new regulation clarified the legal status of LBOs and legalized LBOs under specific conditions. The new reform marked an important turning point for the buyout industry, encouraging its development within the Italian private equity market.

In this paper we have discussed the debate on the legitimacy of LBOs in Italy. Over the last decade, three articles of the Civil Code have been invoked by

the doctrine and jurisprudence against the validity of LBO transactions:

- Article 2357 (restricting the purchase of own shares by a company);
- Article 2358 (prohibiting financial assistance for the purchase of own shares by a company);
- Article 1344 (invalidating any agreement performed with the intention to elude imperative legal provisions).

The LBO financial scheme was considered an instrument fraudulently adopted by the target's management with the sole intention of eluding the financial assistance provisions (especially article 2358) because the target in the end appears to provide a guarantee for the purchase of its own shares. The debate intensified in 2000 when the Supreme Court prohibited the LBO scheme in Italy since perceived in contrast with the financial assistance prohibition (Supreme Court's decision 5503/2000, with reference to the D'Andria case).

A few comments on the relevance of the Supreme Court's decision are necessary.

The Supreme Court declared the illegitimacy of LBOs only incidentally with reference to a criminal law case of fraudulent bankruptcy, probably misunderstanding the defining characteristics of LBO transactions.

The Court implicitly assumed that the target company plays an active role in the acquisition process, providing ex-ante guarantees or loans to the newco in order to facilitate the purchase of its own shares.

In our opinion, it seems premature to have generally declared the LBO scheme illegal in Italy. In an LBO, the debt guaranteed by the target company comes into effect only after the merger has been completed, i.e. after the ownership of the target company has changed. Creditors will not be damaged as long as they have the ability to object to any LBO which reduces the value of their claims. Furthermore, there is no ex-ante and direct equivalence between LBO transactions and the acquisition by the target of its own shares through an intermediary. The legal validity of each deal depends on the specific circumstances and characteristics of each transaction and has to be decided on a case-by-case basis.

The Supreme Court's decision has increased, rather than solving, the debate surrounding the legitimacy of LBOs in Italy, and this has discouraged private equity investors from undertaking these types of transactions.

By looking at the case law and AIFI statistics reports, it is interesting to see that over the period in which the legitimacy of LBOs was uncertain or even prohibited LBOs were carried out anyway, especially in the form of mega deals with a pyramidal ownership structure, having more than one newco, and locating the primary holding newco abroad.

Thanks to the new regulation, the burden of proof has now been reversed: LBOs should be considered legal, unless otherwise proven. Complex

⁹⁴ See Confaklonieri (2006).

buyout deals, with a pyramidal ownership structures, are no longer necessary, at least for a legal purpose.

Notwithstanding the new corporate governance rule, the legal debate on LBOs does not seem to be completely over, mainly with respect to:

a) The legitimacy of those LBO deals which are not specifically regulated by article 2501 bis;

b) The criminal law consequences for the directors involved in the transaction. These consequences are particularly evident for those types of buyouts which remain outside the scope of application of the new corporate governance law (non-merger LBOs for example). In any case, the risk of illegality should be minimal if the LBO transaction is implemented by following the requirements specified by the new law. This would represent a potential proof of good-faith.

Despite the unsolved issues, the Italian experience of LBO legalization offers useful guidelines on how these transactions may be regulated, in order to better protect the interests of the target's stakeholders.

An LBO is merely a financial tool. Like other tools, it can be used properly or misused. When properly used, it allows a company to access an alternative source of finance and improves the performance of the acquired firms.

The lawmakers should then legalize LBOs, instead of prohibiting them. Legislators could also specify a set of requirements that should be satisfied by companies in order to prevent abusive opportunistic behaviors by the directors involved to the detriment of target's stakeholders.

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