The use of principal-agent and incomplete contract approach in mitigating agency risks for mergers and acquisitions in the Baltic States

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# Table of Contents

1 Introduction .......................................................................................................................... 3

2 Characteristics of the entrepreneurial environment in the Baltics ................................. 6
   2.1 Macro-economic environment in the Baltic States ......................................................... 6
   2.2 Taxation system ............................................................................................................. 8
   2.3 Public incentives and stimulus for investments ......................................................... 12

3 Theoretical approaches to managing agency risks ............................................................. 16
   3.1 The development of theoretical approaches regarding agency risk ......................... 16
   3.2 Definitions and identification of problems .................................................................. 19
       3.2.1 The incomplete contract theory ...................................................................... 19
       3.2.2 Principal-agent theory .................................................................................... 20
       3.2.3 The agency risks that that are dealt with under the two approaches .............. 21
   3.3 The incomplete contract theory .................................................................................. 21
       3.3.1 Adverse selection ............................................................................................. 21
       3.3.2 Moral hazard .................................................................................................... 24
       3.3.3 Transaction specificity of assets ....................................................................... 25
       3.3.4 Exogenous risk ............................................................................................... 28
   3.4 The principal-agent theory ......................................................................................... 29
       3.4.1 Adverse selection ............................................................................................. 29
       3.4.2 Moral hazard .................................................................................................... 31
       3.4.3 Transaction specificity of assets ....................................................................... 34
       3.4.4 Exogenous risk ............................................................................................... 36
   3.5 Transaction costs ........................................................................................................ 37

4 The empirical analysis of agency risk management in Estonia ......................................... 40
   4.1 The aim of the empirical assessment ......................................................................... 40
   4.2 The empirical basis for determining the application of the theories on the Baltic mergers and acquisitions market ................................................................. 40
   4.3 The implications derived from the date in regards to the possible use of the principal-agent and incomplete contract approach ....................................................... 43
       4.3.1 Nature of the parties .......................................................................................... 43
       4.3.2 Sales process .................................................................................................... 45
       4.3.3 Form of transaction .......................................................................................... 46
       4.3.4 Payment terms ................................................................................................ 47
       4.3.5 Disputes ........................................................................................................... 49
       4.3.6 Representations and warranties ....................................................................... 50
       4.3.7 Liability and indemnification .......................................................................... 51
       4.3.8 Shareholders’ agreements .............................................................................. 53
       4.3.9 Results of the empirical assessment ................................................................. 56

5 Summary and conclusions ............................................................................................... 58

6 List of references ............................................................................................................. 60
   6.1 Academic literature .................................................................................................. 60
   6.2 Legislative acts .......................................................................................................... 63
   6.3 Online sources .......................................................................................................... 63
1 Introduction

Enhancing the growth of companies that would help to increase economic prosperity and the number of jobs on the market has always been an avid discussion and research topic for academics, policy makers, investors and entrepreneurs alike. In supporting the emergence of such companies, it is almost impossible to overestimate the importance of mergers and acquisitions. Such transactions, regardless of whether done on strategic or purely financial considerations, can help companies with positive future prospects, by providing capital for them and also strategic knowledge and other benefits. Regarding inefficient companies, mergers and acquisitions help to reorganize the assets held up by them and provide a more efficient use for such assets. Without mergers and acquisitions, it would be impossible for many companies to survive and even more, to develop, because access to sufficient credit is often limited and financing projects by other means can also be impossible.

Unfortunately, until recently in the Baltic States, the emphasis in the society has been on enhancing entrepreneurial activity as an independent variable, without understanding the importance of adequate financing opportunities and the need to tackle the risks that associate with investment activities. For example, one of the studies on the venture capital market in Estonia, conducted in 2006, showed that Estonian venture capitalists have disregarded early-stage investments and only look at more established companies to invest in.¹ This is an implication that investors are risk averse and instead of using risk management mechanisms, refrain from investments that include high risk by acquiring companies that have already proven themselves and the risks are therefore lower.

During the last 5-8 years however, the situation has changed. With the growth of the start-up scene and the influx of public money into venture capital funds, investors are looking more and more into early-stage and higher risk ventures, which is the key in bridging the equity gap that is met by many entrepreneurs.

Therefore, as investors are willing to look more into enterprises that contain higher risks, the mechanisms and approaches towards managing agency risks are becoming more and more important. In order to develop these mechanisms as efficiently as possible in practice, it is of great use to first understand the theoretical approaches and use academic research to identify the overall situation in regards to agency risk management in the current investment environment.

The aim of this thesis is to link the current situation on the Baltic mergers and acquisitions market to the vast academic discussion on investments and investor protection. More specifically, the thesis will establish if investors in the Baltic States protect their investments more with active participation in their portfolio companies and see the possibility to develop their relationship with the entrepreneur in course of the investment period, to align their interests or do they rely more on complex and thorough ex ante contracts. The first approach would be in line with the incomplete contract theory on managing agency risks and the other would depict the principal-agent approach. Of course in practice, investors cannot rely exclusively on one or the other approach and elements from both have to be used in order to obtain necessary protection. Still, if a trend towards one or the other approach can be established, it is possible to identify the problems that are to be assessed in the future.

Managing agency risks in investments is one of the most crucial aspects that can determine the success of the investment and on a wider scale, influence the whole financing environment. The agency risk problem is especially important regarding investments in less-established and smaller companies because firstly, the investments in such companies include a substantially higher risk of failure than most other investment types, as there is limited information available to conclude if they can meet the expectations of the investors. Secondly, high-risk investments are mostly made into unlisted companies, for which a future IPO is only a possibility and in the case of Baltics, not a very probable possibility (the market for publicly traded companies is extremely limited– currently there are only 34 listed companies in the Nasdaq OMX Baltic stock exchange, none of which is a high-growth company).² Therefore, in case the interests of the

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investors and entrepreneurs prove to be misaligned, a quick and easy exit might prove to be impossible.

The empirical assessment part of the thesis analysis the data gathered in course of the Baltic M & A Deal Points Study 2013, which analysed 84 mergers and acquisitions that were carried out in the Baltic States during the period between 2011 and 2013. Out of the criteria assessed for the study, the most relevant aspects that give implications towards agency risk management were chosen and used for the empirical part of this thesis. The aim of the empirical assessment is to gain insights towards which of the two assessed agency risk management approaches is more suitable in the Baltic investment environment.
2 Characteristics of the entrepreneurial environment in the Baltics

2.1 Macro-economic environment in the Baltic States

Being small countries with relatively low GDP’s (€ 18.2 billion in Estonia, € 16.4 billion in Latvia and € 18.3 billion in Lithuania 2013 according to Eurostat\(^3\)) and young and developing economies, all three Baltic States have aimed to enhance economic growth and stability by creating a highly competitive, liberal and open economy. Although it is clear that creating such an environment is a complex and long process, the effects of which will take time to become apparent, it seems that the measures taken, have been a success. The effects are most apparent when looking the ranking of the Baltic States in different prestigious rankings concerning economic indicators. For example in the 2014 Index of Economic Freedom by the Wall Street Journal and the Heritage Foundation, Estonia placed 11\(^{th}\), Latvia 42\(^{nd}\), and Lithuania 21\(^{st}\).\(^4\) In the 2014 Ease of Doing Business ranking by the World Bank, Estonia placed 22\(^{nd}\), Latvia 24\(^{th}\) and Lithuania 17\(^{th}\).\(^5\) And in the 2014 Global Competitiveness Index of 2014 by the World Economic Forum, Estonia placed 32\(^{nd}\), Latvia 52\(^{nd}\) and Lithuania 48\(^{th}\).\(^6\) This is a clear indication, that during the short period of independence, all three countries have been successful in moving towards their aims, which should in the long-run create a stable and growth-nurturing economy.

Still, even though the Baltic States have been successful in different key sub-areas, this success is still only beginning to influence macro-economic indicators and a strong and stable economic environment is yet to be achieved. Throughout


its independence, the macro-economic situation in the Baltics has been heavily dependent on the economic situation around the globe, especially the situation in its main trading partners. Due to having a total population of only 6.9 million people for the three countries combined\(^7\) and a purchasing power parity of only 71 % of the EU average for Estonia, 64 % of the EU average for Latvia and 72 % of the EU average for Lithuania\(^8\), even combined, the internal market of the three Baltic states is not large enough to provide stability in case the economic climate among its trading partners should change. The three largest trading partners for Estonia are Sweden (16 % of exports and 15 % of imports), Russia (14 % of exports and 12 % of imports) and Finland (11 % of imports and exports).\(^9\) For Latvia, the biggest trading partners are Lithuania (19.1 % of imports and 14.9 % of exports), Russia (9.2 % of imports and 18.2 % of exports) and Estonia (7.6 % of imports and 12.1 % of exports).\(^10\) For Lithuania, the biggest trading partner is Russia (19 % of imports and 31.6 % of exports), Latvia (11 % of exports and 6.2 % of imports) and Germany (7.9 % of exports and 10 % of imports).\(^11\)

Having a liberal and open economy with low government interference and small internal market has meant that economic growth in all Baltic three states has experienced one of the highest growth-rates as well as steep declines. During the period between 2000 and 2008, the GDP of Estonia grew at an average rate of 7 % a year, which was met by a steep decline in 2008 and 2009 (the GDP growth in 2009 was -14.1 %). Still, Estonia managed to exit the crisis quickly, by using austerity measures rather than increasing public expenditures, which has resulted in the country maintaining a low public debt rate (Estonian government debt is at only 9.8 % and it is the only EU country that has not issued government


bonds). For the period of 2014-2017, the expected GDP growth rate is 3.5 % a year.\textsuperscript{12} In Latvia, the GDP growth has faced even higher volatility, fluctuating between 12.2 % of growth in 2006 and 18 % of fall in 2009. Regarding GDP volatility, Lithuania lies between Estonia and Latvia, having experience a 9.8 % growth in 2007 and a 14.7 % fall in 2009.

\begin{figure}
\centering
\includegraphics[width=\textwidth]{gdp_growth.png}
\caption{GDP growth in Estonia, Latvia and Lithuania during 2004-2013\textsuperscript{13}}
\end{figure}

\textit{Source: The World Bank}

\section{2.2 Taxation system}

Since regaining independence, all three countries have had to completely rebuild their taxation system from ground up. All three countries have decided to opt for a liberal and simple tax system, which should enhance economic growth.

What has raised most interest about the tax environment in the Baltics, is the income tax system of Estonia. The first aspect that raises interest about the system is the fact that unlike many other countries, Estonia has introduced a single flat tax rate on both legal persons as well as natural persons. Such a


system was introduced with the Income Tax Act of 1994\textsuperscript{14}, by which a tax rate of 26\% was introduced.\textsuperscript{15} In the pursuit for a simple, equable and transparent tax system, Estonia has not introduced any special taxation policy or incentives for venture capital investors or any other type of formal or informal investors.\textsuperscript{16} Ever since that period, the government has pursued a liberal economic policy of lowering income taxes and raising taxes on consumption to increase the creation of wealth and reduce consumption. In 2014, the tax rate is 21\% (even though the Income Tax Act stipulates that corporations are taxed with a rate of \(21/79\approx 26.6\%\), the actual tax rate is still 21\%, because the income tax for corporations is calculated from the gross sum and for individuals, from a net sum) and the current Income Tax Act in effect already prescribes that from 2015, the rate will be 20\%. The current rate and even more so the future rate are lower than both the EU average corporate income tax rate of 22.75\% and the global average of 24.08\%.\textsuperscript{17} Although the effect of the relatively low income tax rate on investments and mergers and acquisitions has not been empirically studied, it is probable that it has a positive effect, as low tax rates on income should motivate persons to invest, rather than consume. On an international scale, the difference should induce investments in and into Estonia, as corporations can retain a larger than average portion of their earnings.

Another key aspect about the income tax system in Estonia, which, at least in theory, has an even more influential effect on investment activity, involves the reform that was implemented in the year 2000. The reform brought along the change that resident companies’ profits are tax free but distributions of dividends and transactions that are quasi-dividends or other distributions of


profits are taxed with income tax. Net capital or wealth of either natural or legal persons, is not taxed. The beneficiaries of the distribution of profits do not have to pay any additional income tax on the individual level.

Another important aspect of the income tax system of Estonia is that natural persons engaging in investment activities can also enjoy the possibility of deferring paying income tax until they distribute the profits from their investments. Besides the possibility of making investments through a corporate vehicle, they can use a dedicated investment account. This account can be opened in any retail bank and the tax liability arises only when more money is taken from the account, than has been deposited there (i.e. distribution of profits).

In the context of mergers and acquisitions, another key issue to consider is the taxation of proceeds in the event of liquidation. Although investors of course aim to invest in companies that succeed and therefore prefer to exit through an IPO, trade-sale or secondary sale, it is clear that investments entail risks and liquidation is something that must be paid attention to. The simplicity of the Estonian income tax regulation reflects also in the taxation of liquidation proceeds— all liquidation proceeds are taxed at a flat rate of 21 %. The only issue to consider is that liquidation proceeds are taxed on the level of the receiver not the company that is being liquidated.

Although the overall income tax system should encourage investment activity, the practical benefits of this type of income tax system are not yet conclusively measured. It is clear that the theoretical benefit of increased economic growth can also increase investment activity, as there are more companies to invest in and also more wealth that can be invested. Although it is difficult to conclusively state if the tax system has brought along this desired effect, because the economic growth during the 14 years of its existence has been influenced by

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19 Ibid.


several strong influences, there are still some indications that the system has fulfilled its objectives. In a study done in 2010, 500 entrepreneurs and managers of companies were questioned about their opinions on the system. In their answers, 64.4 % of them said that the tax-system influenced their decision to reinvest profits and 51.8 % found that the tax-system has benefited their ability to find financing.22

The tax system in Latvia, although more conventional in design, also includes specific mechanisms to enhance investment friendliness. Companies are subject to a flat tax rate of 15 %, while for private individuals, the tax rate is set at 24 %.23 Also, to enhance entrepreneurship, Latvia has introduced a system by which small entrepreneurs can engage in business activities, without losing state benefits which derive from paying taxes as an employee. A taxpayer (regardless if a natural or legal person) with an annual turnover of less than € 100 000 and who employs no more than 5 employees, whose monthly income does not exceed € 700, can instead of paying the general income and social taxes, opt to pay a flat tax rate of 9 % on its turnover.24

In addition, Latvia has created special economic zones and free ports that are aimed at attracting companies to conduct their activities in those areas.25 In these areas, among other benefits, companies enjoy 80 % rebates on real estate tax, corporate income tax and withholding tax on dividends. Also, most goods and services provided in these regions are subject to no value added tax.


24 Ibid.

What is also important, in regards to investment activity is the system by which companies can indefinitely carry forward their losses, which enables them to deduct such losses from future profits, thereby limiting their tax base.\textsuperscript{26}

Similarly to Estonia and Latvia, Lithuania has also opted to use a simple and understandable tax system. In Latvia, all corporations are subject to a common income tax rate of 15\%.\textsuperscript{27} Unlike the other Baltic States, Lithuania has not engaged in many elaborate mechanisms through its tax system in order to attract investors and promote entrepreneurship. Still, some stimulus options exist for entrepreneurs. For example, 7 free economic zones have been created, similarly to Latvia.\textsuperscript{28} In these zones, for six years, the companies can operate without being subject to income tax.\textsuperscript{29} In addition, research and development by enterprises is supported by enabling expenses that arise from such activity to be deducted three times.\textsuperscript{30}

### 2.3 Public incentives and stimulus for investments

Governmental participation in financing high-growth companies has in the past been extremely limited and until the accession to the EU, non-existent. During the past 10 years however, several public programs have been established in the Baltics to help starting companies to overcome initial difficulties, many of which are especially aimed at bridging the finance and liquidity gap that small and starting companies often face. Most such programs are aimed at providing direct assistance to entrepreneurs and ventures themselves. Therefore, their effect on investors is implicit. The positive effect for investors of incentives for ventures

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\textsuperscript{30} \textit{Ibid.}
themselves is that companies can access additional capital relatively easily, without having to find additional investors and thereby dilute the position of the venture capitalist that has invested in the company. Also, as such governmental programs mostly provide either non-repayable grant or a loan with lenient conditions, the risk of the company failing is to some extent lower.

In Estonia, the most well-established and prominent governmental agency that deals with providing support for starting entrepreneurs is Enterprise Estonia. Besides supporting entrepreneurs with information, training and personal counselling, Enterprise Estonia has established different financial aid programs, mostly in the forms of grants, to finance starting companies.\textsuperscript{31}

Enterprise Estonia has two different financial grants. The first, called the “start-up grant” is aimed at newly established companies (less than 1 year old) and provides the companies a € 5000 non-repayable sum, without any strict requirements for the company, besides the fact that its profitability must be feasible and it must create at least 1 year-round job. The second grant is called the “development grant” and this is meant for export-oriented companies, which already have a product or service that has proven itself domestically and is ready for exporting. The maximum sum of this grant is € 32 000. Both grants require a project that is to be presented to Enterprise Estonia. The start-up grant is limited to 80 % of the total project and requires 20 % self-financing and the development grant is limited to 50 % of the total size of the project and requires at least 50 % of self-financing.

In Latvia, a similar government as Enterprise Estonia is the Investment and Development Agency of Latvia. Similarly to its analogue in Estonia, it engages in both consulting and training activities for entrepreneurs, as well as providing public incentives to help enhance investments and the business environment. For example, the Investment and Development Agency of Latvia helps businesses to obtain credit guarantees from the Latvian Guarantee Agency. These guarantees can be used to cover up to 80 % of the financial costs occurred and are limited to

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€ 1 500 000 per enterprise. In addition, although they themselves do not distribute any grants and stimulus, they can also help in obtaining loans from the state owned Mortgage and Land Bank of Latvia and obtain mezzanine financing from the Latvian Guarantee Agency.

The Lithuanian analogue to Enterprise Estonia and the Investment and Development Agency of Latvia is named Invest Lithuania. Like its counter-parts in the two other Baltic States, it provides various services for small businesses to enhance entrepreneurship and economic growth. In addition to counselling and other non-financial services (e.g. provide office-space and organize courses on entrepreneurship), Invest Lithuania provides grants in a maximum amount of € 3 500 000 per project and also provides loan guarantees.

The effect of the activities of these three agencies has not yet been researched but it can be argued that at least in theory, they all induce investment activities. Firstly, as discussed beforehand, investors can see these programs as additional funding for the enterprise, without giving away any equity or taking financial responsibilities. This helps mitigating the risk of liquidity crisis that is involved with the high-growth and high-risk companies. Secondly, on the example of Estonia, if an enterprise has already been awarded either or both of these grants, it must have presented its projects to Enterprise Estonia, where an independent committee, which consists of successful entrepreneurs, has already reviewed the project and deemed it viable. Of course this does not abolish the need for a thorough due-diligence on the part of the investor, but at least in theory, it should provide some additional credibility to the company that the investor might invest in. The third benefit of such agencies is that the grants they provide require a certain percentage of self-finance and therefore, entrepreneurs themselves are more eager to find additional investors to find the sum necessary to fulfil the self-finance criteria. As the sums required are relatively small, it is improbable that they themselves would attract investors but it is possible that to

some extent they help to “open up” the company to outside investors and in some cases, also create the need to include smaller investments, mostly by informal venture capital investors, like business angels.

In addition to domestic incentives, a pan-Baltic public program concerning the investment market in all three Baltic States has been established recently. This is the Baltic Innovation Fund (BIF) which was created in 2012 in collaboration of the European Investment Fund and the Governments of Estonia, Latvia and Lithuania.\(^\text{34}\) The BIF created a fund of € 100 million (€ 40 million of the financing comes from the European Investment Fund and each of the 3 participating Baltic countries invests € 20 million), which has its aim in growing the market for investments in high-growth small- and medium enterprises. The investment period for BIF is 4 years, which means that BIF is obliged to invest the assets under its management during that period, while the exit from these investments can take place in a later stage. Like the EDF, the BIF has in its investment strategy also to syndicate with private venture capital investors. But a key difference between the EDF and BIF wishes not only to invest into portfolio companies itself or through its subsidiary, but also it aims to invest into 3 to 6 already established venture capital or private equity funds. This will undoubtedly have a substantial effect on the investment market (especially venture capital funds) in the Baltic States, because the strategy of BIF will directly impact the possibilities for investors to participate on the market, either by obligating the participating venture capital funds to make investments or by enable syndicated investments for other investors on the market.

Although the initiative is too young to empirically assess its impact on the investment market in the Baltics, it is clear that when taking into account the size of the investment, the size of the market and the investment strategy of BIF, the fund has the potential to grow the venture capital market substantially during the next years.

3 Theoretical approaches to managing agency risks

3.1 The development of theoretical approaches regarding agency risk

The theories of mitigating agency risks have developed alongside the analysis on the substance and essence of firms.\textsuperscript{35} The necessity for looking and developing agency risk management theories alongside the theory of “firm”, derives from the fact that firms are the assets that investors as principals obtain by investing in them and agents are the managers whom they employ or the entrepreneurs whom they keep to manage their investments. To safe-guard the interests of the principals and the managers, it is important to correctly evaluate the relationship between the afford-mentioned parties and use appropriate mechanisms to align the interests of the principals and the agents. This must already be paid attention to in the negotiation phase of the investment (before entering a conclusive formal agreement), because the functioning of the future relationship is contingent on what rights and obligations the parties acquire when making the investment. When carrying out a merger or acquisition of the asset, the future relationship between the managers and investors is in many cases also formulated. Often the investor agrees that the prior management will retain their position, so there will be no separate negotiations with the possible future managers. Even if it is not done so and the investor starts to organize the managing of the asset only after entering the investment, the basis of the relationship is still created, because the future negotiation powers are highly dependent on the rights that the investor acquires.

Historically, the theory of firm has not been paid much attention to by legal academics as it has been a point of interest mostly for economics.\textsuperscript{36} Prior to being looked at as a set of contracts between the principal and the agent, firms were mostly researched from their most eminent function for the society as a whole, which is to provide products and services.\textsuperscript{37} Therefore, firms were mostly


\textsuperscript{36} Ibid.

\textsuperscript{37} Ibid.
studied from the perspective of production. During the last century, the economic theory of firm has substantially evolved and created three prominent models on how to look at firms—the neoclassical model, the managerialist model and the transaction costs model.

According to the neoclassical model firms only exist to maximize profits. Therefore, in its original form, the theory pays no attention to the relationship between the principal and agent and the agency risks it entails. Still, when the approach that firms are a set of contracts emerged, the neoclassical theory became the basis for the principal-agent theory which turns its attention to achieving maximum efficiency with optimal contractual mechanisms to reduce agency costs. Alongside the principal-agent theory, the neoclassical theory of firm also gave birth to the positivist agency sub-theory which deals with overcoming the misalignment of the interests of the principal and the agent by the usage of governance mechanisms. These two theories are highly connected as they are based on the same assumptions and ideas and the only prominent difference is placing the emphasis of the research on different problems. Therefore, these theories are often looked as a single theory.

The second widespread theory to explain the essence of firms is the managerialist model. This model sees the firm from an internal perspective, by looking at the actions of the managers. According to this theory, managers act with the aim to satisfy the expectations of the principals regarding the profits but not to maximize the profits. As rational beings, they aim to maximize their own benefit and therefore, do not look at how to maximize the benefit of the shareholders but rather aim to expand the company, which secures their position and provides a higher compensation for them. Although the managerialist model entails great agency risks, there is no specific approach on how to deal

38 Lahti, T. 2008. *Angel Investing in Finland: an analysis based on agency theory and the incomplete contracting theory*. Hanken School of Economics
40 Lahti, T. *Op. cit*
with such risks, as the theory fails to take into account any external effects and stimulus that often have significant effects on mitigating agency risks. In a real-life economy, managers who only pursue their own interests and fail to maximize the profits for the shareholders are constantly threatened by a risk of a take-over and subsequent replacement.  

In addition, in today’s corporate system, managers who fail to maximize the profits cannot easily satisfy the shareholders and at the same time hide the fact that they are not doing everything to maximize the profits, from the shareholders. With ever-increasing regulation regarding disclosure, constant attention by analysts, the media and shareholders themselves, the misalignment of interests can easily be exposed and in such a case, the managers might face replacement. The managerialist model is inadequate to describe the firm in a way that would fit into the existing economic reality. Therefore it also fails to understand the relationship between the principal and the agent in today’s world and cannot be basis for any relevant agency risk management theory.

The third important theory on the definition of firms is the theory of transaction costs. In 1937, R.H. Coase wrote a paper in which he argued that firms exist due to the fact that establishing a body to organize production and marketing helps to minimize transaction costs of operating on the market. Although Coase himself did not turn any attention to governance as a variable which might have an effect to transaction costs, his work later became an important step in promulgating academic debate on the topic. In 1960, Coase published a paper “The Problem of Social Cost” in which he argued that firms and factors of production should be looked as property rights to better explain the effects of production has on the society.

On the basis of the transaction cost theory and the property rights theory, the incomplete contract theory on managing agency risks was developed. In 1986, Grossman and Hart argued that if the parties wish to use their property in

44 Ibid.
creating wealth, formulating *ex ante* contracts that would sufficiently cover all
the possible externalities would be too costly and therefore, to minimize
transaction costs in a continuous relationship, *ex post* control is of great
relevance.\(^ {48}\) With that, the incomplete contracts theory for managing agency
risks was created.

### 3.2 Definitions and identification of problems

#### 3.2.1 The incomplete contract theory

The theory that views the relationship between the investor as a principal and the
manager as an agent, as an incomplete contract between the parties, derives from
the postulate that with an *ex ante* contract, it is impossible to completely regulate
the whole relationship due to the fact that all relevant matters cannot be foreseen
and understood.\(^ {49}\) Therefore, to mitigate the risks that such contracts pose for the
parties, it is important for the principals to have the possibility to have *ex post*
mechanisms to deal with such concerns.

Under the agency theory, the best method of gaining *ex post* control over the
problems that are not foreseen and dealt with in the agreement is to become the
owner of the asset. By obtaining ownership, the principal obtains all residual
rights regarding the asset and therefore can act as he himself pleases (within the
framework of the applicable law) to deal with all possible problems.\(^ {50}\) If the
asset to be obtained is a company, the most important residual rights in regard to
possible conflicts with the agent, is the right to elect the members of the board
and decide on other key issues at the general meeting of the shareholders.

As obtaining all full ownership of an asset may in some cases entail transaction
costs that make it undesirable, under the incomplete contract approach several
other actions can be used to mitigate agency risks. Because contracts between

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Economics and Organization, 4, 119-139.
the parties are never complete, it is important to actively participate in the managing of the asset, make further agreements in the course of the relationship, and if necessary, renegotiate the existing agreements if the prove to be inefficient.

### 3.2.2 Principal-agent theory

Unlike the incomplete contract theory, which assumes that all necessary information is non-existent at the moment of signing the contract, the principal-agent approach is based on the assumption that both the principal and the agent are both able to *ex ante* define and defend their interests.\(^\text{51}\) The agency problems that may occur can be dealt with *ex ante* contractual mechanisms, *e.g.* an incentive system that aligns the interests of both parties.\(^\text{52}\) The alignment of interests is necessary because it is generally understood that without a mechanism to deal with the issue, instead of maximizing his effort to enhance the investor’s interests with his actions, the agent devotes his efforts only to maintain the interests at a satisfactory level.\(^\text{53}\)

As both parties are able to understand and protect their interests at a satisfactory level, the approach proposes *ex ante* contracts as an effective and cost-efficient solution for shaping the entire relationship between the parties, including developing sufficient mechanisms for tackling agency risks.

Another argument that favours the use of the principal-agent approach is the assumption that giving control of the asset to persons that are also residual claimants is ineffective, because in such a decentralized controlling body, decision-making is inefficient.\(^\text{54}\) Having many actors that have the ability to control means that there is also a higher chance that agency risks occur, because


the number of agents is higher. Therefore, only obtaining specific rights with an
*ex ante* contract and employing a specialized management team to act as agents
can prove to be a more efficient solution.

### 3.2.3 The agency risks that that are dealt with under the two approaches

The two competing approaches regarding mitigating agency risks are analysed
through describing how they can be used to tackle different problems that might
occur in a relationship between the principal and the agent. For the analysis, the
problems between principals and agents have been identified and divided into
four categories– adverse selection, moral hazard, transaction specificity of assets
and exogenous risk. Such a division of different agency risks has been identified
by academics to cover all the issues that need addressing in a business contract.\(^{55}\)
Also, it provides for a categorization which is suitably abstract to cover all
relevant agency risks.

The following subchapters explain the essence of these problems and how they
can be managed under the incomplete contract and agency theory. In addition,
the question of transaction costs, which is not directly aimed at managing risks
but still plays an important part in adopting the suitable approach in practice, is
also explained.

### 3.3 The incomplete contract theory

#### 3.3.1 Adverse selection

The problem of adverse selection (also known as “information asymmetry”)
derives from the fact that in a relationship between a principal and an agent, the
agent as an individual that actively manages the asset on a daily basis, has a
much stronger position in regards to the accurate information about the asset and
the value, than the acquirer.\(^{56}\) An identical problem can be identified in a merger

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or acquisition where the seller, as the previous owner, has all or almost all the possible information about the asset available to him. This is in sharp contrast with the buyer’s position, who only receives public information and the information that is handed to him.

In case of a transaction, a principal who buys or owns the asset has no managerial position and therefore, will have limited information about the functioning of the asset. Because of that, his position regarding the information about the value of its investment will also always be more limited to that of the agent as the manager or the previous owner. Managers have unlimited access to the corporation to obtain a clear image of its functioning and in addition, they also have a continuous relationship with the firm which provides for better understanding regarding the long-term issues of the company. Also, in many cases managers and previous owners have a good understanding of the sector the company engages in, which helps them to better understand and estimate exogenous risks and other relevant factors. For the principal, this poses the risk that the real value of the asset will not be as much as he assumes it to be, based on the limited information and understanding that he has. This would result in a situation where returns that the investor expects, will not be achieved.

In a real-life scenario, it is impossible for the investor to exhaustively identify and mitigate all information asymmetries. While most economic models assume that the economic actors are fully rational in all their decisions (the so called “homo economicus”) and have complete information, such a situation is unrealistic in real-world economics. All investment decisions contain at least two parties with contradicting objectives— the investor wishes to obtain the investment at the lowest possible price and residual transaction costs, while the entrepreneur or agent wishes’ to obtain the maximum amount from the investor in exchange for the least amount of “product” (in case of investments, the product is mostly equity in the company) or service. This results in a situation where rationally acting sellers try to “mask” the information that would lower the price of the investment from the investors. The sellers and agents are not interested in lowering the transaction costs for the investors, as such costs are residual for them and lowering them has no effect on their own wealth.
For the investor, trying to uncover such information ex ante results in high transaction costs. The transaction costs derive from substantive due diligence, the cost of negotiating and drafting elaborate and extensive ex post contracts.\(^{57}\) Also, as investors themselves understand the asymmetry of information and the impracticality and impossibility of exclusively mitigating the risk with prior contracts, the might reduce their risks by discounting investments.\(^{58}\) Discounting investments mean that investors lower their expectations for the return. Although such a possibility might be an effective risk reduction mechanism in a specific situation, this is not the most optimal solution on a macro-economic level and also, not in every specific investment deal. It is the aim of investors to seek the highest possible returns and if they see that an investment possibility with a necessary discount, it reduces its attractiveness for investors. For the society as a whole, discounting investments reduces that amount of capital available for enterprises, as investments are less lucrative.

The incomplete contract theory helps in mitigating adverse selection, as it does not rely entirely on ex post contracts. In case of an on-going investment, all relevant information should become apparent during the course of the investment and some of the risks that result from these asymmetries can be dealt with, with active involvement in the investment and possible renegotiation.

First and foremost, the incomplete contract theory advocates mitigating agency risks through obtaining ownership of the asset to gain control over the residual rights. This can indeed be considered an optimal solution in some situations, especially where there are possible information asymmetries regarding the agents on-going conduct, e.g. when an investor buys equity in a start-up and during the course of the investment, needs to obtain information regarding the entrepreneur’s effort. An owner has a much stronger position to conduct such control, as owners are in a position to organize the corporate governance the


company, of which the appointment of the board of directors is the most prominent and important example.

Still, there are some situations where the relationship between the parties has already been established and becoming the owner of the asset may prove to be an inefficient or even an unsuccessful method for tackling adverse selection. This is the case when the information asymmetries are such that if the investor would be aware of them, he would refrain from concluding the contract. If there is some information that the investor does not have access to, which makes the deal unattractive for him, then obtaining the asset may lock him into an unattractive investment. In such a case, the parties acting under the incomplete contract approach can try to renegotiate the deal \textit{ex post}.

3.3.2 Moral hazard

The problem of moral hazard regards the conduct of the agent after the investment has been made and the agent should control and manage the asset for the benefit of the investor.\textsuperscript{59} In such a case, the interests of the principal and the agent can become misaligned, due to the fact that the agent pursues personal goals which might be different from the ones of the principal.\textsuperscript{60} Although there are numerous methods of keeping the interests of the parties aligned with \textit{ex ante} contractual mechanisms (\textit{e.g.} earn-out clauses with which a part of the consideration is to the seller is withheld during the moment of the sale and paid later, when certain criteria are met), these all include several deficiencies. Like with all contractual mechanisms, agreements to keep the interests aligned require constant monitoring.\textsuperscript{61} Principals have to spend resources (both time and money) to check whether the agent is acting in their interests and as agreed upon. Also, such mechanisms are costly because a rationally acting agent will require a premium for agreeing with a mechanism that poses a risk for them, that they might not obtain the total sum for the asset they sell. Therefore, exhaustive

\textsuperscript{59} Lahti, \textit{Op. cit.}


contractual provisions might prove to be non-optimal for reducing the problem of moral hazard.

With the incomplete contract approach, the risk of moral hazard to the interests of the investor is greatly reduced. Through using the shareholder rights he has obtained to actively influence the company, the investor is able to both monitor the management of the asset and deal with any moral hazard that may occur. The monitoring function can take place firstly through the reporting requirements that the managers have to perform. Example of this would be the annual report that is to be presented to the shareholders and from which the shareholders can acquire some relevant information about the effort level of the managers and also the functioning of the company. Also, if the principal is a major investor or even a sole owner of the company, it is highly likely that managers will also cooperate with him and provide information on an informal level as well, due to the fact that the position of the managers is dependent upon the discretion of the shareholders. If a major shareholder finds the managers conduct unsatisfactory or just finds that they are hindering the monitoring of the management, the major shareholders can often discharge the managers from their position.

Also, if it is apparent that a moral hazard has realized and the managers effort is unsatisfactory, the owners are able to make changes in the managers, which means that tackling the problem is also easier than in a case where the principal has only acquired some specific rights for a result from the company through an ex ante contract. For example, if a company has decided to obtain a marketing service from a marketing agency, they are not able to control the management of the company they buy the service from. But if a company decides to obtain a marketing firm (for example with a possible aim to merge it and make it a marketing department in their enterprise), they are able to use all the residual rights of an owner as well, which includes the possibility to appoint suitable managers.

### 3.3.3 Transaction specificity of assets

The phenomenon and problem of transaction specificity of assets is by definition a situation where an investment has a higher value in a specific transaction, than
if it would be used for any other purpose.\footnote{McGuinness, T. 1994. Markets and Managerial Hierarchies. Markets, Hierarchies and Networks London, England. pp. 66-81.} This means that in case both parties enjoy the benefits from this higher values, both parties are interested in developing and maintaining a continuous relationship so that the high value of the asset could generate a constant and high return. For example, a company working in a specialized field requires engineers that have the uncommon or even unique skills to benefit the company and at the same time, the engineer is interested in a relationship with the company because he or she has specific skills that have little or no value in a company that does not have any function for them. But in case the asset specificity is high, the result of such a phenomenon is that it is difficult to redeploy the asset for another purpose if the existing use for the asset should terminate.\footnote{Sanner, J. A. 2011. Asset Specificity and the Hold-Up Problem – Lessons to Learn from Transaction Cost Economics Available at SSRN: http://ssrn.com/abstract=1860210} Although it might be difficult to identify such a situation in some cases, the phenomena of asset specificity is eminent in most mergers and acquisitions as well. In case of a strategic relationship, it is clear that the parties benefit from each other’s unique competences but especially in smaller economies (like in the Baltics), even pure financial investment in the form of obtaining equity for cash might include asset specificity, as suitable and lucrative investment possibilities and sources of capital are relatively limited.

The issue of asset specificity creates several problems that can be addressed under the incomplete contract approach. Firstly, the more specific the asset required by the party must be, the more of a difficulty it is to identify it and monitor its suitability in the course of a relationship.\footnote{Grossman, S. J. & Hart O. D. Op. cit.} If an investor is looking for an asset to invest in that would bring along strategic benefits (e.g. provide additional specific competence to the acquiring firm or enhance his or her portfolio with a company with desired competence), the identification of such a firm can bring along high transaction costs.\footnote{Ibid.} Although a substantial and thorough ex ante due diligence can help in initial identification, this alone is not enough. Due to information asymmetries the risk remains that the target is not
the specific asset that is required and therefore, a complete contract that would
*ex ante* solve all possible conflicts and secure the desired asset for the investor is
not possible. Also companies, humans and other assets are ever-developing and
therefore, even if the desired *status quo* is achieved at the moment of closing,
constant monitoring is required to maximize the benefit from the specific asset.
The incomplete contract approach, through control rights related to ownership,
active involvement and renegotiation of the agreement during the course of the
relationship, helps to monitor and maintain the asset as desired and obtain the
highest possible strategic or financial return.

Secondly, in case an investment is made into an asset with a high level of
specificity, the hold-up problem occurs. This mean that during the course of the
relationship, the owner of the specific asset might become dependent on the
relationship with the other party, as the asset has little or even no worth outside
the realm of the relationship. 66 Historically, such a dependence has been
identified to create problems for the owner of the specific asset, as it hinders his
bargaining position and makes it possible for the other party to forcefully
negotiate an agreement that distributes the benefits from the asset for the
principal (*i.e.* if the other person or company has no other possibilities to use the
asset anywhere else, the principal may demand an disproportionally favourable
agreement). 67 Nowadays, it is recognized that the problem affects both parties,
as in a bi- or multilateral relationship with specific assets, both parties are
dependent on each other. 68

To overcome this problem, the incomplete contract approach can at first be seen
of less use than a strong *ex ante* contract, where the obligations and rights of the
parties are definitively agreed upon, at the signing of the contract, where neither
should already be dependent on each other. But it is clear that no contract can be
all-inclusive and if the overall value from the relationship will seem lower than
the value of an alternate behaviour (either exit the investment or try to act

opportunistically within the framework of the agreement), a rationally acting party will try to reformulate or end the relationship.

Therefore, if the party is trying to maximize long-term value, it might be of higher use to admit that the contract is incomplete and use another approach. As constant renegotiation of the relationship is not a realistic method of resolving the hold-up problem, it can be beneficial for the investor acting under the incomplete contract approach to buy the asset and obtain all the residual rights which enables him to control the asset. 69 Such a solution is of course possible only for assets that can be acquired and not possible in case the specific asset is a skill of a human being.

3.3.4 Exogenous risk

The problem of exogenous risk for the parties is the risk that arises from the changing of external circumstances that might alter the assets of the relationship between the principal and agent. 70 In the context of investments, exogenous risks might create problems in cases where they alter the value of the investment for the principal. Specifying and addressing all such risks in an ex ante contract would create substantial costs and in addition, covering all possible externalities is highly improbable. Therefore, exogenous risk can be best mitigated with ex post risk management mechanisms.

Under the incomplete contract approach, exogenous risk can be mitigated by effective ex post allocation of control. When a party has control over the asset, it is able to gain information about the threatening risk and is able to take the necessary steps to avoid or mitigate it. As stated, the most effective method of gaining efficient ex post control is to obtain the asset completely or at least the majority of it. With obtaining the majority ownership of the equity of the company, the investor obtains the residual rights not only specific rights

mentioned in an *ex ante* contract.\textsuperscript{71} Obtaining the residual rights of the company is of course costly, as the investor must also pay for the control premium that is associated with obtaining control of the asset. Control premiums have been found to be substantial—although they fluctuate depending on the sector, the country and if it has an economy more reliant on the market or bank, they can reach over 30% of the value of the deal.\textsuperscript{72} Therefore, before obtaining control of a corporation, the investor has to compare the costs of contracting and controlling the company with the costs of using the principal-agent approach, which would entail negotiating a more substantial and complex deal with investor protection mechanisms and remedies and later baring the substantial monitoring costs.

Besides obtaining *ex post* control of the company, the incomplete contract approach also prescribes for a possibility for the investor and the entrepreneur to renegotiate their relationship in the course of the investment. In a case where investors are actively participating in their investment company and the relationship between them and the manager is built more on involvement than exhaustive contracts that are more difficult to renegotiate, realigning the interests of the parties and distributing the burden from exogenous risks can be done more easily. This is because the parties should be closer and have more understanding of the others objectives and possibly even have more trust and sympathy towards each other.

### 3.4 The principal-agent theory

#### 3.4.1 Adverse selection

As stated before, the problem of adverse selection derives from the information asymmetry between the principal and agent. The principal cannot be certain if he receives all the necessary information, that he has an interest for and if the


information he is provided is correct. In order to identify and limit risks associated with adverse selection, principals must use signalling and screening devices. As the principal-agent theory relies on ex ante contracts, which make up the firm and along with it also the relationship between the principal and agent, the possibility to use such devices must be agreed upon already in the contracts made prior to the investment.

Regarding the screening of possible information asymmetries, it is of use to identify as many such problems prior to closing of the deal, as possible. This enables firstly to determine possible risks deriving from unequally distributed information ex ante, so to avoid them with minimal costs. Secondly, obtaining accurate and complete information about a target company provides a better bargaining position for negotiations between the seller and buyer. Prior to concluding the contract by which the investor invests his money into the company, he may discover aspects that alter the value of the company, but are not substantial enough to deter them from finalizing the deal. The most prominent example of ex ante screening to minimize possible information asymmetries is a legal due diligence that parties (mostly buyers but in some cases also sellers) conduct.

Besides the ex ante screening, it is also possible to contractually agree for mechanisms that help to monitor the management of the asset during the course of the relationship. In a continuous relationship, it is possible and even probable that problems that were not existent when concluding the agreement arise. Because the managers want to maximize their welfare with minimal effort, they are tempted to hide the negative information that the managers, which helps to show them in a better light, maximize their income and retain their position.

The provisions that enable on-going monitoring and adverse selection mitigation in ex ante contracts may include agreements for periodic reporting by the managers and also covenants, which conditions agents must periodically meet. The covenants can be for example tied with executive compensation, or in some cases with penalties.

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Also, in case of an investment agreement where the other contracting party is also the manager of the company and retains his position after signing the agreement, an outcome based payment system might be used. An example of this would be using an earn-out clause. Earn-out is a payment mechanism where the agreed-upon price for the deal is divided into separate parts— an upfront payment at the closing of the deal and a deferred payment, the payment of which is contingent on the firm achieving pre-determined performance thresholds. Earn-outs are especially relevant and widely used in acquiring companies where the core value of the company is in intangible assets and human capital, such as high-tech start-ups.

3.4.2 Moral hazard

Under the principal-agent theory, the problem of moral hazard can be dealt with in two ways— by the use of penalizing mechanisms and by the use of performance bonus as part of the remuneration for the agent. The penalizing mechanisms to limit the moral hazard include all the contractual provisions between the principal and the agent that enable principal to demand damages or other remedies and even terminate the contract in case an agent fails to meet the expectations or fulfil its duties properly.

The problem with penalizing mechanisms is that they are retro-active which means they can only be used when the damage from moral hazard has already been made. In addition, although the retroactive use of penalties may some deter agents from trying minimize their effort to maximize the profit for the principal, its effect is minimal. Firstly because the use of penalizing mechanisms in practice is somewhat limited. Most such mechanisms can bring along long and costly legal proceedings which means that principals are unlikely to use them, unless there is a very clear and apparent breach of duties, which is rather

unlikely in a principal-agent relationship. The second factor that dilutes the deterrence power of penalizing contractual provisions is the unlikelihood of any underperformance is discovered by the principal. As the information about the conduct of the agent is asymmetric, the effort level of the agent is not easily verifiable.

As the penalizing mechanisms to minimize moral hazard are ineffective and the effort level itself cannot be adequately measured in practice, principals in practice and academics alike, turn most of their attention to incentivizing the agent through performance based remunerations packages, which aim to align the interests of the principals. If the agent’s own wealth is dependent on the effort his spends on improving the performance of the company, he will be not descend into a comfort-zone of trying to minimize his effort.

Under the agency theory, it is of vital importance to construct a remuneration scheme that provides the maximum wealth for the principal. The necessity for performance based payment to incentives the agents has been widely accept, so by now, for example in Australia, the incentive component for the CEO’s remuneration is on average around 50 %. The performance component includes mostly shares in the company, or options to acquire shares in the future or other derivative instruments. Such a mechanism has to be a careful balance between providing a lucrative incentive for the agent and not over-paying the agent. When a remuneration scheme provides too little incentives or deploys a mechanism that is unachievable in practice (or at least seems unachievable for the agent), he shall refrain from striving to use the maximum amount of effort. This is because the agent does not see it as a possibility to increase wealth. On the other hand, when the agent is remunerated too graciously, it may happen that all the extra wealth will fall to the agent and not improve the wealth of the principal. For example, under a falsely constructed remuneration mechanism, when meeting a predetermined threshold for obtaining a part of the

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remuneration, the agent’s income may increase more than the wealth for the principal, as he will employ a minimum amount of effort to only pass the threshold.

Besides creating an *ex ante* contractual mechanism that would reduce moral hazard by penalties and/or positive incentives, it is of importance to either agree on an effective system that enables monitoring of the agents actions, so to determine his or her effort and performance or agree on the criteria, based on which the outcome based compensation is decided and how to monitor such criteria. The monitoring systems that must be agreed upon and devote resources to by the principal, includes a system for budgeting, an efficient reporting procedure and the corporate governance structure. The most important of monitoring mechanisms in a company is the Board of Directors, which among other obligations, has the duty to oversee the conduct of the managers. In a company, which operates with a two-tier board, the function falls upon the Supervisory Board. The Board of Directors has wide discretion over the managers of the company, including appointing and replacing them, reviewing their performance and negotiating over their compensation package, on behalf of the company. Therefore, it is essential for the principal to obtain as much control over the Board of Directors, which in the light of the agency theory means to acquire as much rights as possible for the appointment of directors, relative to other possible principals. Of course when the principal is the sole owner of the company, he enjoys the complete discretion regarding the appointment of the members of the Board, which is only lightly limited by the legislation in the country of incorporation (depending on the local company law, there may be requirement regarding the amount of members of the Board, their independence from the company etc., but the specific Directors themselves are for the owner (*i.e.* the principal) to appoint. In case a principal is only a partial owner of the company, he may try to agree with other shareholders on the composition of the Board but what is a more certain option under the agency theory, is negotiate as much rights when entering the company as a principal, as possible. Such agreements are widely used when two or more parties enter into a

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joint venture or when an investor invests in return for preferred shares (e.g. a venture capital investment).

3.4.3 Transaction specificity of assets

As stated, transaction specificity of assets is a term used to describe a situation where investments used in a particular symbiosis have a higher value than using them for any alternative function. Such a phenomenon can create two different problems for the investor that need to be paid attention to when contracting, depending on the asset in question— the asset specificity regarding the asset that the investor invests in and on the other hand the specificity of the asset invested by the investor into the target. Both problems need to be considered when contracting, so to provide best possible protection for the use of the asset and the maximum return on the investment.

Regarding the asset that the investor invests in, there are two specific problems that need addressing when contracting. Firstly, the more specific an asset is, the higher the risk associated with the investment. When a principal acquires an asset that is commonly used on the market or in case of a company, has a strong and stable product, for which there is proven and consistent demand, the investor can be relatively assured that if needed, he can exit the investment and sell the asset, by which he can in a positive scenario make a positive return or in a worse scenario, at least recoup some of the costs. But if the asset is highly specific, such as a specialized production unit or a high risk start-up, which has an idea for a product that is yet to be produced and demand for which is yet to be proven, the possibility to resell the product is substantially lower and therefore, a high risk is created. A high risk investment might prove to be a sunk cost and produce little or no cash flows or value for the investor.

With an ex ante contract, such a problem can be tackled in multiple ways. Firstly, an investor can aspire to create the contract, where the specific value of the asset is as certain as possible. This requires a through due diligence on the part of the investor to figure out his or her needs (especially in regards to

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strategic investments because for purely financial investments, the asset that is acquired can be expected to generate return individually, not through introducing strategic benefits to other investments). Secondly, the investor must try to obtain reduce information asymmetries as much as possible and obtain the relevant information about the asset. Thirdly, with an ex ante contractual mechanism, the investor may try to allocate the risks in a way that the seller assumes the risk that the asset is such that it produces the necessary value. For example, when an investment is made into production equipment, the principal may order a product based on the description of his or her needs. Similarly, in regards to human capital, the investor may buy a specific service from a person who has the necessary skills to provide it, instead of employing a person with a hope that the person is able to fulfil the tasks the principal wishes.

To mitigate the risk of a specific asset becoming a sunk cost for the investor because of lacking resale possibilities, under the agency theory the principal may try to avoid becoming an owner of the asset, so that he or she only uses it and under an agreement and is not responsible recouping the costs of obtaining the asset, if it is of no use anymore. This is an opposite approach to the incomplete contract theory, which proposes gaining full ownership of the asset so to obtain all the residual rights related to ownership.

For example, regarding an asset necessary for production, the principal may decide to rent the asset or in case the asset is a company, the principal may decide to hire a service from the company and then obtain all the necessary rights in relation to their service or product (e.g. instead of buying a production company, a large film studio may decide to buy their specific product (a movie script) and buy the relevant intellectual property rights of the script).

Looking at the problem of transaction specificity of assets from the viewpoint of the other party, we must take into account that an investment process is bilateral (or in some cases even multilateral) and that assets are traded between both parties. In an investment, the asset devoted to the transaction by the investor is in most cases a sum of money or in some cases, other financial instruments. Although cash or other liquid financial instruments are one of the most universal assets imaginable and therefore do not bring along the commonly recognized problems with asset specificity for the receiving party, there is still one
important consideration for the transferor, *i.e.* the investor– the hold-up problem. Commonly, the problem of hold-up is looked from another viewpoint and defined as a risk that the owner of the specific asset may become dependent on the other party which imposes a threat and a weaker bargaining position.\(^8^3\) From an economic view, this is indeed a problem for the owner of a specific asset but the response to this problem creates a countervailing problem for the investor. The seller will try to tie the investor in with contractual mechanisms for as long period as possible. So a principal who wishes to retain the possibility to exit an investment, a joint venture, an employment contract or any other agreement, must already when signing the *ex ante* contracts, provide for a possibility to exit the investment. Also, the principal must try to anticipate and mitigate the costs in relation to exiting the investment. In case the principal decides to exit the investment, in addition to a possible loss of return and contractual penalties, the party will probably endure costs in relation to exiting and searching for an alternative investment.\(^8^4\) Such costs must be paid attention to when contracting and if possible, risks associated with them should be divided already prior to entering the relationship.

### 3.4.4 Exogenous risk

The fourth important problem that needs to be dealt with in *ex ante* contracts is the problem of exogenous risk. As opposed to endogenous risks, which can be mitigated, as the parties individually or together can influence them, exogenous risks fall outside the influence of the parties.\(^8^5\) In regards to exogenous risks, the most important aspect to consider in an *ex ante* contract, is the allocation of such risks, *i.e.* if they realize, who will bear the burden. Although in some cases, it is preferable to retain the possibility to even exit the agreement if an exogenous risk realizes, the *ex ante* contract should rather try to divide the risks so that the materialization of an exogenous risk would not bring along the termination of


the agreement, because termination would eliminate any future value from the relationship. Therefore, the agency theory requires the parties to develop a contractual mechanism that would provide for risk allocation that would compromise on the interests of the parties in a way that both would retain the interest in retaining the relationship. The *ex ante* contract must be abstract enough to provide a solution for all types of exogenous risks, because creating a *numerus clausus* list of all possible externalities that may affect the relationship is utopian and trying to achieve it would only result in high transaction costs in the form of contracting costs.

Another key issue besides risk allocation that must be paid attention to, is distinguishing exogenous risk from endogenous risks. In other words, this means distinguishing a lack of effort that is under the control of the agent from the realization of regular business risks, such as bad luck. This is important because a distinction must be made between the case an exogenous risk occurs, where the burden of the consequences can only be divided, and the realization of an endogenous risk, where other mechanisms can be used. To enable the parties to make such distinctions, the *ex ante* contracts should stipulate the exact obligations and rights of each party, so that it would be possible to identify *ex post*, what was in the realm of influence of the parties.

### 3.5 Transaction costs

The incomplete contract theory derives from transaction cost theory, which stipulates that the contractual outcome is affected by two types of transaction costs— the cost of creating the contract and the cost of enforcing it in practice.

The costs of creating and negotiating an agreement when applying the incomplete contract approach are in essence, limitless. As the contracts will

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always be incomplete and require *ex post* modification, they are not concluded with the closing of the negotiations and grow with every subsequent renegotiation or any other act by the parties to sculpture their relationship. According to the incomplete contract theory, these costs should be lower than the costs of achieving the same result with an *ex ante* contract due to two reasons. Firstly, to make an *ex ante* contract with sufficient quality (it is impossible to conclusively cover all possible externalities but the more substantive the contract, the more probable it is that the future externalities are adequately covered by it), a lot of resources are required. Time and financial resources must be spent on identifying the probable risks (by carrying out a thorough due diligence and thinking even further to estimate possible exogenous risks), creating sufficient mechanisms to mitigate the risks and then to negotiate it with the other party.\(^\text{90}\) It is also important to keep in mind that every risk reduction mechanism will affect the price of the deal, because a rationally acting seller will wish to receive additional compensation for the risk that is created to them and in addition, a situation might occur where the other party might simply not agree with the stipulations to shield the investor from every possible risk.

Secondly, when trying to identify and mitigate all possible risks with an *ex ante* contract, a lot of unnecessary resources will be used, as it is improbable that most risks that have been accounted for will ever become a real issue between the parties. As lawyers cannot decide with outmost certainty, which issue will become relevant in the course of the investment, they have to identify, analyse, contract for and finally negotiate for every risk that might become relevant. This means that a lot of time will be spent by lawyers, advisors and the parties themselves to deal with issues that will later have no real importance.

The second type of transaction costs related to mitigating agency risks are the costs of enforcing the contracts. These costs themselves can be divided into different subtypes. Firstly, in case of using contractual remedies, substantial resources must be devoted to adjudication to make the successful use of the remedies possible. Regardless of the fact if the remedy that is used in court is stipulated in the contract or in law, the parties must make an effort to explain the

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contract and the relationship between the parties to the adjudicator. This includes costs of explaining the contracts, finding and presenting necessary proof, translating document etc. Therefore, the use of legal remedies is a substantial transaction cost and should influence the parties in agency risk mitigation.

Secondly, regardless if any of the potential risks become real problems, there will always be high monitoring costs related to possible agency risk. Every contractual mechanism and legal remedy can be of use only in case the possible problems are identified and addressed at the appropriate time. This means that the agent’s actions must be sufficiently monitored continuously. Some of the monitoring can be conducted based on public filings and reports (e.g. Annual Report of the company) but even those filings need analysing which induces monitoring costs. Still, only analysing public filings is in most cases not enough to provide sufficient monitoring of the agents conduct and therefore, other information sources must be used. Although these methods vary greatly, the fact that they do not come from public sources means that besides the analysing costs, they create costs connected with discovering and obtaining the information.

Therefore the incomplete contract proposes that, although the costs of creating the contracts under the incomplete contract approach are limitless and ever-increasing in the course of the relationship, they should still remain lower than addressing all the same problems with ex ante contracts. The key issue that should determine the choice between the incomplete contract and principal-agent approach should be how substantial are the transaction costs for the approaches in a specific situation and based on that, the correct approach should be chosen.
4 The empirical analysis of agency risk management in Estonia

4.1 The aim of the empirical assessment

As already mentioned, the mergers & acquisitions market in the Baltics is young, relatively small and still in the early stages of development. In addition, the connections between academic research and theoretical approaches are still to be made. Academics are only starting to discover the necessity of connecting theoretical approaches with real-life situations and therefore, empirical assessments on legal problems are rare and fare between. From the other side, practical participants in the market are also only starting to discover that academic assessment can benefit their work as practitioners and therefore, empirical data can rarely be acquired. Largely due to these two problems, there are currently no assessments available in relation to agency risk mitigation in the Baltics and empirical data to base the analysis on is also still largely unavailable.

Because of the still-existent lack of connection between theoretical approaches and practical solutions and the lack of sufficient data, in order to maximize the practical value of the empirical assessment, the focus is somewhat different than with empirical assessments in more developed markets. The analysis abstains from trying to determine the use of specific theories in the context of insufficient data to do so and the apparent randomness that these results would entail (as the choice of either approach in most cases would not be a conscious choice by the parties). Instead, the characteristics of the mergers and acquisitions market in the Baltics are assessed and based on that, the more suitable options for agency risk management are determined in connection with the theoretical approaches.

4.2 The empirical basis for determining the application of the theories on the Baltic mergers and acquisitions market

The empirical assessment of the suitable risk management theories is based on the data collected in the study “Baltic M & A Deal Points Study 2013”
The study was carried out by five large law pan-Baltic law firms—Sorainen, Raidla Lejins & Norcous, LAWIN, Tark, Grunte, Sutkiene and Borenius. These law firms are one of the most prominent law firms in the Baltics and are the counsellors for a large portion of all the M & A transactions on the market. The study is the only empirical study on mergers and acquisitions that has been carried out on enough of a large-scale to provide valid results and limit the risk of deviating abnormalities altering the overall statistics, to the extent that would make the data unusable.

The study assessed a total of 84 mergers and acquisitions that were carried out in the three Baltic States between July 2011 and June 2013. As the study is a periodically comprised assessment and has been previously carried out in 2009 (hereinafter referred to as “2009 Study”) and 2011 (hereinafter referred to as “2011 Study”) as well, it enables to compare the shifts in the characteristics of the mergers and acquisitions market. Therefore, in addition to providing implications on the prevalent approaches to managing agency risks, where apparent, possible changes and trends on the market are highlighted as well.

In the assessment, most relevant aspects of M&A deals were assessed (the parties; sales process and form of transaction; transaction value and payment; governing law and dispute resolution; timeline; representations and warranties; closing and conditions precedent; liability and indemnification; joint ventures


92 For example, all of the participant law firms are recommended as corporate and M&A sector specialists in all three Baltic states by the prominent Legal 500 analysis of lawfirms.


Legal 500. Latvia– Corporate and M&A. Accessible online: http://www.legal500.com/c/latvia/corporate-and-manda (01.06.2014)

Legal 500. Lithuania– Corporate and M&A. Accessible online: http://www.legal500.com/c/lithuania/corporate-and-manda (01.06.2014)

and shareholders’ agreements; covenants; due diligence and length of the transaction and letters of intent). Although all the analysed criteria cannot provide indications to the agency risk management approaches used, many of them still give helpful indications. This is due to the fact that clauses and separate parts of complex transactions, like mergers and acquisitions, cannot be viewed individually. From a practical viewpoint, it is important that a contract or contracts that are used, work as a whole by limiting risks and enabling value creation. Therefore, the approaches that are used to mitigate agency risks do not only influence single clauses but rather they are prevailing attitudes that have implications to all parts of the contracts.

The use of the “Baltic M & A Deal Points Study 2013” as a basis for the empirical assessment carries with it several strengths but also some risks that must be paid attention to. The most eminent strength of the data-set is that it provides an overview of the market as a whole, as it is not concentrated on any specific type of deal or any other such characteristic. Deals vary between the three Baltic states, between their size, purpose (strategic or financial) and structuring. Therefore, the whole mergers and acquisitions market is covered. Also, as explained, it is important to find implications of agency risk management in the transaction as a whole, not only a specific type of clauses. As the study looks into numerous different variables, a wide overview can be obtained. Thirdly, the fact that the study is based on similar studies carried out in 2009 and 2011 helps in addition to determining the current situation, to also assess the trends on the market.

In addition to outlining the strengths of the basis for the empirical assessment, for deriving valid results, it is also necessary to point out the possible limitations. Regarding these, it must be mentioned that the study looks mostly into the contractual side and phase of the transaction and the further relationship between the parties is paid limited attention to. This is mostly a limiting factor in assessing the use of the incomplete contract approach, as the mentioned approach relies on ex post control. If more appropriate date becomes available regarding the relationship between the principals and agents ex post of concluding deals, further analysis on the topic could be carried out. Unfortunately, currently in the three Baltic states, entrepreneurship and the
market for mergers and acquisitions is still young and underdeveloped and therefore, access to empirical data is limited. Most parties wish to limit all possible issues with unnecessary disclosure and therefore, keep their transactions and relationship confidential. Therefore, at this point it is only possible to draw implications based on a study like the one used and further assessment on the agency risks that emerge and the approaches on solving them, requires waiting until the market develops more openness and more empirical data can be gathered.

4.3 The implications derived from the date in regards to the possible use of the principal-agent and incomplete contract approach

4.3.1 Nature of the parties

The 2013 Study looked into the nature of both the seller and the buyer and divided them into separate categories—strategic, financial/private equity, individuals, family-controlled and other. Different types of investors have specific strengths and weaknesses in regards to mitigating agency risks and therefore, different investors might benefit from different approaches. As this analysis assesses the approach taken by the principals, i.e. acquirers, the nature of the buyer is of importance.

Previous research has shown that regarding venture capital investments, business angels tend to prefer to use the incomplete contract approach while venture capital funds tend to favour principal-agent approach.94 This has been associated with the need for fund managers to provide signals of professionalism to attract investors on the part of the venture capital funds.95 From the point of view of business angels however, the benefit of the business angels on the other hand, the use of incomplete contract approach can be the cost and complexity of establishing a sufficient ex ante contract, which for many of them would entail unbearable costs.

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95 Ibid.
Such theoretical associations can be enhanced to provide a theory that financial investors prefer the use of the principal-agent theory as successful *ex ante* contracting can signal professionalism for possible investors. Strategic investors, individuals and family controlled principals should however favour the incomplete contract approach in risk management. This is partially because of the costs involved with complex contracting and secondly because they have a better position for active participation as equity owners. Such investors who bring sector specific expertise to the table and have other objectives besides pure financial return can participate in the functioning of the company more actively.

The 2013 Study shows that since 2011, the types of buyers have remained roughly the same– 60% of the deals had a strategic buyer, 22% a financial, 13% a private-individual, 3% a family-controlled and 2% of the transactions were management buy-outs. Although this data in itself does not provide any implications on the approach that is used by the acquirers, it shows what approach should be favoured based on the previously concluded theoretical postulates. As strategic investors are interested in other aspects of the company besides its financial return on investment, they are more probable to have the wish and expertise to participate in active management and control of the company. Therefore, as strategic investors make up the majority of acquirers, the incomplete contract approach could provide the best possibilities for managing agency risks.

*Source: Baltic M&A Deal Points Study 2013*
4.3.2 Sales process

Under the category of the nature of the sales process, the 2013 Study firstly assessed whether the deal was concluded via a negotiated sale, a controlled auction or any other form. The usage of negotiated sales implies a greater use of the principal-agent approach in mergers and acquisitions. With a negotiated sale, the parties are more actively involved in negotiating and agreeing a contractual mechanism that would satisfy their interests. With a controlled auction on the other hand, more emphasis is put on the price offered in exchange for equity. Therefore, the process of controlled auction would favour the use of incomplete contract approach because agency risks cannot be managed so thoroughly by elaborate contractual mechanisms but rather by increased residual rights. The results of the 2013 Study show a slight but constant rise in the use of negotiated sales, in comparison with the Study of 2011. The most current study showed that 88 % of the analysed transactions included a negotiated sale, while 10 % were held as an auction and only 2 % of the deals used another sales process. Therefore, in regards to the sales process, the principal-agent approach would be more favourable.

Source: Baltic M&A Deal Points Study 2013
4.3.3 Form of transaction

Regarding the form of the transaction, the study analysed what the principal acquired in return for the investment he made. The greater the use of shares as the consideration that the investor receives, the more possibilities exist for the use of incomplete contract approach. This is due to the fact that while specific assets and convertible securities provide the investor with specific rights, obtaining shares in the company enables the investor to use all the residual rights that derive from equity ownership. For example, when an investor decides to acquire solely the specific assets or enter into a joint venture with another party, his relationship is limited with the stipulations they agree upon in the asset purchase or joint venture agreement. On the other hand, if he obtains shares in the target company, he obtains residual rights as well, which enables him to exercise *ex post* control which is not limited to the stipulations he has agreed upon with the other party but entails all the aspects of a company that can be decided and influenced by the owner. Of course consideration must also be paid to the fact that sometimes shares can be obtained in an amount that does enable the investor to exercise control to a great extent. It is possible that a minority stake is purchased which means that the investor is not able to pass all the resolutions he desires and might need. Still, as Estonian law stipulates a relatively high level of protection and a rigid legal framework that provides investors with a possibility to participate in some aspects of control, even a minority stake provides some implications towards the incomplete contract approach. For example, a shareholder irrespective of his share has a right to ask the management board for information about the activities of the company, which enables him to monitor the agents and detect any possible risks.\(^{96}\) Also, minority shareholders who hold at least 1/3 of the votes at a shareholders meeting can veto the amendment of the articles of association that also provides them with a possibility to influence some decisions that might have an effect on the agents conduct.\(^{97}\)

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The 2013 Study showed that when comparing with the 2011 Study, the use of different forms of transactions has remained roughly the same—80% of the transactions included a purchase of shares, 7% purchased assets, 6% a combination of shares and assets, 5% were joint ventures and 2% of the transactions were the acquisition of shares and convertible bonds. These results show that Baltic mergers and acquisitions transactions favour the use of the incomplete contract approach, as the incomplete contract approach relies on the acquisition of residual rights of the company.

Source: Baltic M&A Deal Points Study 2013

### 4.3.4 Payment terms

Regarding the value and payment characteristics that the 2013 Study assessed, the most important is the mechanism of payment used by the investor. In addition to a simple lump-sum payment, it is possible to agree upon the deferral of the transaction consideration, earn-out clauses and other less-know instruments. The use of such mechanisms implies that the principal-agent approach is of more importance in managing risks than the incomplete contract approach. This is because such mechanisms are in essence *ex ante* clauses that help to reduce moral hazard and should also refrain the agent from retaining
information and thereby creating information asymmetries. This is because when such payment options are used, the agents should have less incentives to indulge in moral hazard and refrain information from the principal, as they cannot gain the deferred or contingent parts of the payment, when the problems become apparent after concluding the transaction. On the other hand, the use of a lump-sum implies that the investor is interested in simply obtaining the object of the transaction and agency risk mitigation must be done by *ex post* control.

The study identified that participants in Baltic mergers and acquisitions strongly favour the use of lump-sum payments as form of consideration. The 2013 Study identified that a plain vanilla lump-sum was used in 55% of the transactions. 16% included a lump-sum payment where the payment was deferred, 11% included a simple payment deferral, 9% included a lump-sum payment with an earn-out clause, 4% a payment deferral and an earn-out and 5% of the transactions contained were based solely an earn-out. This is in sharp contrast with the Study of 2011, where 50% of the transactions were based on deferral, 28%, included a lump-sum at closing and all other options lagged behind, being used relatively rarely. Therefore, as more than half of the deals concluded included no elaborate payment mechanisms, the incomplete contract approach is of greater use, because contractual mechanisms are not so easily enforceable.

*Source: Baltic M & A Deal Points Study 2013*
4.3.5 Disputes

Regarding the issue of disputes, the analysed characteristic that gives the most implications in regards to possible agency risk management approaches is whether or not the transactions resulted in any disputes. Disputes on the basis of transactions imply that a party or both parties found it necessary to defend its or their rights under the signed contracts. In other words, the parties engaged the \textit{ex ante} contractual mechanisms which needed enforcement by a court or arbitration body. This implies that the parties have encountered problems with concluding and enforcing perfect and all-inclusive contracts. Therefore, in case disputes arise often, it would be more optimal to rely on the incomplete contract approach by which the arise of disputes between the principal and agent are minimized as the principals can mitigate agency risks by renegotiation and if such an option proves to be inefficient, use their residual rights to remove the incumbency.

Regarding the situation in the Baltic States, the 2013 Study showed that only 5\% of the transactions resulted in a dispute. This result is similar to the 2011 Study, according to which, 7\% of the analysed transactions resulted in disputes. Therefore, as disputes are few and far between, it can be concluded that parties are able to conclude contractual mechanisms that can be applied successfully in practice and do not need enforcement by the judiciary.

\textit{Source: Baltic M & A Deal Points Study 2013}
4.3.6 Representations and warranties

Regarding the usage of representations and warranties in agreements, the 2013 Study looked at both the popularity of such provisions and also the specific content clauses that were used. From the point of assessing the implications of the use of agency risk management theories, the overall usage of representations and warranties is of greater importance, as the specific conditions (e.g. standard of knowledge) are too dependent on the specific object of the contract and the context of the agreements, to make overall conclusions.

The more representations and warranties are used, in contracts, the bigger are the implications that investors are reliant on contractual protection rather than ex post control. If the other party warrants specific conditions regarding the contract, it shows that the investor needs further protection as he is unable to ascertain that all the relevant factors are as they are represented to him. Such a problem implies that specific ex ante provisions are needed to provide for the specific rights that the investor is interested in. Therefore, the more the investor has to rely on a long list of representations and warranties, the more attention is turned to principal-agent theory in regards to mitigating risks. On the other hand, if the party needs no extra assurance or only in regards to the titles and specific aspects regarding the transaction, it implies that obtaining residual rights are of greater importance.

The 2013 Study showed that 63% of the contracts that were analysed included a long list of representations and warranties from the seller. 34% contained only title and other specific representations and warranties and only 3% of the deals contained no representations and warranties. The trend, in contrast with the 2011 Study, shows a movement towards less representations and warranties, which indicates a strong and even strengthening position of sellers in the mergers and acquisitions in the Baltics. Therefore, the empirical data derived from the use of representations and warranties implies a move towards the incomplete contract approach.
4.3.7 Liability and indemnification

Regarding the liabilities and indemnification clauses, the study most importantly assessed the survival of warranties, caps on liability (i.e. the maximum limit of the liability of the seller) and securities set on the seller’s obligations. The usage of all these provision indicates that the investor regards the ex ante contract as the most important risk management mechanism and therefore, to maximize the protection of the contract, the warranties must survive as long as possible, maximum possible liability coverage must be included (i.e. no caps on liability) and in addition the obligations of the seller must be ensured by warranties. In contrast, when the investor relies on ex post control, it is important to obtain the ownership of the asset with minimal costs and therefore, elaborate protective provision that are both costly to create and raise the price of the deal, are used at a much smaller extent.

Source: Baltic M&A Deal Points Study 2013
The 2013 study showed that 42% of the deals that were carried out, did not include and establishment of general survival period of warranties. Out of the 58% that did, the most common period was 13-18 months, which was used in 22% of the deals.

![Diagram showing the establishment of general survival period of warranties](image)

*Source: Baltic M & A Deal Points Study 2013*

Regarding the cap on liability, the 2013 Study indicated that such a limit existed in 58% of the transactions, which means that less than half of the deals included unlimited liability for the seller for the breach of the representations and warranties provided by him.

![Diagram showing the cap on liability for breach of warranties](image)

*Source: Baltic M & A Deal Points Study 2013*
The assessment of the use of security by the seller for fulfilling his obligations showed that no form of security was used in 69% of the transactions.

Overall, although a little more than half of the deals that were carried out included a survival period of the warranties, it must be noted that as pointed out under the assessment of representations and warranties, the overall use of warranties is declining. This implication, together with the fact that in most deals the liability of the seller was limited to a certain extent and the fact that in most transactions the seller provided no warranty for a case of breach of obligations, implies that regarding liabilities and indemnification, Baltic merger and acquisition contracts do not turn a lot of attention towards ex ante contractual protection. This implies that the incomplete contract approach is more suitable in such transactions.

4.3.8 Shareholders’ agreements

The use of shareholders’ agreements implies that the parties are able to control the risks by the use of contractual mechanisms. Shareholders’ agreements are agreements, which by their stipulations limit the shareholders from using their residual rights and therefore they opt to use contractual mechanisms to protect
their interests instead of executing the powers they have by the rights as the owner of the equity of the company. When shareholders’ agreements are used, the application of the incomplete approach is limited and they are restricted to the \textit{ex ante} provisions they agree upon.

The 2013 Study showed that the usage of shareholders’ agreements has almost halved since the last study was carried out. While the 2011 Study showed almost unanimous use of shareholders’ agreements (96 \% of the transactions included them), the current situations is that only 43 \% of the deals included a shareholders’ agreement.

\begin{figure}
\centering
\includegraphics[width=\textwidth]{chart.png}
\caption{Is there a shareholders’ agreement signed between the parties?}
\end{figure}

\textit{Source: Baltic M&A Deal Points Study 2013}

This sharp fall indicates that more and more investors are valuing the possibility to freely use the residual rights that their position as an owner provides them and the need to turn to the principal-agent approach is not needed.

Out of the shareholders’ agreements that existed in the transactions analysed for the 2013 Study, the most popular provisions were restrictions to encumber (used in 91 \% of the agreements), share sale restrictions (also used in 91 \% of the agreements), first refusal or pre-emptive rights and veto rights (both used in 88 \% of the agreements). Compared to the 2011 study, the usage of veto rights and restrictions to encumber have both fallen, while the usage of share sale
restrictions and rights of first refusal or pre-emptive rights has gained more popularity.

Source: Baltic M&A Deal Points Study 2013

The popularity of the provisions in shareholders’ agreements is again an indication towards the use of the incomplete contract approach. This is due to the fact that although the provisions themselves are ex ante contractual mechanisms, they with by effect do not turn so much attention to mitigating risks that derive from the other parties behaviour but rather protect and help to provide for a possibility for the principal to increase his equity position and thereby gain more residual rights of the company.
4.3.9 Results of the empirical assessment

In total, eleven characteristics were assessed in regards to possible indications towards the most suitable approach for mitigating agency risks. On the basis of the assessment, following results were derived:

<table>
<thead>
<tr>
<th>Characteristic analysed:</th>
<th>Implies the use of:</th>
</tr>
</thead>
<tbody>
<tr>
<td>Nature of the parties</td>
<td>Incomplete contract approach</td>
</tr>
<tr>
<td>Sales process</td>
<td>Principal-agent approach</td>
</tr>
<tr>
<td>Form of transaction</td>
<td>Incomplete contract approach</td>
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<tr>
<td>Payment terms</td>
<td>Incomplete contract approach</td>
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<tr>
<td>Disputes</td>
<td>Incomplete contract approach</td>
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<tr>
<td>Representations and warranties</td>
<td>Incomplete contract approach</td>
</tr>
<tr>
<td>Survival period of warranties</td>
<td>Incomplete contract/principal-agent approach</td>
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<tr>
<td>Limit of seller’s liability</td>
<td>Incomplete contract approach</td>
</tr>
<tr>
<td>Security of seller’s obligations</td>
<td>Incomplete contract approach</td>
</tr>
<tr>
<td>Shareholder agreement</td>
<td>Incomplete contract approach</td>
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<tr>
<td>Shareholder agreement provisions</td>
<td>Incomplete contract approach</td>
</tr>
</tbody>
</table>

As indicated in the table, out of the 11 analysed aspects of Baltic merger and acquisition agreements, 9 implied that the agency risks are or at least can be best mitigated by the use of incomplete contract approach. One characteristic suggested that instead the principal-agent approach is most suitable. And finally, the results of one characteristic were such that the provision was used in around half of the agreements, which can suggest the use of either approach.

These results provide strong indications that the most suitable approach for mitigating agency risks in the Baltics is the incomplete contract approach, by which the principal relies on the carrying out *ex post* control by acquiring the residual rights of the company. The exact reasons why such a situation has occurred cannot be concluded based on the assessment of the empirical data that is available and could be the subject of further research. Still, it is possible that such a situation is the result of the specific characteristics of the countries that were explained prior. The small size of the countries and the economic environment can make it easier to exercise *ex post* control, as acquiring contacts
and information and even physical participation is simpler. Also, the youth of
the Baltic States can definitely affect the abilities of the parties to create and
negotiate elaborate contractual mechanisms and also, if necessary, enforce them
in courts with little experience in such mechanisms.
5 Summary and conclusions

Being small and young countries with an entrepreneurial market that is only in the first steps of development, creating an investment environment that is lucrative and induces capital influx, is a key consideration for all three Baltic States. As agency risks are one of the most important aspects that influence the success of investments, it is of vital importance to provide adequate solutions towards managing such risks, to attract investments in the future.

Regarding the management of such risks, investors can turn their attention to two competing approaches that have been developed by academics, based on real-life possibilities- the principal-agent and incomplete contract approach. The first approach relies on concluding elaborate and all-inclusive *ex ante* contracts that provide contractual mechanisms to limit the agency risks. The second on the other hand acknowledges that exhaustive contracts are impossible to create and therefore, relies on *ex post* control through residual rights that arise from equity ownership. Both the principal-agent and incomplete contract approach towards mitigating agency risks entail their own specificities. As a result, depending on the specifics of the market and the situation in each individual investment opportunity, either of the competing approaches can be used. In addition, in practice, neither of these possibilities is used inclusively and for the best solution, a balance between both is sought.

Even though both theories arise from empirical assessment of the techniques that were used already prior to creating the theories, it is still important to scientifically identify the use of these theories on the investment market. This enables academics, legislators and practitioners to gain a better understanding of the market and develop solutions that best fit the investor’s needs.

The empirical assessment of the Baltic market of mergers and acquisitions identified that currently, the characteristics of the transactions imply that the incomplete contract approach is a more effective solution for dealing with agency risks. The nature of the investors, the content of the contracts they conclude, as well as the aspect of whether or not the transactions result in any disputes indicate, that the creation of *ex ante* contractual mechanisms is not
being paid so much attention to. Instead, *ex post* control by the use of residual rights can result in a more suitable solution for the investor, without occurring unnecessary transaction costs related to identifying the possible issues when negotiation and later, concluding the contract.

Such a result shows that in order to facilitate more investment activity, it is of vital importance to enhance the possibilities to use the residual rights that enable carrying out control. Instead of creating a legal environment with rigid rules that protects passive investors and therefore, limits active investors from exercising control, more attention should be turned to enabling flexibility in carrying out control. Investors should be facilitated with the possibility to govern the companies that they invest in so, that they could develop an optimal structure of corporate governance.

Also, as the results imply that elaborate *ex ante* contracts are not optimal for managing agency risks, less attention should be turned to drafting and negotiating such contracts. This would enable the parties to more freely renegotiate their relationship and adapt to changed circumstances if needed and due to limiting unnecessary transactions costs, provide better return on investments and a more efficient allocation of capital.
6 List of references

6.1 Academic literature


6.2 **Legislative acts**


6.3 **Online sources**


