Estonia

Negotiated M&A Guide 2022

Corporate and M&A Law Committee

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1. INTRODUCTION

The Baltics in general and Estonia in particular have enjoyed steady growth in M&A activity for several years now. While the Covid-19 pandemic slowed activity in the first half of 2020, by the fourth quarter of 2020 the market had almost fully recovered and was in many industries the record year in terms of M&A activity.

The growth trend continued in 2021, fuelled by several factors, including: good availability of debt and equity capital; a growing number of active investors, ranging from private equity firms to family offices of high-net-worth individuals; and fear of inflation increasing the number of attractive targets in many industries,. The sectors with most M&A activity in 2020 and 2021 have been technology, media and telecommunications (TMT), financial services, consumer retail, and health/pharmaceuticals. The market has generally been rather seller-friendly, largely due to the factors mentioned above, including a large number of active investors with good access to capital.

M&A is interdisciplinary by nature. Legal rules governing M&A transactions are included in several different legal acts. Contractual aspects are mostly governed by the Law of Obligations Act (*võlaõigusseadus*); property law aspects are governed primarily by the Law of Property Act (*asjaõigusseadus*); and the Commercial Code (*äriseadustik*) governs the corporate law elements of M&A transactions. In addition, various regulations may apply depending on the circumstances, including competition law, financial regulations etc.

2. TYPES OF TRANSACTION STRUCTURES ADOPTED IN PRIVATE M&A TRANSACTIONS

Below is a list of key transaction structures carried out in private M&A transactions in Estonia:

- acquisition of shares (share deal);
- acquisition of assets (asset deal);
- merger;
- cross-border merger;
- increase of share capital;
- demerger (division);
- acquisition of own shares (share buy-back);
- reduction of share capital; and
- squeeze-out

2.1 Acquisition of shares

2.1.1 General

The most straightforward and common type of an M&A transaction is the acquisition of shares. Different types of limited liability companies are (1) closely-held limited liability companies (*osaühing* or OÜ) and (2) widely-held limited liability companies (*aktsiaselts* or AS). The exact share transfer procedure depends on the type of the company in which shares are being acquired.

For AS-type companies, the share purchase agreement (SPA) for the acquisition of shares can be concluded in any form – in simple written form, by email or even verbally. The shares of the company are kept in electronic form only and are registered in the Estonian register of securities, maintained by Nasdaq CSD. The shares are kept on the securities accounts which may be opened with certain qualifying banks (mostly Estonian and certain Latvian and Lithuanian banks). The acquisition of shares is carried out by a transfer from the securities account of the existing shareholder (the seller) to the securities account of the new shareholder (the buyer), which means that the buyer must open a securities account with a qualifying bank to close the share sale transaction.

For OÜ-type companies, there are three different possible scenarios for the acquisition of shares:

(a) The company's shares are registered in the Estonian register of securities (which is optional for OÜ-type companies). In such case, the share transfer procedure is essentially the same as the acquisition of shares in AS-type companies (see above).
(b) The company's shares are not registered in the Estonian register of securities (Alternative 1). As from 2020, the agreement regarding the specific terms and conditions of the transaction (transaction under the law of obligations or *kohustustehing*) may be concluded in simple written form (there is no longer a mandatory notarial form requirement). However, the agreement to transfer the title to the share (transaction under the property law or *käsutustehing*) must be attested by an Estonian notary. This means that while agreements like option and shareholder agreements may now be concluded in simple written form, the actual transfer of title over shares still requires the notary's involvement.
(c) The company's shares are not registered in the Estonian register of securities (Alternative 2). As from 2020, if the company's share capital is at least €10,000, the shareholders can waive the notarial form requirement for the transaction under the property law. For this, the shareholders of the target company must unanimously adopt a new version of the articles of association which includes such a waiver. The shareholders are allowed to set forth in the articles of association that share transfers (transactions under the property law) may be carried out in a form that can be reproduced in writing. In such case, a notary's involvement is not required, and the entire share purchase transaction can be carried out in simple written form.

The acquisition of majority stake or control over the company by some other means may require prior approval from the relevant competition authority if certain turnover thresholds are exceeded (see Section 6 below).

2.1.2 Advantages and disadvantages

One of the key advantages of the acquisition of shares compared to other types of transactions is minimal interruption to the company's everyday operation, as the transaction does not involve any transfer of any assets or contracts of the company itself. Compared to an asset deal (ie transfer of a going concern), there is also no need to examine the transferability of licences, permits and registrations: all the assets, rights and liabilities remain with the target company and the buyer acquires control over them through the acquisition of the shares in the target company.

In case of acquisition of shares, the buyer does not directly assume the risks related to the target company as opposed to an asset deal (see Section 2.2 below). This means that the buyer's direct financial risk is usually limited to the amount of investment (purchase price) paid for the target company's shares.

Also, the parties are free to choose the moment of the transfer of title (which is not possible in the case of a merger or demerger). However, the parties should note that, for the purpose of the target company itself, the shares are deemed transferred as of the moment the target company's management is notified and provided proof of the transaction (if the OÜ-type company is not registered in the Estonian register of securities) or as of the moment the buyer is entered into the list of shareholders kept by the Estonian register of securities (AS-type company, or OÜ-type company if the company is registered in the Estonian register of securities).

There are also certain disadvantages that the parties must take into consideration in share acquisition transactions. For example, it might be very cumbersome, or even impossible, for non-resident individuals or legal entities to open a securities account with a qualifying bank if the shares of the target company are registered in the Estonian register of securities. In recent years, banks in Estonia have become very conservative in opening securities accounts for non-resident clients due to strict know your customer/anti-money laundering (KYC/AML) obligations.

Also, if the buyer is not acquiring 100 per cent of the shares in the target company, shareholders' pre-emption rights may apply to the share transfer transaction. For OÜ-type companies, in the case of transfer of shares to third parties, other shareholders have a statutory pre-emption right to acquire the shares which are being transferred, unless the shareholders have excluded such right in the company's articles of association. For AS-type companies, the other shareholders have a pre-emption right to acquire the shares, provided that the pre-emption right has been stipulated in the company's articles of association. Transactions which are carried out in violation of such pre-emption rights are void – in the case of AS-type companies, transactions in violation of the pre-emption right are void if the right of pre-emption has been entered into the Estonian register of securities.

In addition, other restrictions to the share transfer transaction – eg, the right of first refusal, tag-along rights etc – may arise from the shareholders' agreement or similar agreements.

The parties should also check for any consent or notification requirements for the share acquisition transaction under agreements concluded by the target company (eg change of control clauses), typically included in financing agreements such as bank loans and leasing agreements. Breach of such restrictions may entitle the counterparty to unilaterally terminate the agreement, claim damages or penalties, or may result in other adverse consequences established in the particular agreement.

If the share transfer agreement must be concluded in notarial form, then notary fees will apply. These will depend on the transaction price and may be considerable.

2.1.3 Leveraged buyout

Under the Estonian Commercial Code, a company is not allowed to grant a loan for the purpose of acquiring that company's shares, or to secure the acquisition of the company's shares. A transaction which is in violation of these financial assistance rules is normally void. If the company secures the loan for the acquisition of the company's shares, then the transaction is not void, but the person whose loan was secured must compensate the damages which were incurred by the company due to such security.

Therefore, leveraged buyouts are usually structured through a special purpose vehicle (SPV): the shares in the target company are acquired by an SPV established specifically for such a purpose. After acquisition, the SPV and the target company are normally merged, allowing the buyer to service the loan on the account of the target's assets. However, such structures may potentially carry a risk of challenge by a tax authority, which may attempt to argue that the interest expense borne by the company after the merger is not related to its business activities and should therefore be taxable as a non-business expense.

2.1.4 Tax considerations

The tax implications of a share deal depend on many different conditions, including the tax residence of the seller and nature of the target. The Estonian corporate income tax (CIT) is effectively a distribution tax, meaning that it generally only applies to profit distributions. Retained/reinvested profits are taxed only upon their distribution. Therefore, sale of shares by a resident company does not normally trigger any immediate taxation with Estonian CIT.

In case of a non-resident seller, sale of shares in an Estonian company is normally not taxable in Estonia, with one notable exception. If the transferred shareholding is a shareholding in a company of whose property, at the time of the transfer or during a period within two years prior to that, more than 50 per cent was directly or indirectly made up of Estonian real property, and in which the non-resident had a holding of at least 10 per cent at the time of the transaction, then the gain received by the non-resident seller will be subject to Estonian CIT. Almost all applicable treaties for avoidance of double taxation allow for such source taxation.

2.2 Acquisition of assets

2.2.1 General

Acquisition of assets is a type of M&A transaction often used if the buyer is not interested in acquiring the entire company, instead acquiring only certain assets of the company which it considers as the value carrier. The exact form for the transaction of the acquisition of assets depends on the assets being acquired. If the assets being transferred include real estate located in Estonia, then the transfer of real estate must be concluded in notarised form.

Like the acquisition of shares, merger clearance may be needed in case control is acquired over a business (or part of the business) and certain turnover thresholds are exceeded.

2.2.2 Advantages and disadvantages

If the transferred assets constitute an enterprise (*ettevõte*) or an organisationally whole part of an enterprise (*organisatsiooniliselt terviklikuks üksuseks olev ettevõtte osa (käitis)*) (hereinafter ‘transfer of business’) in the meaning of the Estonian Law of Obligations Act, then all the obligations which are related to the acquired business transfer to the buyer automatically, together with the assets regardless of the buyer’s knowledge thereof. Therefore, it is crucial to determine whether the assets being acquired constitute an enterprise or not. Parties often structure the transaction for transfer of business in a similar manner as the share acquisition transaction, in which the seller provides representations and warranties regarding the assets, including related obligations, and the seller’s liability for such representations is secured by certain contractual remedies.

In case of transfer of business, the seller and the buyer become jointly and severally (solitarily) liable for the obligations which have arisen before the sale, and either have become enforceable before the sale or will become enforceable within five years from the sale. Although the parties normally agree on the allocation of liabilities among themselves in the asset purchase agreement (APA), such an arrangement is not binding upon third parties unless the third party has expressly consented thereto.

As a rule, all the agreements, rights and obligations which are related to the acquired business (including employment agreements) transfer to the buyer together with the business: the counterparties’ consent is not required. However, this should be determined on a case-by-case analysis. For example, certain agreements with counterparties may include contractual restrictions to the transfer, eg, by requiring prior consent from or notice to such counterparty. Also, not all regulatory licences, permits and consents are transferrable, or may need to be updated after the transaction. Therefore, the buyer risks losing certain agreements or regulatory permits related to the operation of the business if due care is not exercised to ensure their transfer and/or existence after the sale. In addition, Estonian labour law requirements to inform and consult employees must be observed in cases of transfer of business.

If the transferred assets do not qualify as a transfer of business within the meaning of the Estonian Law of Obligations Act, then contracts normally do not transfer automatically and the counterparty's consent is normally required for the transfer of an agreement.

If the transferred assets include real estate located in Estonia, or other assets the transfer of which requires a mandatory notarial form, then the respective agreement for the transaction for the transfer of the assets must be attested by an Estonian notary. The respective notary fee will depend on the value of the transaction and may be considerable.

Considering the above, alternative options to the acquisition of assets are sometimes preferred, particularly share deals.

2.2.3 Tax considerations

The CIT implications of an asset deal will depend on the nature of the assets, the tax residence of the seller, and so on. If the seller is an Estonian resident company, sale of assets normally does not trigger any CIT taxation in Estonia because the corporate profits are subject to CIT only upon distribution. CIT implications for a non-resident seller will depend on the nature of the assets. If the assets include Estonian real property, then the capital gain generated by the sale of such property will normally be subject to Estonian CIT.

If the transferred assets constitute an enterprise or an organisationally whole part of an enterprise (*käitis*) in the meaning of the Estonian Law of Obligations Act, the transaction is outside of the scope of VAT. This means the VAT is not chargeable nor will the transaction impact the seller's ability to deduct the input VAT.

2.3 Merger

2.3.1 General

Merger is one of the most common transaction types for carrying out intra-group restructurings. Merger can be carried out in two ways: (1) a company merges with another company and the acquired company (the company being merged) is considered dissolved; or (2) two or more companies merge to form a new company, in which case all the merging companies are considered dissolved. Companies which are dissolved are deleted from the commercial registry without liquidation proceedings.

Most typical intra-group merger scenarios are: (1) a side-step merger, where group companies at the same level of the group are merged; or (2) an upstream merger, where subsidiaries are merged into the parent company.

A merger entails the following key actions:

(a) signing a notarised merger agreement;
(b) preparation of a merger report and auditor's report (of the merger agreement);
(c) adoption of shareholders' resolution to approve the merger agreement;
(d) preparation (and audit) of the balance sheet of the company being acquired;
(e) entries in the commercial register to register the merger; and
(f) publication of a merger notice in the Official Gazette (*Ametlikud Teadaanded*).

Depending on the specifics of the merger, some of these actions may be skipped and some additional actions may be required.

The shareholders of the merging companies must approve the notarised merger agreement, and at least two-thirds of the votes present at the meeting must approve the merger, unless the articles of association set forth a higher majority requirement. The shareholders of the companies must be granted a certain amount of time to familiarise themselves with the merger documents: the exact amount of time depends on the type of the company. In certain cases – eg, if the merging company has only one shareholder – the statutory waiting period is usually not needed, and the notarised merger agreement and the approval of such agreement can be executed simultaneously. However, it is mandatory to wait for at least one month to submit the merger application with the commercial register after the notarised merger agreement is approved by the shareholders.

The closing balance sheet of the company being acquired shall be prepared as at the date not earlier than eight months before filing the merger application with the commercial register. The closing balance sheet must be prepared, approved and audited according to the same rules that apply to the company's annual reports. If it is not possible to use the balance sheet included in the company's annual report of the previous financial year, then the preparation of a new balance sheet can be quite time-consuming, especially if audit is needed.

The merger is legally completed when the merger is entered into the registry card of the acquiring company (registration of the merger). The merger process takes approximately two and a half months from the date of signing the merger agreement (not including the time needed for the preparation and audit of the closing balance sheet).

Intra-group restructuring does not result in concentration for competition law purposes and is therefore not subject to merger clearance. However, if a merger is taking place between two non-related parties, then merger clearance may be needed if certain turnover thresholds are exceeded.

2.3.2 Advantages and disadvantages

The assets, rights and obligations of the company being merged automatically transfer to the merging company as of the registration of the merger. This means that the parties cannot choose the time of the transfer of the assets as in a share deal. However, this also means that there is no need to carry out separate transactions to effect the transfer of the title in the transferred assets.

If the entire business of the merging companies is transferred to the acquiring company as a going concern, then, like the transfer of assets (ie, enterprise), the Estonian labour law requirements to inform and consult employees may need to be observed.

Also, like the sale of shares and sale of assets, the contracts of the merging companies should be reviewed prior to the merger to make sure that no individual contract establishes restrictions or conditions for the transfer of assets (eg, notification or consent requirements). In addition, the transferability of the regulatory registrations, consents, licences etc should be checked. The completion of the merger may sometimes need to be postponed due the need to apply for new regulatory consents.

Due to statutory waiting periods and the time needed to prepare (and audit) the closing balance sheet of the merging company, a merger may require somewhat more time to complete than an outright sale of assets.

A notary fee applies to the attesting of the merger agreement. The notary fee for attestation of a merger agreement is usually considerably lower than the notary fee applicable in cases of transfer of shares or transfer of assets. This is because, in a merger agreement, the notary fee is calculated based on the amount of the share capital of the merging entity, not the value of assets.

2.3.3 Tax considerations

Mergers are normally CIT and VAT-neutral. The tax assets of the companies being merged may normally be transferred to the merging entity – such tax assets include the right to make CIT-exempt profit distributions on the account of dividends received from certain qualifying subsidiaries.

2.4 Cross-border merger

2.4.1 General

Estonian limited liability companies (AS-type and OÜ-type companies) are allowed to merge with another limited liability company which is registered in a European Economic Area (EEA) country, and which complies with the requirements set out in Directive 2017/1132/EC of the European Parliament and of the Council relating to certain aspects of company law.

Cross-border mergers are usually carried out to implement intra-group restructurings and often result in the companies being acquired continuing the business in the respective jurisdiction through a branch office. The aim is usually to streamline the legal structure of the group and make the administration more cost-efficient. The other possible objectives of intra-group cross-border mergers include the need to subject a financial institution to the regulatory capital requirements of just one jurisdiction.

Similar procedure is carried out for cross-border mergers as in case of domestic mergers, with some exceptions and with consideration to the laws applicable to the other merging companies. For example, the preparation of a merger report is mandatory for cross-border mergers. For merger completion, the following rules apply:

(a) if the acquiring company is an Estonian company, the merger is considered completed as of the registration of the merger in the Estonian commercial registry; and
(b) if the acquiring company is a foreign company, the merger is considered completed in accordance with the laws governing the acquiring company.

2.4.2 Advantages and disadvantages

The advantages and disadvantages of mergers also apply to cross-border mergers.

In addition, as cross-border mergers involve companies from different countries, the merger process is usually more complicated and longer as the rules and regulations applicable in different jurisdictions must be taken into consideration when carrying out the merger. For example, in Estonia, the cross-border merger agreement must be attested by an Estonian notary regardless of which other jurisdictions are involved.

The timeline for the cross-border merger process depends on the statutory waiting periods applicable under the relevant jurisdictions and can therefore vary.

2.4.3 Tax considerations

The CIT implications of a cross-border merger depend on whether the merging entity or the entity being merged is the tax resident of Estonia. In case the company being merged (the transferring company) is an Estonian resident, then the cross-border merger is normally CIT-neutral as long as the transferring company continues its operations in Estonia through a permanent establishment of the non-resident acquiring entity (the merging entity).

2.5 Increase of share capital

2.5.1 General

Increasing a company's share capital can be carried out in one of the following ways.

Increase of share capital with contributions

If additional funding is needed for the company and/or shares need to be issued to new shareholders, shareholders of the company can adopt a resolution to increase the company's share capital – either by issuing new shares and/or increasing the nominal (or notional) value of the existing shares.

If additional funding is contributed to the company's equity by existing shareholders, then such contributions are often made by slightly increasing the share capital and booking the remaining part of the contribution as share premium. Contributions can be either monetary or non-monetary; non-monetary contributions are possible if allowed under the company's articles of association. If the target company's share capital is €25,000 or more, then an auditor's report on controlling the valuation of the object non-monetary contribution may be necessary. Depending on the amount of the increase, the articles of association may also need to be amended to adjust the minimum and maximum amount of the company's share capital set forth in the articles of association. Shareholder approval of the new articles of association can be granted in the same resolution where the shareholders adopt a resolution to increase the company's share capital.

Both resolutions require at least two-thirds of the votes represented at the meeting to be in favour of the resolution (if the articles of association do not require a higher majority).

Increase of share capital by the management board or supervisory board.

If a company is in the position where it needs to raise capital often or according to a predetermined plan, its shareholders may authorise the company's management board (or supervisory board, in case of AS-type company or if the OÜ-type company has a supervisory board) to increase the company's share capital. Such rights may be granted for up to five years (or up to three years, in the case of AS-type companies) and must be set forth in the company's articles of association.

The share capital cannot be increased in this manner by more than half of the share capital which existed at the time the management board (or supervisory board) received the right to increase the share capital.

*Bonus issue (*fondiemissioon*)*

The shareholders may decide to increase the share capital on the account of a share premium or accumulated profits. Sometimes a bonus issue is a first step, followed by the reduction of the share capital to make distributions to the existing shareholders on the account of the share premium (see Section 2.8). The annual report or the interim balance sheet on which the bonus issue is carried out must be audited (if the annual reports are subject to audit) and the date of the annual report /interim balance sheet cannot be earlier than eight months before the share capital increase application is filed with the commercial registry.

Conditional increase of a share capital.

Conditional increase of share capital is usually used if at the time of the resolution it is not known whether or to what extent the share capital will be increased. Conditional increase of share capital may be used in the following circumstances: (1) issuance of convertible bonds; (2) issuance of options; (3) preparation for a merger; (4) preparation for an IPO (in the case of an AS-type company). The shareholders may decide on the conditional increase of the share capital in the amount not exceeding one-half of the share capital which existed at the time of the resolution (in case of AS-type company, not exceeding one-third of the share capital which existed at the time of the resolution). Only monetary contributions are allowed.

A share capital increase is considered completed and new shares issued upon the registration of the new share capital in the commercial registry. In the case of a conditional increase of share capital, the shareholder acquires the share upon its issue to the shareholder.

2.5.2 Advantages and disadvantages

Issuing shares to existing or new shareholders may be complicated due to the existing shareholders having a pre-emption right to subscribe for new shares. As a general rule, shareholders can waive the pre-emption right if at least three-quarters of shareholders represented at the meeting vote in favour of the resolution (unless the company's articles of association require a higher majority). In instances set forth in the company's articles of association, the pre-emption right may be excluded with respect to certain existing shareholders only. All shareholders must be in favour of adopting the articles of association with such a clause.

If the company's shares are registered in the Estonian register of securities, then new shareholders will have to open a bank account in a qualifying bank. This can prove to be quite cumbersome for non-residents due to a general reluctance of local banks to service non-residents with little or no presence in Estonia.

In addition, if monetary contributions are made into the company's share capital, then the management board must be ready to obtain a formal confirmation letter from the company's bank where the bank confirms the delivery of the funds to the company's bank account. If the company's bank account is not with an Estonian bank, then the receipt of such confirmation may take some time.

2.5.3 Tax considerations

Equity contributions must be reported by the company in its monthly TSD tax return. Estonian resident companies may normally make CIT-exempt equity distributions in the total amount of historic equity contributions (see Section 2.8).

2.6 Demerger

2.6.1 General

Demerger (division) of a company can be carried out in two ways:

(a) demerger by distribution, where the company being divided transfers all of its assets to the recipient companies, and as a result of the demerger the company being divided is dissolved without going into liquidation; and
(b) demerger by separation, where the company being divided transfers part of its assets to the recipient company(ies). The recipient company may be an existing or a new company established in the course of the demerger. The company being divided survives the merger by separation.

Demerger entails the following key actions and documents:

(a) signing of a notarised demerger agreement /demerger plan, which has to be attested by an Estonian notary;
(b) preparation (and audit, if applicable) of the balance sheet of the company being divided (in case of demerger by distribution);
(c) adoption of shareholders' resolution to approve the demerger agreement;
(d) notice in the Official Gazette (*Ametlikud Teadaanded*); and
(e) application to the commercial register to register the demerger.

Depending on the specifics of the demerger, additional actions may be needed, such as notifying the employees and/or the Estonian register of securities.

The demerger is legally completed when the demerger is entered into the registry card of the recipient company (registration of the demerger). The demerger process takes approximately two and a half months as from the date of signing the demerger agreement (not including the time needed for the preparation and audit of the closing balance sheet).

Intra-group restructuring does not result in concentration and is therefore not subject to merger clearance. However, if the demerger is taking place between two non-related parties, then merger clearance may be needed in case control is acquired over an undertaking (or part of an undertaking) and certain turnover thresholds are exceeded.

2.6.2 Advantages and disadvantages

As in a merger, the assets, rights and obligations of the company being divided transfer to the recipient company automatically as of the registration of the demerger. This means the parties are not as free to choose the time of the transfer of the assets as when acquiring shares. However, this also means that there is no need to carry out separate transactions for the transfer of the title in the transferred assets.

The companies participating in the demerger are jointly liable for the obligations of the company being divided which are incurred before the registration of the demerger. In the internal relationship, only the party to whom the respective obligation is assigned to by the demerger plan is the obligated person. Moreover, the entity to which the respective obligation of the company being divided is not assigned is liable for the respective obligation, if it becomes enforceable within five years as from the date of the registration of the demerger.

If the entire business is transferred to the recipient company, then Estonian labour law requirements to inform and consult employees should be observed.

Also, similarly to the sale of shares and assets, review of contracts of the participating companies is normally advisable prior to the demerger to make sure that no individual contract establishes any restrictions for the demerger or respective transfer of assets (eg, notification or consent requirements). In addition, the transferability of the regulatory registrations, consents, certificates etc should be checked.

Comments regarding statutory waiting periods, notary fees and contractual restrictions which were mentioned in Section 2.3 also apply in respect to demergers.

2.6.3 Tax considerations

A demerger is normally CIT and VAT-neutral. The companies participating in the demerger are usually free to divide the tax assets of the company being divided among themselves. Such division of tax assets must be reported to the tax authority.

2.7 Acquisition of own shares

2.7.1 General

Share buy-backs are subject to certain requirements and limitations arising from Estonian corporate law:

- a share buy-back must be authorised by a shareholders' resolution setting out the conditions of the buy-back, including the term (deadline) of the acquisition, and the range of the price payable for the shares;
- the company may not buy back shares constituting more than one-third of its share capital (in case of AS-type companies, not more than 10 per cent of the share capital); and
- the buy-back must not trigger a reduction of equity capital below the amount of the share capital and reserves, the distribution of which is restricted under law.

An own share (treasury share) does not give any shareholder rights to the company (voting rights, right to receive dividends, etc.). If the shares are purchased from the shareholders strictly pro rata to their shareholdings, then their stakes in the company's equity will not change.

2.7.2 Advantages and disadvantages

Buy-back of shares can be carried out after the shareholders have approved the respective resolution and does not entail any statutory waiting periods. Therefore, the share buy-back process is normally quicker than, for example, reduction of share capital.

Like other types of transactions, certain contractual obligations may apply to the company requiring the counterparty's consent or informing the counterparty about the share buy-back. Such obligations may often be found in financing agreements. Restrictions on the acquisition of own shares may also arise from existing shareholders' agreements.

The same form requirements apply to share buy-back as to any other transfer of shares in the respective company (see Section 2.1). In addition, if the company's shares are registered in Estonian register of securities, the company is required to open a securities account with a qualifying bank to acquire its own shares.

2.7.3 Tax considerations

The purchase price payable for the own shares is considered to be equity distribution, which must be reported by the company in the monthly tax declaration. The amount of distribution which exceeds the aggregate amount of historic equity contributions is subject to CIT (20 per cent of the gross amount) at the company level. To the extent the distributions do not exceed the total amount of historic equity contributions, such distributions will not be taxable. A share buy-back may also trigger taxation of capital gains at shareholder level.

2.8 Reduction of share capital

2.8.1 General overview

Share capital reduction is the reverse of a share capital increase, with the aim most often being either to extract funds from the company or to cover the company's losses. The law distinguishes between two types of share capital reduction: (1) simplified share capital reduction to cover the company's losses, or (2) share capital reduction making distributions to shareholders.

Share capital reduction is carried out by reducing the nominal value of the existing shares or by cancelling existing shares. The share capital cannot be reduced below the statutory minimum capital requirements: €2,500 for OÜ-type companies and €25,000 for AS-type companies.

If the share capital of the company is not sufficient to make the necessary distributions, then the company's share capital must first be increased on the account of the company's equity (bonus issue, usually on the account of share premium); thereafter the share capital reduction can be carried out. The share premium cannot be distributed to the shareholders directly.

A share capital reduction entails the following key actions and documents:

(a) adoption of a resolution to reduce the share capital;
(b) notice to the company's creditors;
(c) registration of the reduced share capital in the commercial register; and
(d) distribution to the shareholders.

Share capital reduction takes effect when it is entered into the commercial registry.

In an M&A context, the reduction of share capital is not used as a direct means for carrying out the transaction (although this is theoretically possible via excluding one of the shareholders by cancelling their shares), but it normally has a supplementary role. For example, a share capital reduction may need to be carried out during a reorganisation, demerger or transformation.

2.8.2 Advantages and disadvantages

Rigid rules apply to the reduction process which are meant to protect the interests of the creditors. If a share capital reduction is carried out to make a distribution to the shareholders, distributions are allowed to be made only after a statutory three-plus-three month waiting period has expired; in practice, the process can take approximately up to seven months to complete. Therefore, a preferred option can sometimes be a share buy-back as this does not involve statutory waiting periods and the process is not as regulated.

2.8.3 Tax considerations

Equity distributions resulting from a reduction of share capital, share buy-backs or liquidation are taxable via CIT to the extent the distribution exceeds the total amount of historic equity contributions. All equity contributions and distributions must be reported by the company to the tax authority in the monthly tax declaration. The capital gain received by the shareholder may, depending on the circumstances, also be taxed at the level of the shareholder.

2.9 Squeeze-out

Estonian law provides for a mandatory squeeze-out of minority shareholders which is available for AS-type companies (both for publicly and not publicly traded companies).

A shareholder whose shares represent at least 90 per cent of the AS-type company's share capital (majority shareholder) may apply for the general meeting of the shareholders to decide on the takeover of the shares belonging to the remaining shareholders (minority shareholders) in return for fair monetary compensation. Compensation paid to the minority shareholders must be 'fair' – determined by comparing different values of the company according to various methods (eg balance sheet value, market value or discounted cash flow value). The resolution on takeover is adopted if at least 95 per cent of the votes represented by shares are in favour.

Squeeze-out entails the following key actions and documents:

(a) the majority shareholders' takeover application to the management board, including a takeover report explaining the squeeze-out and the compensation and an auditor's report regarding the takeover report;
(b) shareholders' resolution to decide on the takeover of shares;
(c) transfer of the minority shareholders' shares and payment of compensation; and
(d) notice to the commercial registry.

It takes approximately two and a half months to carry out the squeeze-out process (not including the time needed for preparing the required documents).

If the company is a publicly traded company, then the takeover of shares is additionally regulated by the Estonian Securities Market Act. The takeover is carried out at the initiative of the offeror who has acquired at least 90 per cent of the voting shares in the target company as a result of the takeover bid. The shareholders' resolution must be adopted within three months after the expiry of the takeover term and is adopted if at least 90 per cent of votes represented by shares are in favour. The determination of the compensation is simpler, as the shares are publicly traded and there was a recent takeover bid.

As a third option, the law also allows for squeeze-out in the course of a merger. If the acquiring AS-type company (majority shareholder) owns at least 90 per cent of the shares in the company being acquired, the majority shareholder may demand the takeover of the minority shareholder shares within three months as of the conclusion of the merger agreement. The resolution is adopted if at least 90 per cent of the votes represented at the meeting are in favour.

2.9.1 Tax considerations

Taxation of the capital gain earned by the minority shareholder as a result of the squeeze-out depends on whether the shareholder is an Estonian resident or non-resident, and whether the shareholder is an individual or a corporate entity. While for a resident individual the capital gain will normally be taxable with Estonian CIT, the capital gain will not be immediately taxable for a resident company, since CIT is normally only be applicable upon distribution of the profits.

In case of a non-resident shareholder being squeezed out, the sale of shares in an Estonian company is normally not taxable in Estonia, with one notable exception. If the transferred holding is a holding in a company of whose property, at the time of the transfer or during a period within two years prior to that, more than 50 per cent was directly or indirectly made up of Estonian real property, and in which the non-resident had a holding of at least 10 per cent at the time of the transaction, then the gain received by the non-resident seller will be subject to Estonian CIT. Almost all applicable treaties for avoidance of double taxation allow for such source taxation.

3. PRE-AGREEMENT DOCUMENTATION

In the initial stage of the transaction, the parties often conclude a letter of intent (LOI), term sheet or similar document reflecting the parties' commitment to start/continue negotiations. An LOI usually contains the following provisions:

(a) a description of the object of the transaction;
(b) indicative price and/or mechanism for its determination;
(c) due diligence process rules;
(d) an indicative timeline; and
(e) exclusivity (if any) and confidentiality agreements.

Sometimes an exclusivity and/or confidentiality agreement is concluded between the parties even earlier as a separate agreement.

As a rule, an LOI is not considered as a binding obligation for the parties to conclude the transaction but as an obligation to negotiate the transaction in good faith. A binding nature is usually given only to some provisions of the LOI, such as exclusivity, confidentiality, duration, costs, governing law and settlement of disputes.

An LOI should be distinguished from the preliminary agreement set forth in the Estonian Law of Obligations Act. Under the preliminary agreement, the parties undertake to enter into an agreement in the future on the terms set forth in the preliminary agreement. The conditions of the preliminary agreement therefore have a binding nature. Parties who wish to exclude the binding nature of LOI should expressly state this in the LOI.

4. DILIGENCE STAGE

Before the completion of the transaction, the buyer usually wants to carry out an inspection of the activities of the company and/or the acquired assets to confirm their value and have a better understanding of the acquired assets and liabilities – including associated risks. The buyer (and its professional advisers) carry out a due diligence review of the target company and/or acquired assets (looking at legal, technical, financial, tax matters, etc depending on need). The due diligence is usually carried out based on the information and documents delivered by the seller and information available from public sources.

Normally, the documents requested by the buyer are provided through a virtual or physical data room, which is set up to accommodate a due diligence process in M&A transactions. Virtual data rooms usually provide an efficient, secure and easy way to deliver large amounts of documents to multiple parties and their advisers, hold Q&A sessions, and grant or restrict access to documents to certain parties, as needed. However, in smaller deals, parties still sometimes opt for the use of Dropbox or a similar freeware medium for the virtual delivery of the due diligence materials.

The review of due diligence materials is normally carried out by the buyer's professional advisers, and sometimes with the set-up of clean teams who act as an impartial third party depending on the nature of the transaction and sensitivity of the documents to be reviewed. The due diligence review is conducted either prior to the conclusion of the sale agreement, or, less often, after the sale agreement is signed as a condition precedent to closing.

Based on recent practice, while buyer's due diligence is conducted in the majority of cases in Estonia, vendor's due diligence is still quite rare.

5. MAIN TRANSACTION AGREEMENT

The main agreement in share and asset deals is the share/asset purchase agreement (SPA /APA). Typical key clauses in SPAs/APAs are:

5.1 Purchase price and payment

The two mostly used pricing mechanisms in M&A transactions in Estonia are (1) the locked box mechanism and (2) the post-closing adjustment mechanism. The use of the locked box mechanism has been on the rise in Estonia for some time now. In the case of locked box mechanism, the parties agree on a fixed purchase price at the time of signing the sale agreement, usually based on the latest accounts, and then include a regulation in the agreement to protect the buyer against leakages.

Most of the time, the total price is payable either at signing or closing.

5.2 Representations and warranties

The seller usually gives certain representations and warranties (R&W) in the sales agreement to disclose material information about the target company or the acquired business/assets to the buyer. The R&W allocate the risks between the parties and act as the basis of seller's liability – the buyer can bring a claim against the seller (or terminate the agreement) if any of the R&W are untrue, inaccurate or misleading. This part of the agreement is usually one of the most negotiated sections of the agreement, as the usage of R&W insurance (also known as warranty and indemnity insurance) is still not very common in Estonia.

5.3 Conditions precedent

In most transactions, closing depends on the fulfilment of conditions precedent, with the need to obtain a merger clearance the main reason for the postponement of closing.

5.4 Liability and indemnification

Parties normally agree on a set of limitations on claims for breach of R&W, such as:

- basket and *de minimis* thresholds (a *de minimis* threshold is typically less than 0.5 per cent of the purchase price and a basket threshold is typically between 1–2 per cent of the purchase price);
- an overall cap on liability; and /or
- a limitation period (often 12–24 months).

The agreements often exclude recovery of the loss of profit. Parties often also agree on certain carve-outs to limitations of liability, such as in the case of a breach of certain fundamental warranties (eg, tax and title warranties.). Under Estonian law, limitations on liability do not apply in case of intentional breach of the agreement.

5.5 Security

The usage of escrow and payment deferral remain the most common forms of security in Estonia.

5.6 Non-competition and non-solicitation obligations of the seller

Inclusion of non-compete and non-solicitation obligations on the seller are fairly common in Estonian practice. Very often such obligations are secured by a contractual penalty.

5.7 Governing law and dispute resolution

Agreements are usually governed by Estonian laws. Local courts (or arbitration institutions, such as the Arbitration Institute of the Stockholm Chamber of Commerce) are typically used as the dispute settlement venue.

As mentioned in Section 2.1, SPAs may need to be concluded in notarised form, depending on the type of the target company and depending on whether the company has waived the mandatory notarial form requirement applicable to the transfer of shares. The notarial form requirement may also apply to APAs, depending on the type of assets to be acquired.

6. TYPICAL CONDITIONS TO CLOSING/RELEVANT REGULATORY REGIMES

Often, the obligation of the parties to complete the transaction is subject to the fulfilment, on or before closing, of conditions set out in the agreement (conditions precedent). The sales agreement with the terms and conditions of the transaction is signed at one date and, depending on the fulfilment of the conditions precedent, the title to the acquired shares/assets transfer at a future date.

The sales agreement often includes both the seller’s and buyer’s conditions precedent; the buyer’s conditions precedent list is normally longer. The main reason for the postponement of closing is the need for merger clearance. According to the main rule under the Estonian Competition Act, the transaction is subject to merger clearance, if:

(a) the combined Estonian turnovers of the buyer group and the target for the previous financial year exceed €6m; and
(b) the Estonian turnover of each party to the transaction exceeds €2m.

In addition, the so-called ‘two-year rule’ states that, if the buyer group has acquired control over entities which operate within one and the same sector of economy in Estonia as the target within the preceding two years, the turnover of the target must include the turnover of the undertakings over which the buyer group has acquired control within the two years preceding the transaction.

In addition to the receipt of merger clearance, sales agreements often include the following conditions precedent:

(a) consent of a contractual counterparty (eg, change of control clauses, contractual restrictions to the transfer of specific contracts);
(b) correctness of seller's R&W as at closing;
(c) no material adverse effect (MAE) or material adverse change (MAC) having occurred;
(d) conclusion of shareholders' agreement, in case the buyer does not acquire 100 per cent of the shares;
(e) consents from authorities to the transfer of licences, registrations, permits, etc;
(f) pre-transaction restructuring of the target; and
(g) adoption of the new articles of association of the target company.

The parties also often tend to agree on a long-stop date: if the conditions precedent are not fulfilled (or waived) by a certain date set out in the agreement, the seller or the buyer may unilaterally withdraw from the agreement, or the agreement terminates automatically.

7. CLOSING ACTIONS

Closing actions depend, among others, on the type of the transaction (share sale or asset sale) as well as on the type of the target company (OÜ-type company vs AS-type company). For example, depending on whether the shares of the target company are registered with Nasdaq CSD or not, the closing mechanism for the transfer of shares is entirely different.

If shares are being acquired in a target company, the shares of which are registered in the Estonian register of securities, then the transfer of shares will be carried out as a securities transaction. The buyer must open a securities account in one of the qualifying banks – this usually means opening an account with one of the Estonian commercial banks. To close the transaction, the shares of the target company must be transferred from the securities account of the current shareholder (seller) to the securities account of the new shareholder (buyer). The share transfer is carried out through either the (1) delivery versus payment (DVP) method against payment of the purchase price or through the (2) free of payment (FOP) method, where only shares are transferred to the buyer and there is no corresponding money transfer to the seller.

If the company's shares are not registered in the Estonian register of securities (this is voluntary for OÜ-type companies), then the transfer of the title to the shares must be concluded in notarial form. This usually means that closing takes place at the notary's office in Estonia. It is possible to waive such a notarial form requirement, if the share capital of the OÜ-type company is at least €10,000 and the shareholders of the target company adopt a new article of association prior to closing which includes a waiver of the notarial form. All shareholders must be in favour of such a resolution. In such case, the transfer of the title to the shares can be carried out by agreement concluded in simple written form.

In the case of sale of assets, closing may also need to take place by way of concluding a notarised transfer agreement, depending on the composition of assets being acquired. For example, if the assets being acquired include real estate, then the real estate purchase agreements must be concluded in notarial form.

Other closing actions that may be agreed between the parties include the following:

(a) delivery of evidence of the merger clearance;
(b) delivery of evidence of the availability of funds to pay the purchase price, or the notary's confirmation that the purchase price is delivered to the notary's deposit;
(c) delivery of written confirmation from the management board members/supervisory board members of their resignation and/or waiver of claims against the company;
(d) signing of the property law agreements for the transfer of the title to the shares/assets;
(e) delivery to the buyer of the direct possession of the acquired assets and documents related to the acquired assets;
(f) payment of the purchase price to the seller; and
(g) execution of the closing memorandum confirming due fulfilment of the conditions precedent (or waiver thereof) and due completion of the closing actions.

Agreements often also set forth that the closing actions listed in the agreement are regarded as one transaction to have occurred simultaneously and in proper sequence. If any of these actions do not occur, closing is considered not to have taken place and any action – even already carried out – will be fully reversed.

8. POST-CLOSING

Post-closing obligations normally include the seller's confidentiality, non-compete and non-solicitation obligations.

Compared to the share sale transaction, asset sale transactions often require more effort from the parties at the post-closing stage to fulfil the applicable formalities. These may include:

(a) transfer, re-registration and notifications required regarding regulatory permits, consents, registrations and licences pertaining to the acquired assets;
(b) steps regarding certain practical matters relating to IT infrastructure, electricity agreements, etc; and
(c) notices to the contractual counterparties regarding the transfer of business.