Estonia

Negotiated M&A Guide

Corporate and M&A Law Committee

Contacts

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I Introduction

Estonian M&A transactions are primarily regulated by the following applicable Estonian legislation: the General Part of the Civil Code Act, the Law of Obligations Act, the Law of Property Act, the Commercial Code, the Securities Market Act, the Competition Act, and tax laws. The list is not exhaustive as many different acts may apply depending on the complexity and peculiarity of a particular M&A transaction.

However, it should be taken into consideration that the above mentioned acts do not regulate M&A transactions completely and tend to be deficient in many specific areas of M&A. Therefore, the principles of freedom of contract, good faith, and reasonableness are to be complied with by the parties when conducting an M&A transaction in Estonia.

II The Structure of Transactions

The structure of the transaction is the most important aspect when preparing an M&A transaction. Estonian M&A practice includes the following alternative structures of an M&A transaction:

1. Acquisition of shares;
2. Acquisition of assets;
3. Merger;
4. Cross-border merger;
5. Increase of share capital;
6. Public tender of the shares (IPO);
7. Division;
8. Spin off / Equity Carve Out;
9. Leveraged buyout;
10. Acquisition of own shares;
11. Reduction of share capital;
12. Squeeze-out and Sell-out.

A description of the above transaction alternatives is provided and the preferences of sellers and buyers are being discussed below.

1. Acquisition of Shares

The acquisition of shares of a company is the most straightforward acquisition transaction and has the minimum disturbing effect on the economic activity of the target company. As the acquisition transaction takes place at the highest possible management level, it is possible to organize the transaction such that third persons are not affected by it in any way. Hence, nothing changes for the clients or co-operation partners of the company as the company continues its everyday economic activity just as before.

From the buyer's perspective it is highly recommended that the buyer get acquainted with the target company's contractual agreements with clients or suppliers. This is important because the contracts may include change of control clauses, which may allow the other party to the contract to terminate the contract if the ownership of the company changes.

Another important aspect which distinguishes a share acquisition from other alternatives is the fact that the buyer's liability is limited in the case of a share transaction. The buyer acquires a shareholding in an undertaking, but the undertaking remains solely responsible for its obligations. Even in the worst case scenario, the buyer only loses its investment when the undertaking goes bankrupt and the acquired shares become valueless. But compared to other alternatives, e.g. the acquisition of assets or a merger, it is a small loss.

For example, in the case of the acquisition of assets of a company, in Estonia the obligations associated with the acquired assets automatically transfer to the buyer. This means that the buyer becomes responsible for all the liabilities associated with the acquired assets. Furthermore, the buyer's liability is not limited to the transaction value. In the case of a merger, all the obligations of the undertaking being acquired become automatically the buyer's obligations, for which the buyer is responsible. Hence, the acquisition of shares is the safest acquisition option for the buyer and it is also the most popular form of transaction in the Estonian M&A practice.

Before commencing an acquisition transaction, the buyer must find out whether the other shareholders of the company have a pre-emption right to buy the shares of the selling shareholder. The shareholders of a public limited company (in Estonian: *aktsiaselts*) have a pre-emption right only if it is provided for in the articles of association of the company. The shareholders of a private limited company (in Estonian: *osaühing*) have a pre-emption right stipulated by the law, unless the articles of association of the company exclude the pre-emption right.

When acquiring shares of a company in Estonia, taxation issues which rise before and after the transaction (e.g. the taxation of the income of the selling shareholder upon transfer of its share, the taxation of the interests paid to the financier of the transaction, taxation of dividends, etc.) should be considered. Still, the most important taxation consequence is taxation of the income which the selling shareholder gains from the difference between the acquisition cost and the selling price. It is important to know that it is only relevant in the event a natural person (not a legal person) sells the shares. Legal persons in Estonia have to pay income tax upon paying dividends.

2. Acquisition of Assets

Acquisition of assets is a preferred transaction structure in Estonian M&A practice in cases where the buyer does not want to acquire the whole undertaking but only a significant part of a working business. Acquisition of assets is a suitable form of transaction if the essential value of the undertaking lies, for example, in the assets or employees of the undertaking. The acquisition of assets is not suitable if the essential value of the undertaking lies in contractual agreements or licenses and permits that may be subject to termination upon the acquisition of assets.

In addition, rules governing the transfer of an undertaking as laid down in Estonian law should be taken into account. These rules are designed to protect the rights of persons not related to the transaction. Pursuant to the Estonian Law of Obligations Act, the rights and obligations (including employment agreements) attached to the undertaking are transferred automatically to the new owner (buyer) upon the acquisition of assets. To be more specific, the Law of Obligations Act also provides that the rules concerning transfers of undertakings are also to be applied in the event the buyer purchases only a part of a business unit of the undertaking which is considered to be an organisational whole. This means that if the buyer purchases only a part of a company, the buyer must take into account that the obligations and rights related to it are transferred to the buyer together with the acquired assets. Therefore, a proper due diligence of the assets is needed before proceeding with the acquisition.

3. Merger

Two types of merger structures are used in Estonia:

- merger through acquisition; and
- merger through establishment.

In the case of merger of undertakings in Estonia, the main idea is that the assets of the undertaking being acquired are transferred to the acquiring undertaking by way of universal legal succession. This means that the assets of the undertaking being acquired are not transferred based on provisions of the law of property but are considered to be transferred after the merger has been registered in the Estonian Commercial Register. This means that if the assets of a merging undertaking are, for example, immovables, there is no need to sign a contract under the law of obligations to transfer them. This is the main argument that distinguishes a merger from the acquisition of assets where all the assets must be transferred to the acquiring party pursuant to the statutory provisions governing property transactions.

Another important aspect which must be considered when choosing between different M&A transaction structures is taxation. As property of high value is being transferred in a merger process, neutral tax law principles are applied. Thus, the exchange of holdings (share or shares, contribution, down payment) in the merger process is not subject to income tax. Moreover, the transaction is not subject to value added tax either, as pursuant to the Estonian Value Added Tax Act there is no turnover if one undertaking transfers its assets to another undertaking in a merger process.

There are also some other legal circumstances which may favour merger to other M&A transaction structures. For example, through merger it is possible for the undertaking being acquired to transfer its licenses and authorizations to the acquiring undertaking based on the principle of universal legal succession. It is also possible to transfer the company's name in the merger process.

Below there is a brief overview of the procedures that must be performed in the corresponding order when carrying out a merger transaction in Estonia:

1. preparations for signing the merger agreement, preparing a merger report;
2. signing the merger resolution;
3. the merger resolution is audited by an auditor;
4. notifying the Estonian Commercial Register about the merger and publishing a respective notice in *Ametlikud Teadaanded* (www.ametlikudteadaanded.ee);
5. meeting of the shareholders where the merger resolution is approved by the shareholders;
6. procedures in the Estonian Central Securities Registry;
7. submitting a merger application to the Estonian Commercial Register;
8. registering the merger in the Estonian Commercial Register;
9. notifying the creditors of the undertaking being acquired about the merger in *Ametlikud Teadaanded*.

The merging companies must prepare a merger report. The merger report is not necessary if all the shares of the company being acquired are owned by the acquiring company or if all the shareholders of the all the merging companies agree.

A merger resolution is passed at the shareholders' meeting if two-thirds of the votes represented at the meeting are in favour. It is possible to agree on a greater majority requirement in the articles of association of the company. The acquiring company does not have to pass a merger resolution if the acquiring company is the owner of nine-tenths of the share capital of the company being acquired, subject to certain conditions.

4. Cross-border Merger

In addition to the merger transactions explained in Clause 3 above, cross-border merger transactions can also be conducted in Estonia. A public limited company (in Estonian: *aktsiaselts*) or private limited company (in Estonian: *osaühing*) registered in the Estonian commercial register may merge with another limited liability company founded on the basis of the law of another state which is a contracting party to the EEA Agreement and whose registered office, location of the management board or principal place of business is in a contracting state. However, it is forbidden for an investment fund to conduct a cross-border merger, unless the fund is a UCITS fund. The above rule does not prohibit an investment fund which is established as a public limited company (so-called "closed investment fund", e.g. most real estate funds in Estonia) from merging across borders. UCITS funds can be merged cross border in accordance with Directive 2009/65/EC.

Two companies from different states can also form into an European company (Societas Europaea) in order to avoid forming branches of the company in other states or having to terminate one of the merging companies. If the wish for a merging private limited company is to form an European company after the merger, the private limited company must be converted into a public limited company before an European company may be formed because only public limited companies may form European companies. There are also various other prerequisites, dependent on local legislation that need to be fulfilled beforehand.

5. Increase of Share Capital

Share capital can be increased by a supplementary contribution to the share capital or by contributing the company's net profit to the share capital. Pursuant to the Estonian Commercial Code, a supplementary contribution can be monetary or non-monetary. For example, if a shareholder has lent money to the company, then that shareholder has a claim against the company. The shareholder's claim can be converted into share capital as a non-monetary contribution.

An increase of share capital is completed upon registration in the Estonian Commercial Register.

Pursuant to the Estonian Commercial Code, share capital can be increased by (i) additional contributions to the share capital from the equity capital of the company (bonus issue), (ii) issuing additional shares, or (iii) increasing the nominal value of existing shares. It is also important to bear in mind that that, before increasing share capital, amendments must be made to the articles of association of the company on the increase of share capital.

A monetary contribution must be transferred to the company's bank account. The decision regarding a non-monetary contribution must be laid down in a resolution of the shareholders. The procedure for valuation of a non-monetary contribution must be prescribed in the articles of association of the company, and the valuation must follow the ordinary or market value of the non-monetary contribution. Most often the valuation is carried out by experts. When making a non-monetary contribution to the share capital of a public limited company (in Estonian: *aktsiaselts*), the valuation of the contribution must also be audited by an auditor. In the case of a private limited company (in Estonian: *osaühing*), the valuation of the contribution must be carried out if the share capital of the company is at least 25,000 EUR and the value of the contribution exceeds one-tenth of the share capital or if all the non-monetary contributions of the company make up more than half of the share capital.

It should also be taken into consideration that the shareholders of a company have a pre-emptive right of subscription to the issued shares in proportion to their shareholding. Third parties are entitled to acquire the shares only if the shareholders waive their pre-emptive right. The pre-emptive subscription right can be waived when three-quarters of the votes represented at the meeting of the shareholders are in favour. However, the articles of association can prescribe an even greater majority requirement.

A resolution on increasing the share capital of a company is passed when at least two-thirds of the votes of the shareholders represented at the shareholders' meeting are in favour. After contributions to the share capital have been made, the management board must submit an application for registering the share capital to the Commercial Register. The application must be submitted within six months after the resolution on the increase of share capital was passed at the shareholders' meeting.

6. Public Tender of Shares (IPO)

In M&A, the term "IPO" is mostly used for the initial offering of the shares to the public, irrespective of whether the offer concerns the existing shares of a company or issue of new shares. Pursuant to Estonian laws, every type of IPO is considered public, save for a few exceptions. For example, an offer is not considered to be public if shares are offered to professional investors or to a limited amount of persons (less than 150 persons in one state of the European Economic Area) or if the offer does not attract many persons from the public (e.g. the nominal value of the offered share exceeds 100,000 EUR).

According to Estonian law, it is not important in which form or through whom the offer is made. Information about the opportunity to subscribe for shares given to a person in any form or by any means or method that enables a person to make an investment decision is considered to be an offer of shares. The terms and conditions of a public tender of shares are regulated in detail by statutory provisions and deviations therefrom are subject to sanctions.

7. Division

In Estonia, division is carried out without a liquidation proceeding. Division is effected in two ways: by distribution or separation.

Upon distribution, the company being divided transfers its assets to the recipient companies. A recipient company may be an existing company or a new company. Upon distribution, the company being divided is dissolved. Upon distribution, the shareholders of the company being divided become the shareholders of a recipient company.

Upon separation, the company being divided transfers part of its assets to one or several recipient companies, whereas the recipient company may be an existing company or a new company. Upon separation, the shareholders of the company being divided become the shareholders of a recipient company, or the company being divided becomes the sole shareholder.

Contrary to the economic rationale for mergers, the purpose of a division of a company is often the desire to clearly distinguish the different areas of activity, in which case the division gives a good opportunity to transfer the assets related to different areas of activity - things, rights and obligations - under single regulation to different companies.

The same taxation principles apply to division as to merger of companies, i.e. no income tax or VAT is charged. Similar to merger, the positive side of division is that the transfer of licenses and activity permits to another company is possible without the consent of the issuer of the relevant license/permit. In the case of asset/business sale it is not possible. The same may well apply to the transfer of certain contracts.

Just like a merger, division allows the creation of joint ventures with other companies by transfer of assets to existing companies, without the taxation of capital increase and asset transfer. But also similar to a merger, creating a joint venture is quite troublesome. Division is, rather, used for the purpose of economic restructuring within a group or for preparing for another transaction. The other advantage is that the part of the business which the acquirer does not want can be separated from the company being acquired. Compared to regular business transfers, this kind of division enjoys significant tax advantages.

8. Spin off / Equity Carve Out

Technically, spin off means the distribution of the shares of a subsidiary as dividends to the shareholders of the company, making it ideally an independently traded company. Thus, the shareholders of the company and of the spinned off subsidiary are the same immediately after the spin off.

On the other hand, an equity carve-out is technically the sale of the shares of the subsidiary to one buyer, a group of entities or through a public offering. Often, the same effect is achieved by selling assets or a business.

Spin off and equity carve out are both used as common elements in M&A transactions in Estonia. Equity carve-out is more suitable in situations where the company being transferred has value that is not revealed properly without its sale. Spin off, on the other hand, is also suitable for the sale of a less profitable company, as the entire company is usually transferred.

For tax purposes, both spin off and equity carve out transactions are income tax neutral in Estonia, meaning that since the seller is an Estonian company its profit is not taxed. When planning the transaction, first and foremost the acquirers should consider the taxation aspects. If the acquirer plans to resell the unit, it would be wise to do so through a company rather than as a natural person. The sale of assets may be subject to VAT when it is not a transfer of business within the meaning of the Commercial Code and the Law of Obligations Act.

9. Leveraged Buyout

One of the central issues in Estonia concerning leveraged buyouts is its structure. That is, how to use the acquired company's assets as collateral for a loan. The Commercial Code imposes, by the provisions regarding borrowing, a prohibition on public and private limited companies granting a loan or giving collateral for the acquisition of its own shares. This prohibition is absolute. As a consequence of the ban, it is stipulated that a person benefiting from the collateral has to pay damages to the person who established the collateral.

Usually, a leveraged buyout deal in Estonia is carried out such that the acquirer purchases the company through an SPV. The SPV will arrange a loan from the financier and the assets of the company to be acquired will be set as collateral in favour of the financier. After the acquisition, a merger is conducted between the company acquired and the SPV. As a result, the loan, collateral and cash flow are in the same company. This structure resolves the loan/collateral prohibition. However, every leveraged buyout should be conducted on a case-by-case basis, taking into account among other matters possible tax consequences. In addition, a situation where loan repayments are made from the SPV but cash flow is in the acquired company, the sums necessary to repay the loan should be regularly transferred from the subsidiary to the parent company. As a rule, it is considered to be dividend distribution that is subject to income tax.

10. Acquisition of Own Shares

Under certain conditions a public limited company is authorized to acquire its own shares. In particular, the acquisition of its own shares has importance as a restructuring element after a transaction. It is one way in which the acquirer can take equity out of the acquired company. The acquisition of its own shares is carried out relatively quickly compared to the main alternative which is a reduction of share capital. In addition, acquisition of own shares is a common tool to create employees’ option pools.

The acquisition of its own shares is subject to numerous restrictions. As a general rule, a public limited company may not, itself or through a third person acting in its own name but at the expense of the public limited company, acquire or take as security its own shares unless otherwise provided by law. The Commercial Code provides exceptional conditions when acquisition of own shares is allowed.

The acquisition of its own shares by a public limited company is allowed if: (i) this occurs within five years after the adoption of a resolution of the shareholders’ meeting which specifies the terms and conditions for the acquisition of shares and the minimum and maximum amounts to be paid for the shares; (ii) the sum of the nominal values of the shares held by the public limited company does not exceed 1/3 of the share capital; and (iii) acquisition of the shares does not cause the net assets to become less than the total of share capital and reserves which, pursuant to law or the articles of association, may not be paid out to shareholders. All the conditions above have to be fulfilled simultaneously.

11. Reduction of Share Capital

Similar to an increase of share capital, a reduction of share capital has as an important role in structuring M&A transactions. It is a corporate law procedure often used in M&A transactions in combination with other transactions. In particular, reduction of share capital is exercised in post-transaction restructuring and refinancing.

Commonly, share capital is reduced either by the reduction of the nominal values of shares or by the cancellation of shares. Share capital may not be reduced below the amount of share capital specified in law (EUR 25,000 in the case of a public limited company and EUR 2,500, in the case of a private limited company).

The law distinguishes two kinds of reductions of share capital – reduction for the purpose of covering losses (simplified reduction) and reduction by making payments to shareholders. The latter requires greater supervision in order to protect the interests of creditors.

In the context of M&A transactions, capital reduction is not directly used as a means for carrying out the transaction (although it is theoretically possible, e.g. excluding one of the shareholders out of the company by cancelling its shares), but bears a so-called supplementary role, mostly after the transaction (e.g. merger or spin-off). Capital reduction enables the company to pay out the so-called excess cash accumulated in the target (if the company acquired has a high equity capital and it is not necessary for business or can be replaced by a loan). If the target already has a high share capital then share capital can be reduced by making payments to the shareholders; otherwise the excessive funds can first be converted into capital and then the capital can be reduced. Thus, the process of capital reduction is, in essence, similar to definancing and is strictly regulated by law in order to protect the interests of the company's creditors.

12. Squeeze-out and Sell-out

The buyout of minority shareholders (squeeze-out) is regulated by Chapter 29 of the Estonian Commercial Code. It applies to all public limited companies, including publicly traded companies. Overall, the rules governing buyouts of minority shareholders laid down in the Commercial Code comply with the provisions of the European Union Takeover Directive (European Parliament and Council Directive 2004/25/EC). It is important to note, though, that the sell-out regulation of minority shareholders is only provided for in the Securities Market Act, i.e. sell-out applies only to publicly traded companies.

In Estonia, a majority shareholder who is entitled to squeeze-out the minority shareholders must own at least 90% of the voting shares of the company. The majority shareholder's shares may also include the shares of the parent company or its subsidiary if the latter have given their consent to it. It is, however, important to note that the takeover of the shares of minority shareholders has to be decided by a shareholders' meeting and 95% of the total votes represented by shares have to be in favour. This means that if a shareholder holds more than 90% but less than 95% of the voting shares, the success of the takeover is dependent on the minority shareholders' attitude towards the majority shareholder.

The majority shareholder must pay the minority shareholders fair compensation for their shares. However, the amount of compensation is determined by the majority shareholders. It should be based on the value of the shares to be taken over that these shares had ten days prior to the date on which the notice calling the shareholders meeting was sent out.

III Pre-agreement

1. Letter of Intent

In Estonia, a letter of intent (LOI) is a pre-agreement concluded between the parties at the initial stage of negotiations and sets out their agreement on relevant issues. More than half of the transactions in Estonia are formalised in the negotiations stage by a letter of intent. As a rule, it includes a description of the object of the transaction, the transaction price or the basis of its formation, the conditions for the completion of the transaction and other key issues important to each party.

In essence, LOI is a type of pre-agreement that has been taken from the Anglo-American legal system. The Estonian Law of Obligations Act (the LOA) defines a pre-agreement as an agreement under which the parties undertake to enter into a contract in the future under terms agreed upon in the pre-agreement. Therefore, a pre-agreement as defined in the LOA is wholly binding on the parties.

As a rule, a LOI is not binding, other than the provisions relating to confidentiality, exclusivity, bearing of costs and jurisdiction. However, it is customary for the parties to comply with the terms and conditions of a LOI even it is non-binding. In Estonia, it is important to note that if the parties wish to exclude the binding nature of a LOI in some aspects, it must be expressly set forth in the LOI. Otherwise the provisions governing pre-agreements apply and the LOI will be binding on the parties. It should also be noted that the rules on pre-contractual negotiations apply to a LOI, which oblige the parties to act in good faith, consider the other party's interests and rights, and to provide truthful information.

Considering the form of a LOI, it can be a purchaser's expression of intent directed to the seller, which contains the purchaser's proposal to enter into a transaction under certain conditions, which is then signed by the seller. In Estonia, it is usually concluded as a bilateral agreement which includes the expressions of intent of both parties.

As to its content, a LOI may include any provisions agreed on by the parties. As a rule, it contains a description of the object of the transaction. However, the object of the transaction is often not known at the time of conclusion of a LOI and it may become apparent only after the parties have carried out a due diligence of the company and analyzed the different ways of carrying out the transaction and the relevant legal, economic and tax consequences.

One of the main provisions in a LOI is the value of the shares or assets and the basis for the valuation. The transaction price is agreed upon at that stage if the acquirer has previously performed due diligence. If due diligence is carried out after the conclusion of an LOI, it is reasonable to define the bases for price formation and factors that may affect the price.

Typically, a LOI also includes conditions precedent to the completion of the transaction, i.e. no material adverse event has taken place in the company between signing and completion, all the representations and warranties of the seller are true, and the seller has provided all the required information. Similarly, a LOI may prescribe the necessary approvals to complete the transaction and the obligations of the parties upon receipt thereof.

If the purchaser intends to perform due diligence after the conclusion of a LOI, the LOI generally contains obligations of the seller to provide the necessary information and documents in connection with the due diligence. If by then the parties have not signed a confidentiality and exclusivity agreement, the relevant obligations are set forth in the LOI. In such cases, the LOI includes provisions about the expenditure to be incurred by each party in preparing the transaction and whether, and on what basis and in which amount, a party may claim damages from the other party if the transaction is not completed. However, it is important to note that an agreement under which the purchaser may not claim any compensation from the seller if the transaction is not completed does not apply if the seller intentionally causes damage to the purchaser.

Generally, LOI also includes the indicative schedule of negotiations, completion of the transaction and the activities carried out within the framework. It is customary to set the date on which the rights and obligations in the LOI will expire, unless the parties have signed an agreement by such date and fulfilled the conditions for the completion of the transaction. The expiry of a LOI does not usually affect the validity of the confidentiality provisions, and the parties' obligation to keep information obtained in the course of the negotiations confidential remains valid even if the transaction is not completed. Defining the validity of LOI ensures that each party will implement its best efforts to complete the transaction and cannot delay the negotiations in bad faith.

To conclude, LOI is a regular part of M&A documentation in Estonia. The purchasers and sellers can usually understand the need to create a solid basis for further negotiations, to determine the most important conditions, confidentiality and exclusivity obligations at an early stage.

2. Voting Agreements

The General Part of the Civil Code Act provides that entry into agreements on voting is permitted unless otherwise provided by law. However, violation of the agreement does not affect the validity of the vote. Consequently, voting agreements between shareholders are allowed in Estonia, but if the shareholders vote differently at the shareholders' meeting than agreed in the agreement, the decision is not void in terms of company law. Although a voting agreement is concluded in advance, voting still takes place at the shareholders' meeting, rather than at the conclusion of the agreement.

Although voting agreements are permitted, they must not be contrary to good morals and the principles of good faith and equal treatment of shareholders. There are no time limits as to the validity of voting agreements in Estonia.

As for their content, voting agreements provide an obligation to vote in a certain way at the shareholders' meeting or ensure that board members appointed by the shareholders will adopt a certain decision (e.g. by voting in a certain way at the board meeting). Voting agreements may set forth that some questions are to be resolved by consensus or by majority vote.

Usually, a decision of the shareholders' meeting is deemed to have been adopted if more than half of the votes represented at the meeting are in favour.

In the case of deadlock situations, good faith negotiations are usually used and a new shareholders' meeting is convened. If this does not resolve the problem, it can be sent to an *ad hoc* arbitration panel to be resolved, the establishment of which and its procedures and regulations are agreed beforehand between the parties. The arbitration decision is binding on the parties and if a shareholder still votes against the arbitration decision at the shareholders' meeting, he may be forced to pay liquidated damages.

3. Lock-up Agreements

Lock-up provisions are commonly part of shareholder agreements or share purchase agreements. Lock-up agreements in Estonia are similar to those in other jurisdictions. The need to freeze holdings is evident in companies where the sellers of the shares will remain as shareholders or directors of the company and work performance is directly related to their contribution. Such companies include consultation companies and the like whose main assets are its employees and managers. The parties agree on a lock-up period during which the shareholders of the company may not sell their shareholding. The length of a lock-up period depends on how long it is necessary for the new shareholders to be involved in the management so that the normal economic activity and profitability is ensured.

A lock-up obligation may be one-sided (where the exit restriction is imposed only on one party or shareholders) or multilateral (where several or none of the shareholders may leave). The sellers are subject to lock-up restrictions if they remain the company's shareholders (but also if they remain as directors or employees), so they are also responsible for the company's future activities.

IV Acquisition agreement

1. Holdback and escrows

Currently approximately 1/3 of the M&A deals concluded in Estonia include holdbacks. Most popular forms of security continue to be escrow accounts and deferred payments. However, parent company's and bank guarantees are also used. Typically, escrows are used in bigger M&A deals as the seller wants assurance from the buyer that the buyer has the financial means necessary to fulfil its obligations.

2. Representations and warranties

In Estonian M&A practice, the clause “representations and warranties” includes a description of the acquisition target wherein the seller confirms the primary properties of the target at a certain point of time. The buyer must ensure that the representations and warranties given by the seller include all the important aspects of the undertaking being acquired. Thereby the buyer gains additional information about the target and also has the right to withdraw from the acquisition agreement if the seller does not disclose substantial information about the acquisition target or if a representation or warranty turns out to be false.

Usually, before a transaction is performed, the buyer carries out due diligence. According to the Law of Obligations Act, the seller is not liable for any lack of conformity of a thing if the purchaser was or ought to have been aware of the lack of conformity of the thing upon entry into the contract. It is in the interest of the buyer to exclude this provision or at least to qualify it. On the other hand, the seller wants to show that the buyer’s knowledge was as great as possible. There are two extremes to this situation: a) the seller is liable for all representations and warranties despite the buyer’s due diligence; b) all matters that the buyer knows or ought to know in connection with the performed due diligence will release the seller from liability. Mostly, the parties agree somewhere in the middle, e.g. the seller is not liable for matters that have been expressly disclosed to the buyer.

A typical alternative to negotiating the content of each representation is to set a floor or ceiling, under or over which sum the seller is not liable. Over 3/4 of the deals concluded in Estonia include a floor or a ceiling on the seller’s liability. It is important to note that the restriction of liability does not apply if the seller has intentionally breached the agreement.

The time limit for the seller’s liability is commonly from 7 to 18 months. As an exception, tax, title and environmental representations are mostly valid until the company itself can no longer be liable.

The procedure of presented claims and the parties’ cooperation in these matters is also regulated separately. It generally means that the seller is interested in protecting the company from third party claims that may eventually become a breach of a warranty given by the seller. The buyer’s interest is to use the seller’s knowledge of the company to fight the claims, and therefore the parties usually come to an agreement on the issues concerning third party claims.

In addition, during the last years representation and warranty insurance has been introduced as a new instrument on Estonian M&A deal market. However, currently such insurance is seldomly used, whereas only approximately 2% of the deals include insurance.

3. Covenants of the buyer and seller

The most common covenants are the seller’s confidentiality clause, non-competition clause and non-solicitation clause. In Estonian M&A deals it is common to subject the seller to a non-competition and non-solicitation clause for a period of 19 to 36 months from closing the transaction. If the seller breaches the mentioned post-closing covenants, the seller is commonly subject to a contractual penalty.

4. Conditions of Closing of the Buyer and Seller

In general, an acquisition agreement enters into force upon fulfilling certain conditions precedent. For example, in some cases the instant transfer of shares is not possible (e.g. a concentration permit is needed from the Estonian Competition Board) or is not acceptable to one of the signing parties (e.g. a party is obliged to fulfil certain obligations or a party needs time to organize financing for the transaction).

Hence, it is common for the parties to the acquisition agreement to agree that part of the agreement (e.g. representations and warranties, parties’ liability, dispute resolution, confidentiality clause, etc.) will enter into force upon signing of the agreement and the remaining part of the agreement (e.g. the seller’s obligation to transfer the ownership of the shares to the buyer and the buyer’s obligation to pay for the shares) will enter into force once the conditions precedent have been fulfilled.

Typically, the following conditions precedent are used in acquisition agreements:

- The buyer has concluded a legal and financial due diligence of the company being acquired and is satisfied with the results;
- Together with the acquisition agreement, a shareholders' agreement has been signed that regulates relations between the shareholders;
- Consent for the transaction from the buyer's or seller's supervisory board has been acquired;
- Consents from state institutions have been acquired for the transaction (licenses, clearances etc);
- Changes in the management and supervisory board members of the company being acquired have been made (e.g. the buyer appoints the members);
- Consents have been acquired for the continuation of agreements from third parties with whom agreements including change of control clauses have been concluded;
- No material adverse changes or material adverse effects have taken place during the time between signing and closing.

5. Indemnification Provisions

Indemnification provisons in Estonia are typically used if a risk that the acquired company is exposed to at the moment of the acqisition transaction is realized later and this causes damage to the buyer. This means that the seller is liable for it and has to compensate the buyer for all damage caused by it. Typically a cap is set to the seller's liability. The usual amount of cap varies per deal, whereas approximately 1/3 of the deals are capped with 100% of the purchase price and 1/3 of the deals with a cap less than 25% of the purchase price.

6. Dispute resolution

Arbitration is still the most popular form of dispute resolution, whereas in 60% of the deals arbitration is used. In addition to Arbitration Court of the Estonian Chamber of Commerce and Industry, Stockholm Chamber of Commerce tribunal is also widely used. In addition, during the last year a significant rise has been noted in the use of Estonian County Courts for dispute resolution.

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