INTERNATIONAL ASSOCIATION OF YOUNG LAWYERS

The pursuit of a company's interest over the life of a company

Commission(s) in charge of the Session/Workshop: Corporate Acquisition and Joint Ventures Commission

London, 2015

National Report of Estonia

Kadri Kallas

SORAINEN
Pärnu mnt 15,
10147, Tallinn, Estonia
+372 6 400 900

Kadri.kallas@sorainen.com

General Reporters:

Christian Leuenberger, Pestalozzi Attorneys at Law Ltd, Zurich, Switzerland
Pablo Vinageras, J&A Garrigues, S.L.P., Barcelona, Spain

A. Interest of equity holders

1. Start-up phase

In the start-up phase, an entrepreneur or third parties may wish to invest in a business idea as equity holders in a business association. In this context:

1.1. In your opinion, what is an entrepreneur's typical reasoning for setting up a specific business association? Attract investments by third parties? Avoidance of personal liability? Tax reasons? Protect IP rights and technology?

Estonian business practice supports the idea that entrepreneurship is done via business associations, and mostly via private limited liability companies. All of the above reasons are taken into consideration for setting up a specific business association.

If an entrepreneur is involved in business as a natural person, there is no legal distinction between the owner and the business of a Sole Proprietor (abbreviation in Estonian: FIE), which results in unlimited liability. This is also one of the main reasons why Sole Proprietorships (FIE) are not very popular.

The benefits of the rather unique Estonian tax system are typically an additional factor when deciding on the format of a business venture. There is no corporate income tax on retained or reinvested earnings, the gross rate is 20%, dividends, interest and royalties not subject to withholding tax. Natural persons who are Sole Proprietorships (FIE) will pay income tax on all income received from entrepreneurship.

Moreover, as IT startups are team-based ventures, therefore setting up a business association, which facilitates agreeing on allocation of rights and obligations gives a clearer format to the team’s relationship, including formalisation of the trail of IP rights: proper IP transfer and licencing in place from the outset of the project. Establishment of a business association is easy to do and can be done online if the founders have an Estonian ID-card or e-residency (a state-issued secure digital identity for non-residents that allows digital authentication and the digital signing of documents).

1.2. What kind of business association structures does your jurisdiction offer to equity holders (e.g., partnerships, corporation, LLC, etc.)?

Estonian corporate law recognises the following business association structures:

General Partnership – A partnership between at least two partners. There is no minimum capital requirement as the amount of the contribution is stipulated in the partnership agreement, no obligatory management bodies. The liability is unlimited and shared equally by the partners.

Limited Partnership – A partnership between at least two partners. There is no minimum capital requirement as the amount of the contribution is stipulated in the partnership agreement, no obligatory management bodies. The liability is unlimited for at least one general partner, while at least one partner's liability is limited to the extent of their contribution.

Private Limited Company (in Estonian *osaühing or OÜ*) – A limited liability company with at least one shareholder (a legal or natural person). The required minimum capital is EUR 2,500 (founders who are natural persons need not pay in the capital from the outset, although in such an event they are still liable in the amount of the share capital that was not paid in). Shareholders are not personally liable for the private limited company´s obligations. The company is required to have a management board. A supervisory board is mandatory only if specified in the articles of association.

Public Limited Company (in Estonian: *aktsiaselts or AS*) – A limited liability company with at least one shareholder (a legal or natural person). The required minimum capital is EUR 25,000. Shareholders are not personally liable for the company's obligations. The supreme management body of the public limited company is the general meeting of shareholders. A public limited company must have a management board (an executive body, in charge of everyday business of the company) and supervisory board (non-executive body, supervises the activities of the management board).

- What are the most crucial differences between these business association structures from an equity holder's perspective?

The most common business association structures in Estonia are a private limited company and a public limited company.

In general, private limited companies are meant for a "closed" circle of shareholders and are better suited for smaller businesses, while public limited companies are meant to attract a larger number of shareholders and capital from outside.

A public limited company has more stringent requirements than a private limited company. For example, there is a higher capital requirement, a requirement to form a supervisory board, and have an annual audit. Also, the shares of a public limited company must be registered with the Estonian Central Register of Securities (however, this does not constitute a public listing of shares at the local stock exchange).

- If statistics on the use of business association structures are available in your jurisdiction: which are the most commonly used business association structures for start-ups? Do you see a particular reason for the dominance of one specific structure?

The most commonly used business association structure for start-ups in Estonia is a private limited company – easiest to set up, with low capital requirement and least formalistic, however, offering limited liability.

Also, recently the Estonian Parliament accepted several amendments to the Commercial Code which make the private limited companies more flexible and entrepreneur-friendly starting from July 2015:

a. Less rigid share subscription – allowing listing all the shareholders with a subscription right in the resolution rather than listing only the subscribing shareholders.

b. Companies are allowed to own more shares – a private limited company is allowed to own 1/3 of the shares of the company rather than 1/10 as before.

c. Possibility to issue shares with special rights – the articles of association of a private limited company can allow issuing shares with preference rights.

d. Possibility to increase share capital conditionally and to issue bonds – this allows fundraising in the form of convertible bonds or convertible loans and issuing options to employees.

- In case of a corporation or LLC (in the following we simply refer to the "company"): are there any equity instruments other than common shares that are typically used for equity investments? Non-voting shares? Other forms of participation rights?

The public limited companies are allowed to issue preference shares, and from July 2015 so are private limited companies. Preference shares secure that dividends are paid out to preference shareholders before the common shareholders, whereas typically preference shares do not have voting rights (at exceptional circumstances gain voting rights).

- Can equity investors remain anonymous (for example by the use of bearer shares)? Anonymous towards the company, other investors, the public? In the event equity investors cannot remain anonymous when holding shares, is there any alternative scheme that can be implemented to participate on an anonymous basis (for example, silent partnership schemes)?

Under Estonian corporate law, bearer shares are not allowed.

In order to remain anonymous the equity investors have an option to hold their shares through a nominee account[1], as special type of securities account regulated by the Estonian Central Register of Securities Act. Professional participants in the Estonian securities market as well as foreign institutions who have equivalent financial supervision are allowed to operate nominee accounts. Through a nominee account, securities are held for and on behalf of another person (client). The only securities held in a nominee account are securities acquired by the holder of the nominee account in the name of the holder but on behalf of a client for the performance of a mandate of the client. It is prohibited to hold other securities in a nominee account. In the event of a nominee account, the company, other investors, and the public can only access the info on the nominee account, but not the actual beneficial owner of the securities. Nominee accounts are typically used to make it easier to sell and buy shares, but can also be of aid if the purpose is to remain anonymous.

1.3. Once the entrepreneur has set up a company: what could be a typical focus of third party equity investors when they invest in a company in this phase?

- What could typically be the friends', family's and fools' ("FFF") focus? Helping the entrepreneur to get his / her business going?

[1] Section 6 of the Estonian Central Register of Securities Act

The focus is typically the development of the product.

- What could typically be the professional investor's focus?

The focus is typically the development of the product and checking the viability of the product.

- If there is a difference in focus among the various equity investors, how is this typically reflected in the legal relationship (be it corporate or contract law)? Are there legal instruments that are only used by certain investors (e.g., only by professional investors)?

Parties often agree to establish contractual pre-emptive rights, tag-along and drag-along rights. It is common to seek a tag along clause to give the investor an option to exit together with other selling parties (typically in proportion to their shareholdings) or to request a drag along clause to ensure that if a trade sale is conducted the buyer can acquire the entire company. Reverse vesting of founder shares is also sometimes used by professional investors.

2. Growth phase

In the start-up phase a business idea comes into existence: the idea is put into a business plan, a company is set up, first steps relating to production, service, distribution, sales etc. are made. The growth phase allows potential new investors to better assess not only the viability of business idea, but also the commitment of the people involved. In this phase, the new investors are usually not FFF, but professional investors. As a result, the FFF who invested in the start-up phase are faced with more demanding and skilled potential new co-investors. Against this background:

2.1. In your opinion, does the focus of the equity holders (e.g., the FFF or professional investors) shift in the growth phase (as compared to the start-up phase)?

- If so, what could be a particular focus for equity holders in the growth phase? Protection from dilution?

In the growth phase the relationship between the shareholders gets typically more regulated by a shareholders agreement. The main focus of the various equity holders is the development of the product, ensuring the focus of founders on the venture, also protection from dilution is important.

- In your experience, do the equity investors from the start-up phase participate in further capital rounds in the growth phase? Do they usually accept dilution? Do they usually cash out at this point in time?

Professional investors typically participate in further capital rounds in the growth phase, and request anti-dilution measures to be taken. If FFF have enough capital they will participate in further capital rounds, however, in general FFF do not have that much bargaining power and will usually have to accept dilution.

2.2. In your jurisdiction, does the company law provide existing equity holders protection from being diluted in further financing rounds in the growth phase? If so, how are they protected? Is there a need for equity holders to seek protection on a contractual basis?

The commercial law does not protect anti-dilution in its strict sense, however, existing equity holders are protected by the pre-emptive right provided by law.

In case of private limited companies, upon increase of share capital, a shareholder has the right to acquire issued shares in proportion to the shareholder's share unless the resolution on increase of share capital prescribes otherwise. The pre-emptive right of shareholders to acquire shares may be excluded by a resolution of shareholders supported by at least three-quarters of the shares represented at the meeting, unless the articles of association prescribe a greater majority requirement[2].

Similarly to the private limited company´s regulation, a shareholder of a public limited company has a pre-emptive right to subscribe for the new shares in proportion to the sum of the nominal value or book value of the shareholder's shares. The pre-emptive right of the shareholders may be barred by a resolution of the general meeting which receives at least three-quarters of the votes represented at the general meeting[3].

If a public limited company has several classes of shares and new shares of one or some classes are issued, the holders of the corresponding classes of shares have a pre-emptive right in the subscription of such shares before other shareholders.

---

[2] Section 193 of the Commercial Code.

[3] Section 345 of the Commercial Code.

The above is typically supported by an investment/shareholders' agreements typically either in support of the pre-emptive right or require shareholders to waive it.

2.3. When new potential investors offer to come on board during the growth phase, the existing equity holders may be reluctant to provide the information required to satisfy the potential new investor's need for valuation. The reason for the existing shareholders' reluctance may be, for example, that the required information contains (still) unprotected intellectual concepts, knowledge or ideas. In your experience, which legal instruments are used to find a balance between the potential new investor's need for information and the existing equity holders' wish to keep such information confidential? Do existing equity holders have legal means to prevent management from disclosing such information?

The typical way to protect IP (either protected or unprotected) in such processes is entering into a non-disclosure agreement with potential investors. As the financing depends on valuation of the viability of the idea/product, there is typically not much opposition by the management towards disclosure of information, provided the non-disclosure arrangements are in place.

3. Maturity

During the various capital rounds in the growth phase, the circle of equity investors in a company typically becomes larger and the atmosphere may become less familiar. Also, in the maturity phase the management of the company may become more professional in the sense that there is a management in place which is not, or not significantly, invested in the company (i.e., intensification of the principal-agent-conflict). As a consequence, legal concepts that govern the relationship between equity holders (such as fiduciary duties of majority equity holders) as well as legal concepts that govern the relationship between management and equity holders (such as fiduciary duties of the board members / management, duty of loyalty, principle of equal treatment) may become more important. In other words, corporate governance may become more important. Against this background:

3.1. In your opinion, how does the equity holder base change between the start-up phase, the growth phase and the maturity phase? How does the focus of the equity holders change? Focus on fair distributions of earnings?

The most common equity holders in the start-up phase are FFF and angels, for the growth phase VC investments, and for maturity phase potential trade sale or sale to venture capital/private equity firms focusing on maximizing efficiency before trade/secondary IP sale, or IPO.

3.2. In your jurisdiction, does the law provide for stricter corporate governance rules for large (privately-held) companies as compared to small companies? If so, what exactly triggers the application of the stricter corporate governance rules? In which sense are the corporate governance rules different / stricter?

Public limited companies have stricter requirements than private limited companies. For example, public limited companies must have a supervisory board, and have an annual audit, while private limited companies can opt in having a supervisory board, and auditing is mandatory after certain thresholds have been met.

The Tallinn Stock Exchange and the Estonian Financial Supervision Authority have put together Corporate Governance Recommendations[4]. The rules are mandatory for all issuers participating in a regulated market but recommendatory for other public limited companies too.

3.3. In your jurisdiction, do (certain) equity holders (e.g., majority shareholders) have obligations towards (certain) other shareholders or the company (e.g., duty of loyalty)? Please explain such obligations.

In relations *vis-a-vis* the shareholders, the shareholders must act in accordance with the principle of good faith and to respect each other's legitimate interests.[5] The general principle of good faith means that when implementing rights and performing obligations, shareholders must act in accordance with good faith. The Estonian Supreme Court has noted that in general, no obligations to act can be required from a shareholder based on the principle of good faith (e.g an obligation to vote for paying dividends). However, in the event of a deadlock, the shareholder may be required to vote in the shareholders' general meeting in a way as to helping to overcome the deadlock.[6] In addition, a right of the shareholder must not be used for illegal activity or with an aim to create a loss to other person.

[4] https://www.fi.ee/failid/HYT_eng.pdf

[5] See Judgments of the Estonian Supreme Court No 3-2-1-89-14, Section 21, No 3-2-1-65-08, Section 26, No 3-2-1-7-10, Section 31.

[6] See Judgments of the Estonian Supreme Court No 3-2-1-89-14, Sections 21, 23.

3.4. The general principle of good faith is also applicable between the company and the shareholders. The company must treat the shareholders equally under equal circumstances. Does the company have any means to control the circle of its equity holders (i.e., can the articles of incorporation prevent competitors from holding shares in the company?) or have such restrictions to be agreed among the other equity holders (e.g., shareholders' agreement)?

It is possible to restrict the change in the circle of its equity holders by invoking right of first refusal at transfer of shares, or pre-emption rights at capital increases. In case of private limited companies, the right of first refusal of other shareholders upon transfer of shares is provided by law. However, it is generally possible to deviate to a certain extent from this requirement in the articles of association. The right can be removed by the articles of association, or substituted with a requirement that transfer of shares is subject to other pre-conditions such as consent of the other shareholders, management board or other bodies[7]. If the right of first refusal applies, it only applies to transfer of shares for cash or other consideration (i.e sale) to third persons. Therefore, such right generally does not apply in case of gifts or transfer of shares to the share capital of another company as a non-cash contribution.

In case of public limited companies, the presumption is reversed. The law does not provide for a right of first refusal on transfer of shares, but the articles of association may so provide[8]. Thus, it is left to the shareholders to decide whether they wish to control entry to the shareholders circle.

Under Estonian law the right of first refusal is a right upon the exercise of which a sales agreement between a person with a right of pre-emption and a seller is entered into on the same conditions which the seller agreed with the buyer[9].

Also, the shareholders have a pre-emptive right to subscribe for shares at issuance of new shares. Such right can be excluded with three quarters of the shareholders' vote.

[7] Section 149 Subsection 3 of the Commercial Code.

[8] Section 229 Subsection 2 of the Commercial Code.

[9] Section 244 of the Law of Obligations Act.

Restrictions specifying the above as well as regarding competition and non-soliciation can also be agreed in a shareholders´ agreement.

4. IPO / Listed phase

Following the IPO, a company enters into a new phase of being listed. The listing has potentially a great influence on the equity holder: the sale of their interest becomes easier. Against this background:

4.1. How does the focus of the shareholders change through the going public as compared to the maturity phase? Does the fact that a shareholder may at any time sell the residual value in its share (ideally) at a fair price in your opinion soften the focus on distribution of earnings? Does the focus shift from long term to short term?

This will depend on the investor's aim and strategy. For example institutional investors prefer pension funds, and the focus is long term, as opposed to speculative investors´ focus.

4.2. In your jurisdiction, are there publicly available records on the identity of (certain of) the shareholders in a listed company? If so, does this in your opinion influence the shareholders' focus?

All shareholders of public limited companies are listed in the Estonian Central Register of Securities irrespective of whether they are listed in the local stock exchange or not (ref. above on nominee accounts).

4.3. An efficient allocation of resources requires a most accurate pricing of the shares.

- In this regard, are companies that are listed in your jurisdiction under an obligation to publish price-relevant information (ad hoc publicity)? If so, please provide a short overview of the respective rules including the exemptions from such obligation.

Listed companies must notify the stock exchange about all relevant changes in their activities which may influence their share price or seek exemption from this requirement from their supervision authority if this information would otherwise be harmful to the company or its shareholders (i.e., disclosure of trade secrets).

- It can be assumed that no jurisdiction requires listed companies to publish all price sensitive information. If this is correct in your jurisdiction, how does the law protect the market and its participants (including, the equity holders in the company) from market abuse? Are there insider trading and market manipulation prohibitions? If so, please provide a short overview and, if you can, provide certain peculiarities about them?

An insider of a publicly listed company is subject to restrictions on certain types of trades and during certain disclosure periods under stock exchange rules of the Tallinn Stock Exchange and the Securities Market Act. If a party acquiring or selling shares is an insider of a public limited company, then careful attention should be paid to these restrictions.

The misuse of inside information is prohibited under the Securities Market Act[10]. Inside information is deemed to be misused if an insider:

- directly or indirectly acquires or transfers or attempts to acquire or transfer on his or her own account or on the account of a third party a financial instrument or a derivative linked to the financial instrument which is deemed to be inside information;
- discloses inside information to a third party, unless such disclosure is connected with the usual performance of functions or official duties;
- makes recommendations to a third party or influences a third party to acquire or transfer a financial instrument or a derivative linked to the financial instrument which is deemed to be inside information.

Market manipulation is also prohibited under the Securities Market Act. The market manipulation prohibition regulation derives from the Market Abuse Directive and does therefore not have peculiarities compared to the rest of EU.

5. Acquisition

In its life cycle, the company may itself become the object of an acquisition and integration into the acquirer's structure. At this point the life cycle of the company ends. For the purpose of the remainder of this questionnaire, we assume the acquirer proceeds via a public tender offer. Against this background:

[10] Chapter 21 Sub-chapter 2 of the Securities Market Act.

5.1. In case a listed company (target) is approached by another company (bidder), the board of the target will have to decide whether it supports the offer (friendly offer) or not (unfriendly offer). What are the interests that the board of directors needs to take into consideration for this decision? Shareholders' interests only (e.g., offer price only)? The interests of other stakeholders (employees, community etc.)?

The company's and the shareholders' interests only.

5.2. In case of an acquisition of the listed company (target) by another company (bidder), the shareholders' are at a disadvantage as they cannot communicate efficiently or act in concert (for example, regarding the rejection of a low offer). A rational bidder should try to use this disadvantage of the shareholders to his benefit. In your jurisdiction, how does the law protect shareholders of the target in case of public tender offers? (for example, is there a specific process for public takeover offers which provides protection? Does the bidder need to treat target shareholders equally? Are there, for example, minimum price rules and/or best price rules?)

The term for acceptance of an offer made by a takeover is 28 - 42 days based on which the bidder determines the term of the takeover bid (hereinafter term of takeover bid). The term of a takeover bid is calculated as of the term of publication of the prospectus for the takeover bid.

The Financial Supervision Authority has the right to determine the gaining, holding, transfer, absence and scope of dominant influence in each individual case by carefully considering all the relevant circumstances.

A person who has gained dominant influence over the target issuer either directly or together with other persons acting in concert is required to make a takeover bid for all shares of the target issuer within twenty days as of gaining dominant influence.

The bidder is under an obligation:

- to treat all owners of shares of the same type equally;
- the bidder will make a takeover bid if it has sufficient financial resources and the means to carry out the takeover.

The bidder and the target issuer must provide the target persons with significant, correct, accurate, complete and identical information for informed consideration of the takeover bid.

The purchase price must be fair and the ratio between different types of shares must be proportional.

5.3. As mentioned above, a listing provides (ideally) liquidity for the company's shares and ensures a high level of information for a potential new investor. In fact, equity investors may invest in listed companies exactly for these reasons. In your jurisdiction, how is an equity investor protected from a delisting? Does the delisting require (qualified) shareholder consent? What are the deadlines for the delisting? Do issuers need to provide for an off-exchange trading for a certain period following delisting?

Delisting is regulated by the stock exchange rules, and the Tallinn Stock Exchange may deny the delisting application if it decides that delisting will harm minority shareholders.

B. Interest of debt holders

1. Start-up phase

In the start-up phase, the entrepreneur may ask the so called "FFF" (friends, family and fools) for a loan. In other words the entrepreneur asks them to invest in a business idea as debt holders. In this context:

1.1. In your experience, what could be the typical focus of the FFF in this phase? Helping the entrepreneur to get his / her business going? How is this focus reflected in the legal relationship? For example, will such debt holders be likely to refrain from asking for security? Is the agreed interest rate likely to correctly reflect the risks for the debt investor?

Loans are not that usual in the start-up phase. Sometimes convertible loans are used, but it is more likely in the growth phase.

The main reason why loan capital is not more common is that there is no proper collateral available at that stage and the risk can be too big for the debt investor.

1.2. In your experience, is it common for professional investors to act as debt holders in this phase? If so, how is the different focus of professional investors typically reflected in the legal relationship? What are the legal instruments commonly used in your jurisdiction to protect their interests? For example, is it common for the professional investors to request a personal security by the entrepreneur in case the company does not yet have (a lot of) assets to secure a loan?

It is not common to have debt holders in this phase, especially considering there is an issue with collaterals. Personal security (i.e surety) can be requested, but in practice this may not provide a lot of security for the debt holder.

2. Growth phase

2.1. In your experience, who provides debt in this phase and what could typically be their focus (e.g., high return on investment)?

Angel investors usually act as debt holders in this phase, if at all. Bank loans are typically not available. This is additional financing for development of the product, no high returns usually expected. Given that loans at this stage are riskier, hence interest rates tend to be higher.

- Are the debt holders and their focus in the growth phase typically different from the ones in the start-up phase? Is it now mostly professional investors (and no FFF)?

The debt holders in Estonia in growth phase are similar to start-up phase, FFF may be involved still.

- If there is a difference, how could this be reflected in the contractual relationship? For example, do the interest rates or the security for the debt change?

The interest rates at this stage are still at a considerably high level, though lower than at start-up phase. There is no major difference otherwise in contractual relationship.

2.2. What kind of security is commonly request by debt holders in this phase? For example, rather collateral (pledge, etc.) or personal guarantees by the entrepreneur? What is the reason for the preference of a specific kind of security?

Given the phase of the cycle, the most common security is personal surety. If the company is already generating income, there might be security on income stream. Depending on the company, IP may also be object of security.

2.3. During the growth phase, the burn rate of the company may be quite high and the company may continuously be at the verge of over-indebtedness. Will investors usually be willing to subordinate their debt? Usually only the entrepreneur / FFF from the start-up phase or also professional investors?

If professional investors/banks issue loan at all at this stage, they tend to require entrepreneur/FFF to subordinate their claims.

2.4. Investors providing debt in this phase may wish to keep the possibility to participate in the potential valuation upside. How could this wish be accommodated in your jurisdiction? For example, are profit-participating loans or convertible loans commonly used instruments?

Sometimes convertible loans are used by investors at this stage. Convertible loans are fairly straight forward and do not entail much documentation (even loan agreement does not have to be in a written format, however, the conversion needs to be adequately documented in compliance with the Commercial Code[11]).

3. Maturity

After having reached maturity, the structure of debt holders may change fundamentally. Against this background:

3.1. In your jurisdiction, who is usually the debt holder in the maturity phase (e.g., banks)?

- Are the debt holders and their focus in the maturity phase typically different from the ones in the start-up or growth phase?

At maturity phase, bank loans are common, compared to start-up and growth phase. The focus of banks is conventional, interest proceeds.

- If there is a difference, how may this be reflected in the contractual relationship?

[11] Sections 142-143 and 248-249 of the Commercial Codes

Documentation is standard loan documentation. Convertible loan instruments are rarely used. Conventional collateral packages (mortgages, share pledges, floating charges, etc) are in place.

3.2. Before providing debt to a company, the potential debt holder may require information about the company's financial status to assess the default risk. What financial information is publicly available for potential new investors who wish to invest in a privately-held company? Are financial statements available from public registers? Excerpt from the debt enforcement register? Tax returns? Do companies have means to influence the amount of publicly available financial information?

Information on a company's financials and business is widely available in electronic databases. It is possible to obtain the annual report of a company from the commercial register, also info about commercial pledges, mortgages, or share pledges. Additionally, it is possible to get info on tax debts, for a fee it is possible to check the credit rating of the company.

3.3. In your jurisdiction, is it common for privately-held companies to issue notes? Could you provide a short overview of the requirements and the procedure relating to the issuance of notes? Is the focus of note-holders any different from other debt holders?

It is not very common but still there is practice for privately held companies to issue notes, andthe trend is growing.

The privately issued notes are not regulated, if these are publicly offered notes, these need to be registered with the Financial Supervision Authority

In the event of secured notes, the focus of note-holders is mainly on the securities package. In the event of non-secured notes, the focus of note-holders is mainly on the economic situation of the company. In summary, there is not much difference from other debt holders.

4. IPO / Listed

4.1. Once a company is listed, the debt holders have a considerably higher level of information regarding the company's financial situation. One could expect that this reduces the risk for the debt holder. Thus, in your jurisdiction, do listed companies usually have to pay lower interests?

The company´s financial situation is accessible already before listing the company. Both private and public limited companies are under an obligation to submit annual reports to the commercial register, which are then retrievable for a small cost. Listed public limited companies are under an obligation to publish the annual reports on their website. Having said that, listing gives more transparency and may translate into lower interest rates. However, if the company is not performing, it may work against this principle as well.

4.2. In your jurisdiction, is it possible to list notes? Could you provide a short overview of the requirements and the procedure relating to the listing of notes? In your opinion, is the focus of holders of listed notes any different from the focus of other debt holders?

It is possible to list notes. Prospectus, internal rules of the company and other necessary documents are drafted and submitted to the Financial Supervision Authority for approval. After approval by the Financial Supervision Authority the prospectus must be approved also by the Tallinn Stock Exchange Listing Committee.

The focus is similar to other debt holders at this stage – earning of interest proceeds. The focus of local holders of notes is not yet that much on marketability of the notes due to specifics of the market (small and non-liquid market).

5. Acquisition

5.1. In your jurisdiction, what is commonly the effect of a public tender offer on listed notes. Do they have to be redeemed? Can holders of listed notes interfere in the process of a public tender offer? If so, by which means?

There is no common market practice regarding the public tender offer of listed notes.

5.2. In your jurisdiction, what is the typical influence of a public tender offer on existing credit facilities?

There is no specific influence on existing credit facilities. There are also no specific clauses in standard loan agreements regarding the public tender offer. However, the loan agreements include usually a change of control clause, therefore the bank's consent is required for the public tender offer, if the change of control occurs.

C. Interest of management / employees

1. Start-up phase

In the start-up phase, it is essential that the key management is committed towards the development of the business idea or project. In this context:

1.1. Which are the most commonly used means to ensure that the management / key employees will not leave the company until the company reaches the growth or maturity phase? Are warrants or similar incentives granted during this stage?

It is common that the founders are also management/key employees at the start-up phase. Therefore they already have shares. With first financings, it is common that reverse vesting provisions are insisted upon.

1.2. It is likely that at this stage, there are not sufficient funds for remuneration of management / key employees. Is it common to grant warrant or stock incentive schemes in your jurisdiction? Is there any other scheme to liaise with this issue?

If the management/key employees are not founders, options' programmes are often agreed with them.

2. Growth phase

The management plays a crucial part in order that a company achieves going from a start-up phase to a growth phase and tend to assumes considerable risks by devoting to such project. Therefore, it would seem reasonable to protect the management in further financing rounds during the growth phase.

2.1. In case new investors come on board in the growth phase and such investors request replacement of the current management: in such replacement, does the current management usually lose rights granted under an incentive plan? How broad are "bad leaver" provisions usually formulated?

Typically, the options survive new investors at growth phase. It is also typical that for a manager/employee to become a bad leaver, they need to commit a material breach of the terms of their service.

2.2. Upon implementation of an incentive plan, the rights related to the shares that the management will be entitled to receive are usually subject to vesting. Is there any specific vesting period that is applied in your jurisdiction or is the vesting period usually linked to a liquidation event (such as an IPO)?

Vesting is typically made over the period of 3 years at minimum, as employee option plans exercisable before the expiry of 3 years are taxed with a withholding tax (income tax 20%) and the social security tax (33%).

2.3. In certain jurisdictions the management may fall out of labor relationship since it is developing executive duties for the company and/or may hold certain stock of the company (it might fall in a special labor relationship or corporate relationship). Is this the case in your jurisdiction? If so, is the loss of labor rights compensated by special laws or by contractual means?

The employment law is not applicable to the activities of the management board member, therefore all protective clauses need to be included in the agreement. It is not very common, but it is possible that in addition to the management board member activities the person holds a position in the company under an employment contract. In such event, the employment benefits are applicable to a certain extent. For example, an employee who is also a management board member is not entitled to unemployment insurance benefits.

3. Maturity

After having reached maturity, the business activity and the relationship between the shareholders and the management / key employees tend to become more complex (in particular, intensification of the principal-agent-conflict). The increasing complexity triggers certain hindrances or deterrents for the ongoing activity of the company. In this context:

3.1. In your jurisdiction, do the various corporate bodies (e.g., board of directors, directors, management) have

- an obligation to "act in the best interest of the company"? If so, how is the "interest of the company" defined? Is it the interest of all stakeholders (including the interests of all equity holders (e.g., holder of non-voting shares), debt holders, management, employees and public) or just the shareholders? Are only long term interests taken into account or also short term interests?

The laws of Estonia stipulate an obligation of a member of the management or supervisory board to act as a reasonable entrepreneur, which means acting in the best interest of the company. The obligation to act as a reasonable entrepreneur means that a management board member or a supervisory board member is under an obligation to act in the most economically purposeful manner. The Estonian

Supreme Court has explained that a management board member must be prudent, sufficiently informed when adopting resolutions and may not assume unjustified risks. The above obligations are measured against a hypothetical reasonable person acting under the same circumstances and the requirement is fulfilled if another reasonable professional would have acted the same way in a similar situation. In addition, the law stipulates that the members of the governing body of a legal entity must be loyal to the company.[12]

- "fiduciary duties" or a duty to treat equity holders equally? How are these defined?

The Commercial Code provides a general duty of the company to treat shareholders under same set of circumstances equally. Fiduciary duty is defined as an obligation of the management board to be loyal to the company. The fiduciary duty is a general obligation of the management board member in addition to the other obligations derived from the law, articles of association, resolutions of the shareholders or management board or obligations derived from the contract.[13] The fiduciary duty means that management board member is obliged to avoid conflict between his personal interests and the company's interest.[14]

3.2. In your jurisdiction, how are conflicts of interest addressed by the law? Are the rules on conflicts of interests for listed companies applied to non-listed companies? Have the rules on conflicts of interests become more rigid in recent years?

The Commercial Code sets out the competition prohibition to the management and supervisory board members meaning that they must not be sole proprietors or partnership's partners, or in another company's managerial bodies (management board, supervisory board), except if the companies belong to the same group or if the field of activities of the sole proprietor, partnership or another company is different[15].

Also, there are restrictions in entering into contracts between the company and the members of managerial bodies in order to prevent the abuses. The conditions of

[12] Madisson, Karin. *Juhatuse liikme vastutus*, Äripäev 2014, page 97.

[13] Judgments of the Estonian Supreme Court No 3-2-1-33-10.

[14] Judgments of the Estonian Supreme Court No 3-2-1-41-03, 3-2-1-41-05.

[15] Sections 185, 312, 324 of the Commercial Code.

the transactions between the management board member or supervisory board member and the company must be approved by shareholders (transaction with management board, if supervisory board does not exist; or transaction with the supervisory board member) or by the supervisory board (transaction with the management board).

Under Corporate Governance Recommendations, which is mandatory for listed and recommendatory to un-listed companies, members of the management board are advised to inform the supervisory board and other management board members of the existence of a conflict of interests before the conclusion of a contract of service and immediately upon arising of it later. The management board members should also promptly inform other management board members and the chairman of the supervisory board of any business offer made to them, to a person close to or connected with them, that relates to the business activity of the company.

3.3. In your jurisdiction, is it common to put in place incentive plans for key management and employees or are they only entitled to receive a cash bonus (usually based on individual and overall performance)? Do incentive plans provide tax advantage for the company?

Incentive plans have become more common, still cash bonuses are widespread as well. Employee/management related option programmes are not taxed if exercised at the expiry of 3 years.

4. IPO/ Listed phase

Reaching an IPO is often the pinnacle of private companies which have reached certain growth and have an attractive equity interest. Obviously, the management and employees play a significant role in the IPO / listing process. In this context:

4.1. It is our understanding that when a company goes from a private to a public setting it implies considerable changes for management and employees. In your experience and within this framework, what is the most significant change for management and employees? Does going public usually increase the total amount of the compensation and/or does it usually change the structure of the compensation (cash, shares, warrants, etc.)?

The principles of remuneration of management of the public companies are set out by law– the remuneration of the management must be clear and transparent and proceed from the long-term objectives of a company, taking into account in this respect the economic results of an issuer of shares and the legitimate interests of investors and creditors.

In addition, the management and employees must follow the insider rules of the Tallinn Stock Exchange.

If a company goes public, there has been some practice of issuing options to employees.

4.2. Following the IPO the management is constantly assessed by the performance of the share price. Also the management's pay may to large extent depend on the share price performance. One could expect that management may abstain from taking any steps that are likely to weaken the share price – even if such steps are beneficial to the company in long term. In your jurisdiction, are there any measures that are commonly taken to address this conflict (i.e., incentives for long term strategies)? Is, for example, by law or by agreement a part of the pay paid in mid- to long term options?

Options are issued to management of listed companies rather often, it is a sign of the management's belief in the performance of the company.

4.3. Is the management and/or employees bound by a mandatory lock up period upon the IPO? In the event the lock up period is not mandatory, please explain the common standards in your jurisdiction towards implementing a lock up period.

The company's management board members, supervisory board members and procura holders are not allowed to make transactions with the listed shares of the company in order to gain benefits from the short-term share price alterations (such effect is presumed if the person acquires and transfers similar amount of shares within a month).

The persons related to the management board members, supervisory board members and procura holders are also forbidden to trade the shares of the company. The listing organ may grant an exemption of this restriction if it is established that the transaction of the related person is not based on the inside information.

5. Acquisition

In the scenario of the acquisition, it is frequent that the management is essential towards the subsequent development of the company. In this context:

5.1. The focus of the board of directors of a listed company may be set to a large extent on the share price performance. Usually, this should be in line with the corporate interest. However, in case a listed company is being approached by a potential bidder, the board of directors and the management of the potential target may face a conflict of interest: an acquisition that may be beneficial to the shareholders of the potential target, may at the same time require replacement or adjustment of the target's board of directors and management. In your jurisdiction, how is this conflict of interest addressed? For example, are there limits to the defense measures that the board of directors of the target may take?

5.2. There is no specific regulation on the conflict of interests. The law sets out that in the event of the takeover bid, the management board members and supervisory board members of the listed company must be guided by the interests of the company. Which are the common alternatives in order to keep management / key employees focused and keen to continue in the company?

Again, share options may be means to increase loyalty.

5.3. In parallel, is it common to reinforce non-competition and confidentiality undertakings of the management / key employees upon acquisition? Is it common to regulate a non-solicitation by the Seller and that it is enforceable (for which period)?

It is common to have non-competition and confidentiality undertakings in place, also non-solicitation, which can range from 1-3 years typically.

D. Interest of advisors / lawyers

1. Startup

During the startup phase, it is one of the most difficult stages to advise companies and/or projects since the company does not have the resources (funds) to implement an appropriate legal scheme and the management/equity holders tend to think in the short term rather than the long term.

1.1. Which are the common difficulties you liaise with during this stage? How do you tend to structure your fees (for example, do you go below your standard rates and agree to have this difference compensated at a later stage when the company has become more successful)?

Fee structuring is different, e.g a lot of discounted fees, also a lot of pro bono work at the beginning.

1.2. In case you accept warrants / rights to shares as compensation for professional services rendered: how do you set the amount or the value of such warrants and rights? Do you rely on valuations of the company? If so, whose valuations? Is it common for an advisor in this situation to request that the company has previously successfully completed a minimum viable product ("MVP") stage which reduces the risk of failure (i.e., as part of the lean startup methodology it is advisable to diminish uncertainty for the project by means of developing an MVP to validate the project)?

Warrants/rights are not yet very widespread in Estonia for lawyers to take as consideration for fee for services.

2. Growth

Commonly, it is important to provide appropriate legal advice when the company intends to achieve going from the start-up phase to a growth phase. The role of lawyers and advisors would likely enhance the possibilities to effectively reach a solid growth phase. In this context:

2.1. How do you tend to structure your fees during this stage (in particular, is there a difference in the fee structure as compared to the start-up phase)?

At the earlier stage, discounted fees are used as well, but not very often.

2.2. Is it common for advisors (in particular, lawyers) to take board positions during this phase? If so, how is such board member compensated? In cash? Or with exclusivity for providing legal services to the company?

Supervisory board positions are not very often take at this stage, more at mature and IPO stage. Remuneration is typically in cash, typically no exclusivity is given for that.

2.3. As the lawyer you may be asked by the entrepreneur to render advice on the division of equity (in particular to FFF)? What is the basis for your advice regarding the division of equity?

As the division is based on valuation and the ability of FFF to continue financing, such questions are not often asked from legal counsel.

2.4. In certain jurisdictions corporate law is rigid and does not allow to regulate certain rights of the shareholders in the by-laws of the company (such as, preferential preemptive rights, drag along or tag along rights). Please explain (succinctly) which is corporate legal scheme that applies in your jurisdiction. Is the shareholders agreement enforceable against third parties in your jurisdiction or is only binding between the relevant shareholders?

Shareholders agreements are enforceable as between shareholders. For that reason, often the most important clauses relating to transfer of shares (i.e drag-along right, tag-along right, right of first refusal) are included in the articles, to the extent permitted by the Commercial Code (i.e in one class of shares, the distribution of dividends is equal, the articles cannot stipulate differently).

3. Maturity

After having reached maturity, the business activity is much more complex and the interests of the company become more intricate. In this context:

3.1. How do you tend to structure your fees during this stage (in particular, is there a difference in the fee structure as compared to the start-up or growth phase)?

In this phase, typically standard rates apply, different from the start-up and growth phase.

3.2. Are you able to become member of the board of directors of the companies? Do you tend to render more unique advice to companies (while the corporate counsel provides the typical ongoing corporate advice)?

It is allowed to become a member of the boards of the company. It is not often that an outside lawyer becomes a member of the management board of an actively trading company, as the management board is in charge of everyday activities of the company, and therefore full attention may not be possible to be paid to being a board member in addition to being an outside counsel. Membership at non-executive supervisory boards is more common.

Advice given is typically more specialised, e.g M&A related if this is the phase that the company is undergoing.

3.3. From a lawyers' perspective, how is the conflict of interest of the management liaised with (are there any mandatory provisions that apply in your jurisdiction)?

3.4. The general fiduciary duty of the management board members obliges management board members to avoid conflict of interests with the company. The transactions of the management must be approved and the conditions of the transaction must be set out by the supervisory board (if exists) or by the shareholders' general meeting. In any case, the management of the company must follow the company's interests. If not, the management has violated its duties and is obliged to compensate any loss caused to the company due to the violation. Does the anti-money laundering provisions in your jurisdiction have changed the form your render advice?

No, not really.

4. IPO/ Listed phase

Reaching an IPO is often the pinnacle of private companies which have reached certain growth and have an attractive equity interest. It is unlikely that the process of becoming a listed company will be successful without the proper advice. In this context:

4.1. How do you structure your fees for an IPO?

The fees are fixed fees.

4.2. From a lawyers' perspective, which are the main regulatory aspects of offering equity to the public? Is it common that companies reach this stage (in certain jurisdictions becoming a listed company is less rigid)?

As a general rule, a public offer prospectus of the securities is drafted and disclosed to the public at latest by the day of offering equity to the public. The prospectus is registered at the Financial Supervision Authority in order to offer the equity to the public.

It is not very common for Estonian companies to reach the IPO stage in Estonia – rather, by the time of the IPO, the company has been subject to a flip to another jurisdiction.

4.3. Is there any specific secondary market in your jurisdiction that allows early startup companies to become listed with the aim of obtaining more equity (given the complexity of becoming a public company in certain jurisdictions a startup company can become listed in a specific market which is less rigid and allow it to obtain other sources of financing, among others)?

There is no such secondary market for early start-up companies. However, in addition to the Tallinn Stock Exchange, there is an alternative market, First North, which is Nasdaq's European growth market, designed for small and growing companies. Using a less extensive rulebook than the main market, the First North market provides companies more room to focus on their business and development while still taking advantage of all the positive aspects of being a listed company. And unlike the regulated main market, every company on First North has a certified adviser to ensure that companies comply with all requirements and rules.

The First North market runs parallel to the main market, where the shares are traded in a single trading system. This allows approximately 200 European trading members of Nasdaq to easily trade on two markets.

4.4. Does the fact of becoming a listed company imply that the lawyers and/or advisors adjust rates their rates accordingly?

Not necessarily.

5. Acquisition

In the scenario of the acquisition, it is frequent that lawyers and advisors are highly involved. In this context:

5.1. Which is most frequent scheme of implementing an acquisition (asset deal vs share purchase deal)?

There is a preference to share deals, as in essence the liability in front of third persons is the same with respect to both transaction types.

5.2. From a lawyers' perspective, which are the main differences within the process of acquiring a stake in listed companies versus private companies?

Regulatory aspects require observation, the deal term may lengthen due to that, also due diligence process may be affected by that fact.

5.3. From a lawyers' perspective, which are the main steps in your jurisdiction in order that a public entity becomes a private entity as a consequence of an acquisition?

Delisting may occur based on the application of the listed company (resolution of shareholders of the issuer required), or initiated by the Tallinn Stock Exchange. The Tallinn Stock Exchange may refuse the delisting upon the application of the listed company if delisting would materially damage the interests of the investors, or the normal operation of the market. The Tallinn Stock Exchange will delist a company on its own initiative if the company or its shares do not respect the conditions of listing and the company has not assured the conformity within six months from respective notice from the Tallinn Stock Exchange.

5.4. How do you tend to structure your fees during this stage (in particular, is there a difference in the fee structure as compared to other phases)?

Not particular difference in structuring fees from a mature company or a listed company.

BIBLIOGRAPHY

Madisson, Karin. *Juhatuse liikme vastutus*, Äripäev 2014