EKONOMI OCH SAMHÄLLE
ECONOMICS AND SOCIETY

HANKEN

Mezzanine Financing

A Comparison between the Finnish and International Financial Market Regulation

MIKA REUNANEN



Ekonomi och samhälle
Economics and Society

Skrifter utgivna vid Svenska handelshögskolan
Publications of the Hanken School of Economics

Nr 327

Mika Reunanen

Mezzanine Financing

A Comparison between the Finnish and International Financial Market Regulation

Helsinki 2019

Mezzanine Financing: A Comparison between the Finnish and International Financial Market Regulation

Key words: mezzanine, finance, company, law, accounting, taxation, venture capital, bank, subordination, regulation

© Hanken School of Economics & Mika Reunanen, 2019

Mika Reunanen
Hanken School of Economics
Department of Accounting and Commercial Law, Commercial Law
P.O.Box 479, 00101 Helsinki, Finland

Hanken School of Economics

ISBN 978-952-232-381-1 (printed)
ISBN 978-952-232-382-8 (PDF)
ISSN-L 0424-7256
ISSN 0424-7256 (printed)
ISSN 2242-699X (PDF)

Hansaprint Oy, Turenki 2019

PREFACE

This Doctoral Thesis is the outcome of the lengthy process. The idea of becoming PhD became reality only long time after completing my Master Degrees first in Law and later in Business Administration. The desire to learn more has always been in me. However, to work as bank manager in a hectic and continuously changing business environment did not leave time for implementation of any further academic goals. Also, being father of three small children did lead to prioritisations where additional studies had only subordinated position. An academic deep dive in the form doctoral thesis just felt unrealistic. However, years passed and children grew up but the academic desires did remain.

Many years after completing my second Master Degree I found myself starting doctoral studies in Hanken School of Economics. Some time has passed also from that moment but now the doctoral thesis has been completed. I have written my thesis beside my full-time work in the international financing industry. The road from the start to the finish line has been long and winding but also so rewarding. There have been many long evenings and stayed up nights but right now that feels irrelevant. The joy of completed work overcomes all the past burdens.

The underlying work would have been impossible to complete without receiving support and help in many ways. First, I owe my gratitude to my degree supervisor Professor Matti Kukkonen. Thank you for your great support and excellent guidance from the start to the end of my doctoral studies. I thank also Professor Petri Mäntysaari for his valuable comments during the writing process, Docent Niklas Arvidsson for his support in the pre-examination and Professor Matti Rudanko both for his support in the pre-examination and being opponent in the public defence. I want to thank the Nordic Tax Research Council and the Hanken Support Foundation for providing funding for my dissertation project, too.

And finally, I want to thank the people that are closest to me: Kaisa, Ella, Elina and Mikko. Without you I could not have made this scientific adventure.

Espoo 8.4.2019

Mika Reunanen

CONTENTS

1 INTRODUCTION 1
1.1 Mezzanine - something between equity and senior debt 1
1.2 Subject and scope of the study 4
1.3 Structure of the thesis 7
2 RESEARCH METHODOLOGY 9
2.1 Mezzanine as research subject 9
2.2 About the applied research methodologies in general 14
2.3 Comparative law 16
2.3.1 Primary research methodology 16
2.3.2 Comparison 18
2.3.3 Analysis of similarities and differences 20
2.3.4 Comparative study 21
2.4 Mezzanine in bank lending in the future 22
3 MEZZANINE FINANCING FRAMEWORK 24
3.1 Capital structure of limited liability company 24
3.1.1 The general theory of capital structure 24
3.1.1.1 The Pecking-Order theory 24
3.1.1.2 The Modigliani-Miller Theorem 25
3.1.1.3 The Trade-Off theory 26
3.1.2 Limited liability 26
3.1.3 Retained earnings 28
3.1.4 Equity financing 29
3.1.5 Debt financing 30
3.1.6 Cost of capital 32
3.1.7 Maintenance and reduction of capital 32
3.2 About the nature of mezzanine financing 34
3.2.1 Closing the gap between equity and debt 34
3.2.2 Definition of terms 36
3.2.3 Repayment priority 37
3.2.4 Subordination of debt 38
3.2.5 Equity kickers 39
3.2.6 The view of rating agencies 40
3.2.7 Versatility of mezzanine 42

3.3 Types of contract 43
3.3.1 General 43
3.3.2 Bilateral contracts 43
3.3.3 Intercreditor agreements 44
3.3.3.1 Club loans 44
3.3.3.2 Syndicated loans 44
3.3.4 LMA and LSTA documentation 45
3.4 The company law framework 45
3.4.1 EU legislation in general 46
3.4.1.1 Regulatory systematics of EU legislation 48
3.4.1.2 EU Company regulation 49
3.4.1.2.1 Capital maintenance 52
3.4.1.2.2 Protection of the members´ and third parties´ interests 54
3.4.1.2.3 Information disclosure 55
3.4.1.2.4 Domestic mergers of public limited liability companies 56
3.4.1.2.5 Cross-border mergers of limited liability companies 58
3.4.1.2.6 Domestic divisions of public limited liability companies 60
3.4.1.2.7 Setting up a single-member company 61
3.4.1.2.8 European Company 62
3.4.1.2.9 European Cooperative Society 64
3.4.1.2.10 European Economic Interest Grouping 66
3.4.1.2.11 Role of Court of Justice of the European Union 67
3.4.2 Finnish legislation 69
3.4.2.1 About the Finnish legal system 69
3.4.2.2 Companies Act 71
3.4.2.2.1 General principles, incorporation and shares 71
3.4.2.2.2 Shares 73
3.4.2.2.3 Administration and financial statements 79
3.4.2.2.4 Capital structure 83
3.4.2.2.5 Distribution of assets 88
3.4.2.2.6 Changes in company structure 92
3.4.2.2.6.1 Merger 92
3.4.2.2.6.2 Cross-border merger 95
3.4.2.2.6.3 Demerger 96
3.4.2.2.6.4 Cross-border demerger 99
3.4.2.2.6.5 Dissolution of the company 101

3.4.3 Legislation in other countries 103
3.4.3.1 Sweden 103
3.4.3.1.1 About the Swedish legal system 103
3.4.3.1.2 Companies Act 104
3.4.3.1.2.1 General principles, incorporation and shares 104
3.4.3.1.2.2 Management of the company 106
3.4.3.1.2.3 Capital structure 107
3.4.3.1.2.4 Certain private placements 112
3.4.3.1.2.5 Value transfers from the company 113
3.4.3.1.2.6 Distribution of profits 114
3.4.3.1.2.7 Acquisition of own shares 115
3.4.3.1.2.8 Reduction of the share capital and the statutory reserve 117
3.4.3.1.2.9 Merger of companies 118
3.4.3.1.2.10 Demerger of a company 120
3.4.3.2 Estonia 123
3.4.3.2.1 About the Estonian legal system 123
3.4.3.2.2 Commercial Code 123
3.4.3.2.2.1 General part 124
3.4.3.2.2.2 Private limited company 124
3.4.3.2.2.3 Public limited company 132
3.4.3.3 USA 136
3.4.3.3.1 About the legal system of the USA 136
3.4.3.3.2 Company legislation in the USA in general 136
3.4.3.3.3 Model Business Corporation Act 138
3.4.3.3.4 “Delaware effect” 143
3.4.3.3.4.1 Formation 144
3.4.3.3.4.2 Powers 145
3.4.3.3.4.3 Stock and dividends 146
3.4.3.3.4.4 Changes in Capital and Capital Stock 148
3.4.3.4 Other countries 149
3.4.3.4.1 UK 149
3.4.3.4.1.1 About the UK legal system 149
3.4.3.4.1.2 Companies Act 2006 150
3.4.3.4.2 Germany 156

3.4.3.4.2.1 About the German legal system and limited liability regulation....156
3.4.3.4.2.2 German Limited Liability Companies Act....157
3.4.3.4.2.3 German Stock Corporation Act....160
3.4.4 Freedom of contract....164
3.4.5 Principle of loyalty....166
3.4.6 Pacta sunt servanda....167
3.5 Accounting rules....169
3.5.1 IFRS and mezzanine....169
3.5.2 Accounting in Finland....170
3.5.3 Accounting in other countries....172
3.5.3.1 Sweden....172
3.5.3.2 Estonia....174
3.5.3.3 USA....175
3.5.3.4 Other countries....176
3.5.3.4.1 UK....176
3.5.3.4.2 Germany....177
3.6 Taxation rules....178
3.6.1 Mezzanine from taxation perspective....178
3.6.1.1 Thin capitalisation....178
3.6.1.2 Deductibility of interests....179
3.6.2 Taxation in Finland....180
3.6.3 Taxation in other countries....182
3.6.3.1 Sweden....182
3.6.3.2 Estonia....183
3.6.3.3 USA....184
3.6.3.4 Other countries....185
3.6.3.4.1 UK....185
3.6.3.4.2 Germany....186
4 DIFFERENT SYSTEMS OF MEZZANINE IN PRACTICAL MARKET....188
4.1 Venture capital companies....188
4.1.1 About venture capital in general....188
4.1.2 Venture capital in Finland....192
4.1.3 Foreign venture capital markets....194
4.1.3.1 Sweden....194
4.1.3.2 Estonia....196

4.1.3.3 USA ... 198
4.1.3.4 Other countries ... 200
4.1.3.4.1 UK ... 200
4.1.3.4.2 Germany ... 201
4.1.4 Venture capital and mezzanine ... 203
4.2 Banks ... 204
4.2.1 About bank financing in general ... 204
4.2.2 Banks in Finland ... 206
4.2.3 Banks in other countries ... 208
4.2.3.1 Sweden ... 208
4.2.3.2 Estonia ... 208
4.2.3.3 USA ... 209
4.2.3.4 Other countries ... 210
4.2.3.4.1 UK ... 210
4.2.3.4.2 Germany ... 211
4.3 Other financiers - some examples ... 211
4.3.1 Finnvera ... 211
4.3.2 Garantia ... 212
4.3.3 ALMI ... 213
4.3.4 KredEx ... 214
4.3.5 British Business Bank ... 214
4.3.6 German Investment Corporation DEG ... 215
4.4 The interests of lender and borrower ... 216
4.4.1 What does the mezzanine financier want? ... 216
4.4.2 The borrower´s point of view ... 217
5 MEZZANINE IN BANK LENDING ... 220
5.1 The market need ... 220
5.2 Financing of healthy customers ... 220
5.3 Handling of distressed customers ... 227
5.4 Impact of Basel III ... 237
5.5 Regulatory compliance aspects ... 239
5.5.1 Regulatory pressure ... 239
5.5.2 MiFID II/MiFIR regime ... 240
5.5.3 SREP ... 240
5.5.4 MAD/MAR ... 241
5.5.5 Volcker rule ... 242

5.5.6 Guidance on leveraged transactions....243
5.5.7 The impact of regulation on lending....244
5.6 Banks and mezzanine....245
5.7 Is there a need for mezzanine from banks?....248
5.8 Definition of target companies....251
6 DIFFERENCES OF MEZZANINE MARKETS BETWEEN FINLAND AND OTHER COUNTRIES....253
6.1 Regulation and size of market....253
6.2 Transaction examples....253
6.3 Case example: how mezzanine can be concretely used?....253
6.3.1 Group structure....253
6.3.2 Description of the financing structure....254
6.3.3 Ownership and management....256
6.3.4 Business....257
6.3.5 Industry and enterprise risk....258
6.3.6 Financials....258
6.3.7 Security....260
6.3.8 Covenants....260
6.3.9 Company specific implementation of the recapitalisation plan....261
6.3.9.1 Parent Finland Oyj....261
6.3.9.2 Subsidiary Sweden AB....262
6.3.9.3 Subsidiary Estonia OÜ....265
6.3.9.4 Subsidiary USA Inc.....267
6.3.9.5 Subsidiary UK Ltd....269
6.3.9.6 Subsidiary Germany GmbH....271
6.3.9.7 Case example conclusions....273
7 CONCLUDING THOUGHTS....276
7.1 General....276
7.2 What is the company law background concerning the use of mezzanine financing?....277
7.3 What are the main differences of company law regulation, accounting and taxation rules and local market sizes and conclusion....280
7.3.1 Differences of company law regulation....280
7.3.2 Differences of accounting....282
7.3.3 Differences of taxation....283
7.3.4 Relevance of freedom of contract, principle of loyalty and pacta sunt servanda....286

7.3.5 Differences of local market sizes 288
7.3.6 Comparative conclusions on debt subordination 288
7.3.7 Comparative conclusions on covenants 290
7.4 How mezzanine could be used in bank lending going forward in order to support functioning capital markets? 291
7.5 Future research objects 295
7.5.1 Mezzanine bank´s organisation and operating model 296
7.5.2 Mezzanine bank´s credit strategy 296
7.5.3 Mezzanine financing terms 297
7.5.4 Banking regulation influencing to mezzanine lending 297
7.5.5 Digitalisation influencing to mezzanine lending 298
7.5.6 Accounting regulation and practices 298
7.5.7 Taxation 299
7.5.8 Company law regulation de lege ferenda 300
KORT SAMMANFATTNING 304
ABSTRACT 305
REFERENCES 306
Literature 306
Legal material 346
Directives - EU 346
Council regulations - EU 348
Regulations of the European Parliament and of the Council - EU 348
Treaties and agreements - EU 348
Case law - EU 348
Other - EU 349
Finland 351
Sweden 352
Estonia 353
USA 354
UK 354
Germany 354
APPENDIX 1 356
Some of the most significant Court of Justice (ECJ) judgments regarding free movement of companies 356
APPENDIX 2 366
Company laws 366

APPENDIX 3 371
Accounting 371
APPENDIX 4 374
Tax rules 374
APPENDIX 5 376
Size of market 376
APPENDIX 6 379
Transaction example - subordinated debt 379
APPENDIX 7 386
Transaction example - senior ranked convertible debt. 386

1 INTRODUCTION

1.1 Mezzanine - something between equity and senior debt

The founding of a company requires always capital. Also, the daily operations of a company need funding. Besides the daily business activities company may also have exceptional funding needs due to acquisitions or other kind of exceptional investments. In fact, every company no matter at what stage of its development phase needs financing in some form to be able to operate. Corporate financing is activity where the funds needed are provided and received. What kind of financing is granted or received has also implications for the company´s capital structure. On the other hand, what the balance sheet structure is like influences also on the availability of the new financing and its pricing.[1]

In case of limited liability companies, the founders need to invest first in equity. After that it is often banks who provide additional financing. However, there are also other financing sources and needs in the market. The capital and financial markets have developed over the years and there are also demand and supply for other financing forms than plain owner´s equity and traditional secured senior loans from the banks. The reason for this is that equity finance and traditional bank finance leave a gap that needs to be bridged. There is space between senior debt with collaterals received from banks and high risk equity input. This room can be filled with financing forms that have a risk and return profile between debt and equity.

Even if there is no more senior debt available but company has still cash flow for additional long-term borrowing the financial leverage could possibly be increased further. The kind of financing suitable for leverage growth in such a situation is often called mezzanine financing referring to the layer between company's senior debt and equity.[2] Structurally mezzanine can be subordinated to senior debt in terms of payment priority and security but has higher priority than equity. Special features of mezzanine financing are flexibility and versatility. These special features are also often reflected in the terms of the relevant financing contract.

The financing alternatives of a company can be divided in different classes based on security and seniority. A simplified division of the alternatives from a limited liability company´s point of view can be presented in a table (see Figure 1 below).

Figure 1: Financing forms and order of repayment

Financing form	Repayment priority
Equity capital	III
Subordinated loan (mezzanine)	II
Senior debt	I

Mezzanine debt has hybrid nature and is positioned between equity and senior debt in the borrower´s balance sheet. Mezzanine can be an alternative funding form in addition to the

[1] Mäntysaari, P. (2016), p. 179. See also Mäntysaari, P. (2010c), pp. 131-139, where the capital structure is discussed from the equity perspective.
[2] Müller-Känel, O. (2009), pp. 13-14. Mezzanine type financing is sometimes called also hybrid financing. About the definition of hybrid financing see also Knuutinen, R. (2009), pp. 394-396.

traditional main layers. In the table above (Figure 1) the subordinated loan is classified as mezzanine financing. All mezzanine financing is however not subordinated financing.

Financial transactions today may involve many kinds of instruments and mezzanine is one of the interesting forms of financing available in the market today. Mezzanine instruments rank between debt and equity and have features of both financing forms. Because of that all financial instruments having characteristics of debt and equity can be described as mezzanine instruments. This form of hybrid funding is positioned between equity and senior debt also in a company´s capital structure. Mezzanine loan combines the features of equity and debt which correspondingly results in a risk/return -profile that is between equity and debt. This kind of financing transaction can be completed in many ways but in its simplest form it normally involves a subordinated debt. On the other hand, it is also possible to attach in the mezzanine transaction so-called *"equity kickers"* like equity warrants.[3] Although having diverse features mezzanine loans do not substitute the senior bank loans or equity but rather complement them.

The flexible nature of mezzanine makes it suitable financing form for many kinds of situations. The mezzanine capital can be used to finance acquisition, new production facilities, expansion of plants, additional distribution channels etc. Among the specific features of this instrument is also that shareholders´ control does not need to dilute, company´s balance sheet strengthens (subject to subordinated loan) while increased senior borrowing is possible on more attractive terms.

Mezzanine financing has its advantages and disadvantages. It may make financing possible without security and - especially in a form of subordinated loan - it also would give additional buffer for losses from senior financier´s perspective. On the other hand, if mezzanine funding is provided by a venture capital financier the limitations over target company´s business decisions and detailed reporting requirements may not suit for all entrepreneurs.[4] While mezzanine loan has the features of equity and debt, the cost of this kind of loan type is also between the costs of equity and debt.

Venture capital financiers provide capital to companies that are not listed on a stock market. Their investments are made in several different financing forms: equity, mezzanine or senior debt financing instruments. The operating model of venture capital includes ownership and board representation in financed companies, shareholders agreement with the entrepreneurs and organisational setup supporting close monitoring of the investments venture capital funds. Due to this, entrepreneurs sometimes prioritise venture capital over traditional banks or plain equity providers.[5] Because of the operating model venture capital financiers are also sometimes able to provide funding even when banks and equity financiers are not willing to do that.[6]

There are several different ways to use debt and equity in company finance. What are the different alternative ways in detail differ from country to country due to different regulation. Legal norms in company law do differ and additionally taxation and accounting rules are also country specific. Especially in case of internationally operating company groups the differences of national regulations are relevant to identify. The regulation influences the capital structures of the companies. What are the applicable company laws, taxation regulation and accounting rules is relevant to know. When focusing on the status of mezzanine

[3] Nijs, L. (2014), pp. 25-26 and Weitnauer, W. et al. (2016), p. 156.
[4] About the contracts between the venture capital financier and entrepreneur see Kaplan, S. N. and Strömberg, P. (2003), Agmon, T. and Sjögren, S. (2016), pp. 72-73, Ramsinghani, M. (2014), pp. 255-293 and Weitnauer, W. et al. (2016), pp. 359-389.
[5] About the choice between venture capital and bank financing see Cumming, D. ed. (2010), pp. 31-50 and Winton, A. and Yerramilli, V. (2008).
[6] Lerner, J. and Tåg, J. (2013), p. 155.

financing then the information needs must be very specific. In such a situation to know all the applicable company, taxation and accounting regulation concerning the mezzanine financing is relevant.

Taking into consideration the above-mentioned, important questions to be answered in case of planning a mezzanine transaction are among other things the following:

(i) What is the applicable company law in country X?

(ii) What kind of taxation regulation is valid in country Y?

(iii) What are the relevant accounting rules in country Z?

Major banks provide also wide selection of financing services. The role of bank loans is significant in company finance. In Finland banking financing remains the most important external financing source for corporates covering around 2/3 of the total external financing needs.[7] Corporate loans granted by banks are in practice secured senior loans and unsecured senior loans. Also, other forms of bank financing than traditional senior loans can be in exceptional cases found in the market. Such non-traditional banking instruments like subordinated loans are however rare and the volumes they represent are low.

Banks operate under the rules of the Basel Committee on Banking Supervision (BCBS). These so-called Basel rules including supervisory standards, guidelines and recommendation statements of best practices and BCBS decisions are followed by banks. Banks are required to hold a minimum capital amount to guard against potential losses by the banking regulators. The Basel regulation encourages the usage of internal frameworks for risk measurement to determine the required capital at risk. Special credit rating and collateral coverage models are designed based on these risk measures. The availability of credit rating and collateral coverage models are used in day-to-day approval and pricing decisions. This helps among other things to differentiate the pricing between good and poor companies. The most recent Basel rules under the implementation presently are known as Basel III.[8]

Banks involved in corporate financing are frequently in the position where financing is granted without fully secured loans. Traditionally the bank´s return on money lent on traditional debt financing instrument has however been close to that of a secured bank loan. The risk-based loan price concept which considers different elements of risks like default risk, credit concentration risk, collateral risk and recovery risk is not always easy to apply in tight market conditions. It is obvious that pricing not properly taking into consideration customer specific lending risks is unsatisfactory. When banks lend money without fully secured loans, the pricing should be higher than in case of fully secured loans. It is important for the bank to be able to match the return with the actual risk involved.

If the company does not want or need the management support provided by venture capitalists, loan from the bank could be more attractive financing alternative. To be more competitive banks should have also such lending products that are comparable to the financing offerings of venture capitalists. In case of company having shortage of equity bank should then have also subordinated loans in its product portfolio. In case of no shortage of equity subordinated loan is not necessarily needed. But even then, special profit-linked

[7] Suomen Pankki (2015), figure 6, p. 10.

[8] About the Basel III see Ramirez, J. (2017). In the public is also sometimes referred to Basel IV regulation when the latest amendment plans of Basel III are discussed. However, Basel Committee on Banking Supervision (BCBS) itself sees the latest amendment plans as the last stage of Basel III. See also below section *5.4 Impact of Basel III*.

interest payment clauses could provide additional options for corporate lending. To have mezzanine products in banks´ product portfolio is however not the market standard today.

Taking into consideration what is mentioned above about bank lending and mezzanine additional important questions to be answered are among other things the following:

(iv) Could mezzanine be lending instrument for banks?

(v) In what kind of situations would it make sense for banks to lend mezzanine?

(vi) What kind of lending terms should banks use?

The above-mentioned questions (i) - (vi) are connected to the company law and the market where companies operate and questions can be answered in the context of commercial law. Here commercial law refers to branch of private law that concerns principles and rules of the commercial transactions.[9] This branch of law has in its scope the rights and duties of those parties that enter into agreements on goods and services. Mezzanine financing transactions belong into this category of commercial transactions. Referring to the both legal and commercial nature of the topic, commercial law is the apparent scientific discipline to be applied in this doctoral research.

There is some scientific literature around mezzanine financing but it is not very wide.[10] Additionally literature focusing solely on international mezzanine regulation in company law, taxation and accounting is not identified. One explanation for this could be the complicated nature of this type of financing and the possibility to tailor-made financing packages leading to major variety of transactions.[11] This research targets partially to fill in the areas not earlier covered by scientific studies.

1.2 Subject and scope of the study

The purpose of this research is to give understanding what is the company law background concerning the use of mezzanine financing, how mezzanine instruments are handled from accounting and taxation perspective and how they are used in the market today. On top of that is reviewed the size of mezzanine market in relevant countries. The main focus is in Finland and comparison is done to Sweden, Estonia, USA, UK and Germany. For the background also, some EU regulation and court practice in company is reviewed to the extent it has been considered relevant for the research.

The differences of legal frameworks and markets in relation to the discussed financing form are analysed. The research objective is to identify some of the main differences of company law regulation, accounting and taxation rules and local market conditions related to the topic in question. This has been done by studying how mezzanine instruments are handled from company law, accounting and taxation perspective. On top of that has been studied what the

[9] About commercial law see Mäntysaari, P. (2017), pp. 184-196 and Clarke, M.A. et al. (2017), pp. 3-4.
[10] In Finland mezzanine financing has been discussed in Lautjärvi, K. (2015), Lautjärvi, K. (2011) and Villa, S. (1997). In foreign literature mezzanine financing has been discussed among other things in Weitnauer, W. et al. (2016), Baker, H.K. et al. eds (2015), Nijs, L. (2014), Bärsch, S.-E. (2012), Brokamp, J. et al. (2011) and Müller-Känel, O. (2009).
[11] According to Helminen, M. (2010), p. 170 in most countries case by case -approach is applied in taxation when equity and debt features of hybrid financing instruments are assessed.

mezzanine market is like today. Additionally, it is reviewed how mezzanine could be used in credit granting by banks going forward.

The definition of the research questions depends on the chosen scientific discipline - here commercial law - and the knowledge interest of the chosen discipline. Taking that into consideration the research questions can be summarised in a following way:

- What is the company law background concerning the use of mezzanine financing?
- What are the main differences of company law regulation, accounting and taxation rules and local market sizes and conclusions?
- How mezzanine could be used in bank lending going forward in order to support functioning capital markets?

Finland has been chosen to be the country of primary focus as it is my home country. Sweden and Estonia have been taken in the scope as comparison countries as they are neighbours of Finland and thus interesting reference countries. USA, UK and Germany are major economic powers and have important financial centres also from global perspective which supports inclusion of them in the comparison group of the research. To take additionally EU company regulation including some relevant EU court practice in the scope is important as all the countries under observation excluding USA are members of the EU and are thus also influenced by the regulation of that community.[12] To observe the above-mentioned jurisdictions serves also the overall purpose to identify how mezzanine instruments could be used in bank lending in the future.

In the review of legal background, the focus has been primarily on company law. Reference to other legislation is made only when there is need to deepen the understanding of the specific company law regulation in question. The analysis of applicable accounting rules has concentrated on the local GAAP and IFRS regulation. In the review of taxation rules is focused only on thin capitalisation rules and deductibility of interest from the borrower´s view. The taxation in respect to interest or other income, change of asset valuations and taxation of owners are excluded from the scope. When reviewing the local market conditions, the attention has been given to the market size in terms of amount of venture capital actors, volumes of venture capital investments, number of banks and volumes of bank loans. The terms and conditions of single transactions have not been studied. There are however a few general level comments presented on the terms used in mezzanine transactions. Additionally, some more detailed observations on terms are given in connection with the presented case examples.

Additionally, the research is based on academic and professional literature in company law and finance. Also, some statistical information is used as reference.

Out of the referred scientific literature Kari Lautjärvi´s doctoral dissertation "*Välipääomarahoitusinstrumentit" (in English: "Mezzanine Finance instruments") from*

[12] It shall be noted that a referendum was held on June 23, 2016 in UK to decide whether the country UK should leave or remain in the EU. The leave side supporting the so-called *"Brexit"* won and the UK government triggered the process of leaving the EU in 2019. The ongoing negotiations between the UK and EU shall not immediately influence on the application of the EU regulation in the UK. The UK government is however planning to convert the existing EU law into domestic law allowing authorities to decide which parts of the EU law to keep after the country leaves the EU. See for more details Department for Exiting the European Union (2017) in which among other things (p. 5) Prime Minister Theresa May writes that *"…The same rules and laws will apply on the day after exit as on the day before. It will then be for democratically elected representatives in the UK to decide on any changes to that law, after full scrutiny and proper debate."*

year 2015"[13] is used as one of the central reference books in my research. Other books that are used as central references in my dissertation are Wolfgang Weitnauer´s "*Handbuch Venture Capital - von der Innovation zum Börsengang*" from year 2016[14] and Luc Nijs´s "*Mezzanine financing: tools, applications and total performance*" from year 2014[15].

Lautjärvi provides in his relatively fresh dissertation views on some of the topics that are covered also in my study and I have specifically compared Lautjärvi´s and my opinions in some key areas. Lautjärvi´s dissertation analyses different mezzanine structures and the relevant legislation in Finland. Lautjärvi concentrates on mezzanine instruments used by Finnish limited liability companies,[16] which is part of my dissertation scope, too. Major difference is however that in my research specific mezzanine regulation comparison is done additionally to Sweden, Estonia, USA, UK and Germany. This comparative element is the core of my work. Besides, major difference is how possibilities and challenges of mezzanine financing are reviewed in my dissertation with the help of case examples. Furthermore, in my research is discussed also how mezzanine could be used in bank lending going forward to support functioning capital markets. Especially when answering to the third research question the perpective of the lenders and borrowers are emphasized. This user perspective combined with the both legal and economic viewpoint makes this doctoral dissertation as well different from Lautjärvi´s work.

Weitnauer´s book provides practical view of the venture capital financing including how a start-up company is established starting from the business idea, continuing to participation agreement with the investor and ending in the exit of the investor. Weitnauer also presents the business model of venture capital financier including the financing concepts and different financing forms. The discussed financing alternatives include mezzanine finance. In these book sections are in scope not only the specifics of different mezzanine financing forms but also accounting and taxation treatment.[17] Weitnauer´s focus is fully in Germany and his approach is very pragmatic i.e. *"handbook like"*.[18] The book contains also checklists and model agreements for different situations in the venture capital financing process. Compared to my research, similar is the focus on different mezzanine financing forms including review of some accounting and taxation aspects and target to provide benefit also to those readers who are involved in the actual structuring of the transactions. Major difference is that Weitnauer´s book concentrates on venture capital financing only and discusses its topic in practice solely from the German perspective. I however focus on mezzanine financing in general and several different countries Germany being one of them. Due to different scope the Weitnauer´s book does not include the international regulatory comparison that is core of my research. Additionally, major difference is that Weitnauer´s book does not include case examples to illustrate the practical views but checklists and model texts of documents instead. Also, my research includes discussion on how mezzanine could be used in bank lending going forward to support functioning capital markets. This aspect is not in Weitnauer´s scope.

---

[13] Lautjärvi, K. (2015). The dissertation is written in Finnish and the referred title in English is used in the abstract of the book.
[14] Weitnauer, W. et al. (2016).
[15] Nijs, L. (2014).
[16] Lautjärvi, K. (2015), p. 349. In the Abstract of the dissertation he writes that *"This doctoral dissertation provides a comprehensive discussion on various equity and debt financing instruments that Finnish limited liability companies (limited by shares) generally use. The main focus of the dissertation is examining mezzanine debt instruments incorporating such things as control covenants, capital and debenture loans, perpetual hybrid loans, profit sharing loans as well as convertible and option loans. In general, mezzanine finance instruments are used as corporate finance products in Finland and are a form of hybrid capital."*
[17] Weitnauer, W. et al. (2016), pp. 143-194.
[18] Weitnauer, W. et al (2016), pp. 21-26 includes also a short background text section *"Das Vorbild USA"* in which the history, general conditions and development of venture capital business in the USA is reviewed. The venture capital markets of USA otherwise or other foreign countries are however not among the topics of the book.

Nijs´s book concentrates solely on mezzanine finance products including descriptions of structuring and pricing. Nijs covers in his text also specific industry related topics around mezzanine like Basel rules influencing financial industry, infrastructural project finance and real estate financing. Risk analysis and risk mitigation techniques are also discussed. Nijs´s book contains also case examples, term sheets and model contracts and has practical approach.[19] Like in my research the focus is on several mezzanine financing forms, having international scope and use of case examples to illustrate the discussed topics. A major difference is that Nijs´s book does not focus on regulatory comparison between the countries as I do in my dissertation work. Besides, my dissertation includes discussion on how banks could use mezzanine in the future bank lending to support functionality of capital markets. This topic is not covered by Nijs either.

The validity of the regulation in focus in my dissertation has been taken into attention until June 30, 2018.

1.3 Structure of the thesis

This doctoral thesis consists of 7 chapters.

Chapter 1 - *Introduction* - presents the topic of the dissertation. In the opening part the position of mezzanine financing in the capital structure of the company is briefly presented. After that is reviewed subject, scope and structure of the study.

In Chapter 2 - *Research methodology* - is discussed how mezzanine is approached in this study as research subject and what are the applied research methodologies. After that is specifically focused on comparative law as the central research methodology. On top of that is separately discussed research methodology that provides answer to research question "*How mezzanine could be used in bank lending going forward in order to support functioning capital markets?*".

In Chapter 3 - *Mezzanine financing framework* - is at first discussed the key elements of the capital structure of the limited liability company. After that the nature of mezzanine finance is analysed taking into consideration the elements influencing the capital structure and types of mezzanine contracts are presented. The regulatory framework covering the topic is also discussed. Besides addressing the regulation of the countries under observation also reference to the relevant EU company regulation and EU court practice is made. In the latter part of the chapter the relevant accounting and taxation rules are also discussed.

In Chapter 4 - *Different systems of mezzanine in practical market* - is discussed how mezzanine financing is concretely used by venture capitalist financiers, banks and other financiers today. Also, the interests of mezzanine lenders and borrowers are debated to open the different views of the different stakeholders.

In Chapter 5 - *Mezzanine in bank lending* - is discussed the changing market needs, how mezzanine finance could be used more by banks as lenders going forward and how the regulatory environment influences the usage of mezzanine in bank lending. Additionally, potential target companies of mezzanine lending by banks is defined.

In Chapter 6 - *Differences of mezzanine markets between Finland and other countries* - the country specific differences in mezzanine financing between Finland, Sweden, Estonia, USA,

[19] In the preface text of Nijs, L. (2014), p. xiiv is stated that the content *"…can be described as a mix of academic analysis and practical applications for selecting and structuring deals"*.

UK and Germany are reviewed. This has been done in three parts. Firstly, it is referred to separate appendices (Appendices 2-5), which provide comparative information on the countries´ regulatory environment including company laws, accounting and taxation rules and on the size of the country specific markets. The market size has been assessed taking into consideration the amount of venture capital actors, volumes of venture capital investments, number of banks and volumes of bank loans. Secondly, it is referred to separate appendices (Appendices 6-7), in which it has been presented examples of transactions where subordinated debt and senior ranked convertible debt has been used as financing forms. Purpose of this part is to illustrate the different accounting and taxation treatment of mezzanine instruments in different countries. Thirdly, an imaginary corporate financing transaction case has been presented to illustrate the real-life elements that have been discussed in the research. The example case demonstrates among other things the challenges of financing arrangements of a corporate group operating in several countries.

In Chapter 7 - *Concluding thoughts* - are presented the conclusions of the research based on the content of the chapters 2-6. The conclusions cover mezzanine related regulation and main differences of discussed central subtopics. In summary is thus focused on the differences in the chosen areas according to the methodology of comparative law. This means review of variances in

- company law
- accounting
- taxation and
- market sizes

between the countries in scope. Additionally, it is commented mezzanine in bank lending going forward. At the end of the Chapter 7 are included also recommendations for the future research. In the recommendations are included some thoughts on the company law regulation de lege ferenda, too.

2 RESEARCH METHODOLOGY

2.1 Mezzanine as research subject

Every company needs financing to operate.[20] Availability of finance is the core issue for every entrepreneur starting the business. The financing needs can be taken care of in several different ways but normally the funding needs are taken care of by equity capital input and senior debt.

In practice some equity is needed first before debt financing is possible. The equity input can be provided by the owner directly and - after business operations have been started - by generating funds from business activities through the retaining of profits.[21] Additionally company can raise internal funds through divestments, too.[22] Equity funding is the riskiest form of financing as equity capital ranks behind all other financing forms. This means that owner of the equity capital is entitled to repayment only after all other payment obligations of the company are covered. According to that among other things taxes, accounts payable, senior loans and wages of the employees have to be covered first before owner of the equity capital gets distribution or return of equity input. The rate of return required by equity investors is therefore higher than the rate of return of other creditors.

Very often bank loans are used as primary debt funding instruments. In case of bank loan, the borrower agrees to return the principal and the interest payments to the bank according to repayment schedule jointly decided by the parties. The company assets serve often as collateral for the repayment of the given bank loan. If borrower is not able to meet its repayment obligation it can ultimately lead to a liquidation process. Unlike the equity holders bank lenders do not take part in the operative management of the borrower. As senior lenders banks do not have ownership in the borrower and they are thus not either entitled to participate in the management work. Due to high repayment ranking of their lending and the collateral backing the repayment, banks risk position is often at least satisfactory. Because of that the bank lending is cheaper compared to other financing forms.

Companies that have already history of profitable business, operate in business areas familiar to them, have sufficient asset base, low leverage and stable cash-flow forecasts are well equipped to apply bank financing. For a traditionally operating corporate bank to finance this kind of customers is fairly easy. As lender´s focus in the financial analysis of a potential borrower is primarily on the cash flow available to service and repay the debt, the high visibility of future cash flow lowers the lending hurdle. Borrower´s ability to remain profitable is one of the core focus areas in the analysis. If bank financier is able to trust that the risk stays on satisfactory level according to bank´s criteria, senior loans are adequate funding instruments. For a borrower it is also important what is the cost of the funding. Bank financing in its traditional forms is normally cheap form of financing and that also explains banks´ popularity as funding providers in general.[23]

All companies are however not operating in a stable market with low risk outlook. Some businesses may also have specific features that are challenging for a traditional bank financier to manage. For example, corporates with new business models, looking for expansion or preparing themselves for ownership change may face financing gaps that simply cannot be

[20] Lautjärvi, K. (2015), p. 83.
[21] Villa, S. (1997), p. 19.
[22] Nijs, L. (2014), p. 5.
[23] OECD (2013), p. 22.

fully filled by classic corporate banking methods.[24] This has created demand for new kind of financing products.

Sometimes when access to equity and traditional debt funding becomes a challenge, companies may also find themselves in tough market conditions otherwise. To finance major investments in such market conditions may also be difficult only with the traditional equity and senior debt instruments. Some alternative financing forms are then needed, too.

Due to innovations in financial engineering such instruments have been created that combine the elements of equity and debt financing. These mezzanine instruments have also a risk and return -profile that falls between equity and debt. Due to often having tailormade structures for individual transactions mezzanine financing is versatile and flexible by its nature.

As mezzanine financing combines elements of both equity and debt funding and takes into consideration the specifics of individual transactions under this financing form can fall several types of financing instruments like convertible loans, profit-sharing loans and subordinated loans. Additionally, an individual mezzanine transaction can combine all the above-mentioned three elements.

What makes mezzanine financing interesting research object can be motivated in several ways. For this doctoral dissertation one of the main drivers for choosing mezzanine finance as topic is the versatility of this financing form. There is possibility to use this financing form in many different ways in many different situations. The various structures of mezzanine can include combinations of different instruments including subordinated debt, convertible debt and option loans. The flexibility of structuring allows contracting of terms suitable for several different kinds of situations. Within freedom of contract mezzanine can be used among other things to achieve tax benefits, improve liquidity and allow capital expenditure. Interest payment can be based on contracted cash pay to take place on regular basis or as payment-in-kind (PIK).[25] Additionally by including in the financing package equity kickers - for example warrants allowing purchase of equity in a borrower company at a fixed price at a specific moment or conversion right allowing the conversion of a debt or bond receivable to equity - performance linked elements can be included in the financing transaction.[26] These features alone make mezzanine a fruitful object for an academic study.

Many banks have been significantly impacted under Basel III and have been forced to cut their balance sheets due to new regulation.[27] Under the existing regulation banks have been forced to reconsider and adjust their lending operations and avoid riskier financing transactions. However, cash flow positive companies with good growth prospects are priority targets for all the corporate lenders in the market. In certain situations, mezzanine could have a role in increasing borrower´s leverage in a way that not necessarily increases the lender´s risk too much but will generate higher return than traditional loan instruments. This will be discussed later in the text.[28]

When having mezzanine as research subject it is important to open some basics around the capital structure of the limited liability company. Lautjärvi has done that in his dissertation by providing an outline of the funding structure of a limited liability company in Finland and

[24] OECD (2013), p. 19.

[25] In the PIK alternative the interest is not paid out during the loan period but instead is accrued to the principal which is the repaid at the end of the loan period. One advantage of the PIK is that borrower is able to postpone the interest payment and thus reduces the cash flow burden during the loan period. See Nijs, L. (2014), pp. 29-33.

[26] For more detailed review of equity kickers see below section *3.2.5 Equity kickers*.

[27] See more about Basel regulation below in section *5.4 Impact of Basel III*.

[28] See below sections *5.2 Financing of healthy customers* and *5.3 Handling of distressed customers*. These text sections include also case examples illustrating among other things the discussed risk/return aspect.

reviewing the features of both equity and debt.[29] This includes discussion on how equity capital is established, maintained and distributed. Additionally, the rules of creditor protection are discussed.

In my research the nature of mezzanine is explained by reviewing the capital structure of limited liability company. How a company uses mixture of debt and equity to finance its assets is covered by explaining limited liability, retained earnings, equity financing, debt financing, cost of capital and maintenance of capital.[30] The nature of the mezzanine has been further elaborated by discussing some key terminology, repayment priority, subordination of debt, equity kickers and views of rating agencies.[31]

Part of the understanding of mezzanine totality is also understanding the types of contracts used in these kind of financing transactions. Bilateral contracts, intercreditor agreements, Club loans, Syndicated loans, Loan Market Association (LMA) and Loan Syndications and Trading Association (LSTA) documentation have therefore also been explained.[32]

When purpose of the research is to give understanding, what are the relevant domestic and foreign company laws in relation to mezzanine, the relevant regulatory framework has to be also reviewed. This is done by presenting at first the related EU Company regulation including rules of

- capital maintenance
- protection of members´ and third parties´ interests
- information to be disclosed by European Union company
- domestic mergers
- cross-border mergers
- domestic divisions
- setting up a single-member company
- European Company
- European Cooperative Society
- European Economic Interest Grouping.[33]

Additionally, the role of Court of Justice of the European Union in relation to the topic has been discussed.[34]

[29] Lautjärvi, K. (2015), pp. 83-174.
[30] See below section *3.1 Capital structure of limited liability company*.
[31] See below section *3.2 About the nature of mezzanine financing.*
[32] See below section *3.3 Types of contract.*
[33] See below section *3.4.1 EU legislation in general.*
[34] See below section *3.4.1.2.11 Role of Court of Justice of the European Union.*

The review of relevant domestic and foreign company laws has been continued by introducing the Finnish[35], Swedish[36], Estonian[37], USA[38], UK[39] and German[40] company laws and focusing on those parts of the regulation that is deemed to be most relevant for the topic. This has meant among other things coverage of rules on shares, administration and financial statements, capital structure, distribution of assets, mergers, demergers and company´s dissolution, distribution and capital maintenance. In the event of the USA the corporate law is in practice state law as the statute of the state governs the existence of the corporation and its internal affairs. Therefore, focus has been on those US state regulations that are the most significant: Model Business Corporation Act[41] and Delaware General Corporation Law[42].

The freedom of contract and principle of loyalty are important elements in the contractual relationships. Lautjärvi has emphasized in his dissertation that traditionally freedom of contract has made it possible to tailor the debt instruments according to the needs of a company in question.[43] This has led to significant contractual freedom to agree on mezzanine terms and it is also used in practice.[44] According to Lautjärvi principle of loyalty has relevance in contractual relations not only between creditors and a debtors but also between several creditors.[45] In my dissertation also the relevance of contractual freedom and principle of loyalty is identified and it is discussed separately.[46]

As part of his dissertation Lautjärvi discusses mezzanine from the view point of company, accounting and tax legislation.[47] The same topics are included also in my research but the coverage is more comprehensive due to the international focus having not only Finland but also Sweden, Estonia, USA, UK and Germany in scope. In my accounting analysis the applicable accounting rules of each observed country have been reviewed including their applicability to mezzanine transaction.[48] Relevance of IFRS in relation to local accounting regulation has been included in the discussion. In my taxation regulation is reviewed the applicable rules on thin capitalisation and deductibility of interest from the borrower´s view.[49]

Presentation of how and when mezzanine financing is presently used is important part of the total research. This is done by discussing on different actors in the mezzanine market: venture capital companies, banks and some special financing companies.[50] Venture capital part of the market analysis is started by explaining what is meant by venture capital in general, how venture capital financiers operate and what is venture capital market like in Finland and in other observed countries. The market analysis has focused on the participants on the market and the investment volumes with the purpose to give a picture of the sizes of the venture capital markets between the countries in question. Banking part of the market analysis has been started by explaining what is the basic idea behind the banking business. After that the role of bank financing in corporate financing is discussed and major banks of each observed country have been introduced. Presentation of some special financiers - that are not venture capitalists

---

[35] See below section *3.4.2 Finnish legislation*.
[36] See below section *3.4.3.1 Sweden*.
[37] See below section *3.4.3.2 Estonia.*
[38] See below section *3.4.3.3 USA.*
[39] See below section *3.4.3.4.1 UK.*
[40] See below section *3.4.3.4.2 Germany.*
[41] See below section *3.4.3.3.3 Model Business Corporation Act.*
[42] See below section *3.4.3.3.4 "Delaware effect".*
[43] Lautjärvi, K. (2015), pp. 162-163.
[44] Nijs, L. (2015), p. 47.
[45] Lautjärvi, K. (2015), pp. 170-171.
[46] See below sections *3.4.4 Freedom of contract and 3.4.5 Principle of loyalty*.
[47] Lautjärvi, K. (2015), pp. 177-184.
[48] See below section *3.5 Accounting rules.*
[49] See below section *3.6 Taxation rules*.
[50] See below section *4 Different systems of mezzanine in practical market.*

nor banks - but involved in mezzanine financing have also been done. The analysis of how mezzanine is presently used is completed by discussing what are the expectations of mezzanine financier and borrower around a mezzanine transaction.[51]

An important part of the research is discussion on mezzanine as bank lending product in the future.[52] This includes analysis of the market demand and how healthy and distressed corporate customers could be financed going forward. Additionally, it is discussed what is the impact of the Basel regulation and what is the regulatory pressure coming from some of the new regulations that banks are obliged to take into consideration in their daily business activities. On top of that it is concluded what is banks role in mezzanine business: is there a need for mezzanine as bank product and - if so - for what kind of corporate customers?[53]

Another important part of the research is review of differences of mezzanine markets between Finland and other countries. When analysing the differences, the focus has been on

- company law regulation
- accounting rules and
- taxation rules and
- size of market.[54]

The differences of different markets have also been illustrated by country specific mezzanine transaction examples. The transactions discussed regard subordinated debt and senior ranked convertible debt.[55] These instrument types represent features that are fairly common in the world of mezzanine: subordination and warrant. The usage of mezzanine financing has furthermore been illustrated with the help of an imaginary corporate case.[56] In that example case elements of real-life mezzanine transactions have been combined in one imaginary corporate group restructuring. The example case demonstrates challenges of structuring finance package for a corporate group having business operations in several countries.

The last part of the doctoral thesis is the core of the research. This last part contains the concluding thoughts on the items discussed earlier in the text and discussion on future research objects.[57] Here it has been summarized

- what is the company law background concerning the use of mezzanine financing
- what are the main differences of company law regulation
- what are the main differences of accounting rules
- what are the main differences of taxation rules
- what are the main differences of local market sizes

---

[51] See below section *4.4 The interests of lender and borrower.*
[52] See below section *5 Mezzanine in bank lending.*
[53] See below sections *5.6 Banks and mezzanine, 5.7 Is there a need for mezzanine from banks? and 5.8 Definition of target companies.*
[54] See below section *6 Differences of mezzanine markets between Finland and other countries.*
[55] See below section *6.2 Transaction examples* and Appendices 6 and 7.
[56] See below section *6.3 Case example: how mezzanine can be concretely used?*
[57] See below section *7 Concluding thoughts.*

- what is the relevance of freedom of contract and
- how mezzanine could be used in bank lending going forward to support functioning capital markets?

Additionally, recommendations on future research objects have been addressed concerning

- mezzanine bank´s organisation and operating model
- mezzanine bank´s credit strategy
- mezzanine financing terms
- banking regulation influencing to mezzanine lending
- digitalisation influencing to mezzanine lending
- accounting regulation and practices
- taxation
- company law regulation de lege ferenda.

As has been mentioned above this research falls under the subject of commercial law.[58] Sometimes academic researches having strong linkage to jurisprudence include thoughts on how to improve the legislation. In his dissertation Lautjärvi has proposed regulative improvements de lege ferenda for the Finnish company law.[59] In my doctoral research I have also included recommendations on company law regulation de lege ferenda.[60] Here the scope is however much wider as recommendations are based on the analysis of not only Finland but also Sweden, Estonia, USA, UK and Germany and also European Union. Thus, recommendations are applicable to all the observed countries and in principle to any jurisdiction.

2.2 About the applied research methodologies in general

This research is by its nature both legal and commercial and belongs thus under the category of commercial law. Main research methodology is comparative law but also other methodologies have been applied.

Comparative legal analysis is important part of the research methodology as regulatory frameworks and market features of several countries has been examined and compared. The comparative law approach means studying relationships between legal systems or norms of more than one country and reviewing the differences and similarities. Here comparative method is used for comparing company laws in the field of mezzanine financing. After the research questions have been formulated and the jurisdictions to be reviewed chosen the relevant regulations have been described. After comparing the regulations focus has been put into the differences and similarities. The differences have been specifically opened in the research. Finally, the findings have been presented including recommendations on future

[58] See above section *1.1 Mezzanine - something between equity and senior debt.*
[59] Lautjärvi, K. (2015), pp. 331-347.
[60] See below section *7.5.8 Company law regulation de lege ferenda.*

research areas and even some thoughts on *"should be"* regulation. How the comparative law is concretely used as research methodology here is discussed more in the next text section.[61]

Besides applying comparative law as the primary research methodology also principles of legal dogmatics[62] have been utilised. Additionally, theory of law and economics[63] and empirical[64] approaches have been taken into consideration. Further elements of user-friendly legal science discipline[65] are applied.

The core of legal dogmatics consists of the interpretation and systematization of valid law.[66] The subject that is investigated in this thesis is mezzanine finance and the relevant company, accounting and taxation regulation around it. The principles of law and legal system have also been taken into consideration. This means among other things that legal texts are not only reviewed but also interpreted.

Legal dogmatics approach has been applied here in analysis, interpretation and systematization of the regulatory framework covering the area of mezzanine finance of individual jurisdictions. This research method is used to identify the relevant company law, accounting and taxation norms in Finland, Sweden, Estonia, USA, UK and Germany and clarify their content. The identified norms discussed are analysed and interpreted highlighting the elements relevant to the topic. Here I have applied in this respect perspective more typical to a scholar than a judge: choosing subjects under discussion freely, using examples of actual and hypothetical cases, focusing on problematic details and providing at the end de lege ferenda recommendations.[67] It shall be noted here separately that reviewing how various jurisdictions have resolved a similar question is however beyond legal dogmatics and falls under comparative law.

The theory of law and economics has also relevance in this research as economic and financial implications of the topic have also been in the research focus. It is generally known that the economic system and economic trends of a country influence to several areas of the society. Also, legal system is impacted. In law and economics the point of view is the economic efficiency of law.[68] Economic research and empirical data are used to support the conclusions made on markets. The mezzanine market in different countries has been analysed and conclusions are made by taking into consideration the amount of venture capital actors, volumes of venture capital investments, number of banks and volumes of bank loans. The research includes also discussion on how mezzanine could be used as bank lending product in the future in order to support functioning capital markets. Among other things the role of mezzanine in allowing banks to price the lending risks more accurately is discussed combining both elements of law and economics.

The empirical evidence means knowledge that is gained through observations and experience. Here empirical approach is applied when some statistical information is used in analysis and conclusions related to the sizes of the mezzanine market in observed countries are done.

The perspective of the research is the perspective of those parties that are the main operators of the financial transactions: financiers (banks, venture capital funds, capital markets etc.) and

[61] See below section *2.3 Comparative law.*
[62] Aarnio, A. (1978), p. 52 and Siltala, R. (2001), p. 13.
[63] About the concept of law and economics see Cooter, R. and Ulen, T. (2016).
[64] About the empirical method see Romano, V.C. (2015).
[65] Mäntysaari, P. (2017).
[66] Peczenik, A. (2005), p. 1 and Mäntysaari, P. (2017), p. 15.
[67] Peczenik, A. (2005), p. 2.
[68] Mäntysaari, P. (2017), p. 15.

borrowers (corporations).[69] This gives also possibility to interpret this research to belong under the user-friendly legal science discipline.[70] In this discipline of user-friendly commercial law corporations use legal tools to reach their targets.[71] As each company has a management which de facto uses the powers of the company the user-friendly commercial law is also called management-based commercial law (MBCL).[72] The key points of MBCL are that there are companies that operate in market economy under the legal system and they have ultimate goal to survive in the competition with their rivals. The approach of the research is additionally practical and targets to provide answers to some real-life challenges which as well suits for the user-friendly legal science discipline.[73]

When applying the main aspects of MBCL in this research some conclusions can be made based on the perspective of financiers or borrowers used.

Firstly, when using the perspective of the financier the focus is on how the financier sees the mezzanine regulation. Here the research objective is to conclude what are some of the main differences of company law regulation, accounting and taxation rules and local market conditions as perceived by the provider of the financing. This is specifically visible in the text section where is reviewed how mezzanine could be used in bank lending going forward[74] as the perspective used is primarily the perspective of a bank lender.

Secondly when using the perspective of the borrower the attention is on how the receiver of the financial input perceives the mezzanine regulation. The key differences of company law regulation, accounting and taxation rules and local market conditions related to the topic in question - as the receiver of the funding sees it - have also been included in the research.

As in the legal research in general the purpose of this study has been to recognise and retrieve information that would be relevant also for those who make decisions related to discussed subject - in this case mezzanine financing.[75] The information sources used cover not only legal but also economic, business and scientific reference material. This kind of usage of sources from other disciplines is quite typical for any legal research.[76] Also when thinking how important decisions are made in daily business life, this kind of cross-sectoral information sourcing is not extraordinary either.

2.3 Comparative law

2.3.1 Primary research methodology

The primary research methodology applied here is comparative law.[77] To compare how company law regulates mezzanine financing and how mezzanine instruments are handled from accounting and taxation perspective in Finland and internationally falls easily within the

[69] Mäntysaari, P. (2014), pp. 356-357. About choosing the perspective of the firm in commercial law see also Mäntysaari, P. (2012).
[70] Mäntysaari, P. (2017), p. 193.
[71] Mäntysaari, P. (2017), p. 194.
[72] Mäntysaari, P. (2017), pp. 194-196.
[73] According to Mäntysaari, P. (2017), p. 85 *"User-Friendly Legal Science is pragmatic and facilitates problem solving."*
[74] See below section *5 Mezzanine in bank lending.*
[75] Barkan, S.M. et al. (2015), p. 1.
[76] Ibid.
[77] Husa, J. (2013), p. 27. About the method of comparative law see Eberle, E.J. (2009).

comparative law research.[78] To compare domestic law of some specific area with the relevant laws of foreign countries is fairly common in academic researches. In the era of globalisation, the need for such researches is not limited only to the academic world. Comparative researches can be seen increasingly also in every day legal practice.[79] In Europe the EU legislation and similarities in the member states´ laws have led to increased importance of the comparative elements in the legal science.[80]

Comparative legal analysis is important part of the research methodology as regulatory frameworks and market features of several countries have been examined and compared. The comparative law approach means studying relationships between legal systems or norms of more than one country and reviewing the differences and similarities.[81] This approach is used in legal science especially when performing law comparison between different jurisdictions. The comparative law approach is used to serve the purpose to extend and enrich the materials for the analysis.[82] In research work it means analysis of the research topic by studying the different legal systems, finding out specifics of the different systems, identifying differences and similarities, explaining them and drawing conclusions. All of this supports also the analysis of the local regulation in question. Review and analysis of the particular area of study of other jurisdictions may make the researcher to look at some local norms and practices in a new light.[83]

In comparative law methodology comparison can be made on macro level and micro level.[84] On the macro view the focus is on the legal systems or legal regimes and differences and similarities are compared from a general perspective. On the micro level the point of view is more on individual legal institutions - like legal persons or courts - and individual norms. How the macro and micro level comparisons are then combined and used depends on each researcher´s interests. Both macro and micro level comparison has been done in this research. Focus has however been more on micro level comparison.

Here traditional functional method[85] is used for comparing company laws, accounting rules and taxation rules in the field of mezzanine financing and to identify how the usage of this financing form is addressed in several jurisdictions. However, the central point in the functional comparative methodology is not to concentrate only on study of mezzanine rules in a form of written law but also on the *"social need"* in question - in this research on mezzanine financing.[86] The idea is to find out also how different countries have solved the same socio-legal problem.[87] Instead of focusing on concepts or terminology only the researcher focuses also on functions. The common function - the tertium comparationis - is then compared.[88] If

[78] According to Zweigert, K. and Kötz, H. (1998), p. 1 comparative law means comparison of *"the different legal systems of the world"*.
[79] See also below section *6.3 Case example: how mezzanine can be concretely used?* In that section the usage of mezzanine financing is illustrated with the help of an imaginary example case. In that case is demonstrated challenges related to financing arrangements of a group operating in several countries. Before concluding on the transactions having impact on several business units in different countries, the group management has to do also some legal research including comparison of regulations between different jurisdictions.
[80] Mäntysaari, P. (2017), p. 146.
[81] Siems, M. (2014), pp. 13-25 and Husa, J. (2015), pp. 147-186.
[82] Zweigert, K. and Kötz, H. (1998), p. 15.
[83] See Jyränki, A. (1996), p. 11.
[84] Husa, J. (2015), pp. 100-104.
[85] Zweigert, K. and Kötz, H. (1998), pp. 32-47 and Brand, O. (2007), pp. 409-421.
[86] According to Husa, J. (2015), p. 118 "*Ultimately the aim of this kind of comparative law is (on the basis of the source material) to conceive what in each legal system is typical and what its relation is to the surrounding society, political and economic systems and culture.*"
[87] Husa, J. (2015), p. 119.
[88] Husa, J. (2015), p. 148.

the common function cannot be found, comparison in the meaning of comparative law becomes cannot be done.[89]

In traditional functional study, after the chosen social need has been addressed in the relevant jurisdictions, three things will follow:

- comparison
- analysis of similarities and differences and
- comparative study building on the ultimate purpose of the study.[90]

This research has been structured taking into consideration all the three elements. The different stages of the process of comparative law - as it has been applied in this research - are shown in the table below (see Figure 2). What that means in practice is also described in the following text sections.

Figure 2: Process of comparative law applied in this research

Applied process of comparative law	
Stage 1	Addressing the social need: mezzanine financing
Stage 2	Comparison of the different systems and how they have solved the socio-legal problem in question
Stage 3	Analysis of the similarities and differences of problem solving between different jurisdictions
Stage 4	Conclusions building on the ultimate purpose of the study

2.3.2 Comparison

In the applied process, after the research questions have been formulated[91] and the jurisdictions in scope have been reviewed[92], the relevant regulations have been described[93]. In the comparative part of the text the mezzanine regulation of different countries has been compared.

The relevant regulation that has been reviewed here includes the company laws around the chosen research topic. In scope is thus the company law framework regarding mezzanine financing. Company law is the subclass of legislation that provides legal form and regulates rights and obligations of entities driving business activities. The business entities in scope here have own legal personality, investors as owners, liability that is limited, shares that are transferable and management that is delegated.[94]

---

[89] According to Zweigert, K. and Kötz, H. (1998), p. 34 *"Incomparables cannot usefully be compared, and in law the only things which are comparable are those which fulfil the same function"*.
[90] Zweigert, K. and Kötz, H. (1998), pp. 32-47, Husa, J. (2013b), p. 12 and Mäntysaari, P. (2017), pp. 147-151.
[91] See the research questions above in section *1.2 Subject and scope of the study*.
[92] See the jurisdictions in scope above in section *1.2 Subject and scope of the study*.
[93] See the regulations in scope below in sections *3.4 The company law framework, 3.5 Accounting rules and 3.6 Taxation rules.*
[94] Kraakman, R. et al. (2017), pp. 1-15.

To be able to compare laws there have to be at least two regulations in focus. In this research the European Union corporate regulation has been presented as part of setting the comparative scene, but the actual comparative focus is on the company laws of six countries:

- Finland: Limited Liability Companies Act[95]
- Sweden: Companies Act[96]
- Estonia: Commercial Code[97]
- USA: Model Business Corporation Act and Delaware General Corporation Law[98]
- UK: Companies Act[99]
- Germany: Limited Liability Companies Act and Stock Corporation Act.[100]

Although the focus has been primarily on company law also some accounting and taxation rules have been studied and compared. The discussed accounting rules relate mainly to the local GAAP and IFRS regulation. The review of taxation norms covers only thin capitalisation rules and deductibility of interest from the borrower´s view.

The comparison covers countries belonging to different legal cultures. Here regulation of different jurisdictions belonging to Scandinavian (Finland and Sweden), Continental European (Estonia and Germany) and Anglo-American (USA and UK) legal families are discussed.[101] In comparative law to study regulation of different legal families is very common situation.[102]

The comparison of mezzanine related company laws, accounting rules and taxation rules in different jurisdictions is core of comparative law but it is not enough. As functional comparative methodology is applied here the social need in question has to also be understood. What is characteristic in each observed country in the area of mezzanine financing and how the local market functions is discussed. This serves the purpose to find out how

[95] Limited Liability Companies Act (624/2006), in Finnish: Osakeyhtiölaki (624/2006).
[96] Companies Act (SFS 2005:551), in Swedish: Aktiebolagslag (624/2006).
[97] Commercial Code (RT I 1995, 26, 355), in Estonian: Äriseadustik (RT I 1995, 26, 355).
[98] Model Business Corporation Act 2016 and Delaware General Corporation Law (Title 8, Chapter 1 of the Delaware Code). The US corporate law is in practice state law. Here the two most popular state level company regulations have been taken into consideration. About the company legislation in the USA and the chosen state laws see for more details below section *3.4.3.3 USA.*
[99] Companies Act 2006.
[100] Limited Liability Companies Act of April 20, 1892, in German: Gesetz betreffend die Gesellschaften mit beschränkter Haftung, GmbHG von 6. April 1892 and Stock Corporation Act of September 6, 1965, in German: Aktiengesetz von 6. September 1965. In Germany the legal regime for limited liability companies is provided by two separate company laws: Limited Liability Companies Act regulates a company with limited liability and Stock Corporation Act regulates the limited liability stock corporations. For more details see below section *3.4.3.4.2 Germany.*
[101] The concept of *"legal families"* is common topic in comparative law. There are different criteria for grouping the legal systems and many of them lead to different conclusions. The legal families mentioned here - Scandinavian, Continental and Anglo-American - can be identified in several books focusing on the legal family categorization. About the legal families classification in general see David, R. (1978), Zweigert, K. and Kötz, H. (1998) and Husa, J. (2004). About the arguments why Estonia is categorised here as belonging to the continental European family of legal system see Narits, R. (1996) and Varul, P. (2000).
[102] See Husa, J. (2016).

different countries have solved the same socio-legal problem. This common functionality is relevant part of the comparison.[103]

2.3.3 Analysis of similarities and differences

After comparing the regulations focus has been put into the analysis of differences and similarities. In comparative law the researcher is expected to be able to tell why there are similarities and why there are differences.[104] This has made it necessary to take a view also into the legal systems[105] and market conditions[106] of individual countries under observation. The differences of the observed jurisdictions have been specifically opened in this research.[107]

In observing similarities and differences between Finland, Sweden, Estonia, USA, UK and Germany the following items have been focused on:

- company legislation
- accounting rules
- taxation rules and
- size of market.

To be able to analyse the differences of norms the actual research topic has to be understood well. This means in connection with mezzanine financing that elementary features of limited liability company, its capital structure and characteristics of mezzanine instruments financing are explained.

Review and analysis of company regulation of EU and legal systems of the individual countries is also important. This is part of making sure that reader has relevant background information to understand the discussion around regulatory similarities between the countries.

In this research the analysis of differences is crystallised in specific text sections where the main variances are discussed focusing separately on

- differences in company law regulation
- differences in accounting
- differences in taxation
- relevance of freedom of contract and
- differences in local market sizes.[108]

---

[103] Husa, J. (2015), p. 148.
[104] Mäntysaari, P. (2017), p. 149.
[105] See below sections *3.4.2.1 About the Finnish legal system, 3.4.3.1.1 About the Swedish legal system, 3.4.3.2.1 About the Estonian legal system, 3.4.3.3.1 About the legal system of the USA, 3.4.3.4.1.1 About the UK legal system* and *3.4.3.4.2.1 About the German legal system and limited liability regulation.*
[106] See below section *4 Different systems of mezzanine in practical market.*
[107] See below section *6 Differences of mezzanine markets between Finland and other countries.*
[108] See below section *7.3 What are the main differences of company law regulation, accounting and taxation rules and local market sizes and conclusions?*

Each of the above listed item is covered in their own text section.

2.3.4 Comparative study

The comparative study forms the last phase of the traditional functional research. This last stage of the research is built on the purpose of providing answers to the research questions:

- What is the company law background concerning the use of mezzanine financing?
- What are the main differences of company law regulation, accounting and taxation rules and local market sizes and conclusions?
- How mezzanine could be used in bank lending going forward in order to support functioning capital markets?

The research findings have been summarised to provide answers for the research questions. This includes also description on how mezzanine could be used in bank lending going forward[109], recommendations on future research areas[110] and even some thoughts on "should be" regulation[111].

Although mezzanine is not widely known as a bank financing product this financing form is to some extent used by corporate bankers already today. About the potential for mezzanine to become more popular lending instrument for banks is discussed towards the end of the research.

Additionally, it has been presented future research objects related to the topic of mezzanine financing. During this research has been identified several items that would be suitable for future research.

To support increased usage of mezzanine financing the regulatory environment should not unnecessarily limit the possibility to borrow and lend this kind of hybrid form of financing. Keeping this in mind this research includes also recommendations how relevant company regulation should be amended. The proposed amendments target to improve the functionality of the company regulation in order to support increasing use of mezzanine. The better the law would function the better the law would be.[112]

In presenting suggestions for the new company law the idea is to show how regulation could be improved. The perspective used here is the perspective of the users of the regulation: mezzanine lenders and borrowers. This point of view brings the chosen functional approach closer to user-friendly legal science.[113]

---

[109] See below section *7.4 How mezzanine could be used in bank lending going forward in order to support functioning capital markets?*
[110] See below section *7.5 Future research objects.*
[111] See below section *7.5.8 Company law regulation de lege ferenda.*
[112] See Michaels, R. (2006), p. 342. according to which *"the better of several laws is that which fulfils its function better than the others"*.
[113] Mäntysaari, P. (2017), pp. 151-152.

2.4 Mezzanine in bank lending in the future

This research has three research questions to answer:

- What is the company law background concerning the use of mezzanine financing?
- What are the main differences of company law regulation, accounting and taxation rules and local market sizes and conclusions?
- How mezzanine could be used in bank lending going forward in order to support functioning capital markets?

The two first research questions fall easily within the main research methodology comparative law and its different stages. As mezzanine is defined here as the socio-legal problem under research focus, the relevant regulation is naturally also the target of the analysis of similarities and differences.[114]

The third research question *"How mezzanine could be used in bank lending going forward in order to support functioning capital markets?"* is however more challenging from the comparative law perspective. How does answering to this question fit in the process of comparative law? The reply to this is given by taking a brief look at the purpose of a comparative study in general.

Like any research method comparative law and comparative method is chosen for a research by a researcher when she/he considers that methodology to be appropriate. There can be variations in the purpose of a comparative study and purpose can include among other things identification of better law.[115] In this research all such regulative features that have been recognised to support usage of mezzanine are considered as elements of *"better law"*. Although providing answer to the question how mezzanine could be used in bank lending going forward is not directly about identifying of better law, supportive and clear regulation without unnecessary limitations is needed. In this doctoral research some recommendations on company law regulation de lege ferenda has also been given.[116]

The above stated means that comparative law has helped to recognise elements that would improve company laws in the area of mezzanine financing. This has given also inspiration to conclude how mezzanine could be used in bank lending going forward in order to support functioning capital markets. It is however fair to say that the comparative method has not been the primary method for finding answer to that research question.

As mentioned earlier, the theory of law and economics has importance in this research. In answering the research question concerning the future of mezzanine in bank lending economic and financial implications of the topic become highly important. The increased mezzanine lending by banks is seen here as a mean to provide additional funding possibilities for the companies and thus also as an element to support efficiently functioning capital markets. This would improve also the overall economic efficiency. Additionally, to improve the economic efficiency in general the relevant regulation needs to be in place and provide framework for well-organised business models without unnecessary obstacles. Here the principles of the theory of law and economics come in the picture as in law and economics - as discussed earlier

---

[114] See above section *2.3.1 Primary research methodology*.
[115] According to Mäntysaari, P. (2017), p. 148 *"the purpose of a comparative study can be (1) epistemological (understanding legal rules and institutions), (2) comparative (achieving comparability), (3) presumptive (emphasising similarity), (4) formalising (system building), (5) evaluative (determining the better law), (6) universalising (preparing legal unification) or (7) critical (providing tools for the critique of law)."*
[116] See below section *7.5.8 Company law regulation de lege ferenda.*

- the point of view is the economic efficiency of law.[117] As well, when later is discussed pricing of corporate lending by banks and role of mezzanine in it, the principles of economic theory are applied.[118]

The perpective of the lenders and borrowers are used when to the third research question is answered. This takes the topic under the user-friendly legal science discipline.[119] As lenders and borrowers refer in the discussed context to companies and each company has management as decision-maker, this form of commercial law is also called management-based commercial law (MBCL).[120] Here is assumed that the managements of both lender and borrower companies have common interests to enhance corporate financing possibilities in general and thus also see mezzanine instruments among the different financing options available. This would no doubt support functioning capital markets.

[117] Mäntysaari, P. (2017), p. 139.
[118] See below section *7.4 How mezzanine could be used in bank lending going forward in order to support functioning capital markets?*
[119] Mäntysaari, P. (2017), p. 193.
[120] Mäntysaari, P. (2017), p. 194.

3 MEZZANINE FINANCING FRAMEWORK

3.1 Capital structure of limited liability company

3.1.1 The general theory of capital structure

When the capital structure is discussed it refers to the way how an enterprise combines equity and debt in financing its assets. Different explanations have been given for different financing structures but often taxes, adverse selection, transactions costs, bankruptcy costs and agency conflicts have been mentioned as significant drivers for using debt. Also features like access to internal or external finance, company size, company age and industry have relevance. Older and bigger companies have normally more financing possibilities than young and small ones. Reasons for this are ability to accumulate assets during longer time period and chance to build reputation over the years and history of relationships with financial investors.

There are several kinds of options for companies to structure their capital base. Countless combinations can be used with the help of many financing forms like debt, convertible issuance, preference shares, lease finance, equity warrants and forward contracts. Given that firms try to maximize their value, it is also interesting to know what kind of influence a capital structure has to the total value of the company.

Many theories explain the decision-making on capital structures and also researches have been done on the applicability of these theories.[121] The existing theories have assumptions of certain environmental conditions and have focus on some factors that impact on the financing choices and firm´s capital structure. These factors are very important for some firms under corresponding circumstances but in other circumstances this is not necessarily the case. Some of the most known theories are

- Pecking-Order theory based on asymmetric information
- Modigliani-Miller Theorem based on tax benefits associated with debt use and
- Trade-Off theory founded on agency and bankruptcy cost.

3.1.1.1 The Pecking-Order theory

The Pecking-Order theory has its basis on the principle that there is no equal distribution of information among management, owners and outside investors. The concept of an optimal capital structure, that has been described by Myers[122] and Myers and Majluf[123], is built upon the idea of asymmetric information. The relative costs of finance vary among different finance sources because of the asymmetric information that external financiers and the company. The main assumption is that the managers and the owners know the real value of the company assets and growth prospects and the type of financing signals this inside information. External investors can only try to speculate about these values. The funding provided by the firm itself

[121] See about the connections between the normative theories and corporate practice Baker, H.G. et al. (2011), pp. 195-235 and Rajan, R.G. and Zingales, L. (1995). About the determinants of the capital structure see also Holmström, B. and Tirole, J. (1989), pp. 78- 86.
[122] Myers, S.C. (1984).
[123] Myers, S.C. and Majluf, N.S. (1984),

is cheaper because external equity provider will have less information about the firm. New external equity providers will assume a higher rates of return on the funding offered by them. Therefore, it will be more expensive for the firm to issue new shares in comparison to the use of internal funding. The same logic applies to the difference of new debt and internal finance.

As the outcome of the asymmetric information theory firms try to minimize the costs of asymmetric information. This leads to a certain pecking order or hierarchy of firm funding preferences. Firms seeking financing for the new investments are in favour of using funds in accordance to a hierarchy: first are used internal funds, after that comes issuance of debt and at the end issuance of equity. The order of preferences mirrors the relative costs of different funding alternatives. Companies would clearly prioritise internal sources to costly external sources. The hypothesis of pecking order assumes that firms aiming for improved profitability are expected to use less external funding. The described financing pattern limits the inefficiencies caused by informational asymmetries and this decreases the risk and sensitivity to mispricing and valuation errors respectively.

The idea of pecking order theory does not suggest that companies would have precise leverage targets.

3.1.1.2 The Modigliani-Miller Theorem

The Modigliani-Miller Theorem is based on series of papers written by Modigliani and Miller.[124] According to this theory 1) under certain conditions, a debt-equity ratio of a firm has no influence on the market value, 2) a leverage has no influence on firm´s weighted average cost of capital, 3) market value does not depend of firm´s dividend payments and 4) holders of equity are indifferent between capital gain and dividend income. The conclusion is that when the market functions efficiently it is unimportant how the company is financed. As this theorem suggests that under certain conditions, the financial decisions are irrelevant in determining company value, it is also called as the *"Irrelevance Theorem"*.

Although according to Modigliani and Miller the financial structure makes no difference to the firm´s total value, the firms typically prioritise debt. This is because of the tax shield resulting from the interest deduction and boosting the value of the firm. Therefore, the tax benefits can also explain the chosen capital structure. Tax policy has thus relevance for the funding decisions of firms.[125] If corporate taxation rules make it possible to deduct interest on debt and dividend or other payments associated with equity are not tax deductible, this gives incentive for the firms to try to maximise their debt load. The corporate tax advantage stemming from the deductibility of interest payment on debt means that interest payments are income for the investors. Companies are able to forward this benefit to their investors by paying higher returns. The taxation benefits resulting from the issue of more corporate debt may however be counterbalanced by a high interest income tax. Eventually, the trade-off determines the net effect of taxes on debt usage.[126]

The Modigliani-Miller Theorem is criticized because it does not take into account the market imperfections like asymmetric information and agency costs.[127] In the perfect market it may not matter how the firm is financed but in real life the capital structure has relevance.

---

[124] Modigliani, F. and Miller, M. H. (1958), Miller, M.H. and Modigliani, F. (1961) and Modigliani, F. and Miller, M. H. (1963).
[125] Green, C.J. et. al. (2002)
[126] Miller, M. H. (1977).
[127] Gordon, M.J. and Chamberlin, T. (1994) explain how specific market imperfections like tax system, agency costs and bankruptcy costs have significant effect of leverage on the firm value. In another example

3.1.1.3 The Trade-Off theory

The term trade-off theory is often used to describe a family of related theories. The common idea is that it is up to the company to decide what is the amount of debt and equity to use by balancing the benefits and costs. As in the extreme scenario applying the Modigliani-Miller Theorem the firm could be 100 % debt financed, the classical version of the Trade-off theory considers a balance between the bankruptcy costs and the taxation benefits linked to debt.[128] Basically it is a question of entailing offsetting the benefits of debt against the costs of debt. The greater the debt obligation the bigger is the risk of creating financial distress. A company becomes financially distressed when it cannot manage its debt burden. If failing in making payments to the creditors the company can even become insolvent. The costs of financial distress should be considered when decision is done on the optimal capital structure.

As stated by the trade-off theory a company balance sheet includes some agency costs. This explains why - unlike expected by Modigliani and Miller - companies do not have only debt in their balance sheet. The Agency theory[129] acknowledges that difficulties in the principal-agent relationships may arise under conditions of incomplete and asymmetric information between the parties.[130] Managers do not always perform according to the shareholders´s interests and consequently the managers´ goal is not always to maximize the value of the company. Problem can be more significant in larger firms with diversified owner base and low management ownership. Debt could reduce agency costs as debt can be used as a disciplinary instrument making survival the key issue for all involved in the short-term.

The Trade-off theory emphasizes the importance of finding the optimal capital structure. This happens by balancing financial distress and agency costs of debt against the agency costs of equity. However due to transaction costs the firms may temporarily adjust the targeted optimum.[131]

3.1.2 Limited liability

The liability limitation is a fundamental feature of the contemporary company law. In corporate finance the limited liability means capping of shareholders liability to the amount of capital that they have invested for the business. Members are not personally liable for the company´s obligations. The practical consequence of this is that

1) shareholders do not have liability towards the creditors for the obligations that the company has and

2) shareholders do not have obligation to make any payments to the company or to the bankruptcy estate of the company

---

Bhattacharya, S. (1979) concludes that if dividends act as a credible signal of the company's profitability dividend payment decision can be relevant.

[128] Kraus, A. and Litzenberger, R.H. (1973).

[129] Jensen, M.C. and Meckling, W.H. (1976).

[130] According to the classic book Berle, A. A. and Means, G.C. (1932) the separation of ownership and control have decreased shareholders´ possibility to influence decision-making in the company. The shift of control to the managers gives them an opportunity to misuse their position to their own advantage.

[131] See Ozkan, A. (2001), Fama, E.F. and French, K.R. (2002), Flannery, M.J. and Rangan, K.P. (2006) and Antoniou A. et al. (2008).

unless so specifically separately agreed. This undoubtedly encourages people to start business by making it less risky.[132] This complies with the overall aim of the company regulation to encourage efficient trading and minimize transaction costs.[133]

Limited liability enables accumulation of large amounts of capital from several small investors. Without this kind of limitation even a small investment could make a shareholder liable for a significant corporate obligation. Limited liability is the standard element of all companies being publicly listed. A key feature separating a limited liability company form from a sole proprietorship or general partnership is that the owners of the limited liability company do not have personal liability for the business-related debts and claims. The legal personality and liability[134] are separated which means that a shareholder cannot lose more than shareholder has paid for the shares. This limitation applies regardless of the financial obligations of the firm. The private assets of the owners - home, funds in bank accounts, car etc. - are safe from the company´s creditors. The limited liability encourages investors for investments that would not otherwise take place.

The amount the shareholders invest for the company sets the cap for their liability. This limitation of liability has many important benefits:[135]

1) Limiting the liability decreases the need to allocate resources for monitoring agents because shareholders have less to lose in the company´s insolvency. In case of unlimited liability, the shareholders´ costs of monitoring the actions of the company's managers would be very high. This is based on the fact that a shareholder's entire personal wealth could potentially be in jeopardy because of the actions of the company's agents. Limited liability saves from shareholders the costs of attempting to protect themselves from too risky corporate behaviour.

2) Monitoring other shareholders is less costly due to the limited liability. In an insolvency of an unlimited liability company every individual shareholder would be obliged to pay a judgment against an insolvent corporation depending partially on the funds of the other shareholders. This kind of regime would put shareholders' personal wealth in danger. Each individual shareholder would have in such situation an interest in the means of other shareholders and their ability to cover the liabilities of the company. Therefore, in case of unlimited liability, shareholders would have an incentive to monitor other shareholders and influence that shares are not transferred to others with less wealth.

3) Limited liability facilitates the freedom of share transfer.[136] The share valuation depends on the present value of the income that a company generates. In an unlimited liability regime the shares can be traded at one price. The share value would depend on the shareholders´ wealth and additionally on the present value of future cash flows. If liability was unlimited, the share prices would not be uniform because the wealth of the person acquiring the shares would affect the price. It could be expected that a wealthy investor would pay less for the same shares than a poor one on the basis that the wealthy one would be taking on more risk in the default of the company. In case of limited liability situation, the possibility to trade shares at one price also encourages management to act efficiently. Management inefficiency would decrease share price,

[132] Mayson, S.W. et al. (2014), p. 55. See also Wahlroos, B. (2012), pp. 79-108 about the birth of modern company including limited liability more generally.
[133] Kraakman, R. et al. (2017), p. 18 and Pönkä, V. (2012), p. 11
[134] Goddard, D. (1998), p. 11.
[135] Easterbrook, F.H. and Fischel, D.R. (1991), pp. 41-44.
[136] See also Woodward, S.E. (1985), pp. 601-602.

increase likelihood of takeover and increase, as well, probability of management replacement.

4) Limited liability permits efficient diversification, too. This lets people to use their savings for different purposes without too big risk. In case of investing into unlimited liability companies diversification would increase risk as each new investment would be investor´s commitment to lose all of its assets.[137] In unlimited liability regime investors would invest bigger sums in a smaller amount of firms. In such environment the risk carried would be significantly higher. Under a rule of limited liability that risk could be diversified.

5) Limited liability protection encourages for optimal investment decisions. It gives directors incentives to accept higher risk projects due to investors ability to diversify.[138] Projects that have positive net present value will normally be accepted under these circumstances. However, in an unlimited liability regime some projects would be too risky for investors as they were unable to reduce their risk through diversification. Therefore, some projects even with positive net present values would not be approved.

The concept of limited liability means that it is easier to carry on business which possibly could become insolvent. This has led to opinions that option to drive business with the limited liability should be allowed only for people who are not themselves actively participating in the management of the company.[139]

3.1.3 Retained earnings

To able to operate company needs funding. The basic alternatives for a company to finance its operations are issuing shares, taking debt or retain profits.[140] The main split of different funding alternatives is between external (share issues and debt) and internal funding (retained profits). As discussed above there are different views on optimal capital structures depending on the applied policies but often internal financing is favoured instead of external one.[141] In practice internal financing is something that no company can operate without and the decision to use this financing form is within the powers of the company board itself.[142] The board of directors has two options: it can either retain these profits or distribute these profits as cash dividends. The decision to retain the funds leave possibility to reinvest them for future growth. Retained earnings is equity capital and there is no fixed payment of interest due for repayment on the principal burden.

---

[137] Manne, H.G. (1967), p. 262.

[138] This creates agency problem called *"risk shifting"* between shareholders and company creditors, see Jensen, M.C. and Meckling, W.H. (1976) and Green, R.C. (1984).

[139] Mayson, S.W. et al. (2014), p. 55 writes that *"…making it easier to carry on businesses that become insolvent makes economic activity riskier for the community generally if it becomes more likely that money will be lost in dealing with insolvent limited liability companies. Any creditor of a small company in a strong enough negotiation position (such as a bank or a landlord) usually requires personal guarantees from the individuals controlling the company and this makes limited liability meaningless for them. In times of economic recession, ordinary trade creditors and customers who cannot negotiate special protection for themselves become discontented with limited liability. This has led to suggestions that it is necessary to return to the concept that limited liability should be available only for non-managing investors."*

[140] Ferran, E. and Ho, L.C. (2014), p. 42.

[141] See Brealey, R. A. et al. (2014), pp. 472-474, Allen, F. and Gale, D. (2000), p. 15-16 and Tirole, J. (2006), p. 96.

[142] Mäntysaari, P. (2010c), p. 22.

The income from operations is the basic source of retained earnings. Items that increase or decrease retained earnings can be shown in a simplified table (see Figure 3 below):

Figure 3: Retained earnings

Debit (Items decreasing retained earnings)	**Credit** (Items increasing retained earnings)
Net loss	Net income
Dividends	

Earnings generated by the company belong to the owners. The earnings can be channelled to owners as dividends or alternatively returned back into the company. The income that is left in the company and not distributed to the stockholders is defined here as retained earnings. It is increased by net income or decreased by net loss and dividends. Also accumulated profits, accumulated earnings, accumulated surplus, undivided profits and earned surplus are form of retained earnings. Theoretically to retain profits is sensible only if the company by reinvesting the profits generates higher return for the owners. If satisfactory growth rate is not received, it is better to distribute the profits as dividends. Retained earnings is part of equity and thus part of owners´ claim from the company. The other part of the equity consists of funds received through share issuance.

A company can raise internal funds through divestments, too. This way company assets are reorganised into liquid form of funds.

3.1.4 Equity financing

In general, external funding of the company can be either issuing shares or taking new debt. Issuing shares means taking new equity. In equity financing a company gathers or generates funds for company projects through selling a limited amount of stock to the public sector. In practice this means raising money by selling interests in the company. This may involve issuing new ordinary shares[143] or preferred shares to commercial or individual investors.[144]

A preference share is different from ordinary shares in respect of preference over dividends and assets in the liquidation situation. The dividend yield on a preference share can be fixed and usually preference shares do not either have rights to vote.[145] What is the exact content of the priority must be anyhow always defined separately on case by case basis.[146] In practice this is done in the articles of association of the company.

[143] Ordinary share is known as common shares in the USA.

[144] See also Fama, E.F. and French, K.R. (2005) who argue that besides seasoned equity offering there are at least seven other ways to raise equity. These ways are (1) mergers via an exchange of stock, (2) employee stock options, grants, and other employee benefit plans, (3) subscription rights issued to stockholders, (4) warrants attached to other securities, (5) convertible bonds, (6) dividend reinvestment and other direct purchase plans and (7) private placements.

[145] Ross, S. et al. (2013), pp. 249-250 and Vernimmen, P. et al. (2017), p. 107 and pp. 434-435.

[146] Ferran, E. and Ho, L.C. (2014), p. 133. See also the Government Bill for the Limited Liability Companies Act of Finland (HE 109/2005), p. 50-51, where it is even specifically mentioned that term *"etuosake"* (preference share) shall not be used in the law in order not to restrict the freedom of contract.

Regardless what is the exact way of implementation, equity financing is primarily utilized for the purpose of raising money for new company needs.[147] Companies want to naturally maximize the incoming money flow and thus share issuances take often place in times when share prices are on high level.[148]

Both basic methods of getting equity - through issuing ordinary shares and preference shares - have their pluses and minuses.

Advantage for the company is that the issuance of ordinary shares gives possibility to raise permanent capital with no maturity date and without need to return it. There is no fixed dividend burden either to issue the ordinary shares. Dividends could be paid depending on the company earnings and business needs. Ordinary shares of the company grant the shareholders ownership and entitle to a share of the business after the creditors like banks have been paid. Ordinary shareholders have also voting rights but no automatic entitlement to dividend earnings. Owners of ordinary shares stand however behind preference shareholders in dividend payment.

One of the disadvantages for the company is higher cost of capital of ordinary shares. The dividend should be paid in from after-tax profits which means that dividend payment is not tax deductible. Thus, issuance expenses of ordinary shares are generally higher than issuance costs of other securities. On top of that ordinary shares established due to new funding may distract control of the firm because of new shareholders.

What comes to preference shares positive for the company is that also here there is no fixed maturity date and no obligation to repay the principal. Preferred shareholders do not have the voting right which effectively maintains the control of the company in the hands of ordinary shareholders.

One disadvantage brought by preference shares is the higher rate of dividend. The dividend can be cumulative or noncumulative.[149] As the company needs to pay higher rates of dividends to the preference shareholders than to the common shareholders this increases also the cost of capital of the company. The preference shares bring along also similar tax disadvantages as ordinary shares as the dividend should be paid in after-tax profits which is not tax deductible.

3.1.5 Debt financing

As mentioned above external funding of the company can in general mean either share issuance or taking new debt.[150] Debt is borrowed from insurance companies, banks and other financial institutions or raised in the debt markets by way of issuing commercial paper or corporate bonds. In debt financing a company receives a loan and commits to repay the loan. The debt can be established by several different loan instruments covering loans, bonds and leases which can be either secured or unsecured.[151] Common for all debt financing is promise of the company to pay the received funding back in the future. Debt does not change the ownership of the borrower but debt is a balance sheet liability which must be paid back with interest according to agreed timetable.[152] The interest is compensation for the lender for risking the capital.

---

[147] Weitnauer, W. et al. (2016), p. 145.
[148] Tirole, J. (2006), p. 244.
[149] Ferran, E. and Ho, L.C. (2014), p. 135.
[150] See above section *3.1.4 Equity financing*.
[151] Bodie, Z. and Merton, R.C. (2000), pp. 419-422. See also Cranston, R. (2002), pp. 299-300.
[152] Jensen, M.C. (1986) writes about benefits of debt in reducing agency costs.

When new debt is taken funds for repayment must normally come out of company´s cash flow. The company should have sufficient liquidity to withstand short-term negative trading conditions or rising interest rates and enough strength to obtain liquidity during periods of prolonged negative cash flow. Financiers typically base their lending decisions on borrower´s repayment capacity and not on the available collateral.

Debt financing includes both secured and unsecured loans. There is always a risk, that the customers repayment capacity can be unexpectedly reduced before a credit facility is fully repaid. This risk increases especially for credit facilities with long duration. Security involves a form of collateral through pledge/mortgage on assets and other types of support as an assurance that loan repayment takes place.[153] The collateral is used to satisfy payment of the debt in case the company fails to fulfil the payment obligation as initially agreed. Most lenders are very conservative and are not likely to provide loans without security requirement unless there is earlier business cooperation between the lender and the company with good payment history. Even in such relationship lender may still ask to provide collateral on a loan due to risks in financial or economic outlook. There are several factors influencing borrower´s willingness or ability to provide sufficient security.[154] At the end the agreed collateral package depends on the outcome of the discussions between the borrower and the lender.

Like equity financing also debt financing has arguments both for and against.

For the borrower one of the major advantages of debt financing is that the new debt does not change ownership and control of the company. Taking debt means in practice borrower´s commitment to repay the loan according to preagreed schedule. After the full loan repayment lender does not have further claims on the obligor´s business. The conclusion is that the debt financing provides company owners normally also more financial flexibility than financing through equity. Obligations linked to debt are limited to the payments of amortisations and interests and later - after the full loan repayment - there are no further demands from the lender towards the business. Administrative bureaucracy shall also decrease as debt financing involves normally less administrative bureaucracy than equity financing. As an example, there are no such complicated reporting requirements which often come together with equity financing.

Another major advantage of debt financing relates to taxation. Using debt financing instead of equity financing brings advantageous tax position since in most countries distributions related to the payment of debt are tax deductible unlike distributions related to equity capital. In this research taxation is debated more in detail later.[155]

The major disadvantage of debt financing is the requirement to make regular payments of principal and interest. In practice this can mean payments on monthly or quarterly basis. If company has tight liquidity making regular payments may be challenging. In case of payment delays lenders often provide sanctions, which may include charging penalty fees, loan termination or even selling the collateral. All in all, inability to make payments in time can have negative impact on borrower´s credit worthiness, credit rating and thus also possibility to get financing from different sources in the future.

---

[153] See Fuller, G. (2006), p. 67 according to which security "*embraces (a) rights enabling the creditor to look to a third party for satisfaction (such as guarantees and indemnities) and (b) rights enabling the creditor to have recourse to particular property in priority to other creditors*". According to Gullifer, L. and Payne, J. (2015), p. 270 *"a security interest is a proprietary interest that A obtains in relation to property owned by B to secure an obligation owed to A by B, or more rarely, by C"*.

[154] See Holmström, B. and Tirole, J. (2011), pp. 23-26 according to which three factors influence on the *"pledgeable income"* (= term used as synonym for collateral by the authors): bias towards less risky projects, diversification and intermediation.

[155] See below section *3.6 Taxation rules.*

3.1.6 Cost of capital

Companies need to find funds to finance their investments. Normally investments are financed through some combination of equity and debt. In case internal financing is not sufficient external financing is needed. The potential investors to provide external funding are the shareholders and external lenders. Funding - both internal and external - has however its price as there is no *"free"* money. The price is the cost the firm must pay for the funding. This also means that for an investment to be economically rational, the expected return on capital of the investment must be higher than what the invested capital costs. Acknowledging the level of this *"hurdle rate"* is relevant issue for the project investments but can also have wider implications. Some economists see the return of capital as important factor influencing the distribution in wealth in general.[156]

One can understand the cost of capital to be also the required rate of return on invested funds. It includes different components that can be split in two categories:

- risk-free rate of return equalling the amount investors expect as risk-free compensation for allowing somebody to use their money and
- compensation of risk related to the uncertainty of getting the specific investment in question back.[157]

Shareholder wealth is reduced if investment does not cover the company´s cost of funds. According to the same logic investor wealth is decreased if she does not earn from her investment enough to cover the cost of invested funds. Whenever financing decisions are done each component of the firm's capital structure must be taken into consideration. Only this way it is possible to determine the total cost of capital of the company. Therefore, the overall cost of capital of the firm is regularly calculated as a weighted average of its equity cost and debt cost, known as weighted average cost of capital (WACC). This figure indicates the cost of financing a company's asset base. In this calculation the cost of each financing source reflects the risk of the assets the company invests in.[158]

When calculating the WACC it must be determined what is the relative amounts of each source of capital and what is the cost of each financing source. In case of permanent capital structure the calculation of relative shares is easier but when evaluating different funding mixes the mathematics becomes more complicated. What comes to the cost of different financing sources there is also variety of prices to be paid.

3.1.7 Maintenance and reduction of capital

Shareholders are traditionally believed to be the ones that have the ultimate right to govern the company.[159] This does however not allow shareholders to distribute the company funds as

[156] See Piketty, T. (2014) about the issues related to rate of return of capital exceeding rate of growth and of output and income and the impact of that on the distribution of wealth in society. According to Piketty the main driver of inequality - returns on capital that exceed the rate of economic growth - threatens to generate extreme discontent and undermines democratic values.
[157] Pratt, S.P. and Grabowski, R.J. (2010), p. 6.
[158] Koller, T. et al. (2010), pp. 235-238.
[159] Davies, P. and Worthington, S. (2012), pp. 691-692.

they wish. Therefore, sufficiency of company capital and maintenance of it are important issues according to the company law.[160]

In capital maintenance the main idea is that equity capital of company must not be distributed freely to shareholders.[161] This sets certain restrictions for the company to deal freely with its capital. Essential is that the share capital after being paid-up forms a fund which must be maintained for the benefit of creditors.[162] This is a method of protecting shareholders and creditors by safeguarding that operations take place only with a proper amount of assets for a company to be able to meet the claims of the creditors.[163] Creditors as a group include a large variety of different actors that can be divided into contractual creditors and non-contractual creditors. Contractual creditors make contract with the company and in this way their claim towards the company is based on actual contract. Non-contractual creditors - like employees, tax authorities and tort victims - on the other hand, do not have the possibility to contract with the company and thus have claims based on the special legislation like environmental law. It is in the interest of all creditors to secure that their receivables from the company are covered. The capital maintenance regulation relating to the capital distribution is protecting the creditors which makes it easier for the company get financing.[164] These rules are therefore essential for the execution of the corporation's commercial activities.[165]

The important elements of capital maintenance are

- existence of legal capital
- rules for the distribution of company funds
- minimum capital requirements
- rules for preventing circumvention.[166]

Legal capital is the total amount stated in the balance-sheet as a liability. Mandatory minimum share capital is one instrument in creditors´ protection but it alone is not enough. Value of mandatory minimum share capital does not give necessary protection to creditors and therefore protection must be established also with contract provisions.

Rules of distributing the company funds mean that some classes of assets in the company balance sheet can be used or distributed to stakeholders according to the company law only according more difficult procedure.[167] Rules for preventing circumvention refer for example to rules ensuring that the company receives the assets, financial assistance and recharacterization of loans to equity because of insolvency.[168]

The European Union level capital maintenance rules concerning public limited liability companies are included in the Directive (EU) 2017/1132[169]. The target of the regulation is to secure for shareholders and creditors a comparable minimum protection and additionally

[160] About the European company law view towards the legal capital see Geens, K. and Hopt, K.J. eds (2003), pp. 25-59.
[161] Ferran, E. and Ho, L.C. (2014), pp. 156-157.
[162] Raiser, T. and Veil, R. (2010), p. 328.
[163] About the Legal Capital Regime in EU see Mäntysaari, P. (2010c), pp. 145-158.
[164] Rodhe, K. and Skog, R. (2014), p. 24.
[165] Hopt, K.J. and Wymeersch, E. eds (2003), p. 328.
[166] Mäntysaari, P. (2010c), p. 141.
[167] Mäntysaari, P. (2010c), p. 140.
[168] Mäntysaari, P. (2010c), p. 141.
[169] Directive (EU) 2017/1132 of the European Parliament and of the Council of 14 June 2017 relating to certain aspects of company law.

ensure coordination of national rules concerning forming, maintaining, increasing and reducing capital of a public limited company. The capital maintenance provisions have their roots in two leading ideas:

- a company shall have sufficient capital that shall be maintained subsequently[170] and
- there shall be certain shareholders´ rights concerning new capital.[171]

To have these rules set in European Union level shows the importance of capital maintenance for the European law makers.

In the USA the corporation law is state law and there is no general federal corporation law. In the USA the capital maintenance rules differ depending from the state.[172] Unlike in Europe capital maintenance is also not considered very important area of company law.[173]

3.2 About the nature of mezzanine financing

3.2.1 Closing the gap between equity and debt

The founding of a company requires capital. When limited liability companies are observed, the founders need to invest first in equity. After that the owners turn normally to the banks when additional financing is needed. However, these two financing channels are not always enough. The development of capital and financial market during the last decades has led to the need of more flexible financing forms to satisfy the different financing needs.[174] Between equity finance and traditional bank finance lies a *"gap"* which needs filling.[175] There is room between high risk equity and traditional debt secured by collateral. This room can be filled with instruments and products that provide a risk/return profile that lies between debt and equity. When the senior debt capacity has been fully used and company's cash flow has sufficient capacity for additional long-term borrowings the financial leverage could be increased further. This kind of financing is often called as mezzanine financing referring to layer in the middle of equity and a firm´s senior debt.[176] Structurally mezzanine is subordinated to senior debt in terms of payment priority and security but has higher priority than equity. Flexibility and versatility are special features of mezzanine as regards the arrangement of the terms of the contract.

The debt financing alternatives of a company can be divided in different classes based on security and seniority.[177] Below is presented a basic division of the alternatives from a limited

---

[170] Directive (EU) 2017/1132 establishes a series of requirements for the incorporation of a public company limited by shares. Member states have liberty either to introduce higher capital requirements or to comply strictly with the directive, which requires a minimum legal capital of 25.000 Euros. This does not prevent companies from adopting a higher share capital if they consider this necessary. See for more details below in section *3.4.1.2.1 Capital maintenance.*

[171] Two examples of this principle: 1) prohibition to issue shares under their nominal value or - in case of no nominal value - their accountable par and 2) in case of several classes of shares the decision in general meeting to increase capital is subject to separate vote in each class of shareholders.

[172] Mäntysaari, P. (2010c), pp. 151-152.

[173] Booth, R.A. (2005), p. 2.

[174] Lautjärvi, K. (2009), p. 75 and Villa, S. (2001), p. 2.

[175] The gap referred here shall is different from the financing gap that exists between small young firms and mature firms. About the financing gap see e.g. Arnold, G. (2013), p. 399.

[176] Term *"mezzanine"* comes initially from the Italian language referring to *"mezzano"* meaning *"middle"*.

[177] See Brealey, R. A. et al. (2014), pp. 357-358 and 608-609.

liability company´s point of view (see Figure 4 below). Besides different debt forms the list includes also shareholder´s equity. Mezzanine debt is hybrid capital form that has place between equity and senior debt in a capital structure of a company. Mezzanine can be relevant when a financing gap is identified in the middle of the traditional main layers of the balance sheet. In the table below the subordinated loan is classified as mezzanine financing form. Here it is anyway relevant to emphasize that not all mezzanine financing is subordinated financing.[178]

Figure 4: Financing forms and order of repayment

Financing form	Repayment priority
Equity capital	IV
Subordinated loans (mezzanine)	III
Senior debt without security	II
Senior debt with security (including asset-based financing by financing companies)	I

Companies need to think how much they borrow and what type of debt they want. Capital and debt structures require careful planning. Different financing forms have different costs which reflect the risk of the lender/investor. A basic rule is that the longer the repayment period is, the more costs will be generated.[179] However based on the theory of pecking order companies prioritise financing with funds that are generated internally.[180] In the case of borrower company´s default the senior loans are repaid first and equity last.

In funding structures mezzanine finance may fill the gap that arises between equity and traditional senior debt. If a company generates cash flow that supports a bigger debt amount than a traditionally operating senior financier is ready to provide, mezzanine may become a financing alternative. This is the case if a traditional lender lends only subject to collateral and no additional equity is found due to its high return requirement. It is important to observe that mezzanine loans do not substitute the senior bank loans but rather complement them.

Mezzanine finance can take many forms but in its simplest form it is often a capital loan[181] or a subordinated debt without any additional equity elements attached. The so-called *"equity kickers"* like equity warrants can also be part of the transaction package giving the lender the opportunity to participate in the borrower´s equity upside. Although such structures increase the complexity of the financing transaction they are also sometimes used. The equity kickers are discussed later in this research.[182]

The flexible nature of mezzanine makes it very suitable for various financing situations. The mezzanine capital is perhaps most widely used to fund growth opportunities: acquisitions, plant expansion, new product lines and new distribution channels. Shareholders´ control does not dilute, company´s balance sheet strengthens and it possible to obtain further senior debt on more favourable conditions.

[178] About mezzanine definition see below section *3.2.2 Definition of terms*.
[179] Arnold, G. (2013), pp. 465-468.
[180] Brealey, R. A. et al. (2014), pp. 467-471 and Arnold, G. (2013), pp. 799-801.
[181] The term *"capital loan"* refers here to the specific loan type regulated in Chapter 12, Section 1 of the Finnish Limited Liability Companies Act (624/2006). For further details see below section *3.4.2.2.4 Capital structure.*
[182] See below section *3.2.5 Equity kickers.*

While mezzanine loan combines the features of equity and debt, it also results in a risk/return profile that is between equity and debt.

3.2.2 Definition of terms

As discussed above mezzanine finance is most often understood as debt that ranks between senior loans and equity and has features of both financing forms.[183] This hybrid form of financing lies between equity and senior debt on a balance sheet of a company. Structurally it is most often subordinate or "junior" to senior debt in terms of payment priority but senior to equity. It is possible to structure mezzanine also to be a subordinated loan with equity warrants.

The exact definitions of the terms that do not have universal commonly agreed definition vary often depending on the user. In this document the key terms used have following definitions:

Mezzanine financing

- unsecured financing that ranks in terms of risk and return between senior loans and equity
- capital loan (as defined in the Finnish companies act[184]), junior loan that is subordinated to all the other debts[185] or other loan the return of which is tied to financial indicators related to borrower (profitability, solidity, change of value etc.)[186]
- does not include preferred shares or share equity.

Hybrid financing

- as mezzanine financing described above

Private equity

- funding made available by venture capitalists to companies that are not publicly traded on a stock exchange.[187]

Subordinated debt

- debt that ranks lower than other loans and is subordinated (repaid last) in the liquidation of the borrower company.

Senior debt

- debt that will be repaid before subordinated loans in case of liquidation of the borrower company

[183] Niskanen, J. and Niskanen, M. (2013), p. 30 and Arnold, G. (2013), p. 437.
[184] Chapter 12 of the Limited Liability Companies Act (624/2006).
[185] Brealey, R. A. et al. (2014), p. 609.
[186] This loan can be either capital loan, junior loan and senior loan. Relevant here is the structure of the interest clause.
[187] Venture capital is sometimes considered as a subset of private equity. In this document terms venture capital and private equity are used to mean the same issue unless otherwise expressed in the text part in question.

- typical for long-term financing of low-risk companies provided by banks.

Venture capital

- Industry where professional investors co-invest equity with the entrepreneur to finance companies mostly in seed, start-up and expansion stages. As compensation for the high risk investments made by investors is expectation of return rates that are above average. Venture capitalists use also mezzanine financing instruments.

3.2.3 Repayment priority

Bankruptcy is the legal process by which the debts of the firms are resolved.[188] Bankruptcy takes place when debtor - corporate or an individual - is not able to meet its obligations at the due date. It therefore relates to the cash flow of the debtor and is not necessarily related to what the debtor owns. Insolvency law provides rules for determining how the assets and earnings to be used for repayment are divided among creditors. This highlights the important role of insolvency legislation in the economics.[189]

In a bankruptcy or business liquidation principle of pari passu[190] is relevant term. According to this principle all creditors are treated equally and will be repaid at the same relative share out of their claim amount. Some scholars consider it to be relevant part of bankruptcy and liquidation process but some think it has only less important role.[191] In practice debts are ranked according to repayment priority which determines their hierarchy.[192] This priority scheme sets the order in which claims are paid. The priority rank is normally set by the types of debt obligation and depends also on the priority agreed when the debt was created. Therefore, it is difficult to describe comprehensively the priority ranking. In any case creditors´ share out of the estates funds is not equal due to the different priorities and thus the pari passu de facto is applied inside the priority ranks. The basic idea is that *pro rata* distribution takes place among similarly situated creditors.

Subordinated liabilities are financial liabilities for which it has been contractually agreed that they are not to be repaid in the event of liquidation or bankruptcy until all obligations towards other creditors have been fulfilled. Senior debts are then repaid prior to lower-ranking subordinated debt. It is to be noted however that the agreed repayment priority does not cover all the debt obligations. Liquidation and bankruptcy regulations in general recognise also super-priority creditors that have their priority directly based on the law. To have repayment hierarchy in liquidation is an international phenomenon.[193]

It must be noticed that subordination of debt based on law and agreed repayment priority is different thing than subordination based on the structures. Structural subordination is in

---

[188] According to the Finnish Bankruptcy Act (120/2004), Chapter 1 *"A debtor who cannot repay his or her debts can be declared bankrupt in accordance with the provisions of this Act. The court shall make the order of bankruptcy on the petition of the debtor or a creditor. Bankruptcy is a form of insolvency proceedings covering all the liabilities of the debtor, where the assets of the debtor are used in payment of the claims in bankruptcy. In order to achieve the objective of the bankruptcy, the assets of the debtor shall in the beginning of bankruptcy become subject to the authority of the creditors."*

[189] Wood, P. R. (2008), p. 13.

[190] Term *"pari passu"* comes initially from the Latin language referring to *"equal rate"* or *"equal pace"*.

[191] The importance of pari passu is emphasized by Goode, R. (2011), p. 235 and Finch, V. (2002), p. 421. About different view see Mokal, R.J. (2001) according to which pari passu principle has smaller role in bankruptcy.

[192] Wood, P. R. (2011), p. 94.

[193] Wood, P. R. (2008), p. 58.

question when the assets used for the repayment are owned by different entity than the actual obligor.[194]

An example of structural subordination is when assets are owned by the subsidiary but the loan is granted to the parent.[195] In such an arrangement the lender of the parent company is structurally in a weaker position compared to the creditors of the subsidiary as repayment ability of the parent depends on the dividend payments made by the subsidiary. Lenders can however agree on the order of debt repayment with an intercreditor agreement in a way that mitigates the creditors` unequal structural position.

It has been described above that typically senior secured debt has the first repayment priority and in the ladder of priorities senior secured debt is followed by senior unsecured debt obligation.[196] In practice it means that if the debtor is unable to pay the obligation to the secured creditor outside any bankruptcy according to the agreed repayment plan then creditor is paid from the proceeds of the property that secures his interest. In such a case collaterals are sold and the funds are distributed to the holders of senior secured debt. After all senior secured debt is paid the remaining funds will be distributed to claimants of senior unsecured debt. Secured creditors are top-ranking creditors in a bankruptcy case and therefore these creditors are generally safe in a bankruptcy proceeding.[197] If the collateral is not fully covering the claim, then the claim is split into a secured part covered by the collateral and an unsecured part for the remaining portion. The secured part of the claim is fully paid and the part without security gets a pro rata share out of the payments channeled to unsecured creditors.

Unsecured creditors have no encumbrances on any property and therefore repayment of the debt is not backed by specific asset. This means that in most of the insolvency cases there is not enough funds to provide full repayment for unsecured creditors. In fact, very often unsecured creditors receive nothing or very little in a liquidation of the debtor firm. Their status is therefore most uncertain in bankruptcy.

3.2.4 Subordination of debt

Companies´ decisions to borrow are driven by the need for funding and the choice of loan instrument is based on several considerations including agency costs, bankruptcy costs, taxation and general availability of the financing. In some cases company may decide to take financing in a form of subordinated financing.

Subordinated debt is any type of outstanding debt that is lower in priority than other debt obligations. In debt subordination legal techniques are used to allow creditors to contractually settle the repayment rankings of their individual claims. When using this technique creditors accept lower priority than their receivables would typically have.[198] In practice this means that lender agrees not to be paid until other lenders have been paid.[199] This subordination clause can be agreed either directly between the debtor and the creditor or alternatively between creditors through a turnover agreement.[200] Contract of the creditor and debtor covering the subordination states that the creditor of the subordinated debt has right for the payment only

[194] Mäntysaari, P. (2010c), p. 293. See also below section *3.2.4 Subordination of debt.*
[195] Gullifer, L. and Payne, J. (2015), p. 262.
[196] See above section *3.2.1 Closing the gap between equity and debt.*
[197] As financing is essential to the rehabilitation of a company in financial distress and in insolvency getting new financing is difficult some jurisdictions allow priority status for fresh financing for the company under insolvency. See Wood, P. R. (2007), p. 234.
[198] Ferran, E. (1999), p. 545.
[199] Mäntysaari, P. (2010c), p. 292.
[200] Wood, P. R. (2007b), p. 177

after other creditors have been paid fully. The subordination through turnover agreement can be done either by using a specific trust benefiting the senior creditors or alternatively by the junior creditor´s contract commitment to channel the received funds to the senior creditor. In a trust arrangement the junior creditor will act as a trustee and hold money or dividend received from the debtor on trust for other senior creditors until all other senior creditors are fully paid.[201]

In a subordination agreement one debt is established to rank behind another debt in the priority for debt repayment. This creates a hierarchy in how debt obligations are covered in case resources do not cover all the liabilities in full. The priority of debts is very important in case the debtor becomes insolvent. Higher priority debts have a legal right to be repaid fully before debts having lower priority receive any repayments. If the debtor does not possess sufficient funds to repay all debt - which often is the case in bankruptcy - lower priority debts may receive only partial repayment or no repayment at all.

An additional form of subordination is so-called structural subordination. In this arrangement debtors are different companies in the same group like the holding company and the subsidiary being in charge of the daily operative business. The structurally subordinated debt is taken by the company holding the subsidiary shares and the senior debt is taken by the operative subsidiary owning the assets.[202] The primary source of income of holding company is the distribution made by the subsidiary. This income is constrained by the company rules and require distributable assets.[203]

Because subordinated debt is repayable after other debts have been paid, they are riskier for the lender. This means that lenders will also require a higher interest rate as compensation. The higher interest compensates the higher repayment risk of the subordinated debt.

3.2.5 Equity kickers

Mezzanine capital is not a standardised stand-alone financing instrument like loan or stock. Mezzanine financing is characterised by versatility and flexibility as it can represent wide range of features. These features can cover different financial structures in respect of the obligations and rights in the agreement. As mezzanine financiers have claims that are subordinated to senior lenders the required return is higher than the required return of senior loan financiers. This can be taken care of by higher interest rate and/or by so-called profit related “equity kicker” element.[204] The idea of the latter is to allow the mezzanine lender to participate in the upside of the equity value and to compensate the lender for the higher risk taken. This adds desirability of the financing instrument for the potential investors as it helps the lender to get the return better reflecting the risk taken. Even if the forecasted liquidity would not allow the debtor company to compensate the mezzanine financier well enough the equity kicker element can make the mezzanine financing possible.[205]

Equity kickers can be either real or synthetic.[206] The real equity kicker is in question when the mezzanine lender has possibility to subscribe shares i.e. get an equity ownership. The synthetic

[201] Gullifer, L. and Payne, J. (2015), pp. 256-259.
[202] Lehtimäki, M. J. (2007), pp. 11-13.
[203] Mäntysaari, P. (2010c), p. 293.
[204] Mäntysaari, P. (2010c), p. 300.
[205] Müller-Känel, O. (2009), p. 229.
[206] Mäntysaari, P. (2010c), p. 300-301.

alternative refers to arrangement that links the remuneration of the lender to the increase of profit or value of the debtor company according to the tailor-made agreement.

The ownership component is normally identified by an attached warrant or other conversion possibility. The warrants give the holder the right to purchase a specific number of shares at a fixed price during a defined period.[207] The valuation mechanism of the warrant is different depending on whether the company is listed or not. Regarding a listed company, the valuation can be determined based on the public market value.[208] In cases where no market prices exist, the valuation of the equity warrant is defined by using a valuation technique that is agreed contractually.

Normally the structure is such that financier would get some ownership if option to subscribe shares would really be used. However, it should be noted that mezzanine financier rarely targets for using the option to subscribe shares but rather wants to convert the conversion option into money at the moment of exit.[209]

Although compensation terms of mezzanine financing in general is used according to same principles in different financial markets some differentiation in usage of equity kicker element can be observed. In the USA the usage of fixed rate component is more common than in Europe where equity kicker is used more widely.[210]

3.2.6 The view of rating agencies

Credit rating agencies are private companies that issue assessments on what is the probability of the repayment of debt. Standard & Poor´s, Moody´s and Fitch are the market leaders of the industry with the total market share in EU of around 85 % and in the USA of around 95 %.[211] The rating agencies evaluate the borrower´s capacity to satisfy its interest and principal payment obligations according to the agreed schedule.

Credit ratings are aiming to provide a view of creditworthiness which is long-term and based on fundamental analysis. Ratings do not reflect a trader's view of and do not measure asset value or liquidity of a security but rather credit quality. Credit rating agencies provide standardized, widely accepted scale of creditworthiness covering financial instruments across industries. The ratings help among other things to assess company´s creditworthiness and cost of lending. The services of credit rating agencies are used by several different stakeholders in the capital markets like banks, investors, issuers and regulators. Below is an example of a rating scale used by credit rating agency (see Figure 5 below).

Generally, companies in stable industries and low risk business have higher likelihood to get better rating and highly leveraged companies with poor profitability tend to get lower rating.[212]

---

[207] OECD (2013), p. 26.

[208] For example, if the price at which a company share can be purchased by exercising the warrant (= warrant strike price) is 15 EUR and the market price of the share rises to 20 EUR per share, the investor can redeem the warrant and buy the shares for 15 EUR per share.

[209] Müller-Känel, O. (2009), p. 230.

[210] Nijs, L. (2014), p. 14 according to which also *"One most extreme examples of this phenomenon was in the early days of the 2008 financial crisis when liquidity dried up and available equity was almost non-existent: some mezzanine funds in the CEE region, a region heavily impacted in the early days of the crisis, were able to put their product in the market at yields in the first decile only, and often far above the actual equity return at that point of time."*

[211] See reports of U.S. Securities and Exchange Commission (2013) and European Securities and Markets Authority (2013).

[212] Arnold, G. (2010), p. 455.

However, the most important element when assessing credit risk is the repayment priority ranking.[213]

Figure 5: An example of the rating scale used by a credit agency

Long-Term Issuer Credit Ratings*	
Category	**Definition**
AAA	An obligor rated 'AAA' has extremely strong capacity to meet its financial commitments. 'AAA' is the highest issuer credit rating assigned by S&P Global Ratings.
AA	An obligor rated 'AA' has very strong capacity to meet its financial commitments. It differs from the highest-rated obligors only to a small degree.
A	An obligor rated 'A' has strong capacity to meet its financial commitments but is somewhat more susceptible to the adverse effects of changes in circumstances and economic conditions than obligors in higher-rated categories.
BBB	An obligor rated 'BBB' has adequate capacity to meet its financial commitments. However, adverse economic conditions or changing circumstances are more likely to lead to a weakened capacity of the obligor to meet its financial commitments.
BB; B; CCC; and CC	Obligors rated 'BB', 'B', 'CCC', and 'CC' are regarded as having significant speculative characteristics. 'BB' indicates the least degree of speculation and 'CC' the highest. While such obligors will likely have some quality and protective characteristics, these may be outweighed by large uncertainties or major exposures to adverse conditions.
BB	An obligor rated 'BB' is less vulnerable in the near term than other lower-rated obligors. However, it faces major ongoing uncertainties and exposure to adverse business, financial, or economic conditions which could lead to the obligor's inadequate capacity to meet its financial commitments.
B	An obligor rated 'B' is more vulnerable than the obligors rated 'BB', but the obligor currently has the capacity to meet its financial commitments. Adverse business, financial, or economic conditions will likely impair the obligor's capacity or willingness to meet its financial commitments.
CCC	An obligor rated 'CCC' is currently vulnerable, and is dependent upon favorable business, financial, and economic conditions to meet its financial commitments.
CC	An obligor rated 'CC' is currently highly vulnerable. The 'CC' rating is used when a default has not yet occurred, but S&P Global Ratings expects default to be a virtual certainty, regardless of the anticipated time to default.
R	An obligor rated 'R' is under regulatory supervision owing to its financial condition. During the pendency of the regulatory supervision the regulators may have the power to favor one class of obligations over others or pay some obligations and not others.
SD and D	An obligor rated 'SD' (selective default) or 'D' is in default on one or more of its financial obligations including rated and unrated financial obligations but excluding hybrid instruments classified as regulatory capital or in non-payment according to terms. An obligor is considered in default unless S&P Global Ratings believes that such payments will be made within five business days of the due date in the absence of a stated grace period, or within the earlier of the stated grace period or 30 calendar days. A 'D' rating is assigned when S&P Global Ratings believes that the default will be a general default and that the obligor will fail to pay all or substantially all of its obligations as they come due. An 'SD' rating is assigned when S&P Global Ratings believes that the obligor has selectively defaulted on a specific issue or class of obligations but it will continue to meet its payment obligations on other issues or classes of obligations in a timely manner. An obligor's rating is lowered to 'D' or 'SD' if it is conducting a distressed exchange offer.
NR	An issuer designated 'NR' is not rated.

*The ratings from 'AA' to 'CCC' may be modified by the addition of a plus (+) or minus (-) sign to show relative standing within the major rating categories.

Source: Standard & Poor´s (2016), p. 6.

Sometimes in case of structured credit products[214] debts are structured so that cash flows are allocated for the repayment of different debt tranches in accordance to what has been decided in advance.[215] In such structures amortisations and interest payments are channelled to the senior tranches first whereas losses are allocated to the subordinated tranches. In case of investors this gives possibility to buy either well protected senior tranches or subordinated tranches with higher risk. Credit rating agencies assess the subordination level of single tranches and determine after that what is the relevant credit rating of each tranche.[216] The more senior rated tranches generally have higher credit ratings than the lower rated tranches.

[213] Langohr, H. and Langohr, P. (2008), p. 262.
[214] Structured products is generic term used to refer to various capital markets instruments like asset-backed securities (ABS), collateralised debt obligations (CDO) and mortgage-backed securities (MBS). See for more details Choudhry, M. (2011), pp. 403-508.
[215] See An, X. et al. (2014) according to which *"Commercial mortgage-backed security (CMBS) issuers create CMBS by pooling commercial mortgages and carving out tranches (bonds) out of the commercial mortgage pool. CMBS is an example of a structured finance product where assets are pooled and tranched."*
[216] See about credit rating methodology Griffin, J.M. and Dragon Y.T. (2012) pp. 1298-1299.

In practice this means that the losses are distributed based on the position of the tranche in the structure. Losses start from the lowest priority tranche and progress to the senior tranche. This is referred to as the waterfall structure.[217] All in all subordination is one important element of credit enhancement.[218]

3.2.7 Versatility of mezzanine

As has already been discussed funding is needed for the company to conduct its business activities. To establish a company is subject to getting sufficient amount of capital. In case of a limited liability company equity input is needed first. This part of the financing is on the shoulders of the owners. After that normally the banks come into the picture. However, all financing needs of the company cannot be taken care of by the owners and banks.

Between equity input and senior bank financing there is room for additional financing forms. This space can be covered by financing instruments that have a risk/return profile between the senior debt and equity. In such a situation the space is the "home zone" of mezzanine. Financing forms falling into this category belong between debt and equity in a company's capital structure.

Mezzanine financing is globally used financing form. It can fill the financing gaps and generate competitive returns wherever it is used. However local legal environment and market practices must be naturally considered, too. The conditions may to some extent vary between different market areas.

Mezzanine debt is used to fund companies for different kind of purposes like providing working capital, supporting growth or financing acquisitions.[219] It reduces need for other financing like traditional senior debt or equity. Mezzanine can be one piece in the puzzle of creating optimal capital structure. Mezzanine has also major relevance in venture capital as these hybrid instruments allow structuring of decision-making and financial rights of stakeholders in a way which is not possible with the traditional debt and equity instruments.[220]

Mezzanine finance is debt that ranks between senior loans and equity and has features of both financing forms. In terms of structure it is most often subordinated or "junior" in repayment priority towards senior debt but senior towards equity or common stock. Mezzanine can be structured as a subordinated loan with *"equity kickers"* like equity warrants or share options. These additional features can be used to obtain shares in the borrower company.

Being a layer of financing between a borrower´s senior debt and equity mezzanine debt can take several forms. It can exist in a form of convertible debt, option loan or profit-sharing loan and it can be even senior or subordinated debt which highlights its flexible nature. On top of that there are specific instrument types that are regulated by the national legislation and which also fall within the category of mezzanine finance. Examples of such specific products are capital loan in Finland and principal-linked participating debentures in Sweden.

Planning of capital and debt structures must be done carefully. Different financing forms have different costs depending on the risk of the investor. The lower the repayment period is the higher is the cost for the borrower. Because mezzanine loan combines the features of equity

[217] Chatterjee, R. (2014), p. 256.
[218] Darbellay, A. (2013), p. 107.
[219] About the transactions for which mezzanine is used see also Nijs, L. (2014), pp. 7-8.
[220] Sasso, L. (2012), pp. 85-193 and p. 195.

and debt, it also results in a risk/return profile that is between equity and debt. In case of default the senior loans are covered first, mezzanine loans second and equity last.

The flexibility of mezzanine makes it very useful instrument for several kinds of situations. The exact transaction terms can be agreed individually based on the needs of the stakeholders involved. Among the positive features of this financing form belong that it does not dilute shareholders´ control. Mezzanine financing increases liquidity and reduces borrower´s vulnerability to economic fluctuations. Depending on the agreed terms also borrower company´s balance sheet can be strengthened. In such situations also increased senior debt borrowing is possible on more favourable conditions. The many positive features of mezzanine have made it popular instrument in connection with the acquisitions.[221]

3.3 Types of contract

3.3.1 General

In terms of involved parties, the credit documentation used in mezzanine arrangements tend to be like those used in other corporate financing transactions. The clear majority of mezzanine transactions have been made with bilateral agreements involving two parties. When more than one financier is involved, transaction is done as club deals or syndications.

Unsecured mezzanine loan requires normally tailor-made finance agreements. The agreements are specially separately for each arrangement and they include contractual provisions that are called covenants. Lender, borrower and the shareholders enter number of covenants the purpose of which is to improve the status of the creditor by reducing the risk of default. These provisions help the lender to monitor the borrower company and control the repayment of the loan. Early warning signs for negative performance deviations are very important as the financial risk in mezzanine transactions is normally high. It is extremely important for lender to have mechanisms securing high quality performance reporting and mechanisms securing a strong bargaining power towards the borrower and its shareholders as early as possible in case of weakening performance.[222] Financial covenants are set with an agreed headroom.[223] In addition to the financial covenants the loan agreements generally contain undertakings strongly restricting the borrowers from actions which are not included in the commonly agreed business plan. For instance, the company will generally not be allowed to merge, make significant acquisitions, change business strategy or increase debt above agreed thresholds without consent from the lenders. Also, dividend payments may be limited. Breach of covenant gives normally the lender right to require its claim to fall due immediately unless the terms of the loan are not renegotiated.

3.3.2 Bilateral contracts

In case of bilateral loans, the loan documentation is made between one lender and one borrower. Bilateral loan documentation is most often used when the actual funding arrangement is also done between one creditor and one borrower. Bank financing to SMEs

[221] Lautjärvi, K. (2015), p. 221.
[222] Loan agreements contain often mechanisms for regular reporting of operational and financial performance and financial covenants. The reporting takes normally place on monthly or quarterly basis.
[223] Covenant headroom level is case-specific and investor´s target is to ensure that the covenant breach occurs before any payment default.

takes mostly place in form of standardised bilateral documents. As the borrower deals directly with the bank borrower saves money by not having to hire agents to look for financiers and negotiate tailor-made terms. When using lender´s standardised terms possibility for the individual borrower to negotiate the terms is more limited but on the other hand this saves time and decreases the costs.

Also, sizeable loans can be done on bilateral agreements but the bigger the loan amount the greater is the possibility that several financiers are needed.[224] In such a situation there may be need to harmonize the financing terms of creditors and that can be done through club loans or syndication arrangements.[225] Then also possibility to use standardised terms of one creditor for other creditors is limited and more tailor-made terms are often used. This increases complexity of the documentation and costs.

3.3.3 Intercreditor agreements

3.3.3.1 Club loans

Sometimes borrowers' financing need exceeds one lender´s willingness or capacity to fund the whole requested amount. This may be due to the different reasons linked to the amount of the financing need, deal structure, borrower or creditor itself. There is not an exact general limit for funding through one creditor as such but depending on the circumstances the funds may need to come from more than one place. In such a situation bilateral loan is not enough.

A club-loan is in question when small group of banks jointly decide to finance a borrower.[226] Due to the nature of the club loan arrangement involving several parties there are higher agency costs than in bilateral arrangements. Normally a club loan is planned to be kept in the balance sheet of the creditor until the loan maturity.

3.3.3.2 Syndicated loans

Also for syndicated business loans there are several parties involved.[227] Besides the borrower there are several lenders. To structure the syndicated loan arrangement many stakeholders with different responsibility areas are needed. Among other things arrangers and book-runners involving also experts like lawyers and investment bankers are needed.[228] This makes syndication arrangements costly. Normally also the cost paid for the actual loan are higher in case of syndicated loans. For lenders the high pay-off to be received from syndicated loans motivates choosing of this financing form.

From borrower´s perspective the choice between a bilateral loan, club loan and a syndicated loan is driven mainly by the size of the financing need and how important it is to keep the identity of the lender the same throughout the course of an agreement. For syndicated arrangements is typical that lender has right to sell their commitments to primary or

[224] Vernimmen, P. et al. (2017), p. 371.
[225] See below section *3.3.3 Intercreditor agreements*.
[226] Wood, P. R. (2007c), p. 4.
[227] Wood, P. R. (2007c), p. 4.
[228] Iannotta, G. (2010), p. 109 and Mäntysaari, P. (2010c), pp. 126-127.

secondary market. Therefore, by going into syndicated arrangement borrower specifically allows possibility to creditor changes.[229]

3.3.4 LMA and LSTA documentation

Due to the complexity and high cost of syndicated transactions financiers have tried to some extend agree on common principles and terms to be used in primary and secondary market syndicated loan. The UK based Loan Market Association (*"LMA"*)[230] together with the USA based Loan Syndications and Trading Association, Inc. (*"LSTA"*)[231] are organisations that publish model documents to be used as basis for syndicated both for primary and secondary market. There are no standard loan agreements for syndicates as such these model documents are often used as basis when parties start to negotiate on concrete terms.

As UK based organisation LMA assumes in its documentation primarily usage of English law as governing law and English borrowers with investment grade credit rating.[232] The usage of LMA documents have gained wide acceptance in European loan markets.[233] Also in syndications including mezzanine financing structures LMA documentation serves as basis.[234]

Being New York Based organisation LSTA assumes in its documentation usage of US Law as the governing law. The usage of LSTA is not yet so widely accepted in the US market as LMA documentation in Europe.[235] This regards also intercreditor arrangements involving mezzanine type financing.[236] However in terms of absolute nominal loan amounts also the usage of LMA documentation is significant.[237]

3.4 The company law framework

In this section is reviewed the regulatory company law framework relevant for the chosen topic mezzanine financing. When referring to company law it is meant here subsection of legislation that provides legal form for business entities having following features: legal personality,

---

[229] As an example of this see Cranston, R. (2002), p. 55, according to which in so-called *"participation syndicates"* lead/arranger bank enters first in a bilateral deal with the borrower and sells after that participations in the loan to other financiers.

[230] LMA is based in London. LMA (2017) describes the mission of the association as follows: *"The Loan Market Association (LMA) has as its key objective improving liquidity, efficiency and transparency in the primary and secondary syndicated loan markets in Europe, the Middle East and Africa (EMEA). By establishing sound, widely accepted market practice, the LMA seeks to promote the syndicated loan as one of the key debt products available to borrowers across the region."*

[231] LSTA is based in New York. LSTA (2017) describes the mission of the association as follows: *"The LSTA promotes a fair, orderly, efficient, and growing corporate loan market and provides leadership in advancing and balancing the interests of all market participants. The LSTA carries out a wide variety of activities to*

- *Advocate for the shared interests of all loan market participants*
- *Increase market transparency and efficiency*
- *Facilitate and improve the settlement process*
- *Educate market participants*
- *Promote the growth of the loan asset class"*

[232] Wood, P. R. (2007c), p. 36.

[233] Mallon, C. and Waisman, S.Y. eds (2011), p. 89.

[234] Mellor, T. ed. (2014), p. 46.

[235] Mallon, C. and Waisman, S.Y. eds (2011), p. 107.

[236] Mellor, T. ed., (2014), p. 46.

[237] Mellor, T. ed. (2014), p. 72 and p. 76.

limited liability, transferability of shares, delegation of management by board and investors as owners.[238]

In the main focus shall be European Union corporate regulation and Finnish company law. On top of that are reviewed main points of the corporate legislation of Sweden, Estonia and US and - in a slightly less detailed way - UK and German corporate legislation. This coverage includes thus representatives of different legal families: Scandinavian, Continental European and Anglo-American.[239] According to this classification Finland and Sweden belong to Scandinavian, Estonia and Germany to Continental European and USA and UK to Anglo-American legal families.[240] Out of the countries included in the coverage especially Germany, UK and USA represent not only influential legal systems but are also leading market economies in the world.

3.4.1 EU legislation in general

The European Union (EU) has its own specific legal system differentiating it from the international law.[241] The structure is quite unique as EU legal system is an integrated element in the legal system of each member country. Although the members are independent sovereign nations, they have given up a part of their sovereign position to achieve common goals like improved common market.[242] To understand the EU legal system it is relevant to briefly touch the basics related to the birth of EU.

The history of EU dates back to early 1950s when Germany, France, Italy, Belgium, Netherlands and Luxembourg decided to establish European Coal and Steel Community (ECSC).[243] Later the Treaty establishing the European Community - also known as Treaty of Rome - in 1957 deepened the process leading to creation of European Economic Community (EEC). It is said that this started the process of harmonization of domestic laws.[244] This also meant that the focus of European cooperation was not any more limited to individual industry but to the more general economical welfare.[245] Transformation process continued when Single European Act was approved by 1987 and the Treaty on EU (also known as Maastricht Treaty on EU) was signed in 1992. The official renaming of ECC to EU happened upon the Maastricht Treaty entering into force of in 1993. Finland became member of EU in 1995 and after that EU regulation became part of the Finnish legal system.

From the development of EU legal system perspective, the Reform Treaty (also known as Treaty of Lisbon) is very relevant. With this agreement, which entered into force in 2009[246], the EU received the legal personality and took the place of the European Community (EC).[247] This agreement altered the constitutional core elements of the EU: Treaty of Rome and Treaty of Maastricht. It shall be noted that the Treaty of Lisbon - being the amending treaty - shall not be understood as an independent text.[248] The Treaty of Lisbon amended the Maastricht

[238] Kraakman, R. et al. (2017), pp. 1-15.
[239] About legal families see above footnote 101.
[240] Ibid.
[241] About the unique character of EU legal system and EU law see Arnull, A. and Chalmers, D. eds (2015), pp. 23-26.
[242] See European Parliament (2017) about the legal order in EU.
[243] Weatherill, S. (2012), p. 5.
[244] Sealy, L. and Worthington, S. (2013), p. 7.
[245] Weatherill, S. (2012), p. 7.
[246] The Treaty of Lisbon was signed by the EU member states on 13 December 2007 and entered into force on 1 December 2009.
[247] Piris, J.-C. (2010), p. 65.
[248] Piris, J.-C. (2010), pp. 63-65.

Treaty, which presents also a remark to the EU's Charter of Fundamental Rights giving to that document legal conclusiveness. The Charter of Fundamental Rights includes a list of foundational human rights enjoying protection in the EU: equality, dignity, freedom, solidarity, citizens' rights and justice.[249] This means that the Treaties on European Union (Treaty of Maastricht) and on the Functioning of the European Union (Treaty of Rome)[250] and also Charter of Fundamental Rights are legally equally valuable and jointly form the legal basis of the European Union. This is the core foundation for every institution in the EU listing their rights and obligations and explaining the scope of the EU legislation.

The union has until today grown to the totality of 28 member countries which cover area from the Black Sea to Atlantic.[251] Today the EU has become home for more than 500 million people.

In EU regulation the internal market is defined as the area where the movement of goods, persons, services and capital is free. This concept of *"the Four Freedoms in the EU"* is based on the Treaty on the Functioning of the European Union.[252]

Among the central ideas behind the EU is that economically integrated single market is subject to single European Company Law.[253] European Union aims to harmonize the legal systems of its members to improve the functionality of the common market. In practise this is done by giving the EU institutions the powers to form a common market in the Treaty on the Functioning of the European Union.[254] However the plan is not to establish one European Law although in some cases one set of EU rules replaces the different national rules. This simplifies both the legal framework and decreases regulatory complexity. One of the benefits coming out of this is the increase of regulatory predictability. Harmonization of the rules relating to company legislation, accounting and auditing and corporate governance has been considered important when a single market for financial services and products has been created. Such an internal market provides optimal allocations for resources and production factors.[255] The goal of EU regulation in company law, governance, accounting and reporting is increase business opportunities and improve shareholder protection all EU countries.[256]

EU today is said to have elements of federation although legislative and executive powers are not strong.[257] EU regulation and the decisions of EU courts have anyhow a major relevance on

---

[249] The Charter of Fundamental Rights of the EU is a legally binding set of internal rules in EU. According to these rules all the institutions and bodies of the EU must respect the rights contained in the Charter when taking action in respect to EU law and policy. The existence of the charter as a binding part of primary EU law is said to emphasize the constitutional order of EU. See De Vries, S. et al. eds (2015), p. 20.

[250] Originally the Treaty of Rome was known as the Treaty establishing the European Economic Community when it was signed in 1957. The word "*Economic"* was deleted from the treaty's name by the Maastricht Treaty in 1993. The Treaty of Rome was amended as the Treaty on the functioning of the European Union when the Treaty of Lisbon entered in the force in 2009.

[251] The European Economic Community (later European Union) was founded in 1950 and had originally six members: Belgium, France, Germany, Italy, Luxembourg and the Netherlands. In the next phase Denmark, Ireland and the United Kingdom became member states in 1973. After that Greece joined in 1981 and Portugal together with Spain followed in 1986. Austria, Finland and Sweden joined in 1995. In 2004 Cyprus, the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Malta, Poland, Slovakia and Slovenia became member states in the enlargement, which has so far been the biggest one-off membership increase in EU. Three years later, in 2007, also Bulgaria and Romania joined the EU family. Croatia joined the EU on 1 July 2013, bringing the total number of member states to 28.

[252] Treaty on the Functioning of the European Union (2016), article 26.

[253] Ebge, W.F. (1997), p. 961.

[254] Treaty on the Functioning of the European Union (2016), article 26.

[255] Allmendinger, C. (2013), p. 74.

[256] European Commission (2017).

[257] Hartley, T.C. (2014), p. 11.

how company laws are applied in EU countries. Therefore, it is relevant to review briefly the sources of EU regulation and its systematics.

3.4.1.1 Regulatory systematics of EU legislation

EU legislation can be systemised in many ways.[258] Based on the sources EU law can be clustered in three categories: primary, secondary and supplementary law.[259]

In this division the primary law refers to the Treaties which have established EU. They set out the constitutional basis of EU including the competences and powers of different EU institutions including the member states. The most significant treaties in this respect are the Treaty of the EU and the Treaty on the Functioning of the EU.[260] Into the primary law are included also the amending EU Treaties, all protocols that are attached both to the founding Treaties and to the amending Treaties and additionally the Treaties on new member states' accession to the EU. In practice this category of law includes all founding Treaties and their amendments and protocols related to those treaties.[261]

The secondary law refers to unilateral acts and agreements. In this category belong EU regulations, directives, decisions and international agreements. Regulations are directly applicable and their effect is always direct.[262] The directive corresponds to an act which is addressed specifically to member states. It has to be transferred into the domestic legislation as each country deems appropriate. However, in some situations the Court of Justice has recognized also that a directive can have a direct effect if protection of the rights of individuals so requires.[263]

---

[258] Shaw, J. (2000), pp. 240-249, Ojanen, T. (2006), pp. 46-59 and Hartley, T.C. (2014), pp. 87-198.
[259] EUR-Lex (2010).
[260] The Treaty on European Union (TEU) is also known as the Maastricht Treaty. It was undertaken to integrate Europe and it was signed on 7 February 1992 by the members of the European Community in Maastricht, Netherlands. Upon its entry into force on 1 November 1993 it created the EU and led to the creation of the single European currency, the euro. It also introduced elements of a political union like citizenship and common policies in foreign and internal affairs. The Maastricht Treaty has been later amended by the treaties of Amsterdam, Nice and Lisbon. See Treaty on European Union (2016).

The Treaty on the Functioning of the European Union (TFEU) came into force on December 1, 2009. It is an amended version of the Treaty of Lisbon, which made amendments to the TEU. The TFEU defines the objectives of the EU and the scope for action within the different policy areas. The TFEU emphasizes the social dimension of the EU. The treaty also defines the structure and responsibilities of the EU institutions, including the European Central Bank. See Treaty on the Functioning of the European Union (2016).
[261] Ojanen, T. (2006), pp. 48-53.
[262] According to Article 288 of the Treaty on the Functioning of the EU *"To exercise the Union's competences, the institutions shall adopt regulations, directives, decisions, recommendations and opinions. A regulation shall have general application. It shall be binding in its entirety and directly applicable in all Member States. A directive shall be binding, as to the result to be achieved, upon each Member State to which it is addressed, but shall leave to the national authorities the choice of form and methods. A decision shall be binding in its entirety. A decision which specifies those to whom it is addressed shall be binding only on them. Recommendations and opinions shall have no binding force".* According to the judgment of the EU Court of Justice judgement of 14 December 1971 in Case 43/71, Politi s.a.s. v Ministry for Finance of the Italian Republic, this is a complete direct effect.
[263] In the judgment of the EU Court of Justice judgement of 4 December 1974 in Case 41-74, Yvonne van Duyn v Home Office, the Court stated in its case-law that a directive has direct effect when its provisions are unconditional and sufficiently clear and precise. In the judgment of 5 April 1979 in Case 148/78, Criminal proceedings against Tullio Ratti, the EU Court of Justice however concluded, that a directive can only have direct vertical effect and is valid only subject to that the member states have not transposed the directive by the deadline.

A legislative act of the EU is binding upon those to whom it is addressed. In case a decision has no addressees, then it binds everyone. Under unilateral acts belong also regulations that are not included in Article 288 of the Treaty on the Functioning of the EU.[264] Such acts are recommendations, communications, White Papers[265] and Green Papers.[266] The secondary law comprises as well agreements which refer here to 1) international agreements signed by both EU itself and an organization or a country not belonging to EU, 2) agreements between two or more member states and 3) institutional agreements signed only by two or more EU institutions.

The third category of EU law - supplementary law - includes the Court of Justice case law, international law and the generally accepted law principles. These sources are used as legal rules when neither the primary legislation nor the secondary legislation provide direct answers. In a way it is a question of filling the white spots existing between the primary and secondary sources of law. The Court of Justice has used international law as inspiration when developing its case law. The Court may refer not only to codified law but also custom and practise. Generally accepted principles of law refer to undocumented sources of law emerging from the case law of the Court of Justice.[267] These general principles may be similar as in national laws, may derive from particular national laws or are specific to EU.[268] They have allowed the Court to interpret legislative acts but also argue for invalidation if a legislative act is not aligned with the generally accepted principles in question.[269] These principles can be seen to express the systemic principles that underlie the constitutional structure of EU.[270]

3.4.1.2 EU Company regulation

European company regulation is important part of the internal market.[271] In EU the reach of company law is wide and covers among other things following areas:

- shareholders´ protection

---

[264] See EUR-Lex (2010), according to which such acts are considered *"atypical"*.

[265] According to EUR-Lex (2017) *"White Papers are documents containing proposals for European Union action in a specific area. In some cases, they follow on from a Green Paper published to launch a consultation process at European level. The purpose of a White Paper is to launch a debate with the public, stakeholders, the European Parliament and the Council in order to facilitate a political consensus."* About the Green Papers see next footnote.

[266] According to EUR-Lex (2017b) *"Green Papers are documents published by the European Commission to stimulate discussion on given topics at European level. They invite the relevant parties (bodies or individuals) to participate in a consultation process and debate on the basis of the proposals they put forward. Green Papers may give rise to legislative developments that are then outlined in White Papers".*

[267] Pineschi, L. ed. (2015), p. 145.

[268] See EUR-Lex (2010b) according to which *"The general principles of law may be:*

- *common to national laws: the Court of Justice identified those principles common to all the national legal systems and which are compatible with EU objectives. For example, this is the case with legal certainty and legitimate expectation which protects individual from unforeseeable amendments to the law;*
- *derived from particular national laws: the Court of Justice took inspiration from the principles enshrined in certain national legal systems only. This is also the case when the Court must name the institution responsible for harm caused by the EU and it must determine the extent of the harm;*
- *specific to the EU: the Court of Justice identified the principles specific to the EU even if the source of their inspiration was from a national legislation. This is the case with the solidarity between Member States, institutional balance and Community preference."*

[269] Craig, P. and de Burca, G. (2015), p. 111.

[270] Tridimas, T. (2007), p. 4.

[271] European Commission (2012).

- shareholders' rights
- capital maintenance
- mergers and divisions
- disclosure of branches
- European Company (SE)
- European Economic Interest Grouping (EEIG) and
- European Cooperative Society (SCE).[272]

EU company regulation has been one of the prioritised areas in the EU law and it has developed significantly during the existence of the European Union. However, EU law does not include any framework for the commercial businesses. Plans to create a European company law has been difficult due to many different reasons. Due to legal, political and economic complexity a wide-ranging harmonisation of company law in EU level has not taken place and national legislation in this area is still strong.[273]

During the years two different ways have been used to create the common system of European Company Law.[274] One way targets to harmonize the company laws of the individual member states. Here some success has been achieved.[275] Examples of such harmonisation can be found in protection of interest of shareholders, capital maintenance of public limited liability companies, mergers and divisions, takeover bids, shareholders' rights and financial reporting and accounting. The alternative way has been to target to create a common EU level Company Law.[276] In the latter approach there has been some success in form of European Economic Interest Groupings[277], European Companies[278], IAS/IFRS Standards[279] and European Cooperative Societies[280] as few examples.

The purpose of EU rules in company law and corporate governance is manifold. The target is to allow businesses in any EU country, provide shareholder protection, create more efficient and competitive businesses and increase business cooperation in different EU member countries.[281] Additionally, also purpose to stimulate the discussions in the area of company

[272] European Commission (2012), footnote 17.
[273] About the challenges in implementing EU regulation in the local legislation see McLaughlin, S. (2015), p. 18. According to McLaughlin changes to core company law in United Kingdom in the period 1973-2006 occurred piecemeal mainly in response to European Union initiatives. According to her *"the result was unacceptable"*.
[274] Koster, H. (2015), p. 5.
[275] Andenas, M. and Wooldridge, F. (2009), pp. 7-8 and De Luca, N. (2017), pp. 16-17 and pp. 20-44.
[276] De Luca, N. (2017), pp. 18-19 and pp. 45-65.
[277] Council Regulation (EEC) No 2137/85 of 25 July 1985 on the European Economic Interest Grouping (EEIG).
[278] Council Regulation (EC) No 2157/2001 of 8 October 2001 on the Statute for a European company (Societas Europea or SE).
[279] Regulation (EC) No 1606/2002 of the European Parliament and of the Council of 19 July 2002 on the application of international accounting standards.
[280] Council Regulation (EC) No 1435/2003 of 22 July 2003 on the Statute for a European Cooperative Society (SCE).
[281] European Commission (2017).

law modernization and corporate governance has been seen as the aim to harmonize the company legislation.[282]

The most significant company law directives in EU regulate among other things capital and disclosure requirements and creation of limited liability companies and are as follows:

- Directive (EU) 2017/1132 of the European Parliament and of the Council of 14 June 2017 relating to certain aspects of company law.[283]

- Directive 2009/102/EC of the European Parliament and of the Council of 16 September 2009 in the area of company law on single-member private limited liability companies.

- Directive 2012/17/EU of the European Parliament and of the Council of 13 June 2012 amending Council Directive 89/666/EEC and Directives 2005/56/EC and 2009/101/EC of the European Parliament and of the Council as regards the interconnection of central, commercial and companies registers.

Directive (EU) 2017/1132 regards the disclosure of company documents, the validity of companies´ obligations and nullity. It is applicable to all limited liability companies i.e. to both public and private companies. The directive covers also how the public limited liability companies are created and how capital maintenance and alteration is regulated. The minimum capital amount for public limited liability companies is 25,000 euros in EU. It furthermore includes disclosure requirements of such foreign branches that are established by EU companies in another member country or by non-EU companies in the EU. Additionally, the directive deals with mergers inside a single EU country that take place between public limited liability companies and divisions of public limited liability companies. Also, shareholders´, creditors´ and employees´ protection in relation to such mergers and divisions are covered. Besides that, the directive comprises regulation on cross-border mergers which involve limited liability companies in more than one country.

Directive 2009/102/EC (also known as the 12th Company Law Directive) introduces basis on how a single-member company is set up. Although the directive regulates private limited liability companies, an individual country may apply the rules to public limited liability companies, too.

---

[282] McLaughlin, S. (2015), p. 20.

[283] Directive 2017/1132 entered into force on July 20, 2017. It consolidated the following six EU directives:

1) Sixth Council Directive 82/891/ECC of 17 December 1982 concerning the division of public limited liability companies
2) Eleventh Council Directive 89/666/ECC of 21 December 1989 concerning disclosure requirements in respect of branches opened in a Member State by certain types of company governed by the law of another State
3) Directive 2005/56/EC of 26 October 2005 on cross-border mergers of limited liability companies
4) Directive 2009/101/EC of 16 September 2009 on coordination of safeguards which, for the protection of the interests of members and third parties, are required by Member States of companies within the meaning of the second paragraph of Article 48 of the Treaty, with a view to making such safeguards equivalent
5) Directive 2011/35/EC of 5 April 2011 concerning mergers of public limited liability companies and
6) Directive 2012/30/EU of 25 October 2012 on coordination of safeguards which, for the protection of the interests of members and others, are required by Member States of companies within the meaning of the second paragraph of Article 54 of the Treaty on the Functioning of the European Union, with respect to the formation of public limited liability companies and the maintenance and alteration of their capital, with a view to making such safeguards equivalent.

Directive 2012/17/EU concerns the interconnection of central, commercial and companies registers. This sets common standards for interconnecting business registers.

Another relevant set of EU company legislation in relation to the topic in question concerns the rules of EU legal entities. These rules apply also throughout the EU and they are valid besides the local regulation of individual member states. The EU legal entities legislation covers

- Council Regulation 2157/2001 on the statute for a European company (Societas Europea or SE).
- Council Regulation 1435/2003 on the statute for a European Cooperative Society (SCE).
- Council Regulation 2137/85 on the statute for European Economic Interest Groupings (EEIGs).

Besides the regulation covering the formation, capital and disclosure requirements there are also EU level rules related to financial reporting and accounting.[284] Some specific transparency requirements has to be also met by listed companies.[285]

In the sections below is reviewed the content of these most significant EU level company regulations.

3.4.1.2.1 Capital maintenance

Creditor and shareholder protection through capital maintenance rules has been an important element in the harmonization of company law in Europe.[286] From the European Commission view the protection of the interests of members and third parties - what comes to the disclosure and the validity of obligations - is necessary in case of limited liability companies. The minimum capital requirements are also seen as compensation obligation to the shareholders for the benefit they get through the limited liability.[287] The earlier Directive 2012/30/EU, which was called also as the Second Company Law Directive or Capital Directive, aligned the rules in every EU country for setting up and running companies with public limited liability.[288] The Directive 2012/30/EU was repealed by Directive (EU) 2017/1132, which now includes these rules.[289] The capital maintenance regulation aims to provide protection for shareholders

[284] EU has adopted International Accounting Standards (IAS) and International Financial Reporting Standards (IFRS) and related interpretations (SIC/IFRIC) to be used in preparation for financial statements of entities. Standards are issued by an international private organisation called the International Accounting Standards Board (IASB) and must go through a specific process of endorsement before becoming law in the EU.

[285] The Transparency Directive harmonizes requirements on companies regarding information disclosure. It focuses on what information companies must disclose periodically, how they handle investor disclosures and how they distribute regulated information. It also ensures that investors disclose their stakes in companies. The existing Transparency Directive (2004/109/EC) was revised last time on June 12, 2013 when the European Union adopted Directive 2013/50/EU amending the existing Transparency Directive.

[286] This is in line with article 44 par 2 (g) of the Treaty Establishing the European Community on which provision all the numbered Company law Directives are based on. The article provides that the Council and the Commission shall carry out their duties *"...by coordinating to the necessary extent the safeguards which, for the protection of the interests of members and others, are required by Member States of companies or firms within the meaning of the second paragraph of Article 48 with a view to making such safeguards equivalent throughout the Community."* About the legal basis of article 44(2)g EC, see Vossestein, G.J. (2010), p. 103.

[287] Mäntysaari, P. (2010c), p. 146.

[288] EUR-Lex (2014).

[289] The rules on capital formation, maintenance and alteration were established in the Second Company Law Directive (Directive 77/91/EEC), which was published for the first time on 13 December 1976. These rules were

and creditors. This is done by coordinating the nationwide rules to create and run public limited liability companies and to increase or reduce the company capital.[290]

In the valid directive is first defined the types of companies covered by the capital maintenance rules. The names of these companies vary country by country.[291] Exceptions are however allowed as national governments are free to exempt investment companies that have variable capital and certain types of cooperatives. This directive includes rules of minimum harmonization, which allows a member state to establish stricter rules in its own legislation.

The rules set in the directive regard two areas: firstly, the raising of the legal capital and secondly the maintenance of such capital. The capital raised must be sufficient for the company's whole life cycle. Hence, they include the requirements for the payment of the initial capital, rules on the distribution to the shareholders, on restoration of capital sufficiency, capital increase and reduction, purchase and share redemption, publicity and registration. The legal capital rules are orientated to protect the creditors and are set to mitigate the effects of shareholders´ and directors' non-personal liabilities. In addition to that, the directive includes rules on financial assistance.[292] One of the reasons for regulating these is to make sure that creditors and third parties understand with what kind of entity they are interacting with.[293] Equal treatment of shareholders has as well been an important principle that has been followed.[294]

The minimum capital required to register a public limited company shall be 25,000 euros.[295]

later amended by the Directive 2006/68/EC, recasted as Directive 2012/30/EU and finally included in the Directive (EU) 2017/1132.

[290] The capital maintenance regulation does not apply to private limited companies. In some member states the provisions have however been made applicable also to private companies.

[291] According to Articles 2, 44(1) and 45(2) and Annex I, Directive (EU) 2017/1132 following types of companies are covered by the capital maintenance rules: Belgium: société anonyme/naamloze vennootschap; Bulgaria: акционерно дружество; the Czech Republic: akciová společnost; Denmark: aktieselskab; Germany: Aktiengesellschaft; Estonia: aktsiaselts; Ireland: cuideachta phoiblí faoi theorainn scaireanna/public company limited by shares, cuideachta phoiblí faoi theorainn ráthaíochta agus a bhfuil scairchaipiteal aici/public company limited by guarantee and having a share capital; Greece: ανώνυμη εταιρεία; Spain: sociedad anónima; France: société anonyme; Croatia: dioničko društvo; Italy: società per azioni; Cyprus: δημόσιες εταιρείες περιορισμένης ευθύνης με μετοχές, δημόσιες εταιρείες περιορισμένης ευθύνης με εγγύηση που διαθέτουν μετοχικό κεφάλαιο; Latvia: akciju sabiedrība; Lithuania: akcinė bendrovė; Luxembourg: société anonyme; Hungary: nyilvánosan működő részvénytársaság; Malta: kumpanija pubblika ta' responsabbiltà limitata/public limited liability company; the Netherlands: naamloze vennootschap; Austria: Aktiengesellschaft; Poland: spółka akcyjna; Portugal: sociedade anónima; Romania: societate pe acțiuni; Slovenia: delniška družba; Slovakia: akciová spoločnost'; Finland: julkinen osakeyhtiö/publikt aktiebolag; Sweden: aktiebolag; the United Kingdom: public company limited by shares, public company limited by guarantee and having a share capital.

[292] The regulation allows that public limited companies provide financial assistance with a view to acquiring their shares, provided that specific conditions are met and an approval procedure is carried out within the company. The procedure is also known as a *"whitewash procedure"*. Although these provisions are part of directive it shall be noted that the financial assistance rules do not concern the preservation of share capital as such.

[293] Van Gerven, D. ed. (2014), p. 9.

[294] The purpose of the directive is specifically to ensure that national laws guarantee equal treatment to all shareholders who are in the same position and the protection of creditors whose claims exist prior to the decision on reduction.

[295] Article 45, Directive (EU) 2017/1132, according to which this minimum sum will be examined and possibly revised every 5 years in light of EU economic and monetary trends.

3.4.1.2.2 Protection of the members´ and third parties´ interests

It is the view of the European Commission that the protection of the interests of members and third parties concerning disclosure of obligations of limited liability companies is important.[296] This shall take place through coordination between national regulations. The former First Company Law Directive - Directive 2009/101/EC[297] - dealt with the topic.[298] The Directive (EU) 2017/1132, which now includes the regulation of the former directive, targets to protect the interests of members and third parties by allowing them to access information regarding the basic company documents. The regulation applies to private as well as public companies.[299]

This directive in force - as is written in its summary - *"aims to frame the guarantees required of companies to protect the interests of members and third parties"*. The directive relates to the limited liability companies.

According to the regulation in question the disclosure requirement covers specific information and documents of companies incorporated with limited liability. This concerns among other things constitution and statutes, appointment of persons taking part in the administration, subscribed capital amount, changes of office registration, wind-up and liquidation.[300]

Corporations are obliged to have a unique identifier to communicate in relevant registers. The identifier shall enable identification of home country of register, register of origin and company number.[301]

---

[296] EUR-Lex (2012).
[297] Directive 2009/101/EC of the European Parliament and of the Council of 16 September 2009.
[298] Directive 2009/101/EC replaced and repealed the first Company Law Directive (68/151/EEC). Now the discussed regulation is included in the Directive (EU) 2017/1132.
[299] According to Article 7(1) and Annex II, Directive (EU) 2017/1132 following types of companies are covered by the discussed regulation: Belgium: naamloze vennootschap/société anonyme, commanditaire vennootschap op aandelen/société en commandite par actions, personenvennootschap met beperkte aansprakelijkheid/société de personnes à responsabilité limitée; Bulgaria: акционерно дружество, дружество с ограничена отговорност, командитно дружество с акции; Czech Republic: společnost s ručením omezeným, akciová společnost; Denmark: aktieselskab, kommanditaktieselskab, anpartsselskab; Germany: die Aktiengesellschaft, die Kommanditgesellschaft auf Aktien, die Gesellschaft mit beschränkter Haftung; Estonia: aktsiaselts, osaühing; Ireland: cuideachtaí atá corpraithe faoi dhliteanas teoranta/companies incorporated with limited liability; Greece: ανώνυμη εταιρεία, εταιρεία περιορισμένης ευθύνης, ετερόρρυθμη κατά μετοχές εταιρεία; Spain: la sociedad anónima, la sociedad comanditaria por acciones, la sociedad de responsabilidad limitada; France: société anonyme, société en commandite par actions, société à responsabilité limitée, société par actions simplifiée; Croatia: dioničko društvo, društvo s ograničenom odgovornošću; Italy: società per azioni, società in accomandita per azioni, società a responsabilità limitata; Cyprus: δημόσιες εταιρείες περιορισμένης ευθύνης με μετοχές ή με εγγύηση, ιδιωτικές εταιρείες περιορισμένης ευθύνης με μετοχές ή με εγγύηση; Latvia: akciju sabiedrība, sabiedrība ar ierobežotu atbildību, komanditsabiedrība; Lithuania: akcinė bendrovė, uždaroji akcinė bendrovė; Luxembourg: société anonyme, société en commandite par actions, société à responsabilité limitée; Hungary: részvénytársaság, korlátolt felelősségű társaság; Malta: kumpannija pubblika/public limited liability company, kumpannija privata/private limited liability company; the Netherlands: naamloze vennootschap, besloten vennootschap met beperkte aansprakelijkheid; Austria: die Aktiengesellschaft, die Gesellschaft mit beschränkter Haftung; Poland: spółka z ograniczoną odpowiedzialnością, spółka komandytowo-akcyjna, spółka akcyjna; Portugal: sociedade anónima de responsabilidade limitada, sociedade em comandita por ações, sociedade por quotas de responsabilidade limitada; Romania: societate pe acțiuni, societate cu răspundere limitată, societate în comandită pe acțiuni; Slovenia: delniška družba, družba z omejeno odgovornostjo, komaditna delniška družba; Slovakia: akciová spoločnosť, spoločnosť s ručením obmedzeným; Finland: yksityinen osakeyhtiö/privat aktiebolag, julkinen osakeyhtiö/publikt aktiebolag; Sweden: aktiebolag; United Kingdom: companies incorporated with limited liability.
[300] Article 14, Directive (EU) 2017/1132.
[301] Article 15(1), Directive (EU) 2017/1132.

The above-mentioned information shall be published in the national gazettes or in other ways.[302] The information disclosed shall be registered centrally. It shall be additionally published on the European e-justice portal in every official EU language.[303]

When a person carries a legal act on behalf of a company being formed before company acquires a legal personality, the person shall be liable for that action but not the company.[304] After the legal personality has been acquired by the company, commitments done by the company shall bind it in relation to the third parties.[305] This includes also an act which exceeds the limits of the company´s objects unless such an act exceeds the powers of the management body who made the decision in question.[306]

3.4.1.2.3 Information disclosure

The former Eleventh Company Directive (also called the Branch Directive) 89/666/EEC defined the disclosure requirements to be applied to branches that limited liability companies of another EU countries or non-EU countries open in a member state.[307] These norms were also contained within the present Directive (EU) 2017/1132. The purpose is to offer a similar protection for shareholders and third parties and safeguard the right to establish. The rules cover both private and public limited liability companies.[308]

The compulsory disclosure requirements set in the directive cover branches of companies domiciled in other member states. This regards among other things address, activity, registration place and number, name and legal form, appointment of representatives, information on winding-up and branch closure.[309]

Items needing compulsory disclosure are published through the interconnection system of central, commercial and companies registers as stated by Directive 2012/17/EU.[310] A unique identifier of branches allows identification of member state of the register, domestic register and branch number.[311]

If a branch is established outside EU but has a legal form similar to that of a community company, there is an obligation to publish documents that include information required from EU branches.[312] Compulsory disclosure requirements cover several additional items. These

---

[302] Article 15(5), Directive (EU) 2017/1132.
[303] The European e-Justice portal is the European electronic access point for information, which includes information from European company registers. See European e-justice (2017) for more details.
[304] Article 7(2), Directive (EU) 2017/1132.
[305] Article 9(1), Directive (EU) 2017/1132.
[306] This means in practice the renouncement of *"ultra vires"* principle as the obligations entered into in the name of the company are valid to the greatest possible extent in order to ensure the protection of third parties. About *"ultra vires"* principle see Gilani, S.R.S. (2011).
[307] One of the significant features of that regulation was that when companies used the right to establish a branch in other EU country these branches were not be subject to the disclosure requirements obliging the companies by the former First (68/151/EEC), Fourth (78/660/EEC), Seventh (83/349/EEC) and Eight (84/253/EEC) Directives. See Fazio, S. (2007), p. 101, Edwards, V. (1999), p. 212 and McLaughlin, S. (2015), p. 25.
[308] Article 29(1) and Annex II, Directive (EU) 2017/1132. See above footnote 299 for the types of companies covered by the discussed regulation.
[309] Article 30(1) and Annex II, Directive (EU) 2017/1132.
[310] According to European e-justice (2017) the business registers in all EU countries have been interconnected since June 2017. The company information can be accessed in any EU country, Iceland, Liechtenstein or Norway. The information available includes also foreign branches and cross-border mergers of companies.
[311] Article 29(4), Directive (EU) 2017/1132.
[312] Article 36, Directive (EU) 2017/1132.

include law of the country applied for the company, legal form of the company, instruments of constitution, memorandum and articles of association.[313]

In case accounting is not done according to the EU legislation or alike, it may be required by a member state that the relevant documents shall be drawn up and published.[314]

All in all, the protection offered by the directive can be described by its nature to be exhaustive. To achieve the objective of facilitating freedom of establishment the harmonisation of the disclosure requirements is important.[315]

3.4.1.2.4 Domestic mergers of public limited liability companies

To become more competitive the European companies need to grow and EU wants to support this among other things with competitive regulation. Merging of businesses is one way for companies to grow and the achieved economic unity targets to give the merging companies better market position.[316]

The former Directive 2011/35/EU[317] dealt with mergers between public limited liability companies in an individual member state.[318] It was replaced by the present Directive (EU) 2017/1132 which includes now the regulation related to mergers of public limited liability companies.

The essence of a merger under the directive is that one or several companies wind up through transfer of the assets and liabilities to another company without liquidation.[319] The merger is always friendly.[320] The transfer of assets can happen either through a merger by acquisition or by formation of a new company. The former Directive 2011/35/EU applied the universal succession principle that meant no liquidation and creditors´ acceptance for a new debtor.[321] The same approach is valid also under the present directive.

The directive is not applied to cooperatives and companies that are acquired or cease to exist and are in bankruptcy process or wind-up process due to insolvency.[322]

The regulation provides protection to shareholders, creditors and employees.[323] The provisions regard disclosure requirements and safeguards to be afforded to third parties and third parties. The directive targets to decrease the administration load of European public limited liability companies in mergers and divisions. Under the directive companies benefit from reduced reporting requirements and removal of rules leading to double reporting. Also ensuring coherence regarding relevant regulation brings additional benefits. The regulation

[313] Article 37, Directive (EU) 2017/1132.
[314] Article 38, Directive (EU) 2017/1132.
[315] Sjåfjell, B. (2009), p. 135.
[316] Grundmann, S. (2007), p. 547.
[317] Directive 2011/35/EU of the European Parliament and of the Council of 5 April 2011 concerning mergers of public limited liability companies.
[318] Directive 2011/35/EU replaced the Directive 78/855/EEC which was also known as the Third Company Law Directive. The Directive 78/855/EEC of 9 October 1978 based on Art. 54(3)(g) of the Treaty concerning mergers of public limited liability companies was substantially amended several times and finally in the interests of clarity and rationality it was replaced by Directive 2011/35/EU.
[319] Articles 89(1) and 90(1) of the Directive (EU) 2017/1132.
[320] Mäntysaari, P. (2010c), p. 371.
[321] Malke, C. (2010), p. 59.
[322] Article 87(2-3), Directive (EU) 2017/1132.
[323] See Recitals 49-53, Directive (EU) 2017/1132.

covers merger by acquisition, merger by new company formation and acquisition where the acquirer holds at the minimum 90 % of the target company´s shares.

Mergers by acquisition[324] or mergers leading to a new company[325] may be affected if at least one of the companies that are ceasing to exist is in liquidation. Precondition for this is that distribution of the assets to the shareholders has not yet started.[326]

In case of merger the company management needs to draft terms of merger including among other things company type, name, registered office and share exchange ratio including the sum to be paid in cash.[327]

The companies involved in merger have to take into consideration the Directive 2001/23/EC on safeguarding employees' rights in the event of transfers of undertakings[328]. The legislation of the merging companies must as well provide creditors with safeguards about their financial status.[329]

As one risk in legal mergers is that the assets of the acquiring company are not sufficient to cover the liabilities of the new totality. This may put the creditors of the disappearing company in a worse financial position compared to the situation before the merger. To protect the creditors some member states have thus implemented some safety measures in the domestic merger laws. In creditor protection there is however no full harmonization in place and a differences exist between ex ante systems and ex post systems.[330] The existence of these two different systems of regulation for creditor protection could potentially create several problems in mergers.

A merger by acquisition means that after the transfer of assets and liabilities the owners of the acquired company become owners of the acquirer and the acquired company ceases ultimately to exist.[331]

For the protection of members and third parties there are rules that govern the nullity of mergers. According to the directive the member states are allowed to include specific rules on that in their domestic legislation in a limited set of situations. Among other things the nullity

---

[324] Article 89(1) of the Directive (EU) 2017/1132 defines *"merger by acquisition"* as the operation *"whereby one or more companies are wound up without going into liquidation and transfer to another all their assets and liabilities in exchange for the issue to the shareholders of the company or companies being acquired of shares in the acquiring company and a cash payment, if any, not exceeding 10 % of the nominal value of the shares so issued or, where they have no nominal value, of their accounting par value."*

[325] Article 90(1) of the Directive (EU) 2017/1132 defines *"merger by formation of a new company"* as the operation *"whereby several companies are wound up without going into liquidation and transfer to a company that they set up all their assets and liabilities in exchange for the issue to their shareholders of shares in the new company and a cash payment, if any, not exceeding 10 % of the nominal value of the shares so issued or, where they have no nominal value, of their accounting par value."*

[326] Articles 89(2) and 90(2) of the Directive (EU) 2017/1132.

[327] Articles 91 and 109 of the Directive (EU) 2017/1132.

[328] Council Directive 2001/23/EC of 12 March 2001 on the approximation of the laws of the member states relating to the safeguarding of employees' rights in the event of transfers of undertakings, businesses or parts of undertakings or businesses.

[329] See Mäntysaari, P. (2010c), p. 252 where the author is referring to the former Third Company Law Directive according to which member states´ laws must provide *"an adequate system of protection of the interests of creditors of the merging companies whose claims antedate the publication of the draft terms of merger"*. The same provision has been included in the Article 99 of the Directive (EU) 2017/1132.

[330] In an ex ante system creditors can object to the merger before it will become in force. In an ex post system creditors can object to the merger only after the decision to merge is adopted by the general meeting. The existence of these two different systems of regulation for creditor protection could create several problems in cross-border mergers.

[331] Article 105(1) of the Directive (EU) 2017/1132.

shall be based on the court order and to declare a merger void shall not have impact on the obligations´validity.[332]

3.4.1.2.5 Cross-border mergers of limited liability companies

Directive 2005/56/EC[333] which was also known as the 10th Company Law Directive dealt with cross-border mergers between limited liability companies.[334] It was replaced by the present Directive (EU) 2017/1132 which includes now the similar regulation. Like the former rules also the valid ones aim to easen cross-border mergers in the EU.[335] The purpose of the regulation is to cut cost of discussed cross-border transactions, to support for the legal stability and to provide this merger possibility to several companies. Based already on the experience during the previous cross-border directive the regulation lowers the threshold to cooperate and conduct restructuring across European borders.[336]

What is meant by the cross-border merger is defined in the Directive (EU) 2017/1132 itself. First, merger is a transaction in which at least one company is dissolved without liquidation by transferring all assets and liabilities to another existing company or alternatively to a new company to be formed.[337] In return the owners of the company to be dissolved get shares representing the capital of the receiving company - or if a new company is established representing the capital of the new company - and possibly payment in cash.[338] A specific type of cross-border merger is in question when a company, which is not dissolved in liquidation, transfers all its assets and liabilities to the company owning 100 % of the transferor company´s shares.[339] It is relevant to note that in the merger process shareholders do not make decisions on sale of their shares as shares are not sold.[340]

An additional requirement for the application of the Directive (EU) 2017/1132 is that the companies involved in the merger process must be subject to two different member states´ laws. Besides this the limited liability companies must have been founded by the laws of member states and companies´office, administration or main location of business must be situated in the EU area. Once the new entity has been established through the merger the national legislation of the country where the company has its registered office is applied. As a summary this means that the cross-border directive is applicable to mergers subject to that three conditions are fulfilled. Firstly, companies are formed according to a member state law. Secondly, companies have their registered office, central administration or principal place of business within inside the EU. Thirdly, for two companies at the minimum laws of different member states are applied.

The regulation of Directive (EU) 2017/1132 on domestic mergers covers only mergers between public limited liability companies.[341] However in case of cross-border mergers the directive

---

[332] Article 108(1) of the Directive (EU) 2017/1132.
[333] Directive 2005/56/EC of the European Parliament and of the Council of 26 October 2005 on cross-border mergers of limited liability companies.
[334] The Directive 2005/56/EC became effective on 15 December 2005 and it was included into national legislation by all member states until December 2007.
[335] Article 118 of the Directive (EU) 2017/1132.
[336] Bech-Bruun and Lexidale (2013), pp. 5-9.
[337] Article 119(2) points (a) and (b) of the Directive (EU) 2017/1132.
[338] Article 119(2) of the Directive (EU) 2017/1132 sets maximum limits of a cash payment for the securities or shares. A cash payment may not exceed 10 % of the nominal value. In case there is no nominal value a cash payment may not exceed the accounting par value.
[339] Article 119(2) point (c) of the Directive (EU) 2017/1132.
[340] Mäntysaari, P. (2010c), p. 371.
[341] Article 89(1) of the Directive (EU) 2017/1132.

applies to any companies with share capital.[342] This means that the articles applicable to cross-border mergers cover also for example private limited liability companies. Member states have however powers not to apply the directive to cross-border mergers if such merger involves a cooperative and even if the cooperative belongs inside the definition of *"limited liability company"*.[343] Also in general the mergers are governed in each member state by the principles applied to domestic mergers of that specific country, unless the directive states otherwise due to the cross-border feature of the merger.[344]

It is mandatory for the management of every merging company to prepare the common draft terms of cross-border merger. The cross-border merger directive includes a list of the required items that form the minimum content of the draft terms.[345] These elements include

- form, name and registered office of the involved companies
- exchange ratio of shares and cash payment amount
- allotment terms of shares of the company resulting from the merger.

The management or administrative organ of every merging company has to prepare a written report for the shareholders and employees on the proposed cross-border merger.[346] The idea of the report is to justify the economic and legal features of the merger and its implications. The report focuses on the implications to shareholder, employees and creditors. Aim of the reporting obligation is to protect the shareholders and the report has to be available at least one month before the general meeting. Member states can however entitle shareholders and employee representatives by unanimous decisions to renounce it.[347]

Also, an independent expert report about the merger must be prepared.[348] It is an important document aiming to provide independent advice about the merger terms to shareholders.[349] The expert report is not needed if all shareholders of all companies involved in the merger so agree. When report is done it must be available at least one month before the general meeting.

There are several consequences following the cross-border mergers: Firstly, all assets and liabilities are transferred to the new entity. Secondly, the shareholders of the acquired companies become shareholders of the new entity. Thirdly, the acquired companies and the merging companies cease to exist.[350]

Before the transfer of assets, rights and obligations of the merging companies becomes effective the member states may set requirements for the completion of certain formalities. In such situations the company ensuing from the cross-border merger is responsible for taking care of these formalities.[351]

The directive lets the member states to decide on the protection of creditors. The directive does however not give any guidance on the protection level required. This leaves possibility for some variation on the degree of protection between different member states. The non-

[342] Article 119(1) of the Directive (EU) 2017/1132.
[343] Article 120(2) of the Directive (EU) 2017/1132.
[344] Article 121 of the Directive (EU) 2017/1132.
[345] Article 122 of the Directive (EU) 2017/1132.
[346] Article 124 of the Directive (EU) 2017/1132.
[347] Vermeylen, A. and Velde, I.V. (2012), p. 16.
[348] Article 125 of the Directive (EU) 2017/1132.
[349] Vermeylen, A. and Velde, I.V. (2012), p. 17.
[350] Article 131(1) and (2) of the Directive (EU) 2017/1132.
[351] Article 131(3) of the Directive (EU) 2017/1132.

harmonized and distinct systems for protecting creditors cause most likely inefficiency and conflicts in a cross-border environment.[352]

3.4.1.2.6 Domestic divisions of public limited liability companies

Directive 82/891/EEC[353] - also known as the 6th Company Law Directive - dealt with the division of public limited liability companies.[354] It was replaced by the present Directive (EU) 2017/1132 which includes now the regulation related to the division of public limited liability companies in a member state of EU. This regulation sets rules for protection for shareholders, creditors and employees.

Like merger the division is always friendly.[355] The directive covers various patterns divisions can be done. It is the duty of the management board to draw the draft terms concerning both division by acquisition[356] and division by the formation of a new company[357].[358] The draft terms shall include company related information like type, name, registered office, share exchange ratio[359], terms of shares allocation, rights that the acquirer company confers and date since when shareholders have right to profit.[360]

The member states are obliged to provide protection to shareholders and creditors in the division process. For instance, individual countries may regulate that receiver companies have joint and several liability for the obligations of the divided company.[361] Although the directive does not directly require equal treatment of the shareholders, that principle is considered to be the rule.[362]

Protection of creditors is also taken care of by the Directive (EU) 2017/1132. Owners of other securities than shares have to be given rights equal to those rights they possessed in the company that was divided.[363]

According to the directive a judicial authority may supervise the division of companies.[364] This judicial authority like court may provide exemptions to corporates for specific regulations that should normally be applied in division process. This is subject to that no prejudice is triggered to creditors or shareholders.

---

[352] Papadopoulos, T. (2012), p. 536.
[353] Sixth Council Directive 82/891/EEC of 17 December 1982 based on Article 54 (3) (g) of the Treaty, concerning the division of public limited liability companies.
[354] The regulation became applicable from 31 December 1982. EU countries had to incorporate it into national law by 1 January 1986.
[355] Mäntysaari, P. (2010c), p. 380.
[356] Article 136 of the Directive (EU) 2017/1132.
[357] Article 155 of the Directive (EU) 2017/1132.
[358] Article 137(1) of the Directive (EU) 2017/1132.
[359] The share exchange ratio refers to the number of new shares that existing shareholders receive of a company that has been bought or merged with another when they surrender their original shares.
[360] Article 137(2) of the Directive (EU) 2017/1132.
[361] See Article 146 of the Directive (EU) 2017/1132.
[362] Mäntysaari, P. (2010c), p. 381. Although Mäntysaari´s conclusion has been drawn during the validity of the old Directive 82/891/EEC the principle of equal treatment of the shareholders is without doubt applicable also today under present Directive (EU) 2017/1132.
[363] Article 143 of the Directive (EU) 2017/1132.
[364] Article 157 of the Directive (EU) 2017/1132

3.4.1.2.7 Setting up a single-member company

The European Council adopted initially the 12th Company Law Directive in 1989.[365] The Directive was later consolidated to be the Directive 2009/102/EC. Through this limited harmonisation of the national company laws takes place in single shareholder company regulation. Member states are required to allow companies to have a legal form for single individuals to trade with limited liability. This changed the earlier understanding that limited liability is appropriate company form only if person invests in the company without being part of the management.[366] Although the regulation is not praised by everyone[367] some scholars have seen the initial 12th Company Law Directive meaning that limited liability became the foremost business ethic in European Community area countries.[368]

Directive 2009/102/EC concerns single-member limited liability companies as defined in the directive.[369] The regulation requires each member state to recognize this in their domestic provisions.[370] Where an individual EU country allows single-member companies to be also public limited companies, the directive is applied as well.

Both private and public limited liability company may become a single-member company in two ways. A company can be already initially established as a single-member company or alternatively shares of several shareholders may come to an ownership of one shareholder. When a single-member company status is identified because all shares are owned by a single person a specific registration process is triggered.[371] The above-mentioned ownership change and the identity of the sole owner needs to be logged in the files, registered[372] and made accessible to the public. In the register must be mentioned that the company has only one member, when the company became a single-member company and when it ceased to exist like that.

---

[365] Originally 12th Company Law Directive 89/667/EEC

[366] Mayson, S.W. et al. (2014), p. 55.

[367] Hannigan, B. (2015), p. 39, footnote 119. According to Hannigan the directive is *"…modest measure merely recognising that single member companies are permissible"*.

[368] Mayson, S.W. et al. (2014), p. 55.

[369] Article 2, Directive 2009/102/EC.

[370] Types of companies referred to in Article 1 are as follows: Belgium: société privée à responsabilité limitée/besloten vennootschap met beperkte aansprakelijkheid; Bulgaria: дружество с ограничена отговорност, акционерно дружество; Czech Republic: společnost s ručením omezeným; Denmark: anpartsselskaber; Germany: Gesellschaft mit beschränkter Haftung; Estonia: aktsiaselts, osaühing; Ireland: private company limited by shares or by guarantee; Greece: εταιρεία περιορισμένης ευθύνης; Spain: sociedad de responsabilidad limitada; France: société à responsabilité limitée; Italy: società a responsabilità limitata; Cyprus: ιδιωτική εταιρεία περιορισμένης ευθύνης με μετοχές ή με εγγύηση; Latvia: sabiedrība ar ierobežotu atbildību; Lithuania: uždaroji akcinė bendrovė; Luxembourg: société à responsabilité limitée; Hungary: korlátolt felelősségű társaság, részvénytársaság ; Malta: kumpannija privata/Private limited liability company; The Netherlands: besloten vennootschap met beperkte aansprakelijkheid; Austria: Aktiengesellschaft, Gesellschaft mit beschränkter Haftung; Poland: spółka z ograniczoną odpowiedzialnością; Portugal: sociedade por quotas; Romania: societate cu răspundere limitată; Slovenia: družba z omejeno odgovornostjo; Slovakia: spoločnosť s ručením obmedzeným; Finland: osakeyhtiö/aktiebolag; Sweden: aktiebolag; United Kingdom: private company limited by shares or by guarantee.

[371] Article 3, Directive 2009/102/EC.

[372] As referred to in Article 3(1) and (2) of First Council Directive 68/151/EEC of 9 March 1968 on co-ordination of safeguards which, for the protection of the interests of members and others, are required by Member States of companies within the meaning of the second paragraph of Article 58 of the Treaty, with a view to making such safeguards equivalent throughout the Community. Alternatively the information of ownership change and identity of the sole owner can be entered in a register kept by the company. It shall be noted that the Directive 68/151/EEC is no longer in force but references to that Directive have been construed as references to Directive 2009/102/EC (as described in Article 9 of Directive 2009/102/EC).

The sole owner uses the rights and obligations that general meeting has in the company.[373] All decisions made by the sole shareholder has to be included in the minutes or alternatively drawn up in writing.

An individual EU country does not have obligation to permit founding of a single-shareholder company if country´s own laws provide for an individual entrepreneur possibility to establish an undertaking which has limited liability. This is subject to that relevant protection is given for such an undertaking and the safeguards are similar to the ones provided by the directive or other EU regulation that is applied to the companies[374].

The European Commission published a provisional draft of a new directive for a single member shareholder companies in April 2014.[375] The idea of the new regulation is to lower the threshold of establishing single-member private limited liability companies within EU.

3.4.1.2.8 European Company

Council Regulation 2157/2001[376] sets out rules for a specific European public limited liability form called Societas Europaea or - when using abbreviation - SE.[377] The statute became valid in 2004.

The background for the adaption of this European level regulation on specific legal company form relates to the creation of the internal market. To achieve both economic and social benefits of the internal market barriers must be removed. For that purpose, it has been deemed to be important that companies can organize themselves on a European community scale.[378] Societas Europa regulation is an example of legislative development that creates mobility for companies and thus reduces entry barriers.[379]

According to the rules a European company SE shall be governed by the public limited liability regulation of the member state where the company has registered its office. For those aspects not covered by the country specific public limited liability regulation the national rules approved in relation to the European statute about SE shall also be applied. This means in practice that wind-up, insolvency, liquidation and payment suspensions are to significant extent regulated according to national laws.

A European company SE is an entity founded with at the minimum two such companies that originate in different member states. This means that establishing SE is possible only from an already existing base. A minimum capital of 120,000 euros is required and the founding is possible in alternative ways (see Figure 6 below).

---

[373] Article 4, Directive 2009/102/EC.
[374] As defined in Article 1 of the Directive 2009/102/EC.
[375] European Commission (2014).
[376] Council Regulation (EC) No 2157/2001of 8 October 2001 on the Statute for a European company (SE).
[377] EUR-Lex (2011).
[378] In the recital of the Council Regulation (EC) No 2157/2001 is stated that *"The completion of the internal market and the improvement it brings about in the economic and social situation throughout the Community mean not only that barriers to trade must be removed, but also that the structures of production must be adapted to the Community dimension. For that purpose it is essential that companies the business of which is not limited to satisfying purely local needs should be able to plan and carry out the reorganisation of their business on a Community scale."*
[379] Gabor, B. (2013), p. 81.

Figure 6: Establishing European Company SE

Form of establishment	Conditions to be met	Form of company
Merger to establish a European company	At least two companies must originate in different EU countries	Public limited liability companies
Establishment of a European holding company	At least two companies must originate in different EU countries or have had a subsidiary/branch in another EU country for at least 2 years	Public limited liability company or a limited liability company
Establishment of a European subsidiary	At least two companies must originate in different EU countries or have had a subsidiary/branch in another EU country for at least 2 years	Companies, enterprises or other legal entities
Conversion	Public limited liability company	The company must have had a subsidiary in another EU country for at least 2 years

Source: EUR-Lex (2014b)

Moreover, a European company can establish one or several subsidiaries having the European company status.

The formation of a European company is always friendly, as establishing holding SE is always subject to acceptance of management and general meetings of every participating company.[380]

The registered office of the SE must be in the place where the central administration i.e. head office is located.[381] The company is though allowed to move the registered office inside the EU without obligation to dissolve itself first to create a new entity.

When the registration and liquidation of an SE is done it shall be made public in the Official Journal of the European Union.[382]

The European company statute relates to two possible organization structures. When the two-tier system is applied there is a management board and a supervisory board in addition to the shareholders general meeting. In the single-tier system the general meeting is complemented with an administrative board.

[380] Mäntysaari, P. (2010c), p. 377.
[381] Vossestein, G.J. (2010), p. 219.
[382] The Official Journal of the European Union (OJ) is the official compendium of EU legislation and other official documents of the EU institutions, bodies and agencies. It is published every day from Tuesday to Saturday in the official languages of the EU.

The taxation of SE is subject to tax regulation of the member state in which company has its administrative center. This means that there is no EU level tax harmonization in place.

Directive 2001/86/EC established the rules regarding the involvement of employees in the Societas Europea.[383] The SE directive recognised in that way the business role of the employees.[384] It is not possible to establish an SE without selecting a model of employee involvement. This shall be done in agreement between the employees and the management. Such an agreement shall contain information and consultation procedures and - when considered suitable - involvement of employees in the management. Such an involvement is however obligatory only if the employees already benefited from it earlier before the SE was created. The purpose of this is to make sure than in case of existing participation rights of employees those rights will be transferred to the new entity.[385]

3.4.1.2.9 European Cooperative Society

Council Regulation 1435/2003[386] sets the legal statute for a specific European Cooperative Society. This legal person is called Societas Cooperativa Europaea and also abbreviation SCE is in use.[387] The statute entered into force in 2004 but became applicable from August 18, 2006.[388] The idea is to give for cooperatives engaging in commercial activities across borders possibility to make use of the rules.

Like in case of Societas Europea (SE)[389] also here the adaption of European level regulation on legal form of European cooperative is linked to the goal to advance the functionality of the EU internal market. To achieve the economic and social benefits obstacles of well-functioning internal market shall be cleared away. Therefore, possibility for a European community scale organization option shall be offered also for cooperatives. The approach used in the SE legislation has clearly paved the way for the European level cooperative regulation. SCE can be understood to be the cooperative comparable for the European limited liability company form SE.[390]

This regulation in question targets to guarantee level playing field in competition between capital companies and cooperative societies[391]. It also supports cooperative societies in their

---

[383] Council Regulation (EC) No 2157/2001of 8 October 2001 on the Statute for a European company (SE) was supplemented by Directive No 2001/86/EC (the SE directive). The SE directive established the rules with regard to the involvement of employees in the SE.

[384] See Campbell, D. ed. (2009), p. 268 according to which this regulation *"…marks a real shift from shareholders´ interests to stakeholders´ interest which has now been institutionalised…"*

[385] Mayson, S.W. et al. (2014), p. 421.

[386] Council Regulation (EC) No 1435/2003 of 22 July 2003 on the Statute for a European Cooperative Society (SCE).

[387] EUR-Lex (2003).

[388] The Council Regulation (EC) No 1435/2003 was passed into law on 22 July 2003 and began to apply from August 18, 2006. In practice SCEs could be created in member states from 18 August 2006 provided that the necessary national laws had been passed.

[389] See above section *3.4.1.2.8 European Company*.

[390] Cracogna, D. et al. eds (2013), p. 116.

[391] In the recital of the Council Regulation (EC) No 1435/2003 is stated that

"(7) Cooperatives are primarily groups of persons or legal entities with particular operating principles that are different from those of other economic agents. These include the principles of democratic structure and control and the distribution of the net profit for the financial year on an equitable basis.

(8) These particular principles include notably the principle of the primacy of the individual which is reflected in the specific rules on membership, resignation and expulsion, where the "one man, one vote" rule is laid down and the right to vote is vested in the individual, with the implication that members cannot exercise any rights over the assets of the cooperative.

cross-border activities. Unlike in case of SE regulation the Council Regulation 1435/2003 regarding SCEs there are specific rules even how cooperative profits shall be allocated.[392]

The SCE as the legal form was established to abolish the need to form a subsidiary in every EU country state where the cooperative has business activities. The present regulation allows cooperatives to freely transfer their registered office and head office to another country within the EU. This allows cooperatives to keep the legal status without registration or wind-up needs. Regardless the domicile SCEs are regulated by a single European Economic Area (EEA) -wide norms and principles.[393] The EEA-wide regulation is supplemented by the cooperative legislation of each member state. The regulation creates new type of European cooperative and thus has influence on national legislation but does not set direct rules for the national cooperatives.[394]

An SCE can be established by natural and/or legal persons, merger between cooperatives or conversion of a cooperative.[395]

The capital amount of an SCE shall be at the minimum of 30,000 euros. The capital represents shares of the members. The laws of an EU country that require a higher amount of subscribed capital for certain activities like banking and insurance operations apply when an SCE has its office registered in that member state.

Every EU state has to treat an SCE operating according to the Council Regulation 1435/2003 as if the entity in question were a domestic.

The registration has to be done in accordance with the relevant rules of that member state, where an SCE has its office registered. Notices and deletions of registration shall be made public in the Official Journal of the European Union for the information purposes.[396]

---

(9) Cooperatives have a share capital and their members may be either individuals or enterprises. These members may consist wholly or partly of customers, employees or suppliers. Where a cooperative is constituted of members who are themselves cooperative enterprises, it is known as a "secondary" or "second-degree" cooperative. In some circumstances cooperatives may also have among their members a specified proportion of investor members who do not use their services, or of third parties who benefit by their activities or carry out work on their behalf.
(10) A European cooperative society (hereinafter referred to as "SCE") should have as its principal object the satisfaction of its members' needs and/or the development of their economic and/or social activities, in compliance with the following principles:
- its activities should be conducted for the mutual benefit of the members so that each member benefits from the activities of the SCE in accordance with his/her participation,
- members of the SCE should also be customers, employees or suppliers or should be otherwise involved in the activities of the SCE,
- control should be vested equally in members, although weighted voting may be allowed, in order to reflect each member's contribution to the SCE,
- there should be limited interest on loan and share capital,
- profits should be distributed according to business done with the SCE or retained to meet the needs of members,
- there should be no artificial restrictions on membership,
- net assets and reserves should be distributed on winding-up according to the principle of disinterested distribution, that is to say to another cooperative body pursuing similar aims or general interest purposes."

[392] Cracogna, D. et al. eds (2013), p. 18.
[393] The European Economic Area (EEA) refers to the EU member states and the three EFTA States (Iceland, Liechtenstein, and Norway) which have agreed on an Internal Market governed by the same basic rules. The rules aim to enable goods, services, capital, and persons to move freely inside the EEA according to the concept of the four freedoms. The Agreement on the European Economic Area entered into force on January 1, 1994.
[394] Cracogna, D. et al. eds (2013), p. 66.
[395] Andenas, M. and Wooldridge, F. (2009), p. 413.
[396] About the Official Journal of the European Union see footnote 382 above.

The statutes of the SCE allow two alternative organization structures. In the two-tier system there are management and supervisory boards. In addition to that there shall be shareholders general meeting. In the one-tier system the general meeting is complemented with an administrative board.

Depending on what is the management structure type chosen the responsibility to manage an SCE is on management board or administrative board. That body represents cooperative in legal matters and in transactions with a third party.

Members have an equal voting right at the general meeting. Some exceptions are possible in favor of large cooperative investors in certain financial cooperatives.[397]

The laws of the member state where an SCE has office registered shall apply to an SCE. This approach is valid also in case of suspension of payments, insolvency or liquidation.

3.4.1.2.10 European Economic Interest Grouping

As mentioned earlier the establishment of SE and SCE statutes aim at enhancing the positive development of the EU internal market. Through encouraging the activities of these companies and cooperatives the general welfare in Europe is believed to improve. Supporting the idea of removing internal barriers Council has also adopted Regulation 2137/85[398] relating to European Economic Interest Grouping - or by using abbreviation - EEIG.[399]

The EEIG regulation aims to enhance the development of economic activity and establishment of common market conditions throughout the EU. To meet this target and mitigate the legal, fiscal and psychological challenges encountered by both natural and legal persons in cross-border cooperation, the EU decided to create a suitable legal transnational tool by providing EEIG regulation.[400]

The aim is that the grouping facilitates and develops the cross-border business activities of its members. This is done by joining the resources, activities and skills of the members. On the other hand, this joining of activities in a grouping shall not replace the activities of the members. Thus, establishing of grouping allows members to keep their independent legal and economic status although giving also possibility for synergy benefits through pooling of resources. This gives possibility to get better results compared to the situation where members would act alone. However, the intention of the grouping is not to generate profits for itself.[401] Any profits made shall be distributed to the members and shall also be taxed accordingly.

Among many express limitations in the Regulation 2137/85 a grouping is not allowed to employ over 500 people and be a member of another EEIG.[402]

---

[397] As defined in Article 59 of the Council Regulation (EC) No 1435/2003 on the Statute for a European Cooperative Society (SCE).
[398] Council Regulation (EEC) No 2137/85 of 25 July 1985 on the European Economic Interest Grouping (EEIG).
[399] EUR-Lex (1985).
[400] EUR-Lex (2016b).
[401] Preamble, recital 5 and Article 3(1) of the Council Regulation Regulation (EEC) No 2137/85.
[402] Article 3(2) of the Council Regulation Regulation (EEC) No 2137/85.

An EEIG shall be established by two members at the minimum coming from two different EU member states. These members can be individuals, companies or any other legal bodies regulated by private or public law of a member state.[403]

In an EEIG each member has one vote. However, it is possible to prescribe in a formation contract that there is more than one vote for each member. In any case none of the members shall hold a majority of all the votes. The regulation defines decisions that require unanimous voting. Such decisions can regard alteration of the objects of the grouping, change of its official address to another EU country and admitting new members.

The EEIG does not have liability limitations. EEIG members are thus jointly and severally liable for all debts and liabilities that EEIG has. Members may agree on distribution of risks among themselves but they may not limit their liability towards a third party. It is also possible to exclude or restrict in a contract between the grouping and a third party the liability of members for an explicit debt of the grouping.

Members of an EEIG can form the grouping with capital. Alternatively, the members can use also other funding forms like capital creation through contributions in cash, in kind, provision of skills, bank financing or membership fees. It is however not possible to invite public investment.

In the taxation the EEIG is treated like a partnership. This means that EEIG as a legal entity is not taxable on its profits or losses. The grouping´s profit and loss is divided between the members and included in their taxable income for each tax year.[404] For corporate members the income falls under corporate tax and for individual members under income tax. In relation to other taxes like VAT, property tax or capital duty the EEIG is considered taxable like any other entity.

3.4.1.2.11 Role of Court of Justice of the European Union

The role of Court of Justice of the European Union (CJEU) as the judicial institution of the European Union is to ensure that application and interpretation of EU law is done the same way in every EU country. Since its establishment in 1952 the mission of the Court of Justice[405] has been to make certain that the law is interpreted and applied according to the treaties.[406] In that role the court assesses the lawfulness of the acts of the EU institutions. The court also observes that the EU countries fulfil the requirements of the treaties and interprets EU law according to the request of the national courts.[407]

When constituting the judicial authority of the EU the court cooperates with the courts and tribunals of the individual countries. This cooperation is done to ensure EU law is applied and interpreted uniformly.

The Court of Justice of the European Union is located in Luxembourg and comprises three courts: Court of Justice (ECJ), General Court and Civil Service Tribunal.

---

[403] See Tridimas, T. et al. eds (2010), p. 262, where the author writes that *"…the EEIG offers the possibility of a mixed composition, ie to give a somewhat improbable example, a grouping may be formed by a French tax consultant, a German university, a Greek limited company and a British local authority."*

[404] Article 40 of the Council Regulation Regulation (EEC) No 2137/85.

[405] Initially the name of the court was the Court of the European Coal and Steel Community according to the name of the European Coal and Steel Community. See about the EU history above in section *3.4.1 EU legislation in general*.

[406] See about the history of Court of Justice in Rosas, A. et al. eds (2012), pp. 9-36.

[407] CJEU (2017).

To fulfil the tasks given to it the Court of Justice has been granted clearly defined jurisdiction. The responsibility covers different types of proceedings as follows:[408]

- References for preliminary rulings
    - The Court of Justice has cooperation with all the courts of the member countries to make sure that EU law is applied effectively and uniformly. This regards interpretation of EU law or review of the validity of EU law. The reference procedure does however not concern the interpretation of national law.[409]
- Actions for failure to fulfil obligations
    - When determining whether a single country has complied with its obligations under EU law the EU Commission or a member state may bring an action for infringement of EU law before the Court of Justice. Such an action shall be directed at an individual member state.[410]
- Actions for annulment
    - An action for annulment is a proceeding where the applicant seeks the annulment of regulation, directive, decision or other measure adopted by any EU institution. The Court of Justice has exclusive jurisdiction over actions that a member state brings against the European Parliament and/or against the Council with some exceptions or one EU institution brings against another. The action for annulment may be brought only against a binding act.[411]
- Actions for failure to act
    - The legality of the failure of the EU institutions, bodies, offices or agencies to act can be reviewed by the Court of Justice. Where such a failure to act is considered to be illegal, the institution concerned has to stop the failure by relevant actions. The failure to fulfil obligations can be brought to ECJ by natural or legal persons.[412]
- Appeals
    - It is possible to bring an appeal on points of law only to the Court of Justice against the decisions of the General Court.[413] In case of well-founded and admissible appeal, the Court of Justice sets aside the General Court judgment. The Court of Justice can decide the case itself subject to that the state of the proceedings so allows. In other situations, the case is returned to the General Court, that is bound by the Court of Justice appeal decision.
- Reviews
    - The Court of Justice may exceptionally review the decisions of the General Court on appeals against decisions of the European Union Civil Service

[408] CJEU (2017b).
[409] Magnus, U. and Mankowski, P. (2012), p. 34.
[410] Leanerts, K. et al. (2014), p. 184.
[411] Leanerts, K. et al. (2014), p. 427.
[412] MacKenzie, R. et al. (2010), p. 258.
[413] Article 256 of the Treaty on the Functioning of the European Union (TFEU).

> Tribunal. If such a review is done the case may be referred back to the General Court or the Court of Justice that gives itself the final judgment.[414]

In the last years the Court of Justice has become an essential part of the company law regulation. When the European company law harmonization with the 1st Directive (Transparency Directive) started in the end of 1960´s[415] the relevance of EU level case law was very small but the major change took place in the end of 1990´s through the Centros case.[416] In a separate appendix are reviewed some of the most significant ECJ judgments on the area of company law having influence on the free movement of corporations in the EU (see Appendix 1 below). These cases are:

- Centros in 1999
- Überseering in 2002
- Lankhorst-Hohorst in 2002
- Inspire Art in 2003
- SEVIC in 2005
- Cartesio in 2008
- Golden share cases starting from 2000
- VALE in 2012.

3.4.2 Finnish legislation

3.4.2.1 About the Finnish legal system

The Finnish legal system originates from the Nordic legal tradition, that is based on the German civil law tradition.[417] Finland has been a full member of the EU since January 1, 1995

[414] Leanerts, K. et al. (2014), p. 664.
[415] First Council Directive 68/151/EEC of 9 March 1968 on co-ordination of safeguards which, for the protection of the interests of members and others, are required by Member States of companies within the meaning of the second paragraph of Article 58 of the Treaty, with a view to making such safeguards equivalent throughout the Community. This directive was repealed by Directive 2009/101/EC of the European Parliament and of the Council of 16 September 2009 on coordination of safeguards which, for the protection of the interests of members and third parties, are required by Member States of companies within the meaning of the second paragraph of Article 48 of the Treaty, with a view to making such safeguards equivalent. See above section *3.4.1.2.2 Protection of the members' and third parties' interests.*
[416] Hopt, K.J. (2015), p. 21.
[417] The legal system originated during the period of Swedish rule from the 1150-1809. The Swedish legislation remained in force also after that during the period of over 100 years when Finland was an autonomous Grand Duchy of Russia. The autonomous status of Finland with legislative self-determination was the reason that the Swedish laws were still followed and nothing of the legal tradition of Russia remains. Finland has been an independent and sovereign republic since 1917 but some portions of the Swedish legislation continue to be applied still today. Finland represents the characteristics of a Scandinavian legal tradition with influences also from Germany.

and EU law is an important part of the Finnish legal system. Finland is the only Nordic country that has joined the eurozone.

Main elements of the Finnish legal system are

- separation of powers in legislative, judicative and executive powers[418]
- parliamentary system
- centralized administration.[419]

The new Constitution of Finland became valid on March 1, 2000. This meant that the four Constitutional Acts deriving from the early times of Finnish independence were superseded. Additionally, it meant that the most fundamental provisions from all of them were incorporated. Many provisions were simultaneously relegated to the levels of normal parliamentary legislation. The new Constitution reshaped among other things the basic rights system.[420] A distinctive feature in the Finnish legal system are also the role of the President especially in the EU matters[421]. Another distinctive feature relates to the preview of the constitutionality of the legislation. As in the other countries of Nordic Europe there is no constitutional court and the preview over the constitutionality of the legislation is done by Constitutional Law Committee.

In Finland, the judicial powers are exercised by the courts of law. The Finnish courts[422] exercise judicial power by deciding in individual cases. The courts are independent and are bound only by the law in force. Any party dissatisfied with a ruling of a court of law may appeal against the ruling in accordance with appeal instructions provided by the court of law.

On top of that anyone is entitled to write a written complaint to the Chancellor of Justice of the Government or the Parliamentary Ombudsman if considering that a public authority or a public official has conducted unlawfully.

The sources of Finnish law are both national and international. EU law supremacy has also been acknowledged covering primary norms, secondary norms and EU case law.[423] The legal code is the most important source of law. Most sources are written[424] but there are also some unwritten rules to be applied. In case of no written regulation the Code of Justification

[418] Section 3 of the Constitution of Finland (731/1999). See also Husa, J. (2010), pp. 42-49 about the clarity of the separation of the powers.
[419] Husa, J. (2010), p. 121.
[420] Davis, D. et al. eds. (2015), pp. 158-160.
[421] Ruostetsaari, I. (2015), pp. 164-166.
[422] The courts in Finland are divided in general courts and special courts. General courts consist of 1) Supreme Administrative Court and eight Administrative Courts and 2) Supreme Court, six Appeal Courts and 27 District Courts. On top of that there are four special courts: The Market Court, The Labour Court, The Insurance Court and The High Court of Impeachment. The scope of general courts covers administrative cases in administrative courts and additionally both matters of private civil and criminal cases which are first handled in district courts. Special courts are focusing on specific themes like insurances and consumer protection.
[423] The EU laws, regulations and directives bind also Finland as a member of the Union. Regulations are directly applicable to all member states and member states must implement EU directives. Also, the case law of the European Court of Justice is important source of law. See above for more details section *3.4.1.1 Regulatory systematics of EU legislation*.
[424] The written laws shall here be interpreted broadly. In this category belong among other things the Constitution, Acts of Parliament, decrees issued by President, Council of Ministers or individual ministries and legal rules issued by other authorities. Legal rules and decrees may be issued only under the authority of the Constitution or an ordinary Act.

Procedure provides that custom may be the source of law.[425] Validity of the unwritten rules is in such a situation based on the passive acceptance of the legislator. For custom to be binding, it must however be reasonable. Because written regulations have become all the time more covering the relevance of custom as the source of law has decreased. For example, in some commercial areas customary market practice has anyhow still influence as a source of law in case of no written law.

When interpretation is done principle of legality and legal positivism are the most common features.[426]

3.4.2.2 Companies Act

The mezzanine instruments are mainly regulated by the company law but the articles of association of the company concerned have also relevance. The general principles of contract law have naturally also major relevance. How mezzanine financing is seen from the company law perspective is not however always in line with the relevant tax, accounting or insolvency regulation.[427]

The most common Finnish corporate entity is a limited liability company (LLC). There are two forms of LLCs is Finland: the private limited liability company (abbreviation in Finnish: Oy) and the public limited liability company (abbreviation in Finnish: Oyj). Other forms of legal entities are general partnerships (abbreviation in Finnish: Ay) and limited partnerships (abbreviation in Finnish: Ky).

The act regulating all the Finnish types of limited liability companies is the Limited Liability Companies Act, which entered into force on September 1, 2006.[428] It applies both to the private and public limited liability companies. Compared to the previous Finnish company legislation the new Finnish Limited Liability Companies Act widened the contractual freedom of companies when possibility for various kinds of equity financing instruments were created. There is now more than earlier flexibility to structure investments in different ways. For example, new share classes can be created with preferred voting and different economic rights. Also, many quite detailed procedural rules are abolished.

In the text below is focused on those parts of the act that are relevant from the perspective of the discussed topic: mezzanine financing.

3.4.2.2.1 General principles, incorporation and shares

The main principles of the Finnish Limited Liability Companies Act relate to purpose of the company, majority rule, equal treatment of the shareholders, duty of care and loyalty, legal personality, permanence of the capital, limited liability of shareholders, transferability of shares and freedom of contract.

---

[425] See Chapter 1, Section 11 of the Code of Judicial Procedure (4/1734) according to which *"A judge shall carefully examine the true purpose and grounds for the law and render judgment accordingly, and not following his or her own opinions against the law. In the absence of statutory law, the custom of the land, if not unreasonable, shall also be his or her guide."*

[426] Section 2, paragraph 3 of the Constitution of Finland (731/1999).

[427] Lautjärvi, K. (2015), pp. 177-185.

[428] Limited Liability Companies Act (624/2006), Government Bill for the Limited Liability Companies Act (HE 109/2005).

As stated in the Limited Liability Companies Act a company has the purpose to generate profits for its shareholders.[429] This means that management decisions not supporting this purpose are not allowed.[430] There is no specific requirement to generate profit in short term and thus long term development of the company operations and actions needed for that are also in line with this provision of the act.[431] The articles of association may provide that the purpose of a company is something else than profit generation for its owners. If company has profit generation as the purpose there is no need to separately provide that in the articles of association.[432] If company is having other purpose than to generate profits for the shareholders a specific provision in the articles of association has to be included.[433] However in practice such companies have not always adopted provisions that express deviation from generating profits even though that would clarify the actual situation.[434]

Both limited liability corporate forms - private and public - may be founded by one or more individuals or legal entities. There are no limitations on residence or domicile of the share owners. Limited liability company will be established through registration and as an independent legal person such a company is distinct from its shareholders.[435] Shareholders of the limited liability companies bear no personal liability for the company´s obligations.[436] Their liability is restricted to the invested capital. One of the major differences between private and public companies is the amount of share capital. The minimum capital of a private limited liability company is 2,500 euros and of a public limited liability company is 80,000 euros.[437] The assets can be distributed only as provided in the law.[438] This doctrine of capital maintenance stands as a key element in the Finnish company legislation.[439]

Shares of both corporate forms are transferable[440], but only public company shares may be publicly trade.[441] The free transferability of the shares may be limited through specific redemption and consent clauses if relevant provisions have been included in the articles of association. Redemption clause is in practice more common.[442] In case of redemption clause a shareholder, company or third person has a right under certain circumstances to redeem the shares to be transferred to a third party.[443] In case of consent clause the share acquisition by way of a transfer is subject to the consent of the company.[444]

---

[429] Chapter 1, Section 5 of the Limited Liability Companies Act (624/2006).
[430] Mähönen, J. and Villa, S. (2012), p. 15.
[431] Government Bill for the Limited Liability Companies Act (HE 109/2005), pp. 38-39.
[432] Airaksinen, M. et al. (2010), p. 26.
[433] Chapter 13, Section 9 of the Limited Liability Companies Act (624/2006).
[434] See Airaksinen, M. et al. (2010b), p. 86, in which are referred to a special Finnish company form mutual real estate company (MREC). The real estates are often held in Finland in a form of MREC. This is a limited liability company, the shares of which are attributable to certain parts of a real estate property owned by the company. In case of an MREC the rental income will accrue to and is taxed directly from the shareholders of the MREC instead of the real estate company.
[435] Chapter 1, Section 2.1 of the Limited Liability Companies Act (624/2006).
[436] Chapter 1, Section 2.2 of the Limited Liability Companies Act (624/2006).
[437] Chapter 1, Section 3.1 of the Limited Liability Companies Act (624/2006).
[438] Chapter 1, Section 3.2 of the Limited Liability Companies Act (624/2006).
[439] According to Mähönen, J. and Villa, S. (2012), pp. 24-25 the meaning of the principle is expressed more concretely in Sections 13 and 14 of the Limited Liability Companies Act.
[440] Chapter 1, Section 4 of the Limited Liability Companies Act (624/2006).
[441] Public trade here refers to the trade in the regulated market as defined in the Act on Trading in Financial Instruments (748/2012).
[442] Airaksinen, M. et al. (2010), p. 154.
[443] Chapter 3, Section 7 of the Limited Liability Companies Act (624/2006).
[444] Chapter 3, Section 8 of the Limited Liability Companies Act (624/2006).

The owners of the shares use decision-making powers to act in the general meeting.[445] Decision-making is based on the voting majority. The articles of the association may however provide that voting rules applied deviate from the main principle.

All shares shall have equal rights in a company if the articles of the association do not stipulate otherwise.[446] The equal treatment principle is strong, and it targets primarily to provide protection for shareholders in minority position.[447] This balances out the majority rule, which is another important principle. Following the idea of equal treatment excludes possibility to prefer majority shareholders. Any such actions that mean an unjustified advantage to a share owner or third party at the cost of company or another share owner are forbidden. This equal treatment principle covers not only the decisions and measures of the management but also the decisions made by the general meeting. An example of an undue benefit could be a transaction that is favourable for a certain owner but loss-making for the company itself.

The management has duty to promote the interests of a company[448] and not the benefits of the significant share owners only. In practice this means responsibility to perform according to the company´s purpose.[449] This obligation means responsibility of loyalty towards the company and all shareholders.[450] To protect minority shareholders is important and the obligation of due care is relevant also when management's liability for damages is assessed.

The articles of association may include rules on company operations.[451] Provisions that are conflicting with a mandatory rule of the law or conflict with the rules of appropriate conduct shall however not be allowed.[452] For example two contradictory provisions within the articles of association can be non-appropriate conduct.[453]

3.4.2.2.2 Shares

The Finnish Limited Liability Companies Act regulates that all shares of the company shall have equal rights. The articles of association may however provide that the rights and obligations of the company shares vary. What the differences are in detail shall be correspondingly defined in the articles.[454] The legislator has wanted to provide the shareholders freedom to agree on such share structures that satisfy different financing and investment needs.[455]

Shares are in different classes subject to that there is difference between the voting rights, rights related to the distribution of the assets or are otherwise defined to belong to different classes according to the articles of association.[456]

The differences regarding the rights and obligations of the shares do not automatically establish different shares classes.[457] The different classes are established only subject to fulfilling the conditions specifically defined in the law. For example, limitations of voting rights

[445] Chapter 1, Section 6 of the Limited Liability Companies Act (624/2006).
[446] Chapter 1, Section 7 of the Limited Liability Companies Act (624/2006).
[447] Schultén, G. af (2004), p. 120.
[448] Chapter 1, Section 8 of the Limited Liability Companies Act (624/2006).
[449] Hansmann, H. and Kraakman, R. (2001), p. 441.
[450] Mähönen, J. and Villa, S. (2015), pp. 243-245 and p. 376.
[451] Chapter 1, Section 9 of the Limited Liability Companies Act (624/2006).
[452] Kyläkallio, J. et al. (2008), p. 156.
[453] Kyläkallio, J. et al. (2008), p. 158.
[454] Chapter 3, Section 1:1 of the Limited Liability Companies Act (624/2006).
[455] Mähönen, J. and Villa, S. (2012), p. 126.
[456] Chapter 3, Section 1:2 of the Limited Liability Companies Act (624/2006).
[457] Airaksinen, M. et al. (2010), p. 128.

through voting caps applicable for all the shares in the same way do not establish different share classes.[458] However if voting restrictions are applied only to a part of the shares or to different shares in different way, criteria for different share classes would be fulfilled.[459]

The articles of association may include provisions on how shares can be converted to another class.[460] This kind of clause defining conversion conditions and procedures takes effect upon registration.

As the main rule the acquirer of a share shall not exercise shareholder rights before entering into the share register or before declaring the purchase and providing trustworthy verification to the company on that.[461] If the shares are to be incorporated in the book-entry system[462] the rights linked to the shares shall not be exercised before the acquirer has been registered in the relevant shareholder register.[463]

The shares may have a nominal value if that is provided by the articles of association. Alternatively, there may not be a nominal value defined. In the latter case, when company is established or new shares are issued, the sum that is booked for different shares to the share capital may vary. This so-called accountable par can even be zero if due to the rules of the Accounting Act[464] or due to issuing the share for free[465] nothing is credited to the share capital because the reserve for invested unrestricted equity[466] is accounted for.

The reserve for invested unrestricted equity is accounted for with that equity input portion that is not channelled to the share capital, liabilities or any other reserve.[467] Likewise the reduced part of a share capital shall be booked to the invested unrestricted reserve, deducted by an amount that is needed to cover losses or distribute assets. The decisions regarding the usage of reserve for invested unrestricted equity belong within the powers of the board.[468]

The accountable par shall not in any way reflect the rights linked to the share and it shall not even be registered.[469]

In the event of shares having a nominal value that nominal value has to be the same for all shares.[470] In such case the share capital shall be credited by the nominal value at the minimum. This shall apply also in a situation where option rights are used to issue new shares. Any

[458] Lautjärvi, K. (2015), pp. 223-224 and Mähönen, J. and Villa, S. (2012), p.151.
[459] Airaksinen, M. et al. (2010), p. 129.
[460] Chapter 3, Section 1:3 of the Limited Liability Companies Act (624/2006).
[461] Chapter 3, Section 2 of the Limited Liability Companies Act (624/2006).
[462] As referred to in the Act on the Book-Entry System (348/2017).
[463] In Finland shares issued in book-entry form are maintained in a computerised shareholder register kept by the central securities depository. Euroclear Finland acts as the central securities depository in Finland and its duty is to hold the register for shares and debt securities traded in Finland.
[464] Airaksinen, M. et al. (2010), p. 79 and Lautjärvi, K. (2015), p. 111.
[465] Airaksinen, M. et al. (2010), p. 147 and Lautjärvi, K. (2015), p. 114.
[466] Airaksinen, M. et al. (2010), p. 147.
[467] Chapter 8, Section 2 of the Limited Liability Companies Act (624/2006).
[468] Villa, S. (2012), pp. 475-476.
[469] Airaksinen, M. et al. (2010), p. 147. The authors also note that the regulation concerning the accountable par stems from the EU regulation and does not have any material relevance in practice. The rules on capital formation, maintenance and alteration were established in the Second Company Law Directive (Directive 77/91/EEC), which was published for the first time on 13 December 1976. It was later amended by the Directive 2006/68/EC, recasted as Directive 2012/30/EU and finally included in the Directive (EU) 2017/1132. See for more details above section *3.4.1.2.1 Capital maintenance.*
[470] Chapter 3, Section 5:2 of the Limited Liability Companies Act (624/2006).

reduction of the share capital is not possible to the extent that the share capital would decrease below the sum of the nominal values.[471]

In practice the most relevant administrative right in a limited liability company is the right to vote. The starting point in Finland is that one share equals to one vote in the general meeting decision-making.[472] There is no obligation to actually vote but the voting right exists. It is nevertheless possible to regulate in the articles of association that the voting rights of the shares vary.[473] It is even possible to provide that there is no voting right for a share at all or voting rights in certain subjects are decided by the shareholders in the general meeting.[474] This kind of provision on voting limitation shall regard only a part of the shares. In practice a company must always have at least one share class carrying voting rights for each item to be discussed in the general meeting.[475]

In the general meeting one share has one vote in all decision-making. Nevertheless, the Finnish Limited Liability Companies Act sets also some specific rules for a share having no voting rights or limited voting rights subject to that the articles of association do not provide otherwise.[476] Firstly, in case of limited or no voting rights at all a share carries all other shareholder rights. Secondly, in case the dividend distribution based on the articles of association has not been taken place in eight months after the financial period a share having limited voting rights or no voting rights at all shall carry a vote in all matters. Thirdly, in a matter where a share does not have a voting right, the majority needed for a general meeting decision shall be calculated without taking such a share in the calculation.

As stated above the main rule is that shares carry equal rights. If shares differ from each other in terms of the rights towards the distribution they belong to different classes of shares. The contractual freedom allows design of shares that entitle special rights in form of greater dividend distribution or higher priority ranking in distribution of company assets.[477]

The main rule is that limited liability company shares can be freely exchanged. The articles of association may provide lawful transfer restrictions in form of redemption and consent clauses.[478] However in practice a company having its shares publicly traded cannot have any restrictions for free exchange of its shares.[479]

In case of redemption clause, it may be provided that a shareholder, a third person or the company itself has the redemption right for the shares that are to be transferred to a third party by a share owner unless the transferor is the company itself.[480] The provision in articles of association allowing redemption shall define who has the redemption right what is the priority if many persons have the redemption right. With the help of redemption clause, the shareholders can control the transfer of shares and the parties seeking to become

[471] Chapter 3, Section 5:3 of the Limited Liability Companies Act (624/2006).
[472] Chapter 3, Section 3:1 of the Limited Liability Companies Act (624/2006).
[473] See about voting rights linked to shares in general Vahtera, V. (2011), pp. 292-297 and 385-392.
[474] Chapter 3, Section 3:2 of the Limited Liability Companies Act (624/2006).
[475] Government Bill for the Limited Liability Companies Act (HE 109/2005), p. 52.
[476] Chapter 3, Section 4:1 of the Limited Liability Companies Act (624/2006).
[477] Lautjärvi, K. (2015), p. 226 and Mähönen, J. and Villa, S. (2012), p.173-174.
[478] Government Bill for the Limited Liability Companies Act (HE 109/2005), p. 54.
[479] See Nasdaq Helsinki (2017), according to which Nasdaq Helsinki Ltd has in its Rules of the Exchange (valid starting from January 1, 2017) following requirement:
"*Negotiability*
2.2.3.3 The shares must be freely negotiable.
Free negotiability of the shares is a general prerequisite for becoming traded on a regulated market and listed on the Exchange. When the company's Articles of Association include limitations on the negotiability of the shares, such limitations may be typically considered to restrict free negotiability in the meaning of this rule, and other arrangements with a similar effect may lead to a similar interpretation."
[480] Chapter 3, Section 7 of the Limited Liability Companies Act (624/2006).

shareholders. A redemption clause prevents unwanted persons to become share owners. When the existing shareholders wish to transfer their shares, it gives to other existing shareholders priority to increase their holding.

According to the law the redemption right is applicable to every type of acquisition and covers all shares of the acquisition in question. On the other hand, it is possible to provide also otherwise in the articles of association. The redemption price shall represent the fair price of the share.[481] The board of directors provides notification on the share transfers to those persons that have the redemption right. This shall be done either in writing or alternatively in the way defined by the general meeting. The notification shall be provided in one month after the share transfer is informed to the board of directors. The redemption request shall be given to the company - or if redemption right used by the company itself - to the acquirer in two months after the board of directors has been informed about the share transfer. Additionally, the redemption price shall be rewarded in one month after the expiration of the above-mentioned two months period or alternatively, if the redemption price is fixed later, in one month after the redemption price is fixed.

The acquirer shall not use the shareholder rights before it has become clear whether the right of redemption is to be used. Exceptions from this main rule are the right to payment in the asset distribution and the pre-emptive right in a share issue. The one that exercises the redemption right shall receive the rights and obligations stemming from the share issue. It is possible for a company to redeem shares only with distributable assets.[482]

In case of consent clauses, the articles of association may regulate that any share acquisition requires the consent of the company.[483] According to a specific rule in the law this provision does not however apply to a share transfer that is based on a bailiff's auction or an acquisition from a bankruptcy estate. In the articles of association, it is possible to limit the scope of the applicability of the consent clause to be even narrower, but the scope cannot be widened.[484]

The board of directors shall decide on providing consent for the company subject to that the articles of association does not provide otherwise. Provisions on the criteria for giving consent may be included in the articles of association. A consent clause which does not define in detail the criteria of consent leaves major powers for the management of the company to decide whether consent will be given or not.[485]

If the acquisition regards several shares, the consent shall be decided similarly for each share. It is however possible to provide otherwise in the articles of association.

The consent is considered to be given if the applicant has not received a written notification in two months after delivering the application to the company. A shorter period can also be defined in the articles of association. The share acquirer does not have shareholder rights in the company before the consent has been given. Exceptions of this are the right to payment in asset distribution and the pre-emptive right in connection with a share issuance. Shares received based on the pre-emptive right do not have any further rights without the company´s consent.

---

[481] According to Chapter 3, Section 7:2 of the Limited Liability Companies Act (624/2006) the fair price of a share acquired for consideration shall be the price agreed for the share if there is no other evidence of the fair price. See also Airaksinen, M. et al. (2010), p. 160 according to which in case of unfair outcome the redemption price can be adjusted according to the Section 36 of the Finnish Contracts Act (228/1929).
[482] Chapter 3, Section 7:5 of the Limited Liability Companies Act (624/2006).
[483] Chapter 3, Section 8 of the Limited Liability Companies Act (624/2006).
[484] Airaksinen, M. et al. (2010), p. 168.
[485] Airaksinen, M. et al. (2010), p. 169.

In the Limited Liability Companies Act there are also specific rules on share certificates and other certificates in relation to shareholder rights. Share certificates may be shared for the shares by the board of directors.[486] It is however not possible to issue share certificates before the registration of the company and the shares. In practice this requires also that the subscription price of the share is fully paid.[487] A share certificate may also be issued to a shareholder subject that the shareholder is registered in the share register. However, as exception to the above-mentioned no share certificates shall be issued if the shares have been incorporated in the book-entry system. As in the book-entry system the ownership is recorded electronically it eliminates the need to issue paper certificates of ownership.

A share certificate shall be issued only to a person that is specified.[488] The following information shall be included in the share certificate:[489]

- trade name of company and business identity code
- serial numbers or quantity of shares and serial number of the share certificate
- share class in case of several share classes and
- liability to make payments[490], conversion clause[491], redemption clause, consent clause and acquisition or redemption term[492] subject to that provisions on any of these are included in the articles of association.

The share certificate shall be signed by the board of directors or a person authorised by the board of directors and the document shall be dated.[493] Alternatively the signature may be included in the document in a print form or in other comparable manner. In practice even shares prepared completely by handwriting would be allowed by the law.[494]

When the share is cancelled, asset distribution takes place or shares are issued against the share certificate, relevant marking shall be done for the share certificate document without delay. The marking obligation applies also when a share issue certificate[495], option certificate[496] or other certificates on corresponding rights[497] is issued subject to the presentation of the share certificate.

Also, the share certificate shall include relevant marking if the document is delivered as a replacement for a cancelled share certificate.

The company may issue interim certificates before issuing actual share certificates. In such a situation the company issues a certificate regarding the right to one or more shares and

[486] Chapter 3, Section 9 of the Limited Liability Companies Act (624/2006).
[487] Mähönen, J. and Villa, S. (2012), p. 148.
[488] Chapter 3, Section 10:1 of the Limited Liability Companies Act (624/2006).
[489] Chapter 3, Section 10:2 of the Limited Liability Companies Act (624/2006).
[490] As referred to in Chapter 1, Section 2:2 of the Limited Liability Companies Act (624/2006).
[491] As referred to in Chapter 3, Section 1:3 of the Limited Liability Companies Act (624/2006).
[492] As referred to in Chapter 15, Section 10 of the Limited Liability Companies Act (624/2006).
[493] Chapter 3, Section 10:3 of the Limited Liability Companies Act (624/2006).
[494] Airaksinen, M. et al. (2010), p. 177.
[495] A share issue certificate is a certificate on the right to subscribe for shares in a share issue as referred to in Chapter 3, Section 12:2 of the Limited Liability Companies Act (624/2006).
[496] An option certificate is an option right as referred to in Chapter 3, Section 12:2 of the Limited Liability Companies Act (624/2006).
[497] Other certificates on corresponding rights is similar to share issue certificates and option certificates as referred to in Chapter 3, Section 12:2 of the Limited Liability Companies Act (624/2006).

including the condition of exchanging an issued share certificate for the interim certificate.[498] A relevant marking is made in the interim certificate when the share is paid. Otherwise the provisions on a share certificate[499] shall be applied to the interim certificate. The interim certificate could be relevant in the situations where the ownership of a company is transferred or shares are used as collateral before the registration of the shares.[500]

The company may issue several kinds of certificates with special rights including provisions that exercising the special rights is possible only in exchange for the certificate. Examples of these documents with special rights are a share issue certificate and an option certificate.[501] The subscription terms for shares or the exercise of the other right in question shall be included in the certificate.[502]

Due to the voting rights linked to the shares the existence of updated share and shareholders information is important.[503] The board of directors has obligation to keep register on the shareholders.[504] This obligation regards also companies that have been incorporated in the book-entry system.[505] The Limited Liability Companies Act sets quite extensive requirements on the info to be registered. In case of companies not incorporated in the book-entry system the register shall comprise a list of the shares or share certificates in numbering order, the issue dates[506] and the shareholders' names and addresses. The share register shall contain also information on share classes and other possible differences in the rights and obligations linked to the shares. Additionally, all pledges and other types of encumbrances concerning the shares shall be entered the share register if there are no share certificates issued. The logic of this rule is to avoid situations where the share would be later given to the shareholder if it violated the pledge holder's rights. A shareholder register shall also be kept including the name in an alphabetical order, address of the shareholder and number and share class of shares owned by each shareholder. The shareholder register shall be established without any delay after the incorporation of the company.[507] There is an obligation to maintain the registers in a reliable manner and board of directors have the ultimate responsibility on this.[508]

An acquirer of a share is not obliged to notify the company on the share acquisition. However, if notification is done to the company in case of companies not incorporated in the book-entry system the changes shall be entered into the shareholder register without delay.[509] It shall be evidenced in a reliable way that acquisition has taken place and the transfer tax payment has been provided before an entry can be made. The entry shall also be dated. In case of share subject to a redemption right[510] the entry is however not possible before being certain that the

---

[498] Chapter 3, Section 12:1 of the Limited Liability Companies Act (624/2006).
[499] As referred to in Chapter 3, Section 10 of the Limited Liability Companies Act (624/2006).
[500] Airaksinen, M. et al. (2010), p. 180.
[501] Chapter 3, Section 12:2 of the Limited Liability Companies Act (624/2006).
[502] Airaksinen, M. et al. (2010), p. 181 mentions as an example of certificates on corresponding rights so-called sales certificates. These sales certificates could include right for the certificate holder to sell certain securities to the issuer of the sales certificates.
[503] Mähönen, J. and Villa, S. (2012), p. 148.
[504] Chapter 3, Section 15 of the Limited Liability Companies Act (624/2006).
[505] In case of companies incorporated in the book-entry system Chapter 3, Section 15:2 of the Limited Liability Companies Act (624/2006) is applied. According to that the shareholder register kept by the board of directors shall contain information on the name of the shareholder, personal identity code or similar, contact details, payment address and taxation information, the quantity of shares including share class and the account operator maintaining the book-entry account used for the share registration.
[506] According to Kyläkallio, J. et al. (2008), p. 345 and Airaksinen, M. et al. (2010), p. 188 the issue date refers to the date of incorporation agreement if the shares have been issued at the incorporation and in case of later issue to the date of registration.
[507] Chapter 3, Section 15:5 of the Limited Liability Companies Act (624/2006).
[508] Airaksinen, M. et al. (2010), p. 190.
[509] Chapter 3, Section 16 of the Limited Liability Companies Act (624/2006).
[510] As referred to in Chapter 3, Section 7 of the Limited Liability Companies Act (624/2006).

redemption right will not be exercised. Likewise, if consent is required for the acquisition of the share[511] the entry shall not be made until the consent has been given.

Both the share register and the shareholder register shall be accessible to everybody at the company´s head office or - in case of companies incorporated in the book-entry system - in the office of the register holder. [512] Everybody has also the right to receive copies of the both registers or some parts of them. The one requesting the copies is obliged to compensate to the company any expenses of making the copies.

3.4.2.2.3 Administration and financial statements

The shareholders´ decision-making power is exercised at the general meeting.[513] In practice unanimous shareholders can make decisions also without a separate meeting subject to that they document their decision as is required by the law.[514]

Some of the most important items being within the competence of the general meeting are as follows:[515]

- amendment of the articles of association[516]
- appointment of the members of the board of directors[517] and the supervisory board[518]
- appointment of the auditor[519]
- adoption of the financial statements[520]
- distribution of assets or on the authorisation for the board of directors to decide on distribution on assets[521]
- share issue,[522] acquisition and redemption of own shares[523] or authorisation for the board of directors to decide on share issue[524] and redemption of own shares[525]
- reduction of the share capital[526]

[511] As referred to in Chapter 3, Section 8 of the Limited Liability Companies Act (624/2006).
[512] Chapter 3, Section 17 of the Limited Liability Companies Act (624/2006).
[513] Chapter 5, Section 1 of the Limited Liability Companies Act (624/2006).
[514] Chapter 5, Section 2 of the Limited Liability Companies Act (624/2006) and Airaksinen, M. et al. (2010), pp. 240-241.
[515] Airaksinen, M. et al. (2010), pp. 246-247.
[516] Chapter 5, Section 30 of the Limited Liability Companies Act (624/2006).
[517] Chapter 6, Section 30 of the Limited Liability Companies Act (624/2006).
[518] Chapter 6, Section 24 of the Limited Liability Companies Act (624/2006).
[519] Chapter 5, Section 3:2, point 4 and Chapter 7, Section 2 of the Limited Liability Companies Act (624/2006).
[520] Chapter 5, Section 3.2, point 1of the Limited Liability Companies Act (624/2006).
[521] Chapter 13, Section 6 of the Limited Liability Companies Act (624/2006).
[522] Chapter 9, Section 2:1 of the Limited Liability Companies Act (624/2006).
[523] Chapter 15, Section 5:1 of the Limited Liability Companies Act (624/2006).
[524] Chapter 9, Section 2:2 of the Limited Liability Companies Act (624/2006).
[525] Chapter 15, Section 5:2 of the Limited Liability Companies Act (624/2006).
[526] Chapter 14, Section 1 of the Limited Liability Companies Act (624/2006).

- merger,[527] demerger,[528] liquidation,[529] and change of business form[530].

Every shareholder has the right to take part in a general meeting.[531] Holder of the option right is not considered as a shareholder[532] and thus cannot participate in a general meeting as a shareholder. In the Limited Liability Companies Act there are however rules protecting the option holder´s position in different decision-making of the company.[533]

The starting point in terms of decision-making in general meeting is the majority rule. According to the law a proposal supported by more than 50 % of the votes cast shall form the general meeting decision.[534] In the articles of association can be stated that decision is valid only subject to certain minimum number of shareholders to be represented but such regulation is not included in the law itself.[535]

Some decisions require qualified majority. This means that when qualified majority is required for a decision, a proposal that has been supported by at least 2/3 of the votes cast and the represented shares shall constitute the decision of the meeting.[536] Among other things the following decisions shall require qualified majority if not provided otherwise in the articles of association: directed share issue, issue of special rights entitling to shares (for example option rights), directed acquisition of own shares, merger, demerger, liquidation and in case of a public company acquisition and redemption of own shares.[537]

A company shall have a board of directors and - if so decided - both a managing director and a supervisory board.[538] There shall be minimum one member in the board of directors.[539]

Among the general duties of the managing director belongs obligation to take care of the executive management according to the guidance given by the board of directors.[540] The status of a managing director is based on a specific rule in the company law. Among the responsibilities is seeing to it that the company accounts are complying with the law and financial administration has been arranged in a reliable manner. All in all, the managing director is responsible for running the company's operative activities.[541] Both board of directors and managing director shall represent the company.[542]

---

[527] Chapter 16, Section 9:1 of the Limited Liability Companies Act (624/2006).
[528] Chapter 17, Section 9:1 of the Limited Liability Companies Act (624/2006).
[529] Chapter 20, Section 3 of the Limited Liability Companies Act (624/2006).
[530] Chapter 19, Sections 1, 3 and 5 of the Limited Liability Companies Act (624/2006).
[531] Chapter 5, Section 6 of the Limited Liability Companies Act (624/2006).
[532] Airaksinen, M. et al. (2010), p. 272.
[533] Mähönen, J. and Villa, S. (2012), p. 225-226.
[534] Chapter 5, Section 26:1 of the Limited Liability Companies Act (624/2006).
[535] Airaksinen, M. et al. (2010), p. 378.
[536] Chapter 5, Section 27:1 of the Limited Liability Companies Act (624/2006).
[537] Chapter 5, Section 27:2 of the Limited Liability Companies Act (624/2006).
[538] Chapter 6, Section 1 of the Limited Liability Companies Act (624/2006).
[539] Chapter 6, Section 8:1 of the Limited Liability Companies Act (624/2006) and Airaksinen, M. et al. (2010), p. 415.
[540] Chapter 6, Section 17:1 of the Limited Liability Companies Act (624/2006). This is described in the law as *"general Competence"*.
[541] Finnish Corporate Governance Code (2015), p. 14 according to which *"In addition to the daily administrative tasks, the decisions of the board of directors are often based on the managing director's proposals, and the managing director is also responsible for their implementation. In practice, it is the managing director who organises the company's operations, negotiates and concludes major business arrangements, and represents the company."*
[542] Chapter 6, Section 25 of the Limited Liability Companies Act (624/2006).

The board of directors shall appoint and can also dismiss the managing director.[543]

The Finnish Limited Liability Companies Act includes also some regulation regarding auditing and auditors although the main law in this respect is the Accounting Act.[544] This means that both the provisions of the Limited Liability Companies Act and provisions of the Auditing Act apply to the audit of a company.[545]

According to the main rule the auditor is appointed by the general meeting. In case many auditors shall be appointed some of them may be chosen according to different procedure.[546] In a public company there is an explicit requirement to appoint an auditor approved by the Central Chamber of Commerce.[547] In such a case at the minimum one of the auditors appointed by the general meeting shall be approved by the Central Chamber of Commerce.

The financial statements and the annual report shall be prepared in accordance of the Accounting Act and the Limited Liability Companies Act.[548] This means in practice that a breach of the Accounting Act means also breach of the Limited Liability Companies Act.[549] The financial period of the company shall be included in the memorandum of association or the articles of association when incorporation takes place.[550]

The annual report of the limited liability company shall contain the information required in the Limited Liability Companies Act.[551] For small corporates[552] and so-called micro companies[553] the content of annual report shall however be regulated in the Accounting Act. The annual report shall include a proposal of the board of directors how the profits of the company are used and - in case applicable - the distribution of other unrestricted equity.[554] Corresponding information may be included in the notes to the financial statements instead of an annual report unless otherwise provided in the Accounting Act.[555]

The annual report shall include additionally the number of outstanding shares split in the share classes and main provisions of the articles of association concerning each share class.[556] Additionally the main terms of capital loan and the loan interest which is accrued but not entered into the accounts as a cost shall be disclosed in the annual reports.[557] This disclosure requirement allows other creditors and stakeholders to assess the risks related to the capital loan.[558]

---

[543] Chapter 6, Sections 20:1 and 3 of the Limited Liability Companies Act (624/2006). According to Airaksinen, M. et al. (2010), p. 502 the purpose of the regulation is to avoid situation where same body would appoint both board of directors and managing director.
[544] Accounting Act 1336/1997.
[545] Chapter 7, Section 1 of the Limited Liability Companies Act (624/2006).
[546] Chapter 7, Section 2:2 of the Limited Liability Companies Act (624/2006).
[547] Chapter 7, Section 6 of the Limited Liability Companies Act (624/2006).
[548] Chapter 8, Section 3 of the Limited Liability Companies Act (624/2006).
[549] Airaksinen, M. et al. (2010), p. 587.
[550] Chapter 8, Section 4 of the Limited Liability Companies Act (624/2006).
[551] Chapter 8, Section 5:1 of the Limited Liability Companies Act (624/2006).
[552] According to Chapter 1, Section 4a in the Accounting Act (1336/1997) a company is considered a small company if, in two consecutive financial years, max one of the following criteria is exceeded: total assets of 6 MEUR, turnover of 12 MEUR and average number of employees 50.
[553] According to Chapter 1, Section 4b in the Accounting Act (1336/1997) a company is considered a micro company if, in two consecutive financial years, max one of the following criteria is exceeded: total assets of 0,35 MEUR, turnover of 0,7 MEUR and average number of employees 10.
[554] Chapter 8, Section 5:2 of the Limited Liability Companies Act (624/2006).
[555] Chapter 8, Section 5:5 of the Limited Liability Companies Act (624/2006).
[556] Chapter 8, Section 5:3, point 1 of the Limited Liability Companies Act (624/2006).
[557] Chapter 8, Section 5:3, point 2 of the Limited Liability Companies Act (624/2006).
[558] Lautjärvi, K. (2015), p. 245.

The law requires also inclusion of information on debt concerning related parties in the annual report.[559] There is an obligation to disclose loans and commitments to related parties and the main terms of the obligations exceeding 20,000 euros or five % of the equity in the annual report. The *"related party"* relation between company and another person exists if one controls the other or has otherwise significant influence in the decision-making of the other.[560] Relevant in this respect is the decision-making on the financial and business related matters. The rationality of this regulation is to define those parties for whom tighter restrictions shall be applied in certain situations to provide protection for company itself and non-related shareholders and creditors.[561]

The annual report shall contain also relevant information on corporate structure and finance as follows:[562]

- whether the company has become a parent company or taken part in a merger or a demerger
- main contents of a share issue decision
- main contents of a decision related to the issuance of option or other special rights entitling to shares
- main subscription terms of option or other special rights entitling to shares and
- the authorisations of the board of directors concerning share issues, option issues or issues of other special rights entitling to shares.

In the Finnish Limited Liability Companies Act and Accounting Act the definition of group is the same.[563] When a limited liability company exercises control over another corporation or foundation according to Accounting Act[564], the controlling company is considered the parent company and the other corporation or foundation is a subsidiary.[565] A group is formed by the totality of the parent company and all its subsidiaries. According to the law a limited liability company can exercise control over another corporation or foundation also through its subsidiaries. This is the situation when the limited liability company jointly with one or more subsidiaries or a subsidiary or several subsidiaries jointly exercise the control over that corporation or foundation.[566] In practice the *"control"* means right to appoint and dismiss the majority of the board of directors or other relevant body.[567]

[559] Chapter 8, Section 6:1 of the Limited Liability Companies Act (624/2006).
[560] Chapter 8, Section 6:2 of the Limited Liability Companies Act (624/2006).
[561] Immonen, R. and Villa S. (2015), pp. 85-96.
[562] Chapter 8, Section 7 of the Limited Liability Companies Act (624/2006).
[563] Airaksinen, M. et al. (2010), p. 618.
[564] According to Chapter 1, Section 5:1 in the Accounting Act (1336/1997) a company exercises control over another if
1) the company has a majority of the shareholders' or members' voting rights in another undertaking and the majority of voting rights is based on the shareholding, membership, articles or memorandum of association, comparable rules or to a contract entered into with that undertaking;
2) the company has the right to appoint or remove a majority of the members of the board or comparable body or any other body that has the similar appointment and removal right and the right of company has similar basis as the majority voting rights described above in point 1; or
3) has otherwise the right to exercise a dominant influence over an undertaking.
[565] Chapter 8, Section 12:1 of the Limited Liability Companies Act (624/2006).
[566] Chapter 8, Section 12:2 of the Limited Liability Companies Act (624/2006).
[567] Airaksinen, M. et al. (2010), p. 623.

3.4.2.2.4 Capital structure

According to the Finnish Limited Liability Companies Act the company equity consists of restricted equity and unrestricted equity.[568] Restricted equity shall be the combination of the share capital and some additional items as defined with the reference to the Finnish Accounting Act[569] and IFRS-standards: fair value reserves[570] and the revaluation reserves[571].

On top of that limited liability company may have in its balance sheet a legal reserve and a share premium reserve as restricted equity items stemming from the previous Limited Liability Company legislation.[572] Unrestricted equity shall be the combination of other reserves and the profit from the current and the earlier financial periods. Equity from the Limited Liability Companies Act perspective is thus the sum of the capital invested in the company, revaluation reserves and generated profit.

It shall be noted that the distinction of equity into restricted and unrestricted part in the Limited Liability Companies Act is done to control the capital maintenance and maintain the creditor protection.[573] The purpose of the division is not to regulate how balance sheet of the company shall be prepared.[574] As the assets of the limited liability company may only be distributed in accordance with the law the distinction of equity items serve as tools to monitor that.[575]

In the memorandum of association or decision to issue shares can be stated that the subscription price shall be credited to the share capital. The reserve for invested unrestricted equity shall be formed by that part of the share subscription price that is not credited to the share capital and is not credited according to the Accounting Act to liabilities.[576] The same applies also to such other equity inputs which are not credited to any other reserve. In a similar way, unrestricted reserve shall be credited by the amount of reduced share capital after deduction of any amounts needed for the covering of losses or asset distribution.

It is possible for a company to issue new shares or transfer treasury shares.[577] Shares that the company has repurchased, are not cancelled and are held by the company for the later resale are treasury shares.[578] As a main rule there is no distinction in the law whether share issue process regards totally new shares or treasury shares as from the shareholders´ and creditors´ perspective the implications are the same in both alternatives.[579] In case of treasury shares there are however some reliefs related to registration practicalities. For example, registration of the decision according to which a share is issued against payment shall be done only if new

[568] Chapter 8, Section 8:1 of the Limited Liability Companies Act (624/2006).
[569] Accounting Act (1336/1997).
[570] Chapter 5, Section 2a and Chapter 7a of the Finnish Accounting Act (1336/1997).
[571] Chapter 5, Section 17 and Chapter 7a of the Finnish Accounting Act (1336/1997).
[572] The previous law regulating limited liability companies in Finland was Limited Liability Companies Act (734/1978). A legal reserve and a share premium reserve accrued before the entry into force of this act is regulated in the Act on the Implementation of the Limited Liability Companies Act (625/2006).
[573] Lautjärvi, K. (2015), pp. 102-103. About the division of the restricted and unrestricted equity see also Mähönen, J. and Villa, S. (2010), pp. 368-380.
[574] Airaksinen, M. et al. (2010), p. 569. See also about the legal capital regime in general Mäntysaari, P. (2010c), pp. 140-145.
[575] Mähönen, J. and Villa, S. (2012), p. 75.
[576] Chapter 8, Section 2 of the Limited Liability Companies Act (624/2006).
[577] Chapter 9, Section 1:1 of the Limited Liability Companies Act (624/2006).
[578] Kershaw, D. (2012), p. 751.
[579] Airaksinen, M. et al. (2010), p. 643.

shares are issued.[580] Also shareholder rights related to a new share shall be established earliest as of registration.[581]

A share issue may take place in a form of the issue of shares against payment or issue of shares without payment.[582] In the latter alternative the shares there is no separate subscription price to be paid and the issue is thus free of charge.

The general meeting shall make the decisions on issuing shares.[583] It is also allowed to authorise the board of directors to decide on a share issue by the general meeting.[584] This kind of authorisation has to be notified for registration without delay and in any case within one month after the decision.

The shareholders shall have a pre-emptive right in a share issue. The pre-emptive right shall be in proportion to shareholders´ current shareholdings in the company.[585] This fundamental principle of continental European company law is also part of the EU capital maintenance regulation[586] and became part of Finnish Limited Liability Companies Act.[587] If the company has many share classes the pre-emptive rights of shareholders principle means that shares shall be issued in all share classes in proportion to the classes. On top of that shares have to be offered to the shareholders in each share class in proportion to the shareholdings in the corresponding share class.[588] Deviations to the above-mentioned pre-emptive right principles may be included in the articles of association but only in case of a private company.[589] The reason for this is that the capital maintenance rules of Directive (EU) 2017/1132 apply only to public limited liability companies and the mandatory rules of the shareholders pre-emptive rights do not allow deviations for public limited liability companies. However, in a public company the articles of association may state that a share not carrying the right to the distribution of the assets shall not either include the pre-emptive right in a share issue.

According to the Finnish company regulation a so-called directed share issue is possible. A derogation to the pre-emptive right may be made in a share issue in case a weighty financial reason.[590] A relevant reason in this context could be getting a new equity financier, payment of acquisition through share issuance or share payment scheme for employees.[591] However to target to keep the ownership structure unchanged and avoid changes is not considered to be a lawful argument for direct share issues.[592] If shareholders unanimously decide on deviating from the pre-emptive right there is no need to define the weighty financial reason.[593] When assessing the acceptability of a directed share issue, focus shall be put on the relation between the fair price of the share and the subscription price. The more the subscription price is below the fair price of the share the stronger argumentation is required to verify the existence of a *"weighty financial reason"*.[594] A directed share issue may take place without payment only if

[580] Chapter 9, Section 7 of the Limited Liability Companies Act (624/2006).
[581] Chapter 9, Section 15 of the Limited Liability Companies Act (624/2006).
[582] Chapter 9, Section 1:2 of the Limited Liability Companies Act (624/2006).
[583] Chapter 9, Section 2:1 of the Limited Liability Companies Act (624/2006).
[584] Chapter 9, Section 2:2 of the Limited Liability Companies Act (624/2006).
[585] Chapter 9, Section 3:1 of the Limited Liability Companies Act (624/2006).
[586] Directive (EU) 2017/1132. See for more details above section *3.4.1.2.1 Capital maintenance.*
[587] Government Bill for the Limited Liability Companies Act (HE 109/2005), p. 101 and Mäntysaari, P. (2010c), p. 174.
[588] Chapter 9, Section 3:2 of the Limited Liability Companies Act (624/2006).
[589] Chapter 9, Section 3:3 of the Limited Liability Companies Act (624/2006).
[590] Chapter 9, Section 4:1 of the Limited Liability Companies Act (624/2006).
[591] Airaksinen, M. et al. (2010), p. 671.
[592] Airaksinen, M. et al. (2010), p. 671.
[593] Immonen, R. et al. (2011), p. 297, Pönkä, V. (2012), p. 383 and Airaksinen, M. et al. (2010), p. 671. According to Mähönen, J. and Villa, S. (2012), p. 293 the unanimous decision of all shareholders could already itself be a *"weighty financial reason"*.
[594] Airaksinen, M. et al. (2010), p. 672.

there is a specifically weighty reason for that both from the company and shareholders perspective. This kind of specific and strict requirement could be fulfilled in case of reverse share-split when the owners of more valuable shares are compensated with new shares without payment or in certain employee share compensation schemes.[595]

The subscription price to be paid for a new share shall be attributed to the share capital.[596] However if the share issue decision states that the subscription price shall be credited fully or partially to the reserve for invested unrestricted equity or if Accounting Act provides otherwise[597], the crediting must be done accordingly. The price paid for a treasury share shall be credited to the reserve for invested unrestricted equity.[598] If it the share issue decision states that the paid price shall be credited fully or partially to the share capital or if Accounting Act provides otherwise[599], the crediting must however be done accordingly.

The notification for subscription may be done after the shares have been fully paid for and possible other subscription terms have been completed.[600] An example of other terms is condition of share issuance decision according to which share issuance becomes valid subject to minimum amount of subscriptions.[601] The shares shall be notified for registration without unnecessary delay taking into consideration shareholders rights and costs of notification for the company. In practice this could even mean need to notify for registration in several batches.

A new share shall carry shareholder rights - both economical and voting rights - as of registration. However, it is possible to provide a later moment of time in the share issue decision.[602] According to the law the shares carry in any case full shareholder rights one year after registration at the latest.

It is possible for the company to decide on a share issue to itself without any payment at all. In this kind of share issue the new shares registered are governed by the provisions on treasury shares.[603] The provisions on directed share issues shall not be applied for a share issue to company itself. The logic of having this kind of alternative for the limited liability company is to give more possibilities to use treasury shares in share issuance. The purpose of the issue of shares to the company itself can be to have own shares for the payment for the acquisition or share based incentives.[604]

---

[595] Government Bill for the Limited Liability Companies Act of Finland (HE 109/2005), p. 103.
[596] Chapter 9, Section 6:1 of the Limited Liability Companies Act (624/2006).
[597] According to IFRS-standards and Chapter 7a of the Finnish Accounting Act (1336/1997) subscription price may in some situations be recorded as debt. See Government Bill for the Limited Liability Companies Act (HE 109/2005), p. 106.
[598] Chapter 9, Section 6:2 of the Limited Liability Companies Act (624/2006).
[599] See above footnote 597.
[600] Chapter 9, Section 14 of the Limited Liability Companies Act (624/2006).
[601] Airaksinen, M. et al. (2010), p. 712.
[602] Chapter 9, Section 15 of the Limited Liability Companies Act (624/2006).
[603] Chapter 9, Section 20:1 of the Limited Liability Companies Act (624/2006).
[604] See Suominen Corporation Stock Exchange Release 17 July 2013 at 8.50 (EEST) with the title *"Issue of new shares of Suominen Corporation without consideration to the company itself"*. According to the Stock Exchange Release "… *The purpose of the issue of shares to the company itself is to have own shares held by the company available for the payment of the portion of the annual remuneration of the Members of the Board of Directors, which shall be paid in shares of the company and for the payment of the share rewards possibly payable based on the company's share based incentive plan. The share rewards possibly payable based on the company's current share based incentive plan for the years 2012 - 2014 will be paid in the year 2015."*

A public company is not allowed to make a decision on a share issue to itself, if the group holdings after the share issuance exceeded one tenth of all shares.[605] The treasury shares held both by the parent company and its subsidiaries are taken into consideration in this respect.

The Finnish company law gives possibility for the companies to issue option rights and other special rights entitling to shares. In case of weighty financial reason the company may issue special rights for the holder to receive new shares or treasury shares subject to payment.[606] The weighty financial reasons required for option and other special rights can be the same as earlier mentioned in connection with directed share issuance like getting a new equity financier or share incentive scheme for employees.[607] In the case of option right the holder may have possibility to choose whether or not to do the share subscription. Alternatively, the special right can include even subscription obligation if so provided in the issue terms.[608]

The company may issue the above-mentioned rights also to its creditor on condition that the creditor´s receivable is set off against the share subscription price.[609] This means that the debt is actually converted to a so-called convertible loan[610] - or in case of bond financing - convertible bonds[611]. According to the agreed terms the creditor (= the holder of the conversion right) may convert its receivable into share capital. As long as the conversion has not taken place the terms of debt comply with the contract on which the receivable is based on. In case of loan the terms of loan would then comply with the loan agreement. The terms of conversion are agreed when the convertible loan is established. The issuer has to decide among other things on conversion price and conversion ratio.[612]

The general meeting makes decisions on the issue of option rights and other rights.[613] It is possible also that the general meeting authorises the board of directors to decide on an issue of option rights or other rights.[614] In such a authorisation shall be determined the maximum amount of shares to be issued broken down by share class. The law sets some minimum criteria for the content of a decision concerning the issue of option rights or other rights primarily to protect the holder of such rights.[615]

According to the law the share capital of the limited liability company may be increased in three different ways.[616] Firstly, increase can take place by crediting the subscription price of shares, option rights or other special rights fully or partially to the share capital. Secondly, increase can happen through increase from reserves i.e. by transferring assets from reserves of unrestricted equity into the share capital. Thirdly, increase can be done by crediting to the share capital such assets that are invested into the company in any other situation than referred to in the first alternative. The last alternative is known as share capital investment.

---

[605] Chapter 9, Section 20:2 of the Limited Liability Companies Act (624/2006).
[606] Chapter 10, Section 1:1 of the Limited Liability Companies Act (624/2006).
[607] Lautjärvi, K. (2015), pp. 237-238.
[608] According to Airaksinen, M. et al. (2010), p. 738 the possibility for *"obligation"* instead of *"option"* only is also the reason why the law refers to both *"special rights"* and *"option rights"*.
[609] Chapter 10, Section 1:2 of the Limited Liability Companies Act (624/2006).
[610] Airaksinen, M. et al. (2010), p. 712.
[611] Lautjärvi, K. (2015), p. 234.
[612] Mäntysaari, P. (2010c), p. 301.
[613] Chapter 10, Section 2:1 of the Limited Liability Companies Act (624/2006).
[614] Chapter 10, Section 2:2 of the Limited Liability Companies Act (624/2006).
[615] Chapter 10, Section 3 of the Limited Liability Companies Act (624/2006). See also Mähönen, J. and Villa, S. (2012), pp. 225-226 and 347-348.
[616] Chapter 11, Section 1 of the Limited Liability Companies Act (624/2006).

The general meeting shall decide on an increase from reserves[617] or alternatively the general meeting may authorise the board of directors to decide on an increase from reserves[618]. In the latter alternative the authorisation decision must determine the maximum amount of increase. The board of directors shall decide on an increase of share capital based on a share capital investment.[619] The decision shall state the increase amount and the investment on which the increase is grounded.

The increase of share capital shall become valid after the increase has been registered.[620] This rule is applied for all the different share capital increase alternatives. After registration is completed it is not possible for the payer to cancel the increase by stating that transaction condition has not been fulfilled.

The Limited Liability Companies Act contains also special provisions on a specific loan type called capital loan which has features of both debt and equity.[621] Interest and principal of a capital loan can be paid back only within the limits of the unrestricted equity of the company. This loan type is also subordinated to all the other loans of the company. The company may take out a capital loan so that

- the principal and interest are subordinated to all other debts in the company´s liquidation and bankruptcy
- the principal and interest payments take place only to the extent the sum of the unrestricted equity and all the capital loans of the company at the moment of payment exceed the loss on the balance sheet of the latest financial period or the loss on the balance sheet of more recent financial statements and
- the company or a subsidiary shall not provide security for the principal and interest payment.[622]

The capital loan agreement can contain also other provisions but the law sets the minimum requirements and the other terms shall not be contradictory with the minimum requirements set in the law.[623] If repayment of the principal, the payment of interest and the posting of security for a capital loan takes place in contradiction with the provisions of the law, such a transaction shall be subject to the provisions on the unlawful distribution of assets[624] and on criminal penalties[625].

The purpose of the capital loan is to support the repayment of other loans having higher repayment priority.[626] As capital loan is considered to be more debt than equity input in the Finnish legislation therefore the creditor of the capital loan gets the same protection than

[617] Chapter 11, Section 2:1 of the Limited Liability Companies Act (624/2006).
[618] Chapter 11, Section 2:2 of the Limited Liability Companies Act (624/2006).
[619] Chapter 11, Section 3:1 of the Limited Liability Companies Act (624/2006).
[620] Chapter 11, Section 4:4 of the Limited Liability Companies Act (624/2006).
[621] The capital loan regulation was introduced as an amendment of the previous Limited Liability Companies Act (734/1978) in 1997. In the present Limited Liability Companies Act (624/2006) the capital loan regulation has been revised to some extent compared to the old law. About the history of capital loan and relevant regulation before the existing Limited Liability Companies Act see Villa, S. (1997).
[622] Chapter 12, Section 1 of the Limited Liability Companies Act (624/2006).
[623] Government Bill for the Limited Liability Companies Act (HE 109/2005), p. 120.
[624] Chapter 13, Section 4 of the Limited Liability Companies Act (624/2006).
[625] Chapter 25, Section 1 of the Limited Liability Companies Act (624/2006).
[626] Mähönen, J. and Villa, S. (2012), p. 235.

other creditors in case of reduction of share capital[627], demerger[628], merger[629] and change of business form[630].[631] In practice this means right to oppose the planned transaction and demand payment or posting of security.[632] Nevertheless, the amount that is due may be paid or security given only after the registration of the measure that requires creditor protection. It is possible to use the capital loan also for the payment of a share capital increase, conversion into invested unrestricted equity or covering the loss of the company on condition that the creditor provides consent for that.

Some additional requirements applicable to capital loans are as follows:

- A capital loan contract shall be made in writing.
- If unpaid interest is due, the interest shall be deferred for payment based on the first such financial statements that permit payment.
- Capital loans shall have an equal right to the borrower´s assets if not otherwise agreed between the company and the capital loan creditors.
- Capital loans shall be recorded on the borrower´s balance sheet as a separate item.[633]

3.4.2.2.5 Distribution of assets

As mentioned earlier one of the main principles of a limited liability company is to separate a legal person from its shareholders. This means among other things that the shareholders do not have personal liability for the obligations of the company. As one element to balance this restriction of liability there are limitations for how shareholders can distribute assets of the company.[634] The assets of the company can be distributed to the shareholders only as provided in the Limited Liability Companies Act.[635] This thinking is in line with the legal capital regime in the EU.[636] The Finnish legislation identifies several general methods for the distribution of assets.[637] A common method is the distribution of profits i.e. dividend payment and the distribution of assets from reserves of unrestricted equity. Also, the reduction of the share capital[638], the acquisition and redemption of own shares[639] and the dissolution and deregistration of the company[640] are possible distribution methods.

The common feature for all the above-mentioned asset distribution methods is that assets are transferred out from the company either without compensation or in return of the company own shares.[641]

---

[627] Chapter 14, Section 2 of the Limited Liability Companies Act (624/2006).
[628] Chapter 16, Section 6 of the Limited Liability Companies Act (624/2006).
[629] Chapter 17, Section 6 of the Limited Liability Companies Act (624/2006).
[630] Chapter 19, Section 7 of the Limited Liability Companies Act (624/2006).
[631] Chapter 12, Section 1:2 of the Limited Liability Companies Act (624/2006).
[632] Airaksinen, M. et al. (2010), p. 810.
[633] Chapter 12, Section 2 of the Limited Liability Companies Act (624/2006).
[634] Airaksinen, M. et al. (2010b), p. 3.
[635] Chapter 1, Section 3 of the Limited Liability Companies Act (624/2006).
[636] See about the legal capital regime in general Mäntysaari, P. (2010c), pp. 140-158.
[637] Chapter 13, Section 1 of the Limited Liability Companies Act (624/2006).
[638] As referred to in Chapter 14 of the Limited Liability Companies Act (624/2006).
[639] As referred to in Chapters 3 and 15 of the Limited Liability Companies Act (624/2006).
[640] As referred to in Chapter 20 of the Limited Liability Companies Act (624/2006).
[641] Mähönen, J. and Villa, S. (2012), p. 380.

The company may have some other purpose than generating profits for the shareholders.[642] In such a situation a provision specifying this shall be included in the articles of association including provisions on the use of equity in the event of distribution of assets.[643] The general meeting may also make a decision on a donation subject to that the donation amount can be considered to be reasonable.[644] When assessing the reasonability the purpose, the state of the company and other circumstances shall be taken into consideration. The board of directors may use funds for donation to the extent their amount is insignificant in view of the overall situation of the company. These kinds of gifts for philanthropic or other corresponding purposes should be possible within the distributable assets.[645]

Other transactions that increase liabilities of the company or reduce the assets without a sound business reason shall mean illegitimate distribution of assets.[646] A transaction would thus be legal - even if it were later identified to be loss-making - if there were *"a sound business reason"* for it.[647] Assets shall not either be distributed before the registration of the company.[648]

Distribution of assets is not allowed if at the moment of the distribution decision it is known or should be known that the company is insolvent or the distribution will lead to insolvency.[649] When assessing the solvency the observation shall be done based on going concern - perspective.[650] Unless otherwise provided in the solvency application, the company may distribute its reserves of unrestricted equity within the limits of the distributable reserves taking into consideration among other things possible distribution limitations under the articles of association and entries of development expenditures.[651] Before distributing assets the company must thus identify the distributable balance sheet items *("balance sheet test"*) and check the solvency status (*"solvency test"*).[652]

The distribution of assets shall be based on the statutory financial statements of the company.[653] This means in practice that balance sheet test shall be done before the solvency test.[654] Financial statements show the distributable profit of the company and reveal also other information relevant in assessing the solvency like annual report.[655] If company shall have an auditor according to the law or the articles of association, the financial statements shall be audited. The law enables the distribution of interim dividend which means dividend distributed from the profit of the running accounting period.[656] In such a case, the interim accounts should be prepared and - in case of audit requirement - audited for the basis of dividend distribution. Possible significant changes influencing the company´s financials after the completion of the financial statements shall also be taken into consideration when distribution is planned.

---

[642] Chapter 13, Section 1:2 of the Limited Liability Companies Act (624/2006).
[643] Chapter 13, Section 9 of the Limited Liability Companies Act (624/2006).
[644] Chapter 13, Section 8 of the Limited Liability Companies Act (624/2006).
[645] Government Bill for the Limited Liability Companies Act (HE 109/2005), p. 129.
[646] Chapter 13, Section 1:3 of the Limited Liability Companies Act (624/2006).
[647] Airaksinen, M. et al. (2010b), p. 29.
[648] Chapter 13, Section 1:4 of the Limited Liability Companies Act (624/2006).
[649] Chapter 13, Section 2 of the Limited Liability Companies Act (624/2006).
[650] Jokinen, J. (2008), p. 248.
[651] Chapter 13, Section 5 of the Limited Liability Companies Act (624/2006).
[652] See about the balance sheet and solvency tests in general Lautjärvi, K. (2015), pp. 138-146 and Immonen, R. and Villa, S. (2015), pp.75-80.
[653] Chapter 13, Section 3 of the Limited Liability Companies Act (624/2006).
[654] Immonen, R. and Villa S. (2015), p.77.
[655] Government Bill for the Limited Liability Companies Act (HE 109/2005), p. 126 and Airaksinen, M. et al. (2010b), p. 48.
[656] Government Bill for the Limited Liability Companies Act (HE 109/2005), p. 126 and pp. 157-158 and Airaksinen, M. et al. (2010b), pp. 50-52.

The general meeting shall decide on the distribution of assets based on the board of directors' proposal.[657] The general meeting may also provide authorisation to the board of directors to decide on the dividend distribution or distribution of assets from reserves of unrestricted equity.[658] This shall be done by a decision determining the maximum distribution amount. The authorisation may be relevant in a situation where the above-mentioned solvency criteria are not fulfilled at the moment of shareholders´ meeting.[659]

The limited liability company is not allowed to finance acquisition of its own shares. This restriction covers providing loans, assets or security for a third party with the purpose of acquiring shares of the company or its parent.[660] The restriction covers both existing shares and new shares to be issued.[661] However the restriction is not applicable to transactions taken within the distributable assets and aimed for the acquisition of shares for employees or a related party company[662].[663]

For the share capital reduction there are three alternative ways: distribution of share capital, reduction of share capital to transfer assets to reserves of unrestricted equity and use of share capital to cover losses not covered from unrestricted equity.[664] The share capital reduction shall not go below the minimum share capital of 2,500 euros in case of a private limited liability company and 80,000 euros in case of a public limited liability company.[665]

As the share capital reduction collides with the principles of capital maintenance and creditor protection the law sets some specific requirements for the decision-making.[666] This means that the creditors of the company are entitled to oppose the share capital reduction. This is however not allowed if the reduction amount is used for loss coverage or if the share capital is simultaneously increased at the minimum by the reduced amount. On top of that if the share capital reduction has been done for loss coverage there are some limitations for the distribution of unrestricted equity. It is possible to distribute the unrestricted equity to the shareholders during the three years after the registration of the reduction only according to the creditor protection procedure including register notification and application for a public notice[667] and public notice to creditors[668] and preconditions of registration[669].

Acquisition and redemption of shares is also considered as distribution of profits as the purpose is to distribute assets to shareholders.[670] Therefore the Finnish Limited Liability Companies Act has also rules on acquisition, redemption and pledging of own shares. According to the law a company may decide to acquire its own shares, redeem shares from the shareholders to the company free of charge or for consideration and accept own shares as pledge.[671]

---

[657] Chapter 13, Section 6:1 of the Limited Liability Companies Act (624/2006).
[658] Chapter 13, Section 6:2 of the Limited Liability Companies Act (624/2006).
[659] Airaksinen, M. et al. (2010b), p. 69 and Mähönen, J. and Villa, S. (2012), pp. 420-421.
[660] Chapter 13, Section 10:1 of the Limited Liability Companies Act (624/2006).
[661] Immonen, R. and Villa S. (2015), p.115.
[662] As referred to in Chapter 8, Section 6:2 of the Limited Liability Companies Act (624/2006).
[663] Chapter 13, Section 10:2 of the Limited Liability Companies Act (624/2006).
[664] Chapter 14, Section 1:1 of the Limited Liability Companies Act (624/2006).
[665] Chapter 14, Section 1:2 of the Limited Liability Companies Act (624/2006).
[666] Lautjärvi, K. (2015), p. 128.
[667] Chapter 14, Section 3 of the Limited Liability Companies Act (624/2006).
[668] Chapter 14, Section 4 of the Limited Liability Companies Act (624/2006).
[669] Chapter 14, Section 5 of the Limited Liability Companies Act (624/2006).
[670] Airaksinen, M. et al. (2010b), p. 134.
[671] Chapter 15, Section 1 of the Limited Liability Companies Act (624/2006).

These specific provisions on acquisition, redemption and pledging of own shares do however not apply in all situations.[672] These provisions are not applied when business is acquired by the company through merger, demerger or other transfer and in that way own shares owned or held as pledge by the acquired business are acquired. The provisions are not either applicable when the company receives an own share for no consideration or purchases a share - that has been distrained to enforce the receivable of the company - in a bailiff's auction.

The logic for scoping out the above listed transactions from the applicability of the law is that the out-scoped transactions are not considered very problematic from the shareholders and creditors perspective.[673] It shall also be noted that the Finnish Limited Liability Companies Act does not include regulation on the acquisition or redemption of option or other rights issued by the company itself.[674]

The company shares that have come to its possession through acquisition, redemption or otherwise may be kept as treasury shares, cancelled or further transferred.[675] The board of directors may make a decision to cancel treasury shares.[676] Such a decision shall be registered without delay. The cancellation becomes in force once the registration notification has been done.

The general meeting shall decide on acquisitions and redemptions.[677] In a private limited liability company the decision shall be made by majority vote more i.e. more than half the votes cast shall support the decision. In a public company, the decision requires qualified majority i.e. at least 2/3 of the votes cast and the shares represented shall constitute the decision at the meeting.[678]

Directed acquisition and directed redemption is also possible. In directed acquisition own shares may be acquired in a proportion different than that of the shares held by the shareholders. This is possible only subject to that there is a weighty financial reason for that.[679] The *"weighty financial reason"* requirement here is the same as in case of directed share issue.[680] Special notice shall be given to the relation between the fair price of the share and the consideration offered when the acceptability of a directed acquisition is assessed. The decision of the general meeting shall require qualified majority of at least 2/3 of the votes cast and the shares represented at the meeting supporting the transaction.

It is possible to redeem own shares in other proportion than that of the shares owned. This directed redemption is possible only if all shareholders give consent to it.[681] A public company may however decide by qualified majority that shares are to be reverse split.[682] In addition acquisition and redemption clause may be included in the articles of association.[683] In such a case the company has the right or the obligation to acquire or redeem its own shares. The articles of association define then whether it is about acquisition or redemption, has the company the right or the obligation to acquire or redeem, to which shares the provision is

[672] Chapter 15, Section 2 of the Limited Liability Companies Act (624/2006).
[673] Airaksinen, M. et al. (2010b), p. 143.
[674] Lautjärvi, K. (2015), p. 130.
[675] Chapter 15, Section 4:1 of the Limited Liability Companies Act (624/2006).
[676] Chapter 15, Section 12:1 of the Limited Liability Companies Act (624/2006).
[677] Chapter 15, Section 5:1 of the Limited Liability Companies Act (624/2006).
[678] Airaksinen, M. et al. (2010b), p. 148.
[679] Chapter 15, Section 6:1 of the Limited Liability Companies Act (624/2006).
[680] Mähönen, J. and Villa, S. (2012), pp. 500-501.
[681] Chapter 15, Section 6:2 of the Limited Liability Companies Act (624/2006).
[682] As referred to in Chapter 15, Section 9 of the Limited Liability Companies Act (624/2006).
[683] Chapter 15, Section 10 of the Limited Liability Companies Act (624/2006).

applied, procedure to be observed, consideration to be paid and assets that can be used for the consideration payment.

A public company it is not allowed to decide on acquisition or redemption of own shares or accepting them as pledge so that the treasury shares in its possession exceed 1/10 of all shares.[684] It is not possible for a private company to acquire or redeem all its shares but accepting shares as own pledge is not restricted.[685]

3.4.2.2.6 Changes in company structure

Under this subheader is reviewed the main points of the Limited Liability Companies Act related to the changes in company structure:

- merger and cross border merger[686]
- demerger and cross-border demerger[687]
- rights of squeeze-out and sell-out[688]
- change of business form[689] and
- dissolution of the company[690].

3.4.2.2.6.1 Merger

The purpose of a merger is to consolidate two or more companies into one new company leading at least one part to lose its autonomy.[691] There are several types of mergers and also several reasons why mergers are done. Normally this kind of restructuring is done to expand business and create added value for shareholders.

The Finnish Limited Liability Companies Act includes provisions of a merger where a limited liability company, called as a merging company, merges into another limited liability company, which is called as an acquiring company. Such a transaction means the assets and liabilities of the merging company are transferred to the acquiring company. The shares in the acquiring company are paid as compensation - known as merger consideration - to the shareholders of the merging company.[692] Also cash, other assets and future undertakings can be used as merger consideration. In all situations the principle of equal treatment of shareholders[693] shall be applied when merger consideration is assessed.[694]

---

[684] Chapter 15, Section 11:1 of the Limited Liability Companies Act (624/2006).
[685] Chapter 15, Section 11:2 of the Limited Liability Companies Act (624/2006) and Airaksinen, M. et al. (2010b), p. 199.
[686] Chapter 16 of the Limited Liability Companies Act (624/2006).
[687] Chapter 17 of the Limited Liability Companies Act (624/2006).
[688] Chapter 16 of the Limited Liability Companies Act (624/2006).
[689] Chapter 19 of the Limited Liability Companies Act (624/2006).
[690] Chapter 20 of the Limited Liability Companies Act (624/2006).
[691] Schade, V. (2014), p. 4.
[692] Chapter 16, Section 1 of the Limited Liability Companies Act (624/2006).
[693] Chapter 1, Section 7 of the Limited Liability Companies Act (624/2006).
[694] Airaksinen, M. et al. (2010b), pp. 227-230.

The forms of merger may vary. A merger may occur in a form of absorption merger or combination merger.[695] In an absorption merger one or several merging companies merge into the acquiring company. In a combination merger at least two merging companies merge and incorporate this way jointly an acquiring company. This latter form of merger means that all the companies taking part in the merger cease to exist and a totally new entity is established. Therefore, combination merger can be considered more complicated than absorption merger where one entity keeps its identity.[696]

A subsidiary merger is a special type of absorption merger in which the companies participating in the merger[697] own all the shares of the merging company.[698] In case the subsidiary company has issued option rights and other special rights entitling to shares in the company the parent company must be also the holder of the option rights and special rights in order the merger to be a subsidiary merger.[699]

A triangular merger is defined as an absorption merger where the merger consideration is provided by a party other than the acquiring or merging company.[700] Normally such a third party is the parent of the acquiring company.[701] In case the third party is a listed company the usage of liquid listed shares as merger consideration may increase the attractiveness of the merger transaction from the perspective of the shareholders of the merging company.[702]

The companies involved in the merger shall draft the written terms of merger.[703] The body responsible of preparing the draft is the board of directors. The draft terms of merger are in practice the merger proposal to the general meeting.[704] In a triangular merger the party providing the merger consideration is also responsible of signing the draft terms of merger. The draft terms shall include among other things the following information:[705]

- the identifying information of the companies participating in the merger
- an account of the reasons for the merger
- a proposal if relevant for other merger consideration and - in case this consideration comprises option rights or other special rights entitling to shares - the terms of them[706]

[695] Chapter 16, Section 2:1 of the Limited Liability Companies Act (624/2006).
[696] Airaksinen, M. et al. (2010b), pp. 227-230.
[697] According to Chapter 16, Section 2:4 of the Limited Liability Companies Act (624/2006) companies involved in the merger refers to a merging company and to an acquiring company.
[698] Chapter 16, Section 2:2 of the Limited Liability Companies Act (624/2006).
[699] Government Bill for the Limited Liability Companies Act (HE 109/2005), p. 145.
[700] Chapter 16, Section 2:3 of the Limited Liability Companies Act (624/2006).
[701] Government Bill for the Limited Liability Companies Act (HE 109/2005), p. 147.
[702] Airaksinen, M. et al. (2010b), p. 242.
[703] Chapter 16, Section 3:1 of the Limited Liability Companies Act (624/2006). According to the law the draft terms shall be dated and signed.
[704] Government Bill for the Limited Liability Companies Act (HE 109/2005), p. 147.
[705] Chapter 16, Section 3:2 of the Limited Liability Companies Act (624/2006).
[706] As referred to in Chapter 10, Section 3 of the Limited Liability Companies Act (624/2006). It shall be noted that a requirement to include in the draft terms of merger the proposal for other merger consideration is not applicable in a subsidiary merger. The assumption is that in a subsidiary merger the holders of the option rights or other special rights are part of the new entity. Therefore the rights expire in the merger and thus there is no need to mention them separately in the draft terms of the subsidiary merger. See Airaksinen, M. et al. (2010b), pp. 276-279 about the position of the holders of the option rights and other special rights in a merger.

- a proposal for the rights of the holders of option rights and holders of other special rights that entitle to shares in the merging company[707]

- an account of capital loans the creditors of which are entitled to object to the merger[708].

It is also possible to include in the draft terms of merger also terms and conditions that are not specifically required by the law.[709]

As a part of the merger process a statement of an auditor is also required to assess among other things the fairness of merger consideration. [710] A public notice to creditors must be also made in case of merger.[711] As described above a public notice concerns also capital loan lenders. The merger may trigger the repayment of capital loan even if repayment criteria based on the credit documentation are not fulfilled.[712] Also merger process may lead to a collateral arrangement for the capital loan borrower which takes away the capital loan nature of the loan.[713]

Restructuring proceedings[714] are considered separate legal procedures with legal effects of their own. Restructuring proceedings shall replace the above-mentioned public notice.[715] In such proceedings a creditor shall have no right to object the merger. This is subject to that the merger happens in accordance with the Limited Liability Companies Act, all companies part of the merger belong to the same group and the approval of the restructuring programme happens simultaneously for all of them. In such a situation the draft terms of merger shall be attached to the proposed restructuring programme.[716]

According to the main rule the general meeting shall make the decision on a merger in the merging company.[717] In a subsidiary merger however the decision shall be made by the board of directors in the merging company. There is a requirement in the law that a specific notice of the general meeting that will decide on the merger shall be sent to shareholders and holders of option rights and other special rights entitling to company shares.[718] This specific regulation is important especially for the holders of the option and specific rights as the company does not have obligation to keep updated list of the holders of those rights.[719]

A shareholder of the merging company that has opposed the merger may demand that his or her shares shall be redeemed.[720] The demand shall be done at the general meeting that decides

---

[707] See Airaksinen, M. et al. (2010b), pp. 276-279 about the position of the holders of the option rights and other special rights in a merger.
[708] As referred to in Chapter 16, Section 6 of the Limited Liability Companies Act (624/2006).
[709] Mähönen, J. and Villa, S. (2012), p. 567.
[710] According to Chapter 16, Section 4 of the Limited Liability Companies Act (624/2006) *"The companies involved in the merger shall designate one or several auditors to issue a statement on the draft terms of merger to each of the companies involved in the merger. The statement shall contain an analysis of whether a true and fair view has been provided of the grounds for setting the merger consideration, as well as on the distribution of the consideration. The statement to be issued to the acquiring company shall also indicate whether the merger is conducive to compromising the repayment of the company's debts.*
If all shareholders of the companies involved in the merger consent to the same, or if the matter is of a subsidiary merger, only a statement as to whether the merger is conducive to compromising the repayment of the company's debts shall be needed."
[711] Chapter 16, Section 6 of the Limited Liability Companies Act (624/2006).
[712] Airaksinen, M. et al. (2010b), p. 317.
[713] Ibid.
[714] As referred to in the Restructuring of Enterprises Act (47/1993).
[715] Chapter 16, Section 8:1 of the Limited Liability Companies Act (624/2006).
[716] Chapter 16, Section 8:2 of the Limited Liability Companies Act (624/2006).
[717] Chapter 16, Section 9:1 of the Limited Liability Companies Act (624/2006).
[718] Chapter 16, Section 10 of the Limited Liability Companies Act (624/2006).
[719] Mähönen, J. and Villa, S. (2012), pp. 587-588.
[720] Chapter 16, Section 13:1 of the Limited Liability Companies Act (624/2006).

on the merger at the latest.[721] Also holder of an option and other special rights has right to demand redemption of the rights.[722]

The redemption price is the fair price of the share, option right or other special right that entitles to shares at the time preceding the merger.[723] The assumption is that redemption price is set in an arbitrage process.[724] The law however allows also agreement on the redemption price.[725] This agreement shall in such a case be done between the shareholder or holder of the option rights or other special rights and the acquiring company. This is because the acquiring company is liable for the redemption price payment.[726]

The execution of the merger must be registered. According to the law the companies involved in the merger are obliged to notify the registration authority of the merger implementation.[727] This must take place within six months of the merger decision. If the due date is missed the merger shall lapse. If none of the creditors has opposed the merger or if a court has affirmed that the creditor has received payment or security fully covering the receivable, the registration authority shall register the merger.[728]

When the implementation of the merger has been registered, the transfer of assets and liabilities to the acquiring company shall be executed without liquidation.[729] The merging company shall be completely dissolved[730] and - in case of a combination merger - the acquiring company shall be created.

3.4.2.2.6.2 Cross-border merger

A Finnish company may participate also in a merger with a foreign company. In the cross-border merger a foreign company merges into a Finnish company or a Finnish company merges into a foreign company.[731] Such a merger may be implemented subject to that the foreign company fulfils the limited liability company comparability criteria as described in the law.[732]

---

[721] Honkamäki, T. and Pennanen, M. (2010), p. 117.
[722] Chapter 16, Section 13:2 of the Limited Liability Companies Act (624/2006).
[723] Chapter 16, Section 13:4 of the Limited Liability Companies Act (624/2006).
[724] Airaksinen, M. et al. (2010b), p. 353.
[725] Government Bill for the Limited Liability Companies Act (HE 109/2005), p. 159.
[726] Chapter 16, Section 13:6 of the Limited Liability Companies Act (624/2006).
[727] Chapter 16, Section 14:1 of the Limited Liability Companies Act (624/2006).
[728] Chapter 16, Section 15:1 of the Limited Liability Companies Act (624/2006).
[729] Chapter 16, Section 16:1 of the Limited Liability Companies Act (624/2006).
[730] Immonen, R. et al. (2011), p. 101.
[731] Chapter 16, Section 19:1 of the Limited Liability Companies Act (624/2006).
[732] Chapter 16, Section 19:2 of the Limited Liability Companies Act (624/2006) defines the foreign limited liability company. According to the law

"(1) that is a company referred to in article 1 of First Council Directive (68/151/EEC) on co-ordination of safeguards which, for the protection of the interests of members and others, are required by Member States of companies within the meaning of the second paragraph of Article 58 of the Treaty, with a view to making such safeguards equivalent throughout the Community (Directive 68/151/EEC), or another comparable company which:

- *(a) has equity or other comparable capital*
- *(b) is a legal person*
- *(c) has assets that stand alone against the liabilities of the company and*
- *(d) is subject to conditions under domestic legislation that are comparable to the safeguards laid down for the protection of shareholders, members and third parties in Directive 68/151/EEC and*

The companies involved in a cross-border merger shall prepare draft terms of merger as described in the law.[733]

A statement of an independent expert is also required. The provisions of the statement of the auditor in domestic mergers[734] apply to the independent expert´s statement when the draft terms of a cross-border merger and the Finnish company participating in the merger is assessed.[735]

The Finnish limited liability companies being part of a cross-border merger shall notify the draft terms of merger for registration as in case of domestic merger.[736] The provisions of domestic merger related to creditor protection, merger decisions and redemption of shares, options and other rights entitling to shares apply also to Finnish companies in case of cross-border mergers.[737] This means that the creditor protection rules are not applied to foreign companies participating in a cross-border merger.[738]

The cross-border merger shall come into force in accordance with the legislation that applies to the acquiring company. When the cross-border merger becomes valid the assets and liabilities of the merging company shall be transferred to the acquiring company.[739] Simultaneously the merging Finnish company shall be dissolved.[740] At that moment also the shareholders and the holders of options and other special rights entitling to shares shall get the right to the merger consideration as described in the draft terms of merger.

3.4.2.2.6.3 Demerger

In the current economic environment companies face several challenges and sometimes restructuring is needed to manage these challenges. One form of restructuring is a demerger in which the entity's business operations are split into one or more components.

In a demerger of a limited liability company the assets and liabilities of the demerging company are transferred fully or partially to one or several limited liability companies.[741] The transferee is called the acquiring company. In such a transaction the shareholders of the demerging company receive shares of the acquiring company as demerger consideration in proportion of their ownership.[742] Besides shares the demerger consideration may also be made up of cash, other assets or undertakings.

A demerger may proceed in two alternative ways which are called full demerger or partial demerger.[743] In the full demerger all the assets and liabilities of the demerging company are

---

(2) that is registered in another state within the European Economic Area and that is subject to the domestic legislation of another state within the European Economic Area on the basis of its seat, place of central administration or principal business location."

[733] Chapter 16, Section 22:1-2 of the Limited Liability Companies Act (624/2006).

[734] As referred to in Chapter 16, Section 4 of the Limited Liability Companies Act (624/2006).

[735] Chapter 16, Section 23:1 of the Limited Liability Companies Act (624/2006).

[736] Chapter 16, Section 24:1 of the Limited Liability Companies Act (624/2006).

[737] Chapter 16, Sections 24:2-4 of the Limited Liability Companies Act (624/2006).

[738] Mähönen, J. and Villa, S. (2012), p. 624.

[739] Chapter 16, Section 27:2 of the Limited Liability Companies Act (624/2006).

[740] See Airaksinen, M. et al. (2010b), pp. 440-441 according to which the merger becomes into force when the merger is registered by the country of the acquiring company. In practice this means that merging Finnish company ceases to exist when foreign registration is done even if the Finnish company is not yet deregistered in Finland.

[741] Chapter 17, Section 1 of the Limited Liability Companies Act (624/2006).

[742] Immonen, R. (2011), p. 382.

[743] Chapter 17, Section 2:1 of the Limited Liability Companies Act (624/2006).

moved to two or more acquiring companies. As a result, the demerging company is dissolved. In the partial demerger only part of the assets and liabilities belonging to the demerging company are transferred to one or several acquiring companies.

The law separates also two types of demergers depending on the incorporation time of the acquiring company:[744] A demerger into an existing company refers to a transaction in which the acquiring company has been established before the implementation of the demerger. A transaction where the acquiring company is incorporated only in connection of the demerger is known as a demerger into a company to be incorporated. A demerger may advance into an existing company and into a company to be incorporated simultaneously. The existing company may also be a dormant company.[745]

The companies being part of the demerger shall put together written draft terms of demerger and the document shall be dated and signed.[746] The draft shall be done by the boards of directors. The signing can be done by the board or other persons having relevant powers to act to do so.[747] The draft terms of demerger shall contain some key information as described in the law.[748]

A statement of an auditor is also required for all the companies involved in the demerger process.[749] In the statement shall be included an analysis of whether the draft terms of demerger provide a true and fair view of the grounds for setting the demerger consideration. Also, distribution of the consideration shall be commented. The statement that will be given to the acquiring company shall as well specify whether the demerger jeopardises the repayment of the company's debts. All in all, the auditor´s statement is similar as is required in merger process.[750]

The creditors of the demerging company shall have the right to oppose the demerger subject to that their receivables have been valid before the registration of the draft terms of

---

[744] Chapter 17, Section 2:2 of the Limited Liability Companies Act (624/2006).
[745] Mähönen, J. and Villa, S. (2012), p. 632.
[746] Chapter 17, Section 3:1 of the Limited Liability Companies Act (624/2006).
[747] Airaksinen, M. et al. (2010b), pp. 468-469.
[748] Chapter 17, Section 3:2 of the Limited Liability Companies Act (624/2006). Among other things following information is required in the law:

- the identifying information of the companies involved in the demerger
- the reasons for the demerger
- a proposal, if relevant, for the quantity of the shares to be issued as demerger consideration if a demerger into an existing company is planned
- a proposal, if relevant, for other demerger consideration and in case the consideration consists of option rights or other special rights entitling to shares, the terms of these rights
- a proposal for the rights of the holders of option rights or other special rights entitling to shares in the demerging company
- a proposal, if relevant, for the increase of the share capital of the acquiring company if a demerger into an existing company is planned
- a proposal for the share capital of the acquiring company if a demerger into a company to be incorporated is planned
- a statement of the assets, liabilities and equity of the demerging company and of the relevant valuation circumstances
- a proposal of the split of the assets and liabilities between the acquiring companies and of the anticipated effect on the acquiring company´s balance sheet
- a proposal to reduce the share capital to distribute assets to the acquiring company or to its shareholders or to cover immediately losses that cannot be covered from unrestricted equity
- a statement about capital loans whose creditors are entitled to oppose the demerger.

[749] Chapter 17, Section 4:1 of the Limited Liability Companies Act (624/2006).
[750] See above footnote 710.

demerger.[751] The process equals the creditor protection procedure regulated in connection with the merger.[752] This means that a public notice concerns also here capital loan lenders. The registration authority shall issue to the creditors a public notice in which it is mentioned that the creditor has right to object to the demerger on the due date mentioned in the public notice.[753]

The company is obliged to send a written notification of the public notice to those creditors who are known and who have receivables that have been established before the draft terms of demerger have been registered.[754] This shall happen one month before the above-mentioned due date at the latest. If the demerging company has a shareholder that demands redemption or if the holder of an option right or some other special right entitling to shares demands redemption[755] the creditors shall be notified. After the general meeting has made decision on the demerger the notification shall be sent. The notification may be sent earlier only if all shareholders and holders of the above-mentioned option and special rights have waived the redemption right or if they do not possess the redemption right at all.

Like in case of mergers also in demergers the restructuring proceedings[756] shall replace the above-mentioned public notice to the creditors. A creditor does not have right to oppose the demerger if only companies belonging in one group are involved and the restructuring programme is approved simultaneously for all of them.[757]

According to the main rule the general meeting shall decide on a demerger in the demerging company.[758] When the companies involved own 100 % of the shares in the demerging company and any option or other special rights entitling to shares, the board of directors shall make the decision on a demerger in the demerging company. A demerger decision in the acquiring company shall be made by the board of directors.[759]

Regarding the notice of the general meeting and notice to holders of option rights and other special rights entitling to shares there are some explicit rules.[760] This regulation is similar as in case of merger process.[761] Among other things the draft terms of demerger have to be registered before the notice of the general meeting deciding on the demerger shall be delivered.[762]

The notice of the general meeting in the demerging company shall include provision of the redemption right of the shareholders.[763] The demerging company shall provide notice of the

---

[751] Chapter 17, Section 6:1 of the Limited Liability Companies Act (624/2006).
[752] See above footnote 711.
[753] Chapter 17, Section 6:2 of the Limited Liability Companies Act (624/2006).
[754] Chapter 17, Section 7 of the Limited Liability Companies Act (624/2006).
[755] As referred to in Chapter 17, Section 13 of the Limited Liability Companies Act (624/2006).
[756] As referred to in the Restructuring of Enterprises Act (47/1993).
[757] Chapter 17, Section 8 of the Limited Liability Companies Act (624/2006).
[758] Chapter 17, Section 9:1 of the Limited Liability Companies Act (624/2006).
[759] Chapter 17, Section 9:2 of the Limited Liability Companies Act (624/2006). As described in the law when the acquiring company has less than 9/10 of the shares in the demerging company, the decision shall however be made by the general meeting if shareholders with at least 1/20 of the shares in the company so demand. The total number of shares owned by the company itself or its subsidiaries shall not be included in the calculation of total number of shares.
[760] Chapter 17, Section 10 of the Limited Liability Companies Act (624/2006).
[761] Mähönen, J. and Villa, S. (2012), p. 640. See also above footnote 718.
[762] Chapter 17, Section 10:1 of the Limited Liability Companies Act (624/2006). Additionally, it is stated in the law that the notice shall not be distributed earlier than two months and, unless a longer period has been mentioned in the articles of association, no later than one month before the general meeting, the last date for advance notices of participation or the date of record for companies in the book-entry system. In a public company the notice may however be delivered three months before the above-mentioned date at the earliest.
[763] Chapter 17, Section 10:2 of the Limited Liability Companies Act (624/2006).

redemption right to those holders of option rights or other special rights entitling to shares who have the redemption right.

The holder of option rights or other special rights entitling to shares is allowed to demand the redemption of the right.[764] This can be done at the general meeting that decides on the demerger or alternatively in written request addressed to the demerging company before the general meeting.

The redemption price is the fair price of the option right or other special right entitling to shares at the time before the demerger decision.[765] When the redemption price is determined the price decrease on the price of the shares, option rights and other special rights entitling to shares possibly caused by the demerger itself shall not be taken into account.[766] The acquiring company is liable for paying the redemption price of the shares .[767] The companies participating in the demerger shall however have joint and several liability for the payment of the redemption price of option rights and other special rights entitling to shares. The reason for the latter obligation is that the rights in question concern all companies involved in the demerger process.[768]

The companies being part of the demerger process are obliged to notify the registration authority of the demerger implementation in six months after the demerger decision.[769] In case of failing to do this the demerger process will lapse. The demerger shall be registered by the registration authority subject to that no creditor has opposed the demerger or if a court judgment affirms that the creditor has been fully paid in full or covering security for the receivable is in place.[770]

The registration of the implementation of the demerger means that the acquiring companies get all the assets and liabilities of the demerging company but there is no liquidation.[771]

3.4.2.2.6.4 Cross-border demerger

A company may also participate in a cross-border demerger in which a foreign company demerges into a Finnish company or alternatively a Finnish company demerges into a foreign company.[772] A cross-border demerger may only be implemented as described in the Limited Liability Companies Act subject to that the foreign company corresponds to a limited liability company.[773]

---

[764] Chapter 17, Section 13:2 of the Limited Liability Companies Act (624/2006).
[765] Chapter 17, Section 13:4 of the Limited Liability Companies Act (624/2006). See also KKO 1993:31.
[766] Government Bill for the Limited Liability Companies Act (HE 109/2005), p. 159.
[767] Chapter 17, Section 13:6 of the Limited Liability Companies Act (624/2006).
[768] Airaksinen, M. et al. (2010b), p. 511.
[769] Chapter 17, Section 14:1 of the Limited Liability Companies Act (624/2006).
[770] Chapter 17, Section 15:1 of the Limited Liability Companies Act (624/2006).
[771] Chapter 17, Section 16:1 of the Limited Liability Companies Act (624/2006).
[772] Chapter 17, Section 19:1 of the Limited Liability Companies Act (624/2006).
[773] Chapter 17, Section 19:2 of the Limited Liability Companies Act (624/2006). According to the law the foreign limited liability company is a company

"*1. referred to in article 1 of First Council Directive (68/151/EEC) on co-ordination of safeguards which, for the protection of the interests of members and others, are required by Member States of companies within the meaning of the second paragraph of Article 58 of the Treaty, with a view to making such safeguards equivalent throughout the Community (Directive 68/151/EEC), or another comparable company which:*

a) has equity or other comparable capital;

b) is a legal person;

c) has assets that stand alone against the liabilities of the company and

The companies taking part in a cross-border demerger shall prepare draft terms of demerger.[774] Besides the information to be included in the draft terms of domestic demergers the draft terms of a cross-border demerger shall contain among other things the following information:[775]

- corporate form of the companies taking part of the demerger and a proposal for the corporate form of the company planned to be established
- location where the foreign companies taking part of the demerger have been registered
- description of the probable impact of the cross-border demerger on employment
- description of how the financial statements of the companies taking part of the demerger have been used when the demerger terms have been determined and
- description of how the demerger implementation and the equal treatment of the shareholders is done if the demerger cannot come into force in some state.[776]

In every company involved in the demerger the board of directors shall prepare an description on the impact of the demerger on the shareholders, creditors and employees if this is not included in the draft terms of demerger.[777]

A statement of an independent expert is also required.[778] The provisions of the statement of the auditor in domestic mergers[779] apply to the statement on the draft terms of a cross-border demerger and additionally on the Finnish company involved.[780]

The Finnish limited liability companies taking part in a cross-border demerger shall notify the draft terms of demerger for registration like in case of domestic merger.[781] The provisions of domestic merger related to creditor protection, merger decisions and redemption of shares, options and other rights entitling to shares apply also to Finnish companies in case of cross-border demergers.[782]

If a Finnish limited liability company takes part in a cross-border demerger as the acquiring company, the demerger notification for registration shall be done by companies involved in six months. The set period of time starts from the demerger decision of the Finnish companies involved in the demerger and the receipt of the demerger certificate by the other involved companies.[783] It shall also be a precondition for the registration that the foreign companies

---

d) is subject to conditions under domestic legislation that are comparable to the safeguards laid down for the protection of shareholders, members and third parties in Directive 68/151/EEC and

2. that is registered in another state within the European Economic Area and that is subject to the domestic legislation of another state within the European Economic Area on the basis of its seat, place of central administration or principal business location."

[774] Chapter 17, Section 21:1 of the Limited Liability Companies Act (624/2006).

[775] Chapter 17, Section 21:2 of the Limited Liability Companies Act (624/2006).

[776] As referred to in Chapter 17, Section 25:6 of the Limited Liability Companies Act (624/2006).

[777] Chapter 17, Section 21:3 of the Limited Liability Companies Act (624/2006).

[778] Chapter 17, Section 22:1 of the Limited Liability Companies Act (624/2006).

[779] As referred to in Chapter 16, Section 4 of the Limited Liability Companies Act (624/2006).

[780] Chapter 17, Section 22:1 of the Limited Liability Companies Act (624/2006). Additionally, according to Chapter 17, Section 22:2 the board of directors of the companies participating in a cross-border demerger may jointly appoint one or more independent experts to provide a common statement on the draft terms of the demerger to all the companies involved.

[781] Chapter 17, Section 23:1 of the Limited Liability Companies Act (624/2006).

[782] Chapter 17, Sections 23:2-4 of the Limited Liability Companies Act (624/2006).

[783] Chapter 17, Section 24:1 of the Limited Liability Companies Act (624/2006). The demerger certificate refers here to the certificate issued by the registration authority of the country the laws of which apply to the demerger.

involved accept the right of redemption of shares, option rights and other special rights entitling to shares.[784]

If a demerger is to be registered in another state, the demerging company´s assets and liabilities shall be moved to the acquiring company without liquidation.[785] Simultaneously the shareholders and the holders of options and other special rights entitling to shares shall get the right to receive the consideration according to the draft terms of demerger.

3.4.2.2.6.5 Dissolution of the company

A Finnish limited liability company shall dissolve as a result of liquidation.[786] A company can also be dissolved in bankruptcy if at the moment of terminating the bankruptcy there are no assets left or the use of the assets is determined on in the bankruptcy.[787] Additionally a company may also dissolve as a result of merger or demerger[788] as has been described above.[789] It shall be noted that just stopping all the business activities of the company does not mean that company ceases to exist unless it is dissolved according to Chapter 20 of the Limited Liability Companies Act.[790]

The registration authority shall deregister the company in specific situations stated in the law instead of placing a company into liquidation.[791] Firstly if company assets are not sufficient to cover the costs of liquidation or secondly if there is no knowledge on the assets the company must deregistered. Only if a shareholder, creditor or third party commits to carry the liquidation costs the process can be started. This is an exception from the main rule according to which the company operations should primarily be dissolved because of liquidation.[792]

The general meeting shall make decision on putting the company into liquidation.[793] The decision shall be made by qualified majority i.e. a proposal that has been supported at the minimum by 2/3 of the votes cast and the shares represented at the meeting.

The registration authority shall issue a liquidation or deregistration order for the company, if

- there is no registered and competent board of directors
- there is no registered representative[794]

The certificate shows that the demerger process has been completed. In the demerger implementation notice shall be attached an assurance from the members of the board of directors and from the managing director of the acquiring Finnish company. In the assurance document shall be stated in line with the draft terms that the demerging company´s assets will belong to the ownership of the acquiring Finnish company at the latest when the demerger implementation is registered in Finland.

[784] Chapter 17, Section 24:2 of the Limited Liability Companies Act (624/2006) where is referred to Chapter 17, Section 13.

[785] Chapter 17, Section 26:2 of the Limited Liability Companies Act (624/2006).

[786] Chapter 20, Section 1:1 of the Limited Liability Companies Act (624/2006).

[787] Chapter 20, Section 1:2 of the Limited Liability Companies Act (624/2006).

[788] Chapter 20, Section 1:3 of the Limited Liability Companies Act (624/2006).

[789] See above more about merger and demerger in section *3.4.2.2.6 Changes in company structure.*

[790] Immonen, R. (2011), p. 252.

[791] Chapter 20, Section 2 of the Limited Liability Companies Act (624/2006).

[792] Airaksinen, M. et al. (2010b), p. 635.

[793] Chapter 20, Section 3:1 of the Limited Liability Companies Act (624/2006).

[794] As referred to in Section 6 of the Freedom of Enterprise Act (122/1919).

- there are no financial statements for registration within one year after the end of the financial period irrespective of an exhortation by the registration authority [795] or

- bankruptcy has been declared but it has lapsed due to lack of funds.[796]

The registration authority shall provide the order of the company liquidation or deregistration, unless before the order it is proved, that there are no more grounds for the liquidation or deregistration.[797]

The process of liquidation or deregistration of the company may be initiated in practice by anybody who may have interest in the matter.[798] The parties mentioned in law as potential initiators are board of directors, individual member of the board of directors, managing director, auditor, shareholder, creditor or any other having rights depending on appropriate registration or the placing of the company into liquidation.[799] There is a possibility also for the registration authority itself to start the process on its own initiative.

In the liquidation process the target is to determine the financial position of the company and repay the company debts.[800] This means in practice converting company assets to cash and after repaying the debts the surplus is returned to the shareholders. The general meeting can decide to terminate the liquidation process and continue business operations if circumstances allow that.[801] However the liquidators shall apply for the bankruptcy if the company does not have sufficient funds to repay all its payment liabilities.[802] If liquidators started to pay some company debts in the situation where bankruptcy should be applied they may become liable for the damages caused for the creditors not receiving full payment.[803]

After completing the liquidation process the liquidators shall present a report of the liquidation process.[804] The company shall be dissolved after the liquidators have presented the final report to the general meeting.[805] .

Equity shortfall may also trigger a special procedure. If company´s equity has become negative, the board of directors shall make a register notification on the loss of share capital.[806] If the equity of the company is later more than ½ of the share capital, the earlier registration of the loss of share capital may be removed based on a new register notification done by the company. When the company is obliged to appoint an auditor based on the law or the articles of association, the financials must be audited. When calculating the amount of equity, a capital loan[807] shall be considered as part of equity.[808] Also the depreciation difference[809], the voluntary reserves and difference between market and book value of the company assets shall

[795] As required in Chapter 8, Section 10 of the Limited Liability Companies Act (624/2006).
[796] Chapter 20, Section 4:1 of the Limited Liability Companies Act (624/2006).
[797] Chapter 20, Section 4:2 of the Limited Liability Companies Act (624/2006).
[798] Airaksinen, M. et al. (2010b), p. 648.
[799] Chapter 20, Section 6 of the Limited Liability Companies Act (624/2006).
[800] Chapter 20, Section 7:1 of the Limited Liability Companies Act (624/2006).
[801] Chapter 20, Section 7:1 of the Limited Liability Companies Act (624/2006).
[802] Chapter 20, Section 7:2 of the Limited Liability Companies Act (624/2006).
[803] Jokinen, J. (2012), p. 35.
[804] Chapter 20, Section 16:1 of the Limited Liability Companies Act (624/2006). The report shall contain account of the asset distribution, financial statements, annual reports and auditor's reports from the liquidation period.
[805] Chapter 20, Section 17:1 of the Limited Liability Companies Act (624/2006).
[806] Chapter 20, Section 23:1 of the Limited Liability Companies Act (624/2006).
[807] As referred to in Chapter 12 of the Limited Liability Companies Act (624/2006).
[808] Chapter 20, Section 23:2 of the Limited Liability Companies Act (624/2006).
[809] According to Chapter 20, Section 23:2 of the Limited Liability Companies Act (624/2006) the depreciation difference refers to the compound difference between the actual and planned depreciation of the assets of the company.

be taken into account as additional elements of equity. The additions mentioned above shall be explained in the annual report or in the balance sheet notes.

If the equity of a public company is less than ½ of the share capital, the board of directors shall be obliged to draw up without delay financial statements and annual report to determine the company´s financial status.[810] When the equity decreases below ½ of the share capital, a general meeting shall be invited by the board of directors without delay to consider actions to improve the financial standing of the company.[811] The general meeting shall take place in three months of the completion of the financial statements. It shall be noted that in this calculation of controlling the *"one half of the share capital"* - unlike in the previously mentioned calculation of negative equity - a capital loan shall not be considered as equity. This is due to the former EU Capital Directive which is the basis for the Finnish regulation in question and which does not identify capital loan as an item to be included in the calculation.[812]

In case of dissolving company in bankruptcy the process will follow the regulation of the Bankruptcy Act.[813] In the Limited Liability Companies Act there are also some additional rules to be taken into consideration.

The board of directors and - if company is in liquidation - the liquidators can decide on filing for a bankruptcy of a company. [814] The company shall be considered to be dissolved due to the bankruptcy, if there are no funds left at the end of the bankruptcy process or if there is a decision on the use of the remaining assets.[815]

3.4.3 Legislation in other countries

3.4.3.1 Sweden

3.4.3.1.1 About the Swedish legal system

The Swedish legal system derives also from the same Nordic legal tradition, which has its roots on the German civil law tradition. Sweden has been a full member of the European Union since 1 January 1995 and therefore EU law is also an integral part of the Swedish legal system.

The Swedish constitution consists of four fundamental laws:[816]

- The 1810 Act of Succession, which regulates the succession to the throne
- The 1949 Freedom of the Press Act
- The 1974 Instrument of Government
- The 1991 Fundamental Law on Freedom of Expression.

The Instrument of Governments contains central provisions corresponding most closely to the constitution of other countries. Although not specifically written out in the fundamental

[810] Chapter 20, Section 23:3 of the Limited Liability Companies Act (624/2006).
[811] See Jokinen, J. (2012), pp. 40-44 about the challenges of assessing the future actions.
[812] Airaksinen, M. et al. (2010b), p. 709. The Article 17 of the former Capital Directive (Directive 77/91/ECC) referred to by Airaksinen is now Article 58 of the Directive (EU) 2017/1132.
[813] Bankruptcy Act (120/2004).
[814] Chapter 20, Section 25:1 of the Limited Liability Companies Act (624/2006).
[815] Chapter 20, Section 25:2 of the Limited Liability Companies Act (624/2006).
[816] Regeringskansliet (2013), p. 3.

documents among the main features of the Swedish legal system the separation of powers into legislative, executive and judiciary powers exist.[817]

Sweden is monarchy although the tasks of the king are mainly representative. Political power rests within the parliament. Within the execution the prime minister of the government has a very strong position.

The sources of Swedish law are both national and international. Supremacy of EU law has also been recognized covering primary norms, secondary norms and EU case law.[818]

3.4.3.1.2 Companies Act

The Swedish Companies Act entered effect on January 1, 2006.[819] It applies both to the private (abbreviation in Swedish: AB) and public limited liability companies (abbreviation in Swedish AB (publ)).[820] One of the notable new features of the act is the participating debenture[821] which together with the profit-sharing debentures[822] provide to Swedish companies increased alternatives when raising debt.[823]

3.4.3.1.2.1 General principles, incorporation and shares

According to the Swedish law the main rule is that shareholders of a company shall bear no personal liability for the company's obligations.[824] This principle is commonly regarded as the distinguishing feature of corporate law.[825]

A company shall have a share capital which according to the Accounting Act[826] shall be either in Swedish kronor or euros.[827] In case of kronor the private company share capital shall not be less than SEK 50,000 and in case of euros the amount corresponding to SEK 50,000.[828] With respect to public companies the applicable minimum amount is SEK 500,000 or the equivalent amount in euros.[829] The share capital shall be stated in the articles of association.[830] When the share capital is split into several shares, each share shall represent an equal portion of the share capital.[831] Shares shall be paid for with cash or with non-cash consideration.[832]

---

[817] Nergelius, J. (2011), p. 16.
[818] See Swedish Supreme Administrative Court decision in Lassagård case RÅ 1997, ref. 65.
[819] Companies Act (SFS 2005:551), Government Proposal for the Companies Act (Prop. 2004/05:85).
[820] Chapter 1, Section 2:1 of the Companies Act (SFS 2005:551).
[821] In Swedish *"kapitalandelslån"*.
[822] In Swedish *"vinstandelslån"*.
[823] The participating debenture was a known feature in Sweden in the late 1920′s when it was utilised also internationally by the Swedish industrialist Ivar Kreuger and his investment company. However, following the collapse of Kreuger industry imperium in the early 1930′s and the numerous lawsuits related to that the participating debentures lost their popularity. Later the debt instrument became even forbidden in the previous Swedish Company Act of 1975. The usage of profit-sharing debenture has been allowed also earlier and remains to exist also according to the present Company Act.
[824] Chapter 1, Section 3:1 of the Companies Act (SFS 2005:551). See also Bergström, C. and Samuelsson, P. (2015), p. 67.
[825] Government Proposal for the Companies Act (Prop. 2004/05:85), p. 196 and Andersson, S. et al. (2015), p. 1:7. About the recent court practice see also NJA 2014, p. 877.
[826] Accounting Act (SFS 1999:1078), in Swedish *"bokföringslagen"*.
[827] Chapter 4, Section 6 of the Accounting Act (SFS 1999:1078).
[828] Chapter 1, Section 5:1-2 of the Companies Act (SFS 2005:551).
[829] Chapter 1, Section 14:1-2 of the Companies Act (SFS 2005:551).
[830] Andersson, S. et al. (2015), p. 1:11.
[831] Chapter 1, Section 6 of the Companies Act (SFS 2005:551).
[832] Chapter 2, Section 16 of the Companies Act (SFS 2005:551).

The main rule according to the law is the equality principle i.e. all shares shall carry equal rights in the company.[833] This is a basic principle in the Swedish company law.[834] It means also that shareholders of similar shares must be treated equally.[835] It can however be included a provision in the articles of association according to which there shall be shares of different classes or the right to issue such shares.[836] That clause must include information about differences between the classes of shares and number or portion of shares of each class.

Differences in voting rights can be possible but a share may carry voting rights only up to ten times greater than the voting rights of any other share.[837]

The articles of association of a company - the shares of which are not registered in a central securities depository CSD[838] - may include a so-called consent clause. According to this clause one or more shares may be transferred to a new owner only subject to the company's consent.[839] There is no requirement to name an acceptable new owner before the transaction as it is often difficult to do because of natural reasons.[840] A consent clause shall state among other things whether the general meeting or the board of directors shall consider such a request for consent, types of transfers that require the company's consent and whether the company shall be entitled to grant or refuse consent for a smaller number of shares than requested.[841]

If consent is not given based on the consent clause it must be argumented[842] and a new transferee must be addressed by the company if so required by the transferor.[843] A consent clause does not restrict the transfer of attached shares or shares that are included in an estate in bankruptcy or insolvent liquidation.[844] The latter sentence means in practice that vindication execution is easier.[845]

The articles of association of a company - the shares of which are not registered in a central securities depository CSD - may include also a provision inviting a shareholder or other party to purchase a share before it is transferred to a new owner.[846] This right of first refusal clause shall state among other things type of transfers covered by the clause, whether a right of first refusal offer may be exercised in respect of a smaller number of shares than covered by the offer and holders of first refusal rights and the order in which they shall be invited to purchase.[847]

The articles of association of a company may include also a clause pursuant to which a shareholder or other person shall be entitled to purchase a share which has been transferred to a new owner.[848] This kind of post-sale purchase right clause are very common.[849] It shall state among other things type of transfers covered by the clause, whether an offer regarding a post-sale purchase right may be exercised for a smaller number of shares than covered by the

[833] Chapter 4, Section 1 of the Companies Act (SFS 2005:551) and Sandström, T. (2015), p. 237.
[834] Andersson, J. and Pehrson, L. (2008), p. 118.
[835] Bergström, C. and Samuelsson, P. (2015), p. 168.
[836] Chapter 4, Section 2:1 of the Companies Act (SFS 2005:551).
[837] Chapter 4, Section 5 of the Companies Act (SFS 2005:551).
[838] As referred to in the Financial Instruments Accounts Act (SFS 1998:1479).
[839] Chapter 4, Section 8 of the Companies Act (SFS 2005:551).
[840] Government Proposal for the Companies Act (Prop. 2004/05:85), p. 265.
[841] Chapter 4, Section 9:1 of the Companies Act (SFS 2005:551).
[842] Chapter 4, Section 12 of the Companies Act (SFS 2005:551).
[843] Government Proposal for the Companies Act (Prop. 2004/05:85), p. 550.
[844] Chapter 4, Section 10 of the Companies Act (SFS 2005:551).
[845] Andersson, S. et al. (2015), p. 4:22.
[846] Chapter 4, Section 18 of the Companies Act (SFS 2005:551).
[847] Chapter 4, Section 19:1 of the Companies Act (SFS 2005:551).
[848] Chapter 4, Section 27 of the Companies Act (SFS 2005:551).
[849] Government Proposal for the Companies Act (Prop. 2004/05:85), p. 253.

offer and the holders of post-sale purchase rights including the order in which they shall be invited to purchase the shares.[850] Compared to consent and right of first refusal clause one downside of the post-sale purchase right clause is that the latest clause type becomes applicable only after the share transaction is already done.[851]

According to the Swedish Companies Act the shareholders make decisions regarding the company affairs at general meetings.[852] In the Swedish limited liability company the general meeting is the highest decision-making body.[853] The shareholders right to participate at general meetings is subject to having the share ownership registered in the share register on the day of the general meeting.[854] A shareholder may vote with all the shares that he owes or are represented by him unless that right is limited in the articles of association.[855]

3.4.3.1.2.2 Management of the company

In Sweden every limited liability company shall have a board.[856] A company shall have a board of directors which comprises at least one member. However, in a public company the board of directors shall comprise three members at the minimum.[857] In the Companies Act there is also reference to the Private Sector Employees Board Representation Act[858] which has provisions governing employee representatives on the board of directors. If not otherwise stated in that Act or in the Companies Act, employee representatives shall be equated with members of the board of directors.[859] The members of the board have joint responsibility over their duties.[860]

The board of directors is responsible for the organisation of the company and its administration.[861] The board of directors shall regularly assess the company's financial position and in case of the company being the parent of a group, the whole group's financials.[862] The board is also responsible in ensuring that the company's organisational structure in general supports proper monitoring of accounting, management of funds and the company's finances.[863] The board can delegate its tasks to individual members of the board or even persons not members of the board.[864] In such situations the board will anyhow carry the final responsibility of the actions of the delegates.[865] The board of directors is responsible of all tasks of behalf of the company unless the law or the articles of association prescribe otherwise.[866] The board members have a general loyalty obligation towards the company. They are not allowed to run competing business activities due to forbidden *"corporate opportunity"*.[867]

[850] Chapter 4, Section 28:1 of the Companies Act (SFS 2005:551).
[851] Sjöman, E. (2008), p. 74.
[852] Chapter 7, Section 1 of the Companies Act (SFS 2005:551).
[853] Andersson, S. et al. (2015), p. 7:5.
[854] Chapter 7, Section 2:1 of the Companies Act (SFS 2005:551).
[855] Chapter 7, Section 8 of the Companies Act (SFS 2005:551).
[856] Chapter 8, Section 1:1 of the Companies Act (SFS 2005:551).
[857] Chapter 8, Section 46 of the Companies Act (SFS 2005:551).
[858] Private Sector Employees Board Representation Act (SFS 1987:1245).
[859] Chapter 8, Section 2 of the Companies Act (SFS 2005:551).
[860] Dotevall, R. (2015), p. 262.
[861] Chapter 8, Section 4:1 of the Companies Act (SFS 2005:551).
[862] Chapter 8, Section 4:2 of the Companies Act (SFS 2005:551).
[863] Chapter 8, Section 4:3 of the Companies Act (SFS 2005:551).
[864] Chapter 8, Section 4:4 of the Companies Act (SFS 2005:551).
[865] Government Proposal for the Companies Act (Prop. 2004/05:85), p. 1406.
[866] Dotevall, R. (2015), p. 267.
[867] Svernlöv, C. (2012) p. 17-18, Svernlöv, C. (2014), p. 309 and Chapter 18 of the Commercial Code (SFS 1736:01232).

A chairman of the board shall be elected in companies where a board of directors consists of more than one member.[868] The chairman shall be one of the members of the board. His duty is to preside over the work of the board and monitor that the board performs as is required in the law.

The board of directors may appoint a managing director and his deputy.[869] In a public company there is an obligation to appoint a managing director.[870] That person shall attend to the daily management[871] of the company and act according to the guidelines and instructions issued by the board of directors.[872] He shall also act according to the law and articles of association.[873] This means that he is not obliged to obey such guidelines and instructions of the board that are against the law or the articles of association.[874] The managing director may also without authorisation by the board of directors take actions that are unusual or of great significance subject to that the board of directors decision cannot be waited for without significant harm to the company. If actions described above are done the board of directors shall be informed as soon as possible.[875] The managing director shall take any measures needed to make sure that the company's accounts and funds are managed soundly and according to the law.[876]

If the board decides to take responsibility over a single task that has belonged to managing director´s responsibility, his competence over the task will cease to exist.[877]

3.4.3.1.2.3 Capital structure

According to the Swedish Companies Act the company's share capital may be increased in several ways.[878] Increase can be done through bonus issue[879] and by subscribing for new shares in exchange for payment pursuant to a resolution regarding a new issue of shares[880]. Additionally, share capital may be increased by subscribing for new shares in exchange for payment upon the exercise of warrants issued by the company[881] and by issuing of new shares in exchange for convertible instruments issued by the company[882].

General meeting decides on resolutions regarding bonus issues, new issues of shares or issues of warrants or convertible instruments.[883] In certain situations resolutions regarding new issues of shares or issues of warrants or convertible instruments may also be adopted by the board of directors.[884]

---

[868] Chapter 8, Section 17:1 of the Companies Act (SFS 2005:551).
[869] Chapter 8, Sections 27:1 and 28:1 of the Companies Act (SFS 2005:551).
[870] Chapter 8, Section 50 of the Companies Act (SFS 2005:551).
[871] About what belongs to the daily management see Dotevall, R. (2008), p. 105.
[872] Chapter 8, Section 29:1 of the Companies Act (SFS 2005:551).
[873] Kollegiet för svensk bolagsstyrning (2016), p. 9.
[874] Sandström, T. (2015), p. 213.
[875] Chapter 8, Section 29:2 of the Companies Act (SFS 2005:551).
[876] Chapter 8, Section 29:3 of the Companies Act (SFS 2005:551).
[877] Båvestam, U. (2001), p. 255.
[878] Chapter 11, Section 1 of the Companies Act (SFS 2005:551).
[879] As described in Chapter 12 of the Companies Act (SFS 2005:551).
[880] As described in Chapter 13 of the Companies Act (SFS 2005:551).
[881] As described in Chapter 14 of the Companies Act (SFS 2005:551).
[882] As described in Chapter 15 of the Companies Act (SFS 2005:551).
[883] Chapter 11, Section 2:1 of the Companies Act (SFS 2005:551).
[884] Board of directors' decisions are possible pursuant to Chapter 13, Sections 31-38, Chapter 14, Sections 24-31 and Chapter 15, Sections 29-36.

Bonus share rights and subscription rights shall be registered according to the Financial Instruments Accounts Act[885] in case of CSD company.[886] When a holder of warrants or convertible instruments has a pre-emption right to subscribe for new shares, warrants or convertible instruments and the warrants or convertible instruments have been registered in the central securities depository, the pre-emption right shall also be registered in the central securities depository.[887]

There are specific rules related to dividend-linked participating debentures and principal-linked participating debentures. Dividend-linked participating debentures refer to specific type of profit-sharing loans (*"vinstandelslån"*)[888] and principal-linked participating debentures refer to specific type of value-appreciation loan (*"kapitalandelslån"*)[889]. Taking a loan where the interest or the amount to be repaid is dependent on dividends to be paid, changes in the company's shares price, result or financial position must be decided by the general meeting.[890] Alternatively the general meeting may authorise the board of directors to decide on taking a loan described above. This kind of authorisation may be valid at the maximum until the next annual general meeting.[891]

A company which has a specific restriction of dividend payment is not allowed to take a profit-sharing loan or a principal-linked participating debenture.[892] The usage of these special loan types is not considered to be in line with the dividend payment restriction.[893]

When bonus issue is done, the share capital is increased through an amount being transferred from the statutory reserve, the revaluation reserve or unrestricted equity pursuant to the latest approved balance sheet or the value of a fixed asset being written up.[894]

When new bonus shares are issued, the main rule is that the shareholders shall be entitled to receive shares pro rata to the number of shares owned by them prior the new issuance.[895] However where the company has issued different classes of shares which differ in relation to the entitlement to share in the company's assets or profits, the shareholders shall receive new shares according to the provisions of the articles of association.[896] The issuance of new shares may regard also different share classes where the difference is based on something else than to the above-mentioned difference in relation to the entitlement to share in the company's assets or profits. In such a case the new shares shall be issued pro rata to the existing number of shares of the same class. The old shares shall carry an entitlement to new shares of the same class pro rata to their portion of the share capital.[897]

When issuing new shares, the main rule is that the shareholders shall hold pre-emption rights to the new shares pro rata to the number of shares they own.[898] The purpose of this regulation is to give all shareholders opportunity to get the benefit of possibly favourable subscription price.[899] However this main rule is not applied when the shares are to be paid for with non-

[885] Financial Instruments Accounts Act (SFS 1998:1479).
[886] Chapter 11, Section 8:1 of the Companies Act (SFS 2005:551).
[887] Chapter 11, Section 8:2 of the Companies Act (SFS 2005:551).
[888] Skatteverket (2012), pp. 80-81.
[889] Skatteverket (2012), pp. 81-82.
[890] Chapter 11, Section 11:1 of the Companies Act (SFS 2005:551).
[891] Chapter 11, Section 11:2 of the Companies Act (SFS 2005:551).
[892] Chapter 32, Section 7 of the Companies Act (SFS 2005:551).
[893] Andersson, S. et al. (2015c), p. 32:14.
[894] Chapter 12, Section 1 of the Companies Act (SFS 2005:551).
[895] Chapter 12, Section 2:1 of the Companies Act (SFS 2005:551).
[896] Chapter 12, Section 2:2 of the Companies Act (SFS 2005:551).
[897] Chapter 12, Section 2:3 of the Companies Act (SFS 2005:551).
[898] Chapter 13, Section 1:1 of the Companies Act (SFS 2005:551).
[899] Andersson, S. et al. (2015b), p. 13:3.

cash consideration or the pre-emption right shall be governed in another manner.[900] The *"another manner"* can take place as a consequence of provisions of the articles of association[901], terms and conditions which have been issued in conjunction with an earlier issue of warrants or convertible instruments or provisions of the issue resolution.

The above-mentioned gives possibility for the company also to decide on the share issuance without any kind of pre-emption rights. This would mean that shareholders and third parties have equal rights to participate in the issuance.[902]

In case of issuing of warrants with attendant subscription for new shares the main rule is also that the shareholders shall hold pre-emption rights to the warrants pro rata to the number of shares they own.[903] This shall not apply when the warrants are to be paid for with non-cash consideration or the pre-emption right shall be governed in another manner.[904] Here the *"another manner"* can happen as a consequence of provisions of the articles of association[905], terms and conditions which have been issued in conjunction with an earlier issue of warrants or convertible instruments or provisions of the issue resolution.

Subscription for new shares upon exercise of warrants shall take place on a subscription list which contains the issue resolution.[906] For a CSD company the subscription with respect to all or a certain part of the issue may take place through payment if so decided in the issue resolution

There are separate rules also covering issues of convertible instruments with attendant conversion to new shares.[907] In conjunction with issues the shareholders shall hold pre-emption rights to the convertible instruments pro rata to the number of shares they own.[908] This shall however not apply if the convertible instruments are to be paid for with non-cash consideration or the pre-emption right shall be governed in another manner.[909] The *"another manner"* refers here to provisions of the articles of association[910], terms and conditions which have been issued in conjunction with an earlier issue of warrants or convertible instruments or provisions of the issue resolution.

The party raising the proposal of an issue of convertible instruments, shall prepare a proposal for the general meeting.[911] Normally the proposal is done by the board of directors. The proposal shall include information on

- amount the company shall borrow
- nominal value of the convertible instruments;
- amount to be paid for each convertible instrument (subscription price) and the interest rate

[900] Chapter 13, Section 1:2 of the Companies Act (SFS 2005:551).
[901] As referred to in Chapter 4, Section 3 of the Companies Act (SFS 2005:551).
[902] Rodhe, K. and Skog, R. (2014), p. 59.
[903] Chapter 14, Section 1:1 of the Companies Act (SFS 2005:551).
[904] Chapter 14, Section 1:2 of the Companies Act (SFS 2005:551).
[905] As referred to in Chapter 4, Section 3 of the Companies Act (SFS 2005:551).
[906] Chapter 14, Section 32:1 of the Companies Act (SFS 2005:551).
[907] Chapter 15 of the Companies Act (SFS 2005:551).
[908] Chapter 15, Section 1:1 of the Companies Act (SFS 2005:551).
[909] Chapter 15, Section 1:2 of the Companies Act (SFS 2005:551).
[910] As referred to in Chapter 4, Section 3 of the Companies Act (SFS 2005:551).
[911] As referred to in Chapter 15, Section 3 of the Companies Act (SFS 2005:551).

- holders of the pre-emption right to subscribe for convertible instruments and persons who shall otherwise be entitled to participate in the issue;
- time period of the subscription for convertible instruments
- allocation principles to be applied by the board of directors with respect to convertible instruments which are not subscribed according to pre-emption rights and
- time period within which payment must be made for convertible instruments.[912]

If derogation from the shareholders' pre-emption rights is done, the reasons for that and the principles on which the subscription price is based shall be mentioned in the resolution.[913]

If applicable the proposal shall also include other specific terms governing the loan like (i) coupons attached to share certificates shall be used as issue certificates, (ii) how excess subscription rights shall be sold and (iii) company authorisation for the board of directors to determine the loan amount and specific loan terms in case of convertible instruments.[914] The item (iii) regards only companies being listed in a regulated market. [915] Additionally, for companies being listed in a regulated market specific rules related to payment of convertible loan through set-off shall be applied.[916] These rules limit the boards right to accept set-off as payment method.[917]

A proposal shall include also additional details with respect to conversion as follows:[918] (i) amount by which the share capital might be increased, (ii) conversion price between the convertible instruments and the new shares, (iii) time period within which conversion may be exercised and (iv) date from which the new shares shall carry right to dividends.

When a proposal of convertible instruments is prepared it shall also include a report regarding the assessment of the value of non-cash consideration or issue terms and conditions concerning rights of set-off.[919]

The proposal can entail that any person who holds a claim against the company shall be entitled to subscribe for a convertible instrument and to pay the subscription through set-off of the claim. In such a case the report shall identify the claims holders, the claim amount and the amount that may be set-off.[920]

The above-mentioned report shall be reviewed by one or more auditors and the statement of the review shall be appended to the proposal.[921] The auditor shall provide information regarding issue terms and conditions with respect to a right of set-off. Among other things the auditor shall describe the non-cash consideration and state the method used in the valuation. An auditor shall be an authorised or approved public accountant or a registered accounting firm.[922] The auditor shall be appointed by the general meeting if not specifically stated

[912] Chapter 15, Section 4 of the Companies Act (SFS 2005:551).
[913] Chapter 15, Section 4:3 of the Companies Act (SFS 2005:551).
[914] Chapter 15, Section 5:1 of the Companies Act (SFS 2005:551).
[915] Chapter 15, Section 5:4 of the Companies Act (SFS 2005:551).
[916] Chapter 15, Sections 5:5 and 41 of the Companies Act (SFS 2005:551).
[917] Andersson, S. et al. (2015b), p. 15:10.
[918] Chapter 15, Section 6:1 of the Companies Act (SFS 2005:551).
[919] Chapter 15, Section 9:1 of the Companies Act (SFS 2005:551).
[920] Chapter 15, Section 9:3 of the Companies Act (SFS 2005:551).
[921] Chapter 15, Section 10:1 of the Companies Act (SFS 2005:551).
[922] Chapter 15, Section 10:3 of the Companies Act (SFS 2005:551).

otherwise in the articles of association. The review shall be done by the company's auditor if no specific auditor is appointed.

Normally subscription for convertible instruments shall be done on a subscription list containing the issue resolution.[923] Subscription may however also take place on the minutes of the general meeting. The prerequisite of this is that all convertible instruments are subscribed by persons entitled thereto at the general meeting at which the issue resolution was done.[924] It is possible to decide that subscription of the issue shall take place through payment.[925]

After completion of the subscription the board of directors shall decide upon allotment to the subscribers.[926]

When convertible instrument is subscribed payment in cash or with non-cash consideration shall be done.[927] A subscription debt may be set-off against a claim on the company only where the issue resolution contains such a provision.[928] When issuer is a public company the convertible instruments may be paid by set-off provided that payment does not contravene the issue resolution and the board of directors considers the payment arrangement appropriate.[929] Additionally it is required that the set-off shall not prejudice the company or its creditor.

The board of directors shall notify the resolution of issuing convertible instruments for registration in the companies register in six months after the issuance resolution.[930] The registration shall be done subject to following conditions:[931] (i) the total amount to be paid for the convertible instruments equals the amount determined for the issue, (ii) full and acceptable payment has been provided, (iii) a certificate regarding the payment in cash is presented from a credit institution[932] and (iv) an auditor statement is presented regarding the possible non-cash consideration.

The Swedish Companies Act does not include any regulation how conversion of convertible instruments to shares shall take place. In practice this regulation must be included in the terms of convertible instruments.[933] After conversion to shares has happened the new shares shall be entered in the share register without delay.[934] In case of a CSD company the conversion notification shall be given immediately to the central securities depository.[935] When the convertible instruments are issued in paper form, they shall be affixed with a notation about the conversion.[936]

An approved public accountant or a registered accounting firm must sign a statement for the registration of the exercised conversion. In the statement shall be mentioned that the company

---

[923] Chapter 15, Section 15:1 of the Companies Act (SFS 2005:551).
[924] Chapter 15, Section 15:2 of the Companies Act (SFS 2005:551).
[925] Chapter 15, Section 15:3 of the Companies Act (SFS 2005:551).
[926] Chapter 15, Section 20 of the Companies Act (SFS 2005:551).
[927] Chapter 15, Section 21 of the Companies Act (SFS 2005:551).
[928] Chapter 15, Section 25 of the Companies Act (SFS 2005:551).
[929] Chapter 15, Section 43 of the Companies Act (SFS 2005:551) according to which in a public company "convertible instruments may be paid for by way of set-off provided:

1. *such does not contravene the issue resolution;*
2. *the board of directors deems it appropriate; and*
3. *set-off may take place without prejudice to the company or its creditors*."

[930] Chapter 15, Section 26 of the Companies Act (SFS 2005:551).
[931] Chapter 15, Section 27:1 of the Companies Act (SFS 2005:551).
[932] As referred to in Chapter 15, Section 22 of the Companies Act (SFS 2005:551).
[933] Andersson, S. et al. (2015b), p. 15:44.
[934] Chapter 15, Section 37:1 of the Companies Act (SFS 2005:551).
[935] Chapter 15, Section 37:2 of the Companies Act (SFS 2005:551).
[936] Chapter 15, Section 37:3 of the Companies Act (SFS 2005:551).

has received consideration which corresponds at the minimum the quotient value of earlier shares.[937] When registered the increase in the share capital is considered as the total of the minimum consideration which according to the above-mentioned statement has been contributed to the company in the conversion.[938]

3.4.3.1.2.4 Certain private placements

When a new issuance of shares or warrants or convertible instruments is done by a public company or its subsidiary the resolution must be approved by the general meeting if certain people belonging to the close circle of the issuer company have subscription right overruling the pre-emption rights of the shareholders or provisions of the articles of association.[939] The close circle refers here to (i) members of the board of directors, (ii) managing director, (iii) other employees of the issuing company, (iv) spouse, cohabitee or person being under custody of any person referred to in points (i) - (iii) or (v) legal person over which any person referred to in points (i) - (iv) exercises a controlling influence.

When a subsidiary of a public company has issued shares, warrants or convertible instruments to another company inside the same group with subscription rights, the latter company is not allowed to transfer the shares, warrants or convertible instruments to any close circle person referred to above unless the general meeting of the company so decides.[940] Additionally a transfer from a subsidiary as described above must also be approved by the general meeting of the public company which is the parent of the whole group.[941] A public company or its subsidiary may neither in other than above-mentioned situations transfer to the public company shares in a subsidiary or warrants or convertible instruments which have been issued by such a company to any close circle person referred to above unless the transfer has been approved by the general meeting of the public company.[942] In case the public company is a subsidiary of another public company the transfer must also be approved by the general meeting of the parent company.[943] Transfers violating the above-mentioned are invalid based on the specific rule in the law.[944] This is the case regardless whether the receiver is in a good faith or not.[945]

A resolution to take up a dividend-linked participating debentures and principal-linked participating debentures must always be adopted by the general meeting where any close circle person referred to above shall hold a right of priority to subscribe for the debenture or a right to subscribe subject to special terms and conditions.[946] When the loan has been taken up by a company being a subsidiary of a public company, the decision must be approved also by the general meeting of the parent company.[947] The notice to attend to that general meeting shall state the principal content of the proposal.[948]

When resolution must be approved by the general meeting according to the description above the decision to be valid shall be supported by shareholders holding at the minimum 90 % of both the shares voted and of the shares represented.[949] In case parent company general

[937] Chapter 15, Section 39 of the Companies Act (SFS 2005:551).
[938] Chapter 15, Section 40 of the Companies Act (SFS 2005:551).
[939] Chapter 16, Section 2:1 of the Companies Act (SFS 2005:551).
[940] Chapter 16, Section 4:1 of the Companies Act (SFS 2005:551).
[941] Chapter 16, Section 4:2 of the Companies Act (SFS 2005:551).
[942] Chapter 16, Section 5:1 of the Companies Act (SFS 2005:551).
[943] Chapter 16, Section 5:2 of the Companies Act (SFS 2005:551).
[944] Chapter 16, Section 6 of the Companies Act (SFS 2005:551).
[945] Andersson, S. et al. (2015b), p. 16:13.
[946] Chapter 16, Section 7:1 of the Companies Act (SFS 2005:551).
[947] Chapter 16, Section 7:1 of the Companies Act (SFS 2005:551).
[948] Chapter 16, Section 7:2 of the Companies Act (SFS 2005:551).
[949] Chapter 16, Section 8 of the Companies Act (SFS 2005:551).

meeting approval is required - and there are several public parent companies - the approval is required from the parent of the largest group.[950]

3.4.3.1.2.5 Value transfers from the company

In the Swedish Companies Act term *"value transfer"* means distribution of profits, acquisition of a company´s own shares[951], share capital reduction or statutory reserve for repayment to the share owners.[952] Acquisition of a company's own shares does in this connection however exclude

- acquisitions for which no payment shall be made
- acquisitions of business operations by the company and the shares represent a small portion of the company's share capital;
- acquisitions where own shares are redeemed in relation to involuntary liquidation and buy-out due to fraud on the minority[953]
- acquisitions at auction if own shares have been subject to a levy of execution in respect of the company's claims and
- takeover of such new shares after the share split or reverse split that are not owned by the shareholders[954].[955]

Also, any another business event as a consequence of which the company's assets are reduced and which is not of a purely commercial nature for the company shall be considered as *"value transfer"* according to the law. The logic behind defining value transfers in the legislation is to limit the applicability of these transaction types.[956] The challenge of value transfers referred in the law is that company is losing its assets without getting any relevant payment in return.[957]

On top of that there are special provisions regarding transfers of assets in connection with mergers or demergers of companies and distribution of assets upon liquidation[958].[959]

Value transfers from the company may take place only according to the provisions of the law as (i) profit distribution, (ii) acquisition of own shares, (iii) reduction of the share capital or statutory reserve for repayment to the shareholders and (iv) gifts[960] and (v) financial support within the group[961].[962]

A value transfer may happen only if even after the transfer the company's restricted equity is not covered.[963] The basis for the control calculation shall be the most recently adopted balance

---

[950] Chapter 16, Section 9 of the Companies Act (SFS 2005:551).
[951] However excluding acquisitions referred to in Chapter 19, Section 5 of the Companies Act (SFS 2005:551).
[952] Chapter 17, Section 1:1of the Companies Act (SFS 2005:551).
[953] As referred to in Chapter 25, Section 22 of the Companies Act (SFS 2005:551).
[954] As referred to in Chapter 4, Section 50:1 of the Companies Act (SFS 2005:551).
[955] Chapter 19, Section 5 of the Companies Act (SFS 2005:551).
[956] Andersson, J. (2010), p. 76.
[957] Sandström, T. (2015), p. 295.
[958] As referred to in Chapters 23-25 of the Companies Act (SFS 2005:551).
[959] Chapter 17, Section 1:2 of the Companies Act (SFS 2005:551).
[960] As referred to in Chapter 17, Section 5 of the Companies Act (SFS 2005:551).
[961] As referred to in Chapter 6 b, Section 6 of the Banking and Financing Business Act (SFS 2004:297) or Chapter 8 b, Section 6 § of the Securities Market Act (SFS 2007:528).
[962] Chapter 17, Section 2 of the Companies Act (SFS 2005:551).
[963] Chapter 17, Section 3:1 of the Companies Act (SFS 2005:551). See also Andersson, J. (2010), p. 115.

sheet taking into consideration also changes in restricted shareholders' equity that have taken place after the date of the balance sheet. The company may however implement a value transfer to shareholders or another party only according to the so-called *"prudence rule"* is applied. This means that value transfer shall be acceptable taking into consideration the size of shareholders' equity and need to strengthen the balance sheet, liquidity and financial position.[964] The financial position of the company shall be strong enough to take care of its obligations even after the value transfer.[965] Where the company is a parent company, the prudence rule consideration shall also be given to the demands with respect to the group's equity, balance sheet, liquidity and financial position.[966]

It shall be noted that the creditor protection aspect of the value transfer regulation is so significant that not even a unanimous decision of all shareholders allows deviations from these rules.[967]

Value transfers may not exceed the amount which, at the time of the last annual general meeting, was available for value transfers.[968] Changes in shareholders' equity that have occurred after the most recent annual general meeting shall be taken into consideration.

The general meeting or in situations with minor significance, the board of directors, may decide to make gifts for charitable or comparable purposes. This is however subject to that such transaction may be deemed reasonable taking into consideration the purpose of the transaction and the circumstances in general including company's financial position.[969] The gift shall neither violate the requirement to protect the company's restricted shareholders' equity and the prudence rule.[970]

3.4.3.1.2.6 Distribution of profits

Distributions of profits shall be decided by the general meeting.[971] This right cannot be delegated to anybody else by the general meeting.[972] The decision is often done according to the proposal of the board of directors but not always. The general meeting may however decide on distribution that exceeds the proposal of the board of directors only when articles of association set obligation for that or the distribution is based on the minority request as described below.

There are specific rules for a distribution of profits upon request by minority shareholders.[973] If the owners of not less than 1/10 of all shares so require, the annual general meeting shall decide upon the distribution of 50 % of the remaining profit. The profit shall be calculated based on the balance sheet where following deductions are made: (i) losses carried forward that exceed unrestricted reserves, (ii) amounts that must be transferred to restricted equity according to the law or the articles of association and (iii) amounts which according to the articles of association shall be used for other purpose than distribution to the shareholders.

The articles of association may also include clause that a distribution of profits may be requested by a shareholder holding a smaller portion of the company's shares than the above-

[964] Chapter 17, Section 3:2 of the Companies Act (SFS 2005:551).
[965] Andersson, J. (2010), p. 123.
[966] Chapter 17, Section 3:3 of the Companies Act (SFS 2005:551).
[967] Andersson, S. et al. (2015b), p. 17:9, Andersson, J. (2010), p. 20 and Johansson, S. (2011), p. 147.
[968] Chapter 17, Section 4 of the Companies Act (SFS 2005:551).
[969] Chapter 17, Section 5 of the Companies Act (SFS 2005:551).
[970] As described in Chapter 17, Section 3 of the Companies Act (SFS 2005:551).
[971] Chapter 18, Section 1 of the Companies Act (SFS 2005:551).
[972] Andersson, S. et al. (2015b), p. 18:2.
[973] Chapter 18, Section 11:1 of the Companies Act (SFS 2005:551).

mentioned 1/10 of all shares.[974] Also it can be prescribed that the right to a distribution of profits shall relate to a higher amount than the above-mentioned 50 % of the profit.

It is not possible for the general meeting decide on a distribution exceeding 5 % of the company's shareholders' equity. The distribution may not either violate the provisions related to sufficient coverage of restricted equity and the above-mentioned *"prudence rule"*.[975]

3.4.3.1.2.7 Acquisition of own shares

The Swedish company law sets a restriction for a company to subscribe for its own shares.[976] There are no exceptions for this rule.[977] If however, a company has subscribed for its own shares, the board of directors and the managing director shall be considered to have subscribed for the shares on their own behalf. This means also that the board of directors and the managing director shall be jointly and severally liable for payment. If a board member or managing director can prove that she was not aware or should not have been aware either of the share subscription the above-mentioned personal liability is not applicable.[978] Also in a situation where shares of a company have been subscribed for by a person on behalf of the company but in her own name, the subscriber shall be considered to have subscribed the shares on her own behalf.[979] The above-mentioned approach shall also be applied with respect to a subsidiary's subscription for shares in its parent company.[980]

A company is not allowed to accept its own shares as security.[981] A subsidiary is not either allowed to accept shares in its parent company as security.

As a main rule company may not acquire its own shares.[982] However company may (i) acquire its own shares for which there is no payment obligation, (ii) acquire its own shares as a part of an acquisition of a business operations subject to that the shares represent a small portion of the company's total share capital, (iii) redeem its own shares in relation to involuntary liquidation and buy-out due to fraud on the minority[983] , (iv) purchase its own shares at auction if shares have been subject to a levy of execution in respect of the company's claims and (v) takeover of such new shares after the share split or reverse split that are not owned by the shareholders[984].[985]

If shares have been acquired as described above and they have not been retired through a reduction of the share capital they shall be divested. The divestment shall take place as soon as possible without occurring loss but not later than three years from the date of the acquisition.[986] Shares which have not been divested in three years shall be declared void by the company. This means that the company shall reduce the share capital by the portion of the share capital represented by such shares. The reduction shall be decided by the general meeting. The amount of the reduction shall be transferred to the statutory reserve.

---

[974] Chapter 18, Section 11:2 of the Companies Act (SFS 2005:551).
[975] As referred to in Chapter 17, Section 3 of the Companies Act (SFS 2005:551).
[976] Chapter 19, Section 1:1 of the Companies Act (SFS 2005:551).
[977] Andersson, S. et al. (2015b), p. 19:3.
[978] Chapter 19, Section 1:2 of the Companies Act (SFS 2005:551).
[979] Chapter 19, Section 1:3 of the Companies Act (SFS 2005:551).
[980] Chapter 19, Section 2 of the Companies Act (SFS 2005:551).
[981] Chapter 19, Section 3:1 of the Companies Act (SFS 2005:551).
[982] Chapter 19, Section 4:1 of the Companies Act (SFS 2005:551).
[983] As referred to in Chapter 25, Section 22 of the Companies Act (SFS 2005:551).
[984] As referred to in Chapter 4, Section 50:1 of the Companies Act (SFS 2005:551).
[985] Chapter 19, Section 5 of the Companies Act (SFS 2005:551).
[986] Chapter 19, Section 6:1 of the Companies Act (SFS 2005:551).

A public company[987] need not to divest shares that are acquired as described above if the company would have been permitted to hold such shares.[988] A public company may not acquire its own shares if acquisition would lead for holding exceeding 1/10 of all shares in the company.[989] Shares held by any subsidiary shall be deemed to be shares held by the parent company.

As a main rule a subsidiary may not acquire shares in its parent company.[990] An agreement in violation of this prohibition shall be void. However, in following situations a subsidiary may acquire shares in its parent:[991] (i) acquisition of shares for which there is no payment obligation, (ii) acquisition of shares as a part of an acquisition of a business operations subject to that the shares represent a small portion of the company's total share capital and (iii) purchase of shares at auction if shares have been subject to a levy of execution in respect of the company's claims.

For acquisition and transfer of own warrants and convertible instruments there are specific rules. When a company acquires its own warrants or convertible instruments, the amount related to the warrant or conversion right may not exceed the amount available to value transfers.[992] For example in case of convertible loan the acquisition of the loan means payment of the loan which has no impact on the equity and this kind of transaction thus falls outside of the scope of this rule.[993]

After a company has acquired its own convertible instruments the instrument shall cease to apply.[994] The board of directors shall notify for registration in the companies register the number of convertible instruments which have ceased to apply.[995] This notification shall take place no later than three months after the company has acquired its own convertible instruments. There is also a special rule for situations where an acquisition has taken place based on an offer which applies for a period more than one year. In such a situation the notification shall be made not later than three months after the expiry of the financial year during which the acquisition took place.

There are several special rules for public companies. Among other things a public company which is listed on a Swedish or foreign exchange or on any other regulated market may - in addition to the above-mentioned general company limitations of acquiring own shares - acquire its own shares only as follows:[996] (i) on a regulated market within the European Economic Area, (ii) on an exchange or any other regulated market outside the European Economic Area as authorised by the Swedish Financial Supervisory Authority or (iii) based on a purchase offer which has been given to all shareholders or all holders of a particular class of shares.

---

[987] As referred to in Chapter 19, Section 13 of the Companies Act (SFS 2005:551).
[988] Chapter 19, Section 6:2 of the Companies Act (SFS 2005:551).
[989] Chapter 19, Section 15 of the Companies Act (SFS 2005:551).
[990] Chapter 19, Section 7:1 of the Companies Act (SFS 2005:551).
[991] Chapter 19, Section 7:2 of the Companies Act (SFS 2005:551).
[992] Chapter 19, Section 10 of the Companies Act (SFS 2005:551). In the specific Section is referred to value transfers pursuant to Chapter 17, Sections 3 and 4 of the Companies Act (SFS 2005:551). See more about the value transfers above section *3.4.3.1.2.5 Value transfers from the company.*
[993] Andersson, S. et al. (2015b), p. 19:21.
[994] Chapter 19, Section 11 of the Companies Act (SFS 2005:551).
[995] Chapter 19, Section 12 of the Companies Act (SFS 2005:551).
[996] Chapter 19, Section 14:1 of the Companies Act (SFS 2005:551). See also Rutberg, A. and Skog, R. (2000), p. 11 about the applicability of so-called Dutch auction method for public companies.

A public company may acquire its own shares only up to the amount of max 10% of all shares in the company.[997] Shares held by subsidiary shall be taken into consideration when calculating the above-mentioned shares amount.

Where an acquisition by a public company has led to violation of the regulation the acquired shares shall be divested within a timeframe of six months.[998] If divestment has not been done in time the shares shall be declared void by the company. The practicalities related to this is under the responsibility of the board.[999] This means also that the company shall reduce the share capital accordingly. A proposal regarding a reduction shall be presented at the first general meeting after the declaration of shares becoming void. The reduced amount shall be transferred to the statutory reserve.

3.4.3.1.2.8 Reduction of the share capital and the statutory reserve

According to the Swedish company law the reduction of the share capital may take place in three alternative situations: (i) to cover losses, (ii) for transfer of funds to unrestricted shareholders' equity and (iii) for repayment to the shareholders.[1000]

Reduction of the share capital may also happen according to a clause in the articles of association.[1001] A share capital reduction can be done with or without retirement of shares.[1002]

The general meeting shall decide on a reduction of the share capital unless otherwise prescribed in the articles of association.[1003] If the share capital can vary at a lower or higher amount without amending the articles of association, the share capital may be reduced through redemption of shares. In such a case a relevant redemption clause may be included in the articles of association.[1004] The redemption clause can be formulated so that also individual shareholder has right to claim the redemption.[1005]

A general meeting decision regarding a reduction of the share capital shall be valid only subject to shareholders support not less than 2/3 of both the votes cast and the shares represented.[1006] A general meeting resolution regarding a reduction in share capital according to a redemption clause requires a simple majority of the votes cast.[1007]

There are special restrictions in the law in cases where the reduction of the share capital is planned to be used for transfer to a fund to be used by the general meeting decision or for repayment to the shareholders.[1008] The company may not implement such a reduction without the permission of the Swedish Companies Registration Office or - in case of dispute - a relevant court.[1009] If company simultaneously with the reduction takes measures that do not lead to reduction of restricted shareholders' equity or share capital the above-mentioned permission is not required.

[997] Chapter 19, Section 15 of the Companies Act (SFS 2005:551).
[998] Chapter 19, Section 16 of the Companies Act (SFS 2005:551).
[999] Andersson, S. et al. (2015b), p. 19:34.
[1000] Chapter 20, Section 1:1 of the Companies Act (SFS 2005:551).
[1001] Chapter 20, Section 1:2 of the Companies Act (SFS 2005:551).
[1002] Chapter 20, Section 2 of the Companies Act (SFS 2005:551).
[1003] Chapter 20, Section 3:1 of the Companies Act (SFS 2005:551).
[1004] Chapter 20, Section 31:1 of the Companies Act (SFS 2005:551).
[1005] Andersson, S. et al. (2015b), p. 20:49 and Stenbeck, E. et al. (1970), p. 154.
[1006] Chapter 20, Section 5:1 of the Companies Act (SFS 2005:551).
[1007] Chapter 20, Section 3:2 of the Companies Act (SFS 2005:551).
[1008] As referred to Chapter 20, Section 1:1, points 2 and 3 of the Companies Act (SFS 2005:551).
[1009] Chapter 20, Section 23 of the Companies Act (SFS 2005:551).

When the above-mentioned authority permission is required, the company shall notify its known creditors.[1010] There is notification obligation if the auditors state that the reduction does not the position of the creditors.[1011]

The statutory reserve may be reduced only in following situations:[1012] (i) to cover losses if unrestricted shareholders' equity is not available for that[1013], (ii) to increase the share capital through a bonus issue or new share issuance, (iii) for repayment to the shareholders or any other purpose subject to the Swedish Companies Registration Office or - in case of dispute - a relevant court permission[1014].

A decision to reduce the statutory reserve shall be done by the general meeting.[1015] A simple majority of the votes cast is required.[1016]

3.4.3.1.2.9 Merger of companies

Merger of companies may take place through transferring all the assets and liabilities of a company to another company in exchange for consideration to the shareholders of the transferor company.[1017] In a merger the transferor company is dissolved without liquidation. A merger may take place in a form of absorption or consolidation.[1018] In the first option the merger takes place between the transferee company and the transferor company. In the latter alternative two or more transferor companies form a new transferee company (consolidation). The merger cannot be partial i.e. it shall regard all the assets and liabilities of the company.[1019]

The merger consideration to the share owners of the transferor company or companies shall comprise shares in the transferee company or alternatively cash.[1020] More than half of the value of the merger consideration must be covered by shares. The merger consideration shall be paid according to the market value of the shares of the transferor company.[1021] A merger is possible only in case the merging companies having the same accounting currency.[1022]

In case of merger the Swedish company law includes special rules for the holders of warrants, convertible instruments or other securities conveying special rights in the transferor company. The holders of these instruments may according to the merger plan be entitled to demand that the transferee company buy-out their securities. If the merger plan will not provide such possibility holders shall receive rights in the transferee company which are at least equal to the rights they possessed in the transferor company.[1023]

In the consolidation merger the board of directors of the transferor company and - in case of absorption merger - of the transferee company shall jointly prepare a dated merger plan.[1024]

[1010] Chapter 20, Section 24:1 of the Companies Act (SFS 2005:551).
[1011] Chapter 20, Section 24:2 of the Companies Act (SFS 2005:551).
[1012] Chapter 20, Section 35 of the Companies Act (SFS 2005:551).
[1013] According to Andersson, S. et al. (2015b), p. 20:55 this applies both to losses based on the last audited balance sheet and also losses generated after the date of the balance sheet.
[1014] As referred to in Chapter 25, Sections 23-29 of the Companies Act (SFS 2005:551).
[1015] Chapter 20, Section 36:1 of the Companies Act (SFS 2005:551).
[1016] Chapter 20, Section 36:2 of the Companies Act (SFS 2005:551).
[1017] Chapter 23, Section 1:1 of the Companies Act (SFS 2005:551).
[1018] Chapter 23, Section 1:2 of the Companies Act (SFS 2005:551).
[1019] Andersson, S. et al. (2015c), p. 23:4. According to the authors a *"partial merger"* can be done in a form of partial demerger. See more about the demerger below in section *3.4.3.1.2.10 Demerger of a company*.
[1020] Chapter 23, Section 2 of the Companies Act (SFS 2005:551).
[1021] Andersson, S. et al. (2015c), p. 23:7-7a and Government Proposal for the Companies Act (Prop. 2004/05:85), p. 812.
[1022] Chapter 23, Section 3 of the Companies Act (SFS 2005:551).
[1023] Chapter 23, Section 5 of the Companies Act (SFS 2005:551).
[1024] Chapter 23, Section 6:1 of the Companies Act (SFS 2005:551).

In that plan among other things the following shall be stated in respect of each company:[1025] (i) company name, category, number and locality, (ii) number of shares in the transferee company to be exchanged for shares in the transferor company and cash payment as merger consideration, (iii) planned date for the dissolution of the transferor company and (iv) rights in the transferee company to be vested in holders of shares, warrants, convertible instruments and other securities with special rights in the transferor company.

In a consolidation merger the merger plan shall additionally consist of the memorandum of association of the transferee company.[1026]

The merger plan shall be reviewed comprehensively by generally accepted auditing standards. This shall be done by auditors of each of the transferor companies and in absorption merger also of the transferee company.[1027]

A decision by a general meeting to approve the merger plan shall be done by shareholders holding at the minimum two-thirds of both the votes cast and the shares represented at the meeting.[1028] In order the merger to become valid the merger must be approved by all the general meetings that must approve the merger plan.[1029]

After the merger has become valid the participating companies shall notify the decision to known creditors in writing.[1030] The creditors have right to oppose implementation of the merger plan. There is no need for the transferee company to inform its creditors if the auditors in their statement conclude that the merger does not jeopardise the position of the transferee company's creditors.[1031] For transferor company there is not similar possibility to avoid notification for its creditors. The stronger protection is granted for the creditors of the transferor company because from their angle the debtor will change.[1032]

An application for authorisation to implement the merger plan must be also done. This shall be done by the transferee company or - in case of consolidation merger - by the oldest of the transferor companies.[1033] The application shall be made to the Swedish Companies Registration Office.

The Swedish Companies Registration Office shall grant the companies authorisation to implement the merger plan if none of the creditors oppose the application.[1034] In case any creditor opposes the application, the authority shall address the issue to the court. The court to handle the issue is the District Court in the locality where the transferee company has its registered office.

The boards of directors of the companies may decide that the fully owned subsidiary shall be merged into the parent company.[1035] In an absorption merger of wholly owned subsidiaries the merger plan shall also be reviewed by the company auditor according to generally accepted

[1025] Chapter 23, Section 7 of the Companies Act (SFS 2005:551).
[1026] Chapter 23, Section 6:2 of the Companies Act (SFS 2005:551).
[1027] Chapter 23, Section 11:1 of the Companies Act (SFS 2005:551).
[1028] Chapter 23, Section 17:1 of the Companies Act (SFS 2005:551).
[1029] Chapter 23, Section 18 of the Companies Act (SFS 2005:551).
[1030] Chapter 23, Section 19:1 of the Companies Act (SFS 2005:551).
[1031] Chapter 23, Section 19:2 of the Companies Act (SFS 2005:551).
[1032] See Andersson, S. et al. (2015c), p. 23:39 according to which the stronger creditor protection is needed for the creditors of the transferor company. The reason for this is that normally change of debtor is subject to creditor´s permission but in merger this permission is not required.
[1033] Chapter 23, Section 20:1 of the Companies Act (SFS 2005:551).
[1034] Chapter 23, Section 23 of the Companies Act (SFS 2005:551).
[1035] Chapter 23, Section 28:1 of the Companies Act (SFS 2005:551).

auditing standards.[1036] The parent company shall submit the merger plan for registration in the companies register in one month after the preparation of the plan.[1037] This requirement does not exist if all participating companies are private companies and all shareholders of the parent company have signed the merger plan.[1038]

In an absorption merger of wholly owned subsidiaries shareholders owning at the minimum 5 % of all shares in the parent company have right to get the merger plan for the approval of the general meeting.[1039] There is no need for a handling in a general meeting in the event of a merger in which all participating companies are private companies and all shareholders of the parent company have signed the merger plan.[1040] Both in cases where the merger plan is not handled in the general meeting of the parent company or where the plan is approved by the general meeting, a written notice shall be given to known creditors about the merger plan entering into force.[1041]

The parent company shall also apply for authorisation to implement the merger plan.[1042] The application shall be submitted to the Swedish Companies Registration Office. The authorisation to implement a merger plan shall be registered in the companies register.[1043] Only after the registration the legal consequences of the merger - passing the subsidiary's assets and liabilities to the parent and dissolving the subsidiary - company shall enter in the force.[1044]

3.4.3.1.2.10 Demerger of a company

A Swedish company may be divided through a demerger as regulated in the Swedish Companies Act. In such a situation the company's assets and liabilities are taken over by one or several other companies in exchange for consideration to the shareholders of the transferor company.[1045] Demerger may take place through dividing the transferor company in two alternative ways:[1046] Firstly all assets and liabilities can be acquired by two or more other companies. In such a case the transferor company shall be dissolved without liquidation.[1047] Secondly part of assets and liabilities can be acquired by one or more other companies. In this case the transferor company shall not be dissolved.[1048]

A company acquiring the assets and liabilities i.e. a transferee company may be an existing company or a company to be formed in connection of the demerger.[1049]

The demerger consideration to be paid to the shareholders of the transferor company shall be paid in form of shares in the acquiring company or cash.[1050] More than half of the value of the demerger consideration must be covered by shares. The possibility to pay the demerger

[1036] Chapter 23, Section 29:1 of the Companies Act (SFS 2005:551).
[1037] Chapter 23, Section 30:1 of the Companies Act (SFS 2005:551).
[1038] Chapter 23, Section 30:2 of the Companies Act (SFS 2005:551).
[1039] Chapter 23, Section 31:1 of the Companies Act (SFS 2005:551).
[1040] Chapter 23, Section 31:3 of the Companies Act (SFS 2005:551).
[1041] Chapter 23, Section 32 of the Companies Act (SFS 2005:551).
[1042] Chapter 23, Section 33:1of the Companies Act (SFS 2005:551).
[1043] Chapter 23, Section 34:1of the Companies Act (SFS 2005:551).
[1044] Chapter 23, Section 34:2 of the Companies Act (SFS 2005:551).
[1045] Chapter 24, Section 1:1 of the Companies Act (SFS 2005:551).
[1046] Chapter 24, Section 1:2 of the Companies Act (SFS 2005:551).
[1047] Andersson, S. et al. (2015c), p. 24:2 according to which this form of merger is called *"fission"*.
[1048] Andersson, S. et al. (2015c), p. 24:2-3 according to which this form of demerger is called as *"avknoppning"*.
[1049] Chapter 24, Section 1:3 of the Companies Act (SFS 2005:551).
[1050] Chapter 24, Section 2 of the Companies Act (SFS 2005:551).

consideration in combination of shares and cash shall not be used so that a shareholder gets the payment without his consent differently than the other shareholders.[1051]

Like in case of merger also demerger may take place only when the involved companies have the same accounting currency.[1052] The liquidation of the transferor company is not an obstacle for the demerger subject to that distribution of the company's assets has not commenced.[1053]

A debt owed by the transferor company which is mentioned in the merger plan and transferred to a transferee company through the demerger will become liability of the transferee company.[1054] If part of the assets and liabilities is acquired by a company without the transferor company being dissolved the transferor company shall also remain liable for the debt in question. The amount of liability is however limited to the amount corresponding to the actual net value of the assets transferred.

When a debt is not addressed in the demerger plan, the transferee companies shall have joint and several liabilities.[1055] In the event of demerger where only part of the assets and liabilities is acquired, the transferees and the transferor shall have joint and several liabilities. This means also that if one of the joint and severally responsible companies pays the whole liability that company has recourse right towards the other companies having joint and several payment responsibilities.[1056]

Holders of warrants, convertible instruments or other securities with special rights in the transferor company shall receive corresponding rights in the transferee company.[1057] This is however not the situation when demerger plan entitles the rights owners to have their securities bought out by the transferee company.

The merger process requires a demerger plan which shall be prepared by the boards of directors of the transferor and the transferee companies.[1058] If the transferee company shall be formed in connection with the demerger, the demerger plan shall also become a memorandum of association.[1059]

There are requirements set for the content of the demerger plan in the law. The document shall contain among other things the following:[1060] (i) company name and identification data, (ii) description of the assets and liabilities to be transferred including their actual value, (iii) number of shares and cash payment to be provided as demerger consideration, (iv) rights in the transferee company to be vested for holders of shares, warrants, convertible instruments and other securities with special rights in the transferor company or measures otherwise to be taken for the benefit of the above-mentioned holders of special rights and (v) whether any person in any other ways shall obtain special rights or benefits from the transferee company which is formed in connection with the demerger.

[1051] Svensson, B. and Danelius, J. (2012), p. 177.
[1052] Chapter 24, Section 3 of the Companies Act (SFS 2005:551).
[1053] Chapter 24, Section 4:1 of the Companies Act (SFS 2005:551).
[1054] Chapter 24, Section 5:1 of the Companies Act (SFS 2005:551).
[1055] Chapter 24, Section 5:2 of the Companies Act (SFS 2005:551).
[1056] There are no specific rules on the recourse right in Companies Act but Andersson, S. et al. (2015c), p. 24:11 refers to general principles of the obligation law as described in Rodhe, K. (1986).
[1057] Chapter 24, Section 6 of the Companies Act (SFS 2005:551).
[1058] Chapter 24, Section 7:1 of the Companies Act (SFS 2005:551).
[1059] Chapter 24, Section 7:2 of the Companies Act (SFS 2005:551).
[1060] Chapter 24, Section 8 of the Companies Act (SFS 2005:551).

The demerger plan shall be reviewed by one or more auditors for each participating company according to the generally accepted auditing standards.[1061] The auditors' statements shall be put as appendix to the demerger plan.[1062]

The transferee company shall submit the plan to the Swedish Companies Registration Office for registration in the companies register.[1063] This shall take place in one month of the preparation of the demerger plan. This requirement does not exist in the event of a demerger where all participating companies are private and all shareholders have signed the demerger plan.[1064]

Shareholders holding at the minimum 2/3 both the votes cast and the shares represented at the general shall approve a demerger plan.[1065] In a company having several classes of shares, the above-mentioned requirement shall also apply to each class of shares which is represented at the general meeting.[1066] An additional special rule exists regarding a merger between a transferor company which is a public company and a transferee company which is a private company. In such a case the decision of the public company is valid only subject to support from all shareholders present in the meeting and they must represent together at the minimum 90 % of all the shares in the company.[1067]

Like in case of merger also in demerger the participating companies shall notify the approval decision to known creditors in writing.[1068] It shall be informed that the company intends to apply for authorisation to implement the demerger plan and the creditors' have right to oppose the implementation. The purpose of the notification is to give creditors chance to oppose the demerger.[1069] The creditors of the transferee company need not be notified if auditors in their demerger plan statement conclude that they have not found the demerger jeopardises the position of the transferee company's creditors.[1070]

An application to the Swedish Companies Registration Office is needed for authorisation to implement the demerger plan. The application shall be made by the transferor company.[1071] Where no impediment exists and no creditors oppose the application, the companies shall be provided authorisation to implement the demerger plan by the Office.[1072] In case any creditor opposes the application, the authority shall address the issue to the court. The court to handle the issue is the District Court in the locality where the company in question has its registered office

The demerger shall be registered in the companies register. The registration application shall be done jointly by the boards of directors of the transferee companies.[1073]

[1061] Chapter 24, Section 13:1 of the Companies Act (SFS 2005:551).
[1062] Chapter 24, Section 13:4 of the Companies Act (SFS 2005:551).
[1063] Chapter 24, Section 16:1 of the Companies Act (SFS 2005:551).
[1064] Chapter 24, Section 16:2 of the Companies Act (SFS 2005:551).
[1065] Chapter 24, Section 19:1 of the Companies Act (SFS 2005:551).
[1066] Chapter 24, Section 19:2 of the Companies Act (SFS 2005:551).
[1067] Chapter 24, Section 19:3 of the Companies Act (SFS 2005:551).
[1068] Chapter 24, Section 21:1 of the Companies Act (SFS 2005:551).
[1069] Andersson, S. et al. (2015c), p. 24:39.
[1070] Chapter 24, Section 21:2 of the Companies Act (SFS 2005:551).
[1071] Chapter 24, Section 22:1 of the Companies Act (SFS 2005:551).
[1072] Chapter 24, Sections 24 and 25 of the Companies Act (SFS 2005:551).
[1073] Chapter 24, Section 27:1 of the Companies Act (SFS 2005:551).

3.4.3.2 Estonia

3.4.3.2.1 About the Estonian legal system

The Estonian legal system has its roots in the Roman law and is thus part of continental European legal tradition.[1074] Estonia became a full member of the European Union since May 1, 2004 and therefore EU law is also an integral part of the Estonian legal system.

The Estonian legal system is norm-based and the case law does not have a precedent value.[1075] However the decisions of the Supreme Court are also relevant especially when gaps in legislation need to be covered.

The current Estonian Constitution was adopted on 1992. The Constitution stipulates that Estonia is a sovereign democratic republic where the supreme power of the state is vested in the people.[1076] State authority is exercised solely under the Constitution and laws.[1077] The Constitution also notes that generally recognised principles and rules of international law are an indivisible part of the Estonian legal system.[1078] Among the key principles in the Constitution are the principle of separation of powers[1079] and the principle of legality[1080] and equal treatment[1081].

3.4.3.2.2 Commercial Code

The Commercial Code[1082] in Estonia entered in the force on September 1, 1995. The law includes the basic principles of Estonian entrepreneurship and regulates any type of company formation in Estonia. Also, the role of the Commercial Register is regulated in the Commercial code. The law is divided in 10 Parts totalling 541 Sections.

Compared to the Finnish Limited Liability Companies Act the Estonian Commercial Code covers areas for which Finland has separate legislation. Such areas are

- Business name (in Finland: Trade Name Act (128/1979))
- Procuration (in Finland: Procuration Act (130/1979))
- Commercial register including general provisions on documentation, entry, content, registry card, maintenance, etc. (in Finland: Commercial Register Act 129/1979))
- General Partnership and Limited Partnership including foundation, relations among partners etc., dissolution (In Finland: General Partnership and Limited Partnership Act (389/1988)).

Several modifications have been made to the law over the years to keep the legislation updated. For example, due to the EU membership of Estonia there has been a need to adapt to the

[1074] Merimaa, M. and Mändla, S. (2011), p. 25.
[1075] Laffranque, J. (2005), p. 224.
[1076] Chapter 1, Section 1 of the Constitution of Estonia.
[1077] Chapter 1, Section 3 of the Constitution of Estonia.
[1078] Chapter 1, Section 3 of the Constitution of Estonia.
[1079] Chapter 1, Section 4 of the Constitution of Estonia.
[1080] Chapter 1, Section 13 of the Constitution of Estonia.
[1081] Chapter 1, Section 12 of the Constitution of Estonia
[1082] Commercial Code (RT I 1995, 26, 355).

European directives. Some of the latest changes have facilitated the incorporation procedures allowing possibility to registrate company electronically and allow fundraising in the form of convertible bonds or convertible loans.

3.4.3.2.2.1 General part

In Estonian Commercial Code are identified five types of business entities: general partnership, limited partnership, private limited company, public limited company or commercial association.[1083] The legal capacity of an Estonian company is subject to its entry in the commercial register.[1084]

A group of limited liability companies exist on two conditions:[1085]

- When a company is a shareholder of another company and owns a majority voting right. A company in which one or more subsidiaries - with or without the parent - have a majority voting rights is also a subsidiary of the parent company.

- When a company controls another company based on an agreement or without an agreement the companies form a group.[1086]

According to the Estonian company law a company may only have one business name.[1087] In case of a private limited company the appendage *"osaühing"* (private limited company) or abbreviation *"OÜ"* shall be used. In case of public limited company, the appendage *"aktsiaselts"* (public limited company) or abbreviation *"AS"* shall be used.

3.4.3.2.2.2 Private limited company

In Estonia the private limited company is defined with three basic features.[1088] Firstly, share capital shall be split into private limited company shares. Secondly, owner of a share shall not have personal liability for the obligations of the private limited company. Thirdly, private limited company shall have liability for its obligations with all of its assets. This means that the creditor of the private limited company can claim the receivable from the company only from the company and not from the shareholder.[1089] Shareholder´s personal liability is limited only to the amount of invested share capital.[1090]

Share capital currency shall be euros and the share capital shall be at least 2,500 euros.[1091] The law sets several requirements for the maintenance of this capital.[1092]

The Estonian Commercial Code sets several requirements for the founding of the private limited company.[1093] Such a company may be established by one or more persons.[1094] A

[1083] Chapter 1, Section 2:1 of the Commercial Code (RT I 1995, 26, 355).
[1084] Chapter 1, Section 2:2 of the Commercial Code (RT I 1995, 26, 355).
[1085] Chapter 1, Section 6 of the Commercial Code (RT I 1995, 26, 355).
[1086] See Saare, K. et al. (2015), p. 86 according to which the basis for forming group can be ownership, contractual basis or factual basis.
[1087] Chapter 2, Section 9 of the Commercial Code (RT I 1995, 26, 355).
[1088] Chapter 17, Section 135 of the Commercial Code (RT I 1995, 26, 355).
[1089] Saare, K. et al. (2015), p. 89.
[1090] See Vutt, A. (2005) about the Estonian regulation related to share capital in general.
[1091] Chapter 17, Section 136 of the Commercial Code (RT I 1995, 26, 355). In case of public limited liability company, the share capital shall be least 25,000 euros according to Chapter 23, Section 222 of the Commercial Code.
[1092] Saare, K. et al. (2015), p. 44.
[1093] Saare, K. et al. (2015), p. 94.
[1094] Chapter 18, Section 137:1 of the Commercial Code (RT I 1995, 26, 355).

founder can be a natural person or a legal person.[1095] The key documents in the founding process are a memorandum of association and articles of association.[1096]

When founding a private limited company, a memorandum of association shall be prepared.[1097] The memorandum of association shall include among other things following items:[1098]

- business name, registered office and address of the company
- name and residence or registered office of each founder
- proposed share capital amount
- nominal value and number of shares
- amount to be paid for shares
- information on the management board members and - in case a supervisory board exists - information on supervisory board members.

The founders shall also prepare and approve the articles of association as an attachment to the memorandum of association.[1099] Both documents shall be signed by all founders and notarised.[1100] The memorandum of association shall be replaced by a notarised foundation resolution signed by the founder in case there is only one founder.[1101] This notarial involvement is required both in case of private and public limited companies.[1102]

The articles of association of a private limited company shall set out among other things business name and registered office of the private limited company, amount of share capital, specific rights attaching to a share or specific rights of a shareholder and formation and amount of legal reserve.[1103]

The share capital can be defined either as a specific amount or as a minimum and maximum capital. In case of the latter alternative the minimum capital shall be at least 1/4 of the maximum capital.

In case of the specific rights attaching to a share are established or different share classes are established they shall be specified in the articles of association.

A contribution for the share may be either monetary or non-monetary.[1104] A non-monetary payment is possible only if the articles of association so require. The founders are required to pay their contribution for the shares before submitting an entry petition in the commercial register.[1105] It is however possible to prescribe otherwise in the memorandum of association.[1106] There is a special regulation forbidding payment for a share by set-off against

[1095] Chapter 18, Section 137:2 of the Commercial Code (RT I 1995, 26, 355).
[1096] Saare, K. et al. (2015), p. 102.
[1097] Chapter 18, Section 138:1 of the Commercial Code (RT I 1995, 26, 355).
[1098] Chapter 18, Section 138:2 of the Commercial Code (RT I 1995, 26, 355).
[1099] Chapter 18, Section 138:3 of the Commercial Code (RT I 1995, 26, 355).
[1100] Chapter 18, Section 138:4 of the Commercial Code (RT I 1995, 26, 355).
[1101] Chapter 18, Section 138:5 of the Commercial Code (RT I 1995, 26, 355).
[1102] Saare, K. (2004), p. 85.
[1103] Chapter 18, Section 139:1 of the Commercial Code (RT I 1995, 26, 355).
[1104] Chapter 18, Section 140:1 of the Commercial Code (RT I 1995, 26, 355).
[1105] Chapter 18, Section 140:2 of the Commercial Code (RT I 1995, 26, 355).
[1106] Värv, A. (2008), p. 28.

salary, fees or other receivables from the private limited company being founded.[1107] There is also possibility to found a private limited company without immediate payment of the shares.[1108] This option is reserved only for situations where founders are physical persons and share capital is below 25,000 euros.[1109]

The minimum nominal value of a share of private limited company shall be one euro or its multiple.[1110] Shares may have different nominal values.[1111] Shares that have the same rights form one class of shares.[1112] Owner of a share gets the participation right in the management of the company and right in distribution of profit.[1113] There is no possibility to issue a certificate for a share of a private limited company.[1114] However it is possible that the shares are entered in the Estonian register of securities.[1115]

A share can be freely transferred from a shareholder to another shareholder.[1116] When transferring a share to a third person, the other share owners have a pre-emption right.[1117] If pre-emption right shall be used it has to be done in one month since the presentation of the transfer agreement. In practice this shall be done that the sales contract shall be given to the management board of the company by the seller. After that the management board shall without delay inform the other shareholders of entry into the sales contract.[1118]

The articles of association may contain additional requirements related to the transfer of shares. It can be prescribed in the articles of association that a resolution of the other shareholders, the management board, the supervisory board or another person is obligatory to a share transfer.[1119] In such a situation the above-mentioned reference to shareholders pre-emption right is not applied in the private limited company. In the articles of association may also be prescribed that the pre-emption right shall not be applied at all upon the transfer of a share. If a transaction is done without the fulfilment of additional condition the transaction shall be null and void. It is however possible for the shareholder to demand that the other shareholders, the management board, the supervisory board or another person in question is required to give permission for the transfer a share. According to the law such a demand can be done *"with good reason"*.

The share transfer is completed when the transfer and a certification of it is notified to the company.[1120] This does not however apply if the shares are entered in the Estonian register of securities.[1121] Such transactions that transferor and the company have entered into before the share transfer notification to the company and which relate to shareholder-company relationship shall be applied to the transferee.[1122] After receiving a share transfer notice the

[1107] Chapter 18, Section 140:3 of the Commercial Code (RT I 1995, 26, 355).
[1108] Chapter 18, Section 140^1 of the Commercial Code (RT I 1995, 26, 355).
[1109] Vutt, A. (2011), p. 16.
[1110] Chapter 19, Section 148:1-2 of the Commercial Code (RT I 1995, 26, 355).
[1111] Saare, K. et al. (2015), p. 90.
[1112] Chapter 19, Section 148:3 of the Commercial Code (RT I 1995, 26, 355).
[1113] Chapter 19, Section 148:5 of the Commercial Code (RT I 1995, 26, 355).
[1114] Chapter 19, Section 148:6 of the Commercial Code (RT I 1995, 26, 355).
[1115] Chapter 19, Section 148:7 of the Commercial Code (RT I 1995, 26, 355).
[1116] Chapter 19, Section 149:1 of the Commercial Code (RT I 1995, 26, 355).
[1117] Chapter 19, Section 149:2 of the Commercial Code (RT I 1995, 26, 355).
[1118] Law of Obligations Act (RT I 2001, 81, 487) contains additional rules to be applied with regards the right of pre-emption.
[1119] Chapter 19, Section 149:3 of the Commercial Code (RT I 1995, 26, 355).
[1120] Chapter 19, Section 150:1 of the Commercial Code (RT I 1995, 26, 355).
[1121] Chapter 19, Section 150:6 of the Commercial Code (RT I 1995, 26, 355). See Securities Register Maintenance Act (RT I, 26.06.2017) about the registration of transfer of shares that are entered in the Estonian register of securities.
[1122] Chapter 19, Section 150:2 of the Commercial Code (RT I 1995, 26, 355).

management board shall amend the entries in the list of shareholders accordingly.[1123] This however does not either apply if shares are entered in the Estonian register of securities.[1124]

A private limited company share can be transferred or pledged also partially. In such a case a share shall be divided.[1125] The decision of the shareholders is required for the division of the share subject to that the articles of association do not prescribe otherwise.

The principle of the equal treatment of shareholders in equal situations is included in the Estonian Commercial Code. Shareholders´ treatment shall be equal in equal conditions.[1126] A shareholder is not obliged to make a contribution more than the nominal value and premium of the share unless her consent.[1127]

The articles of association of the company may provide specific rights attached to a share or specific rights for a shareholder. Such rights may influence to the shareholders´ resolutions and distribution of profit and division of remaining assets in the company´s liquidation.[1128] Any resolution for amendment of the articles of association annulling or changing these specific rights shall be subject to the consent of all the shareholders having such specific right.[1129] It is however possible also to prescribe differently in the articles of association.

A shareholder must make a contribution equivalent to the nominal value of the share.[1130] This means that a shareholder is not allowed to pay a contribution which is below the nominal value of the share.[1131] The articles of association may prescribe the right of the company to issue shares with a premium i.e. for a price exceeding their nominal value.[1132] The shareholder is in such a situation also obliged to pay this premium amount. If the private limited company cannot cover its loss by retained profit, legal reserve or other reserves a premium may be used to cover such a loss or alternatively a premium can be used to increase share capital by a bonus issue.[1133]

Dividend payment is possible from net profit or retained profit after deduction of losses based on the approved annual report.[1134] This means that distribution of capital to shareholders requires free reserves as defined in the law.[1135] A shareholder is entitled to dividend in proportion to his ownership share subject to that the articles of association do not prescribe otherwise.[1136] Payments are made to shareholders only if the net assets of the private limited company are at the minimum on the level of total of share capital and reserves.[1137] The minimum level is defined according to the law or the articles of association.

Company has a possibility to capitalise the expenditure related to the development as intangible assets. If the development expenditure has not been fully depreciated, the amount equal to the undepreciated development expenditure out of the sum of the normally

[1123] Chapter 19, Section 150:3 of the Commercial Code (RT I 1995, 26, 355).
[1124] See above footnote 1121.
[1125] Chapter 19, Section 152:1 of the Commercial Code (RT I 1995, 26, 355).
[1126] Chapter 19, Section 154:1 of the Commercial Code (RT I 1995, 26, 355).
[1127] Chapter 19, Section 154:2 of the Commercial Code (RT I 1995, 26, 355).
[1128] Chapter 19, Section 154^1:1 of the Commercial Code (RT I 1995, 26, 355).
[1129] Chapter 19, Section 154^1:2 of the Commercial Code (RT I 1995, 26, 355).
[1130] Chapter 19, Section 155:1 of the Commercial Code (RT I 1995, 26, 355).
[1131] Saare, K. et al. (2015), p. 114.
[1132] Chapter 19, Section 155:2 of the Commercial Code (RT I 1995, 26, 355).
[1133] Vutt, A. (2011), p. 35.
[1134] Chapter 19, Section 157:1 of the Commercial Code (RT I 1995, 26, 355).
[1135] Vutt, A. (2011), p. 33.
[1136] Chapter 19, Section 157:2 of the Commercial Code (RT I 1995, 26, 355).
[1137] Chapter 19, Section 157:3 of the Commercial Code (RT I 1995, 26, 355).

distributable reserves - i.e. profit and the retained profit from previous periods - cannot be distributed.[1138]

Shareholders can become creditors of the company but investing in the share capital does not make shareholders the creditor status.[1139] Any shareholder has however the right to demand payment of a dividend according to a resolution of the shareholders.[1140] Such a payment shall be done in money or - in case of shareholders' consent - also in other assets.[1141]

As stated in the law or the articles of association legal reserve shall be established from annual net profit transfers and other transfers entered in the legal reserve.[1142] This is an equity item in the balance sheet that has cannot be distributed to shareholders.[1143] In case prescription of legal reserve is included in the articles of association the legal reserve shall be at the minimum 10 % of the share capital.[1144] In each financial year at least 5 % of the net profit shall be entered in the legal reserve. After the legal reserve reaches the amount defined in the articles of association, the net profit shall not be used to increase the legal reserve any more.[1145] Shareholders may decide that legal reserve is used to cover a loss or to increase share capital.[1146] In case that is done the legal reserve must be increased back to the minimum amount.[1147] There is a specific rule in the law stating that the legal reserve shall not be used to make payments to shareholders.[1148]

There are specific rules on convertible bonds in the Estonian Commercial Code. A private limited company may issue convertible bonds which give to their holders right to convert the bonds to shares.[1149] This conditional increase of the share capital is subject to prescription in the articles of association and a resolution of the shareholders.[1150] A convertible bond shall be registered and it may be transferred on similar conditions as a share.[1151] It is possible to issue convertible bonds after the issuer company is registered in the commercial register.[1152] The shareholders shall have the pre-emptive right[1153] to subscribe for convertible bonds.[1154] According to the law at least the nominal value of a convertible bond shall be paid in money. The nominal value of a share issued for the bond may exceed the nominal value of the bond but only provided that the difference is paid for in money.[1155] The sum of the nominal values of convertible bonds shall not exceed 50 % of the share capital.[1156]

The shareholders of the private limited company are competent to make among other things following decisions:[1157]

[1138] Chapter 19, Section 157:3[1] of the Commercial Code (RT I 1995, 26, 355).
[1139] Tolstov, L. (2015), p. 19.
[1140] Chapter 19, Section 157:4 of the Commercial Code (RT I 1995, 26, 355).
[1141] Chapter 19, Section 157:5 of the Commercial Code (RT I 1995, 26, 355).
[1142] Chapter 19, Section 160:1 of the Commercial Code (RT I 1995, 26, 355).
[1143] Vutt, A. (2005), p. 156.
[1144] Chapter 19, Section 160:2 of the Commercial Code (RT I 1995, 26, 355)
[1145] Chapter 19, Section 160:3 of the Commercial Code (RT I 1995, 26, 355)
[1146] Chapter 19, Section 161:1 of the Commercial Code (RT I 1995, 26, 355).
[1147] Saare, K. et al. (2015), p. 305.
[1148] Chapter 19, Section 161:2 of the Commercial Code (RT I 1995, 26, 355)
[1149] Saare, K. et al. (2015), pp. 293-294.
[1150] Chapter 19, Section 167[2]:1 of the Commercial Code (RT I 1995, 26, 355)
[1151] Chapter 19, Section 167[2]:2 of the Commercial Code (RT I 1995, 26, 355)
[1152] Chapter 19, Section 167[2]:3 of the Commercial Code (RT I 1995, 26, 355)
[1153] As described in Chapter 21, Section 193 of the Commercial Code (RT I 1995, 26, 355)
[1154] Chapter 19, Section 167[2]:4 of the Commercial Code (RT I 1995, 26, 355)
[1155] Chapter 19, Section 167[2]:5 of the Commercial Code (RT I 1995, 26, 355)
[1156] Chapter 19, Section 167[2]:6 of the Commercial Code (RT I 1995, 26, 355)
[1157] Chapter 20, Section 168:1 of the Commercial Code (RT I 1995, 26, 355)

- amending the articles of association
- increasing and reducing share capital
- electing and removing members of the supervisory board
- electing and removing members of the management board subject to that the company does not have a supervisory board
- approving the annual report and distribute profit
- electing an auditor
- deciding on dissolution, merger, division or transformation.

The shareholders may also adopt resolutions on such items that are within the management board´s or supervisory board´s competence.[1158] When doing so the shareholders face the same liability as members of the management board or supervisory board.[1159]

In the articles of association can be prescribed about the shareholders voting rights. If not otherwise prescribed the number of votes of a shareholder shall be in proportion to the amount of the shareholder's share.[1160] Also - if not otherwise prescribed in the articles of association - each one euro of a share is equal to one vote.[1161]

For a shareholders´ meeting to be competent to approve resolutions votes over 50 % of the shares shall be represented unless it is prescribed a greater representation requirement in the articles of association.[1162] A resolution of the shareholders favoured by over 50 % of the votes represented at the meeting shall be adopted unless there is a greater majority requirement in the law or in the articles of association.[1163] If the adoption of resolution has taken place without calling a meeting of shareholders[1164] the resolution shall be adopted if over 50 % of the votes of the shareholders are in favour if no greater majority requirements stem from the law or the articles of association.[1165]

A resolution on amendment of the articles of association shall require at the minimum 2/3 of the votes of the shareholders participating in the meeting.[1166] If the resolution has taken place without calling a meeting of shareholders [1167] the adoption requires at least two-thirds of the votes of the shareholders. If the articles of association prescribe a greater majority requirement that must be followed.

The role of the management board is to represent and manage the private limited company.[1168] The management board shall have at the minimum one member.[1169] A management board member does not need not be a shareholder. There is an additional requirement for a member

[1158] Chapter 20, Section 168:2 of the Commercial Code (RT I 1995, 26, 355).
[1159] Saare, K. et al. (2015), p. 185.
[1160] Chapter 20, Section 169:1 of the Commercial Code (RT I 1995, 26, 355).
[1161] Chapter 20, Section 169:2 of the Commercial Code (RT I 1995, 26, 355).
[1162] Chapter 20, Section 170:2 of the Commercial Code (RT I 1995, 26, 355).
[1163] Chapter 20, Section 174:1 of the Commercial Code (RT I 1995, 26, 355).
[1164] As described in Chapter 20, Section 173:1-2 of the Commercial Code (RT I 1995, 26, 355).
[1165] Chapter 20, Section 174:2 of the Commercial Code (RT I 1995, 26, 355).
[1166] Chapter 20, Section 175:1 of the Commercial Code (RT I 1995, 26, 355).
[1167] As described in Chapter 20, Section 173:1-2 of the Commercial Code (RT I 1995, 26, 355).
[1168] Chapter 20, Section 180:1 of the Commercial Code (RT I 1995, 26, 355).
[1169] Chapter 20, Section 180:2 of the Commercial Code (RT I 1995, 26, 355).

of the management board to be a natural person with active legal capacity.[1170] As the legal representative of a company the board member takes care of the economic activities of the enterprise.[1171]

The private limited company may also have a supervisory board. In such a case the management board shall act according to the orders of the supervisory board.[1172] The management board may perform operations outside the scope of daily economic activities only subject to the supervisory board consent. This restriction is not applicable regarding third persons.

Additionally, there is a requirement for a management board member to perform all duties with due diligence.[1173]

A decision to increase share capital shall be adopted by the shareholders. Such a resolution shall be adopted if at least 2/3 of the votes of the shareholders participating in the meeting support the resolution.[1174] If the adoption of resolution has taken place without calling a meeting of shareholders[1175] at least 2/3 of the votes of the shareholders shall be in favour. If the articles of association require a greater majority that condition must be followed.

In case there is a need to amend articles of association due to the increase of share capital, the articles of association shall be amended first.[1176] An increase of share capital shall not be approved either until the private limited company is registered in the commercial register.[1177]

Unless otherwise prescribed in the increase resolution, when share capital is increased a shareholder´s pre-emptive right allows subscription for the shares to be issued in proportion to the shareholder's ownership share.[1178] A shareholder has also right to give up the pre-emptive right. In such a situation the other shareholders get the right to subscribe the new shares.[1179] This means that the other shareholders using the pre-emption right have then chance to divide the new *"given up"* shares in proportion to their shareholder´s share out of those shareholders using the pre-emption right.[1180]

A company may increase its share capital on account of the shareholders' equity without making contributions.[1181] In this kind of transaction the amount of the total equity of the company does not change but only the share capital.[1182] The shareholders may decide on this *"bonus issue"* based on the profit distribution resolution and the annual report.[1183] In this scheme the increase of shareholder´s share shall take place in proportion to the nominal value of the shareholder's share.[1184] A resolution contradicting the above-mentioned shall be considered void.

[1170] Varul, P. et al. (2005), p. 53.
[1171] Tolstov, L. (2015), p. 7.
[1172] Chapter 20, Section 180:4 of the Commercial Code (RT I 1995, 26, 355).
[1173] Chapter 20, Section 187:1 of the Commercial Code (RT I 1995, 26, 355).
[1174] Chapter 21, Section 192:1 of the Commercial Code (RT I 1995, 26, 355).
[1175] As described in Chapter 20, Section 173:1-2 of the Commercial Code (RT I 1995, 26, 355).
[1176] Chapter 21, Section 192:2 of the Commercial Code (RT I 1995, 26, 355).
[1177] Chapter 21, Section 192:3 of the Commercial Code (RT I 1995, 26, 355).
[1178] Chapter 21, Section 193:1 of the Commercial Code (RT I 1995, 26, 355).
[1179] Chapter 21, Section 193:2 of the Commercial Code (RT I 1995, 26, 355).
[1180] Saare, K. et al. (2015), p. 288.
[1181] Chapter 21, Section 195:1 of the Commercial Code (RT I 1995, 26, 355).
[1182] See Saare, K. et al. (2015), pp. 290-292 about the bonus issue and its impact on the balance sheet items.
[1183] Chapter 21, Section 195:2 of the Commercial Code (RT I 1995, 26, 355).
[1184] Chapter 21, Section 195:3 of the Commercial Code (RT I 1995, 26, 355).

There are also rules on conditional issue of share capital related to issuance of convertible bonds. Here the shareholders may decide on the conditional share capital increase up to the total amount of the nominal values of the convertible bonds.[1185] The shareholders´ resolution may also prescribe the increase of the share capital even to the level above the total amount of the nominal values of the exchangeable convertible bonds. In such a situation the difference between the nominal value of the convertible bonds and the nominal value of the shares shall be covered in money.

Conditional increase of capital is also possible by issuing subscription rights i.e. option rights.[1186] The holder of the rights has possibility to subscribe new shares as has been agreed in the resolution to issue subscription rights.[1187] It is not possible to decide on a conditional share capital increase exceeding existing share capital by more than 50 %.[1188]

In a decision on conditional increase of share capital following points shall be included: (i) objective of the conditional increase, (ii) persons permitted to participate in the conditional increase, (iii) issue price of shares and (iv) terms of performing the subscription rights.[1189] After the resolution adoption the management board shall apply for entry of the conditional increase in the commercial register.[1190] Shares shall not be issued before the conditional increase of share capital has been registered.[1191] The share capital and number of shares shall be increased as of the issue of the share.[1192]

A decision to reduce the share capital requires at least 2/3 of the votes of the shareholders participating in the meeting.[1193] If meeting has taken place without calling a meeting of shareholders,[1194] at least 2/3 of the votes of the shareholders shall be in voting for the resolution, unless even greater majority is required by the articles of association.

In case of a reduction of share capital by reducing the nominal values of shares or cancelling shares other than proportionally special decision-making rules shall apply.[1195] Besides the voting requirement mentioned above, the resolution shall be approved by the shareholders whose shares are disproportionally reduced or cancelled compared to other shares. [1196]

When the articles of association are amended due to the reduction of share capital the amendment shall be done before the share capital reduction.[1197] However this is not applicable if a share capital increase at least up to the minimum amount[1198] of share capital is decided parallelly with a share capital reduction.[1199] No separate notification to creditors[1200] either is required if a share capital increase at least up to the current level of the share capital is decided simultaneously. Such shares that are issues simultaneously with the share capital decrease can

[1185] Chapter 21, Section 195[1]:1 of the Commercial Code (RT I 1995, 26, 355).
[1186] Chapter 21, Section 195[1]:2 of the Commercial Code (RT I 1995, 26, 355).
[1187] Saare, K. et al. (2015), p. 294.
[1188] Chapter 21, Section 195[1]:3 of the Commercial Code (RT I 1995, 26, 355).
[1189] Chapter 21, Section 195[1]:5 of the Commercial Code (RT I 1995, 26, 355).
[1190] Chapter 21, Section 195[1]:7 of the Commercial Code (RT I 1995, 26, 355).
[1191] Chapter 21, Section 195[1]:8 of the Commercial Code (RT I 1995, 26, 355).
[1192] Chapter 21, Section 195[1]:10 of the Commercial Code (RT I 1995, 26, 355).
[1193] Chapter 21, Section 197:1 of the Commercial Code (RT I 1995, 26, 355).
[1194] As described in Chapter 20, Section 173:1-2 of the Commercial Code (RT I 1995, 26, 355).
[1195] Chapter 21, Section 197:1[1] of the Commercial Code (RT I 1995, 26, 355).
[1196] Saare, K. et al. (2015), p. 296.
[1197] Chapter 21, Section 197:2 of the Commercial Code (RT I 1995, 26, 355).
[1198] As described in Chapter 17, Section 136 of the Commercial Code (RT I 1995, 26, 355).
[1199] Chapter 21, Section 198:2 of the Commercial Code (RT I 1995, 26, 355).
[1200] As referred to in Chapter 21, Section 199 of the Commercial Code (RT I 1995, 26, 355).

paid for in money only. The change of share capital shall be registered in the commercial register.

A resolution on share capital reduction shall include argumentation for the reduction, extent and method of reduction and new nominal values of shares.[1201]

There is also a process for a simplified reduction of share capital for private limited companies.[1202] According to that share capital may be reduced without applying the creditor notification procedure[1203] in order to cover a loss of the private limited company.[1204] The simplified reduction process may also be used when the profit and the legal reserve are not enough to cover a loss and the company has no other reserves either.[1205] When deciding on the reduction of share capital it shall be indicated what is the loss for which the share capital need to be reduced.[1206] The reduction of share capital is possible only to cover the loss.[1207] No payments and dividend distributions shall be made during the financial year on which the share capital decrease was decided and the two subsequent financial years.[1208]

3.4.3.2.2.3 Public limited company

According to the Estonian Commercial Code a public limited company has share capital divided into shares of public limited company.[1209] A shareholder shall not in such a company be personally liable for the company´s obligations.[1210] Nevertheless, a public limited company itself is liable for its obligations with all of its assets.[1211] The concept of limited liability allows separation of company assets and liabilities from those of company owners.[1212]

Share capital shall be denominated in euros and it shall be at least 25,000 euros.[1213] The law sets several requirements for the maintenance of this capital.[1214]

In a public limited company, a share may be issued with nominal value or without nominal value.[1215] Both types of shares cannot be issued simultaneously.[1216]

In case of shares without nominal value an equal part of the share capital shall conform to all shares.[1217] In practice the book value of the share i.e. part of the share capital corresponding to one share shall be the share capital divided by the number of shares. If a public limited company has issued shares with different nominal value they can be changed to shares without nominal value. This requires however the equalisation of the nominal values of the shares before the introduction of the share without nominal value.[1218] This change shall be registered

[1201] Chapter 21, Section 197[1] of the Commercial Code (RT I 1995, 26, 355).
[1202] Saare, K. et al. (2015), p. 299-300.
[1203] As referred to in Chapter 21, Section 199 of the Commercial Code (RT I 1995, 26, 355).
[1204] Chapter 21, Section 199[2]:1 of the Commercial Code (RT I 1995, 26, 355).
[1205] Chapter 21, Section 199[2]:2 of the Commercial Code (RT I 1995, 26, 355).
[1206] Chapter 21, Section 199[2]:3 of the Commercial Code (RT I 1995, 26, 355).
[1207] Chapter 21, Section 199[2]:4 of the Commercial Code (RT I 1995, 26, 355).
[1208] Chapter 21, Section 199[2]:5 of the Commercial Code (RT I 1995, 26, 355).
[1209] Chapter 23, Section 221:1 of the Commercial Code (RT I 1995, 26, 355).
[1210] Chapter 23, Section 221:2 of the Commercial Code (RT I 1995, 26, 355).
[1211] Chapter 23, Section 221:3 of the Commercial Code (RT I 1995, 26, 355).
[1212] Saare, K. et al. (2015), p. 331.
[1213] Chapter 23, Section 222 of the Commercial Code (RT I 1995, 26, 355).
[1214] Saare, K. et al. (2015), p. 44.
[1215] Chapter 23, Section 222[1]:1 of the Commercial Code (RT I 1995, 26, 355).
[1216] Saare, K. et al. (2015), p. 336.
[1217] Chapter 23, Section 222[1]:2 of the Commercial Code (RT I 1995, 26, 355).
[1218] Chapter 23, Section 222[1]:3 of the Commercial Code (RT I 1995, 26, 355).

in the commercial register and the number of shares without nominal value shall be deemed to become valid when relevant registration is made.[1219]

The nominal value or book value of a share shall be at the minimum ten cents or multiple of ten cents.[1220] A share shall also be indivisible.[1221]

The share´s issue price shall be at the minimum the share´s nominal value or book value.[1222] There is no upper limit for the issue price of a share.[1223] According to the law it is possible to use a premium to cover a loss if loss cannot be covered by the retained profit or legal reserve and to increase share capital through a bonus issue. The issue price of a share shall always be fully paid by the subscriber when share is issued.[1224]

In a public limited company, a share shall grant the shareholder several different rights.[1225] Besides what is provided by law or articles of association a shareholder shall be entitled to participate in the general meeting, distribution of profits and - in case of dissolution - remaining assets.[1226]

When subscribing a share, a subscriber receives the right to receive a share and undertakes to pay for it.[1227] A subscriber may also receive a certificate of subscription for the subscribed shares.[1228] The rights and obligations attached to a subscription may be transferred.[1229] The subscriber and the transferee shall be in solidarity liable for payment not paid in full. What is regulated for transfer of registered shares shall apply to transfer of certificates of subscription, too.

Shares shall be registered by entering them in the Estonian register of securities.[1230] The rights that are attached to a share shall be owned by the person that has been entered in the share register as the shareholder.[1231]

The shares entered in the shares register may be transferred freely.[1232] It can be prescribed in the articles of association that shareholder´s pre-emptive right applicable to each share transfer for charge.[1233] The term of such right shall not be over two months calculated from the presentation of the transfer agreement. It is the obligation of the seller to notify the entry of sales contract to the management board which will after that notify the other shareholders therefrom.[1234]

[1219] Chapter 23, Section 222[1]:4 of the Commercial Code (RT I 1995, 26, 355).
[1220] Chapter 24, Section 223:1-2 of the Commercial Code (RT I 1995, 26, 355).
[1221] Chapter 24, Section 224 of the Commercial Code (RT I 1995, 26, 355).
[1222] Chapter 24, Section 225:1 of the Commercial Code (RT I 1995, 26, 355).
[1223] Chapter 24, Section 225:2 of the Commercial Code (RT I 1995, 26, 355).
[1224] Chapter 24, Section 225:3 of the Commercial Code (RT I 1995, 26, 355).
[1225] Saare, K. et al. (2015), pp. 335-337.
[1226] Chapter 24, Section 226 of the Commercial Code (RT I 1995, 26, 355).
[1227] Chapter 24, Section 226[1]:1 of the Commercial Code (RT I 1995, 26, 355).
[1228] Chapter 24, Section 226[1]:2 of the Commercial Code (RT I 1995, 26, 355).
[1229] Chapter 24, Section 226[1]:3 of the Commercial Code (RT I 1995, 26, 355).
[1230] Chapter 24, Section 228:1 of the Commercial Code (RT I 1995, 26, 355).
[1231] Chapter 24, Section 228:2 of the Commercial Code (RT I 1995, 26, 355).
[1232] Chapter 24, Section 229:1 of the Commercial Code (RT I 1995, 26, 355).
[1233] Chapter 24, Section 229:2 of the Commercial Code (RT I 1995, 26, 355).
[1234] The provisions of the Law of Obligations Act (RT I 2001, 81, 487) apply otherwise to the right of pre-emption.

The Estonian register of securities or another depository shall maintain a share register concerning a public limited liability company.[1235] Such a register shall contain following information:[1236]

- shareholder´s name, address and personal identification code or registry code
- class and nominal value of the shares
- date of subscription and acquisition of the shares.

Shares may have unlike rights in relation to profit distribution and division of assets upon liquidation.[1237] The different rights shall be based on the articles of association.[1238] Shares with the same rights belong in the same class of shares.

Rights connected to the shares may be amended by a general meeting resolution if at the minimum 4/5 of votes are supporting the decision.[1239] In the articles of association may be prescribed an even greater majority requirement. On top of that at least 9/10 of such shareholders must vote in favour of the resolution who have shares belonging to the class the rights of which are modified.

Each share is entitled to a separate vote unless law provides otherwise.[1240] This means that the more shares one has the more the more voting power one can use.[1241] Equal nominal values of shares shall mean equal number of votes.[1242] Different voting rights of shares shall match the differences in nominal values. If shares do not have a nominal value they shall grant an identical number of votes.[1243]

A public limited company has possibility to issue non-voting shares that include preferential right in distribution of dividends and in distribution of remaining assets upon dissolution.[1244] These preferred shares have otherwise the same rights as normal shares excluding the right to vote. The sum of the nominal values or book values of preferred shares shall be at the maximum 1/3 of the share capital.[1245] In practice this limitation rule does not restrict the funds possible to obtain through preferred shares as share issuance is possible also above par.[1246]

A preferred share has voting right in certain limited situations if the articles of association so prescribe.[1247] Every holder of preferred shares shall provide their consent before decision on cancelling or amending of the preference rights is applied. The holders of preferred shares shall have the voting right upon cancellation of the preferential right.[1248]

[1235] Chapter 24, Section 233:2 of the Commercial Code (RT I 1995, 26, 355). See also the Securities Register Maintenance Act (RT I, 26.06.2017).
[1236] Chapter 24, Section 233:1 of the Commercial Code (RT I 1995, 26, 355).
[1237] Chapter 24, Section 235:1 of the Commercial Code (RT I 1995, 26, 355).
[1238] Saare, K. et al. (2015), p. 338.
[1239] Chapter 24, Section 235:2 of the Commercial Code (RT I 1995, 26, 355).
[1240] Chapter 24, Section 236:1 of the Commercial Code (RT I 1995, 26, 355).
[1241] Vutt, M. (2010), p. 190.
[1242] Chapter 24, Section 236:2 of the Commercial Code (RT I 1995, 26, 355).
[1243] Chapter 24, Section 236:3 of the Commercial Code (RT I 1995, 26, 355).
[1244] Chapter 24, Section 237:1 of the Commercial Code (RT I 1995, 26, 355).
[1245] Chapter 24, Section 237:2 of the Commercial Code (RT I 1995, 26, 355).
[1246] Sander, P. and Kõomägi, M (2007), p. 200.
[1247] Chapter 24, Section 237:3 of the Commercial Code (RT I 1995, 26, 355).
[1248] Chapter 24, Section 237:4 of the Commercial Code (RT I 1995, 26, 355).

The owner of a preferred share shall have right to a dividend payment prior to other shareholders.[1249] The dividend shall be prescribed in the articles of association.[1250] The distribution shall be defined as a percentage of the nominal value or book value of the share unless the articles of association state differently. The holder of a preferred share may also receive a greater dividend distribution than prescribed in the articles of association.[1251] In case of shortage of the distributable profit the holders of preferred shares may not receive the dividend at all or may receive only part of the dividend.[1252] That part of the dividend that is not paid will be added on top of the dividend that has to be paid next year. The same timetable applies for the interest to be paid according to the law.

If dividends are not paid to the holder of a preferred share during two financial years, the right to vote is established for the holder of a preferred share.[1253] Regarding a share with nominal value the right to vote will be established according to the nominal value of the share. In case of a share without nominal value a preferred share is granted an equal number of votes with other shares. The votes of the holders of the preferred shares shall be counted in the quorum of the general meeting. The holder of a preferred share keeps the voting right until the last day of the financial year in which a dividend is fully paid.[1254]

It shall be also noted that if the right to vote is acquired, the acquisition shall not release the public limited company from the responsibility of dividend payment from the earlier years and the relevant interest according to law.[1255] It is not either possible to cancel the preferential right to get dividends and to participate in the asset distribution upon dissolution.

There are also separate rules on convertible bonds in public limited company. Subject to prescription in the articles of association, a public limited company may issue bonds by a decision of the general meeting.[1256] Such a convertible bond granting its holders the right to convert their bonds to shares may be registered.[1257] After relevant entry in the commercial register convertible bonds may be issued.[1258] According to the law the nominal value of a convertible bond shall be paid for the convertible bond in money at the minimum. It is allowed the nominal value or book value of shares issued for the bond to exceed the nominal value of the bond but only subject to that money is used to pay the difference.[1259] The sum of the nominal values of convertible bonds shall not exceed 1/3 of the share capital.[1260] As convertible bonds can be issued above the par the cap set for the nominal values of the convertible bond do not limit the actual amount received through these instruments.[1261]

Also, in case of public limited company there are rules on conditional issue of share capital related to issuance of convertible bonds.[1262] Here the management board may decide on the conditional increase of the share capital up to the total amount of the nominal values of the convertible bonds. The management board has powers to decide as well on the increase of the share capital even to the level above the sum of the nominal values of the exchangeable

[1249] Chapter 24, Section 238:1 of the Commercial Code (RT I 1995, 26, 355).
[1250] Saare, K. et al. (2015), p. 424.
[1251] Chapter 24, Section 238:2 of the Commercial Code (RT I 1995, 26, 355).
[1252] Chapter 24, Section 238:3 of the Commercial Code (RT I 1995, 26, 355).
[1253] Chapter 24, Section 239:1 of the Commercial Code (RT I 1995, 26, 355).
[1254] Chapter 24, Section 239:2 of the Commercial Code (RT I 1995, 26, 355).
[1255] Chapter 24, Section 239:3 of the Commercial Code (RT I 1995, 26, 355).
[1256] Chapter 24, Section 241:1 of the Commercial Code (RT I 1995, 26, 355).
[1257] Chapter 24, Section 241:2 of the Commercial Code (RT I 1995, 26, 355).
[1258] Chapter 24, Section 241:3 of the Commercial Code (RT I 1995, 26, 355).
[1259] Chapter 24, Section 241:4 of the Commercial Code (RT I 1995, 26, 355).
[1260] Chapter 24, Section 241:5 of the Commercial Code (RT I 1995, 26, 355).
[1261] Sander, P. and Kõomägi, M (2007), p. 200.
[1262] Chapter 29, Sections 351-351[2] of the Commercial Code (RT I 1995, 26, 355).

convertible bonds. In such a situation the difference between the nominal value of the convertible bonds and the nominal value of the shares shall be covered in money.

Conditional increase of capital is also possible by issuing subscription rights i.e. option rights.[1263] The holder of the rights has possibility to subscribe new shares as has been agreed in the resolution to issue subscription rights.[1264] It is not possible to decide on a conditional increase of the share capital exceeding existing share capital by more than 1/3.[1265] However in case of issuing subscription rights for shares that are aimed to be traded on a regulated securities market the 1/3 threshold can be exceeded if general meeting so decides with the majority of ¾ of the votes represented at the general meeting.[1266]

3.4.3.3 USA

3.4.3.3.1 About the legal system of the USA

Because of the history under the British empire the US legal system of the USA derives from the English common law. The United States was founded as a union of 13 colonies each of them declaring their independence from the British Crown 1776.[1267] Because of the strong authority of the individual states the country is a complex organization of Federal government and in total 50 states today.

The United States Constitution which came into force 1789 is the supreme law of the United States of America. It includes among other things the doctrine of the separation of powers into legislative, executive and the judicial branches.[1268] The judicial branch consist of the Supreme Court and other federal courts. The constitution gives specific powers to the national federal government.[1269] This means in practice that all powers not delegated to the federal government remains with the states.[1270] Each of the 50 states has its own state constitution, legal codes, judiciary and governmental structure.

The U.S. is a common law country. The legal system in every state is based on the common law except in Louisiana.[1271] There is limited statutory basis and judges establish common law through written opinions. These opinions bind the lower courts in their future decision-making.

3.4.3.3.2 Company legislation in the USA in general

In the USA business can be driven by four different types of firms: corporations, limited liability companies, partnerships and sole proprietorships.[1272] The most dominating type of

[1263] Chapter 29, Section 351:4 of the Commercial Code (RT I 1995, 26, 355).
[1264] Saare, K. et al. (2015), p. 294 and p. 439.
[1265] Chapter 29, Section 351:5 of the Commercial Code (RT I 1995, 26, 355).
[1266] Chapter 29, Section 351^2:1-2 of the Commercial Code (RT I 1995, 26, 355).
[1267] The Declaration of Independence is the statement adopted by the Continental Congress meeting at Philadelphia, Pennsylvania on July 4, 1776. The declaration announced that the thirteen American colonies which were at war with Great Britain, regarded themselves as thirteen newly independent sovereign states.
[1268] Vile, J.R. (2015), pp. 23-24.
[1269] The Constitution of the United States of America, Article 3, Section 2.
[1270] Bradley, C. A. (2015), p. 2.
[1271] The state of Louisiana has a legal system founded on a civil-law tradition due to the French heritage. See for more details Palmer, V.V. (2012), pp. 277- 353.
[1272] Berk, J. and DeMarzo, P. (2017), pp. 36-39.

firm in terms of economic significance is corporation.[1273] The focus in the text below is on corporations only.

The federal law sets the minimum standards for many activities of corporations. Such rules relate to securities laws like the Securities Act of 1933[1274], the Securities and Exchange Act of 1934[1275], the Sarbanes-Oxley Act of 2002[1276] and the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010[1277]. On top of that there are different systems of corporate law in each state leading to 50 different corporate legislations. This means that the US corporations are subject to both federal law and state corporate law.[1278] As the statute of the state governs the existence of the corporation and its internal affairs the US corporate law can be considered in practice to be state law.[1279]

The US Constitution allows corporations to incorporate in the state of their choice regardless of where their headquarters are.[1280] This means that states compete on ways of attracting companies into their jurisdiction due to increase of tax revenues.[1281] This has led to a massive regulative competition.[1282] Some scholars consider the regulatory competition as positive by arguing among other things that it increases the shareholder value.[1283] Those who criticize the regulatory competition see especially the decreased protection of shareholders and creditors problematic.[1284]

Every state has its own corporation statute describing the incorporation, rights and roles of shareholders and other fundamental elements of corporate life. Out of the several alternatives two sources of corporate laws have become the most significant:

- Model Business Corporation Act (later referred to also as MBCA) drafted by the American Bar Association and
- Delaware General Corporation Law (later referred to also as DGCL).

[1273] Berk, J. and DeMarzo, P. (2017), p. 38.
[1274] The Securities Act of 1933 sets requirements for corporates to provide investors financial and other significant information regarding securities being offered for public sale. See for more details SEC (2013).
[1275] The Securities and Exchange Act of 1934 created the Securities and Exchange Commission (SEC) with broad authority over the securities industry related to registration, regulation and overseeing. See for more details SEC (2013).
[1276] The Sarbanes-Oxley Act of 2002 provided reforms to enhance corporate responsibility and financial disclosures and combat corporate and accounting fraud. The Act also created the Public Company Accounting Oversight Board (PCAOB) to oversee the auditing activities. See for more details SEC (2013).
[1277] The Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 changed the U.S. regulatory system in several areas including among other things consumer protection, corporate governance, trading restrictions, regulation of financial products and credit ratings. See for more details SEC (2013).
[1278] Beinbridge, S.M. (2012), p. 4 highlights the importance of federal law for public corporations in the dual regulatory scheme of the USA. On the other hand, Cross, F.B. and Prentice, R.A. (2007), p. 12 states that corporate law is primarily created by states and not by the federal government.
[1279] Cahn, A. and Donald, D.C. (2010), p. 17.
[1280] This is based on the corporations having the same privileges and immunities as other *"citizens"* as concluded by U.S. Supreme Court in the case Santa Clara County v. Southern Pacific R.R., 118 U.S. 394 (1886).
[1281] As an example of how corporate law has been used as a device for raising tax revenues see Seligman, J., (1976), pp. 265-270.
[1282] The idea of regulatory competition was recognised by the U.S. Supreme Court in the case *Louis K. Liggett Co. v. Lee, 288 U.S. 517 (1933).*
[1283] Those who support regulatory completion describe it as the *"race to the top".* See Winter Jr., R.K. (1977) and Romano, R. (1985).
[1284] Those who criticize regulatory completion describe it as the *"race to the bottom".* See Cary, W. (1974) and Bebchuk, L.A. (1992).

Over twenty states have adopted the MBCA as the basis of their state corporation laws.[1285] However more than half of the US corporations are incorporated under the Delaware law making it as the winner in the regulative competition.[1286] Below is first reviewed briefly the MBCA and after that more comprehensively the company legislation of Delaware.

3.4.3.3.3 Model Business Corporation Act

The Model Business Corporation Act (MBCA) is a model set of law prepared by the Committee on Corporate Laws of the Section of Business Law of the American Bar Association.[1287] The MBCA was originally published in 1950. The states defined corporations in different ways which resulted in uncertainty among the different stakeholders of the corporations. This was a problem especially with the companies operating in different states than where they were incorporated.[1288] The MBCA seeked to clarify the regulative uncertainty by providing answers to several open questions and became gradually adopted by more and more states.[1289]

The model act has been continuously updated over the years. The existing version was published in December 2016.[1290]

The MBCA consists of 17 chapters and an interesting part of the MBCA regards the shares and distribution regulated in Chapter 6.[1291] According to the MBCA the articles of incorporation

---

[1285] The exact figure varies depending on how the partial adoptions are taken in the calculations. According to Bainbridge, S. (2015), p. 10 the MBCA version of MBCA has been adopted in whole by 24 states and partially by *"many others"*. According to Morris, G.G. (2015), pp. 983-984 the MBCA is basis of the corporate law of 31 states including the state of Louisiana which adopted the customised version of the Act effective January 1, 2015. Morris adds that including District of Columbia the MBCA is adopted in 32 jurisdictions.

[1286] Bainbridge, S.M. (2015), p. 10. According to the author Delaware *"…is far and away the dominant source of state corporation law. This is so because more than half of the corporations listed for trading on the New York Stock Exchange and nearly 60% of the Fortune 500 corporations are incorporated in Delaware."*

[1287] According to American Bar Association (2017) the American Bar Association (ABA*) "is committed to supporting the legal profession with practical resources for legal professionals while improving the administration of justice, accrediting law schools, establishing model ethical codes, and more."* The association is founded in 1878 and has nearly 400,000 members. ABA headquarters are located in Chicago.

[1288] See Jennings, R.W. (1958), pp. 193-196 about the regulative challenges in the early years of the first MBCA.

[1289] See Garrett, R. (1950) about the history and purpose of MBCA in general.

[1290] See Corporate Laws Committee (2017) about the revision of the Model Business Corporation Act.

[1291] Model Business Corporation Act, version 2016 is also available on American Bar Association (ABA) Internet-page. See American Bar Association (2017b). The 17 chapters including more detailed structure of Chapter 6 are as follows:

Chapter 1: General Provisions
Chapter 2: Incorporation
Chapter 3: Purposes and Powers
Chapter 4: Name
Chapter 5: Office and Agent
Chapter 6: Shares and Distributions
Subchapter A.
SHARES
§ 6.01. Authorized shares
§ 6.02. Terms of class or series determined by board of directors
§ 6.03. Issued and outstanding shares
§ 6.04. Fractional shares
Subchapter B.
ISSUANCE OF SHARES
§ 6.20. Subscription for shares before incorporation
§ 6.21. Issuance of shares
§ 6.22. Liability of shareholders

must include information of different classes of shares the corporation is authorized to issue.[1292] The prescription must define a distinguishing designation for different class or series and the terms, including the preferences, rights and limitations. According to the main rule all shares of a same class or same series must have identical terms, including preferences, rights and limitations.

The articles of incorporation must authorize any classes of shares or series of shares that jointly have unlimited voting rights and right to receive the net assets of the corporation in dissolution.[1293] The description in the articles of corporation constitutes a contract of shareholders and must therefore be done sufficiently detailed.[1294]

The articles of incorporation may authorize shares to

- have special voting rights or no right to vote unless otherwise provided by the act
- be redeemable or convertible
    - at the option of the company, the shareholder or another person or when a specific event occurs
    - for cash, indebtedness, securities or property of other kind and
    - at price and in amount specified in a formula
- entitle the holder to a distribution calculated in any method or
- have preference over any other share class or series relating to distributions.[1295]

---

§ 6.23. Share dividends
§ 6.24. Share rights, options, warrants and awards
§ 6.25. Form and content of certificates
§ 6.26. Shares without certificates
§ 6.27. Restriction on transfer of shares and other securities
Subchapter C.
SUBSEQUENT ACQUISITION OF SHARES BY SHAREHOLDERS AND CORPORATION
§ 6.30. Shareholders' preemptive rights
§ 6.31. Corporation's acquisition of its own shares
Subchapter D.
DISTRIBUTIONS
§ 6.40. Distributions to shareholders
Chapter 7: Shareholders
Chapter 8: Directors and Officers
Chapter 9: Domestication and Conversion
Chapter 10: Amendment of Articles of Incorporation and Bylaws
Chapter 11: Mergers and Share Exchanges
Chapter 12: Disposition of Assets
Chapter 13: Appraisal Rights
Chapter 14: Dissolution
Chapter 15: Foreign Corporations
Chapter 16: Records and Reports
Chapter 17: Transition Provisions.

[1292] Chapter 6, Subchapter A, Section 6.01.(a) of the Model Business Corporation Act.
[1293] Chapter 6, Subchapter A, Section 6.01.(b) of the Model Business Corporation Act.
[1294] American Bar Association (2008), p. 6-4.
[1295] Chapter 6, Subchapter A, Section 6.01.(c) of the Model Business Corporation Act.

Shares of each class or series can be issued as authorized by the articles of incorporation.[1296] Issued shares are considered to be outstanding shares until the moment they are reacquired, redeemed, converted or cancelled. Shares must be outstanding at all times if they have unlimited voting rights and are entitled to receive the net assets of the corporation upon dissolution.[1297] If company redeemed all its shares it should start the dissolution process at the time of the redemption at the latest.[1298]

According to the main rule the board of directors may authorize shares to be issued unless the articles of association reserve this right to shareholders.[1299] When shares, convertible securities or rights exercisable for shares are issued approval of shareholders are however in some situation required according to the MBCA. At the shareholders meeting a majority of the votes is required for transactions where the shares, other securities or rights are issued for other than cash consideration and the votes of shares that are issued and issuable because of the transaction will comprise more than 20% of the votes of the shares outstanding immediately before the transaction.[1300] The 20 % threshold rule mentioned above is in line with the rules of major stock exchanges in the USA.[1301]

The one who purchased from a corporation of its own shares is obliged to pay the consideration for which the shares issue was authorized.[1302] If not otherwise stated in the articles of incorporation, a shareholder of a corporation does not have personal liability for the obligations of the corporation unless he becomes personally liable due to his own actions or conduct.[1303]

A share issuance is considered to be dividend payment if shares are issued pro rata and without consideration to the shareholders.[1304] This kind of dividend payment is however not possible unless the articles of incorporation authorize that, a majority of the votes entitled to be cast by the class or series to be issued approve the issue or no shares of the class or series to be issued are outstanding.[1305]

It is possible for a corporation to issue rights, options or warrants for the purchase of its shares or other securities.[1306] It is the board of director's responsibility to determine the conditions upon which the rights, options or warrants are issued and the conditions including the consideration for which the shares or other securities are to be issued. When the board of directors for the corporation decides to issue rights, options or warrants the decision includes also authorization to issue the shares or other securities for which the rights, options or warrants can be exercised.

[1296] Chapter 6, Subchapter A, Section 6.03.(a) of the Model Business Corporation Act.
[1297] Chapter 6, Subchapter A, Section 6.03.(c) of the Model Business Corporation Act.
[1298] American Bar Association (2008), p. 6-13.
[1299] Chapter 6, Subchapter B, Section 6.21.(b) of the Model Business Corporation Act.
[1300] Chapter 6, Subchapter B, Section 6.21.(f) of the Model Business Corporation Act.
[1301] See NYSE (2017), Section 312.03 and NASDAQ (2017), Stock Market Rule 5635 (a). According to these regulations the main rule is that listed issuers must obtain shareholder approval before securities like common stock or securities convertible into or exercisable for common stock representing 20 percent or more of the common stock or voting power outstanding prior to the issuance can be issued.
[1302] Chapter 6, Subchapter B, Section 6.22.(a) of the Model Business Corporation Act.
[1303] Chapter 6, Subchapter B, Section 6.22.(b) of the Model Business Corporation Act.
[1304] Chapter 6, Subchapter B, Section 6.23.(a) of the Model Business Corporation Act.
[1305] Chapter 6, Subchapter B, Section 6.23.(b) of the Model Business Corporation Act.
[1306] Chapter 6, Subchapter B, Section 6.24.(a) of the Model Business Corporation Act.

According to the MBCA the terms and conditions of rights, options or warrants may include also some restrictions.[1307] If so decided it is possible to preclude or limit the exercise, transfer or receipt of such rights, options or warrants by some persons.

It is also possible for the board of directors to authorise its officers to define the recipients of rights, options, warrants or other equity compensation awards involving share issuance.[1308] The authorisation can also include possibility to determine the stockholders, the number of the above-mentioned instruments and their terms.

MCBA sets also some restrictions on transfer of shares and other securities. These restrictions may originate from the articles of incorporation, bylaws, a shareholder agreement or even an agreement between the company itself and the shareholders.[1309] Share transfer restrictions are quite common and their content may vary.[1310] Such a restriction is not normally applied to shares issued before the restriction became valid. However, if the shareholders themselves are parties to the restriction agreement or voted for the restriction the applicability shall cover also earlier issued shares.

A restriction on the transfer as described above is valid subject to that the restriction is noted on the certificate or in the information statement required on certificates.[1311] Unless noted like described above a restriction is not enforceable against a person who was not aware of the restriction. The purpose of the transfer restrictions is to maintain the company status when it depends on the identity or number of its shareholders, to maintain exemptions under federal or state securities law or for other proper reason.[1312]

There are several kinds of restrictions on the transfer that can be applied. Such restrictions can oblige the shareholder to give the corporation or other persons an opportunity to acquire the shares first, oblige the corporation or other persons to acquire the restricted shares, require the corporation, other shareholder or person to approve the transfer of shares or forbid the transfer of the shares to designated persons.[1313] It is specifically stated in the model act that term *"shares"* refers also to a security convertible into or carrying a right to subscribe for or acquire shares.[1314]

The shareholders of a corporation have limited pre-emptive right to acquire the corporation's unissued shares according to the MBCA. The shareholders do not have that right except to the extent the articles of incorporation so provide.[1315] According to the model act it is possible to include in the articles of incorporation a statement allowing the corporation to have pre-

[1307] Chapter 6, Subchapter B, Section 6.24.(b) of the Model Business Corporation Act.
[1308] Chapter 6, Subchapter B, Section 6.24.(c) of the Model Business Corporation Act.
[1309] Chapter 6, Subchapter B, Section 6.27.(a) of the Model Business Corporation Act.
[1310] American Bar Association (2008), pp. 6-33 and 6-34.
[1311] Chapter 6, Subchapter B, Section 6.27.(b) of the Model Business Corporation Act.
[1312] Chapter 6, Subchapter B, Section 6.27.(c) of the Model Business Corporation Act.
[1313] Chapter 6, Subchapter B, Section 6.27.(d) of the Model Business Corporation Act.
[1314] Chapter 6, Subchapter B, Section 6.27.(e) of the Model Business Corporation Act.
[1315] Chapter 6, Subchapter C, Section 6.30.(a) of the Model Business Corporation Act.

emptive rights.[1316] In such a case the principles listed in the model act shall be applied unless the articles of incorporation expressly provide otherwise.[1317]

What is applicable for the pre-emption right concerning the shares is also applicable for the pre-emption right concerning a security convertible into or carrying a right to subscribe for or acquire shares.[1318]

A corporation may acquire its own shares. The own shares acquired are considered authorized but unissued shares.[1319] This means that there is no distinction between authorized and never issued shares compared to formerly issued authorized but reacquired shares.[1320] If it is prohibited in the articles of incorporation to reissue the acquired shares the number of authorized shares shall be reduced by the amount acquired shares.[1321]

Dividend payment to shareholders is allowed by the decision of a board of directors.[1322] The restrictions of the articles of incorporation must however be taken into consideration. In addition to that distribution of dividends is not allowed if after the distribution (i) the corporation would not be able to pay its debts when they are due[1323] or (ii) the corporation's total assets would be less than the sum of its total liabilities.[1324] Unless otherwise prescribed in the articles of incorporation the *"total liabilities"* mentioned above shall also include the

---

[1316] Chapter 6, Subchapter C, Section 6.30.(b) of the Model Business Corporation Act according to which *"A statement included in the articles of incorporation that "the corporation elects to have preemptive rights" (or words of similar effect) means that the following principles apply except to the extent the articles of incorporation expressly provide otherwise.*
(1) The shareholders of the corporation have a preemptive right, granted on uniform terms and conditions prescribed by the board of directors to provide a fair and reasonable opportunity to exercise the right, to acquire proportional amounts of the corporation's unissued shares upon the decision of the board of directors to issue them.
(2) A preemptive right may be waived by a shareholder. A waiver evidenced by a writing is irrevocable even though it is not supported by consideration.
(3) There is no preemptive right with respect to:
(i) shares issued as compensation to directors, officers, employees or agents of the corporation, its subsidiaries or affiliates;
(ii) shares issued to satisfy conversion or option rights created to provide compensation to directors, officers, employees or agents of the corporation, its subsidiaries or affiliates;
(iii) shares authorized in the articles of incorporation that are issued within six months from the effective date of incorporation; or
(iv) shares sold otherwise than for cash.
(4) Holders of shares of any class or series without voting power but with preferential rights to distributions have no preemptive rights with respect to shares of any class or series.
(5) Holders of shares of any class or series with voting power but without preferential rights to distributions have no preemptive rights with respect to shares of any class or series with preferential rights to distributions unless the shares with preferential rights are convertible into or carry a right to subscribe for or acquire the shares without preferential
rights.
(6) Shares subject to preemptive rights that are not acquired by shareholders may be issued to any person for a period of one year after being offered to shareholders at a consideration set by the board of directors that is not lower than the consideration set for the exercise of preemptive rights. An offer at a lower consideration or after the expiration of one year is subject to the shareholders' preemptive rights."
[1317] American Bar Association (2008), pp. 6-38 and 6-39.
[1318] Chapter 6, Subchapter C, Section 6.30.(c) of the Model Business Corporation Act.
[1319] Chapter 6, Subchapter C, Section 6.31.(a) of the Model Business Corporation Act.
[1320] Hanks, J.J. (2011), p. 216.
[1321] Chapter 6, Subchapter C, Section 6.31.(b) of the Model Business Corporation Act.
[1322] Chapter 6, Subchapter D, Section 6.40.(a) of the Model Business Corporation Act.
[1323] Chapter 6, Subchapter D, Section 6.40.(c)(1) of the Model Business Corporation Act.
[1324] Chapter 6, Subchapter D, Section 6.40.(c)(2) of the Model Business Corporation Act.

preferential rights upon dissolution of shareholders whose preferential rights are superior to those receiving the distribution.

The so-called *"equity insolvency test"* referred to in point (i) above is based on overall judgment requiring likelihood that the company is able satisfy anticipated obligations and possible near-term refinancing needs.[1325] The *"balance sheet test"* referred to in point (ii) above is based on balance sheet items.[1326]

The board of directors may determine the legality of the distribution based on financial statements, on a fair valuation or other reasonable method.[1327]

The above-mentioned distribution rules shall not apply to distributions in liquidation.[1328]

3.4.3.3.4 "Delaware effect"

The state of Delaware has had corporate regulation already since the Delaware Constitution of 1776. At first it was based on the common law of England and later based on domestic acts.[1329] Delaware's first general corporation legislation was passed in 1883.[1330] In 1899 it was reformed by the new General Corporation Law which was strongly influenced by the liberal nature of the corporation law of neighbour state of New Jersey.[1331] However the actual rise to the pole position in the regulatory competition took place little bit later in the beginning of 1900s. This became possible when New Jersey - at that time the most popular corporate jurisdiction in the country - tightened is regulatory requirements with the support of the presidential campaign of its governor Woodrow Wilson.[1332] The antitrust and other laws passed by New Jersey in 1913 led many companies to find more favourable jurisdictions.[1333] After that more and more companies started to incorporate themselves in Delaware and since then the state has kept its position as the market leader. Although having its origins in the end of 1800s the Delaware Corporate legislation has been kept up-to-date by continuous development and several amendments have been passed during the years.

The reasons for explaining the success of Delaware General Corporation Law are at least the business-friendly legislation, legislature with corporate expertise and efficient specialised court system.

Firstly, the legislation is business friendly and the infrastructure around it is attractive.[1334] More than one hundred years of corporate jurisdiction has remained flexible and favourable especially for the management of the company. Although the regulatory competition with other states have become more intense Delaware has kept its position among other things through constant revision of the regulation.

[1325] American Bar Association (2008), pp. 6-43 and 6-44.
[1326] American Bar Association (2008), pp. 6-44 and 6-45.
[1327] Chapter 6, Subchapter D, Section 6.40.(d) of the Model Business Corporation Act.
[1328] Chapter 6, Subchapter D, Section 6.40.(h) of the Model Business Corporation Act.
[1329] See about the development of corporate regulation in Delaware in general Arsht, S.S. (1976).
[1330] Pistor, K. et al. (2002), p. 798.
[1331] Seligman, J., (1976), p. 271.
[1332] Chen, R. and Hanson, J. (2004), p. 143.
[1333] Parsons, D.F. and Slights III, J.R. (2008).
[1334] Booth, R.A. and Hamilton R.W. (2014), p. 3.

Secondly the Delaware legislature gives high priority to corporate matters bringing corporate expertise to these matters. The state officials have good cooperation with the Delaware Bar Association which is even allowed to draft the relevant legislation.[1335]

Thirdly there is a specialised court for the corporate cases which system is widely considered to be good.[1336] The Court of Chancery has no juries and the judges are called upon representing the expertise of corporate law. The court also explain on regular basis the reasons for the decisions. The long history has accumulated expertise through thousands of cases and supports also quick and effective process including ability to answer to several problems. As the Court of Chancery specialises on corporate law cases there is no backlog of criminal and tort cases and thus no similar resource challenges either as in many general courts.[1337]

The Delaware General Corporation Law (DGCL) consists of 18 subchapters.[1338] Some of the most significant of them from the perspective of the discussed topic are reviewed below.

3.4.3.3.4.1 Formation

According to the DGCL any person, partnership, association or corporation may incorporate or organize a corporation.[1339] This means that the law applies both non-stock and stock companies and even non-profit organisations making the regulation truly general.[1340]

The certificate of incorporation must include certain items. Among these obligatory matters belong among other things name of the corporation, address, nature of the business, the total number of shares of stock which the corporation shall have authority to issue and name and mailing address of the incorporator.[1341]

Besides the obligatory provisions the certificate of incorporation may also contain voluntary provisions.[1342] An example of the voluntary provisions is right to grant to the holders of the stock the pre-emptive right to subscribe to any issues of stock or to any securities of the

---

[1335] Alva, C. (1990), pp. 899-901.
[1336] Kahan, M. and Kamar, E. (2002), p. 708.
[1337] Black, L.S. Jr (2007), p.6.
[1338] Delaware General Corporation Law (Title 8, Chapter 1 of the Delaware Code). The law text is also available on the State of Delaware official Internet-page. See DGCL (2017). The 18 subchapters are as follows:
Subchapter I. Formation
Subchapter II. Powers
Subchapter III. Registered Office and Registered Agent
Subchapter IV. Directors and Officers
Subchapter V. Stock and Dividends
Subchapter VI. Stock Transfers
Subchapter VII. Meetings, Elections, Voting and Notice
Subchapter VIII. Amendment of Certificate of Incorporation; Changes in Capital and Capital Stock
Subchapter IX. Merger, Consolidation or Conversion
Subchapter X. Sale of Assets, Dissolution and Winding Up
Subchapter XI. Insolvency; Receivers and Trustees
Subchapter XII. Renewal, Revival, Extension and Restoration of Certificate of Incorporation or Charter
Subchapter XIII. Suits Against Corporations, Directors, Officers or Stockholders
Subchapter XIV. Close Corporations; Special Provisions
Subchapter XV. Public Benefit Corporations
Subchapter XVI. Foreign Corporations
Subchapter XVII. Domestication and Transfer
Subchapter XVIII. Miscellaneous Provisions
[1339] Subchapter I, Section 101(a) of the Delaware General Corporation Law.
[1340] Welch, E.P. et al. (2016), pp. CGL-5.
[1341] Subchapter I, Section 102(a) of the Delaware General Corporation Law.
[1342] Welch, E.P. et al. (2016), p. CGL-14.

corporation convertible into such stock.[1343] This kind of right - if granted - shall be expressly provisioned in the certificate of incorporation.[1344]

3.4.3.3.4.2 Powers

The company directors and stockholders possess and may exercise all the powers and privileges granted by the law or by certificate of incorporation subject to that such powers and privileges are necessary or convenient for the business.[1345] The reference *"necessary and convenient"* in the law is not considered to have significant limitation of powers.[1346]

Every corporation shall have additionally specific powers listed in the law.[1347] This list covers among other things following powers:

- purchase, sell, mortgage or pledge all or any of its property and assets wherever situated
- wind up and dissolve itself
- make donations for the public welfare or for charitable, scientific or educational purposes
- make contracts of guaranty and suretyship, incur liabilities, borrow money, issue its notes, bonds and other obligations and secure any of its obligations by mortgage, pledge or other encumbrance of its property.
- lend money for corporate purposes, invest and reinvest its funds,
- pay pensions and carry out pension, profit sharing, stock option, stock purchase, stock bonus, retirement, benefit, incentive and compensation plans, trusts and provisions for its directors, officers and employees.

Any corporation may guarantee, purchase, take, own, sell, lease, exchange, transfer or otherwise dispose of and deal with bonds and other obligations, shares or other types of securities.[1348] When owning any such securities the company may exercise all the rights, powers and privileges of ownership including the voting right.[1349]

Rules on effect of lack of corporate capacity or power and ultra vires are also included in the DGCL.[1350] According to the main rule no act shall be invalid because the corporation did not have capacity or power to do such act. However, such lack of capacity or power may be asserted in some cases by a stockholder against the corporation, by the corporation itself against former officers or directors or by the Attorney General.[1351]

[1343] Subchapter I, Section 102(b) of the Delaware General Corporation Law.
[1344] Ibid.
[1345] Subchapter II, Section 121(a) of the Delaware General Corporation Law.
[1346] Welch, E.P. et al. (2016), p. CGL-79.
[1347] Subchapter II, Section 122 of the Delaware General Corporation Law.
[1348] Subchapter II, Section 123 of the Delaware General Corporation Law.
[1349] Welch, E.P. et al. (2016), p. CGL-85.
[1350] Subchapter II, Section 124 of the Delaware General Corporation Law.
[1351] According to Subchapter II, Section 124 of the Delaware General Corporation Law
"…lack of capacity or power may be asserted:
(1) In a proceeding by a stockholder against the corporation to enjoin the doing of any act or acts or the transfer of real or personal property by or to the corporation. If the unauthorized acts or transfer sought to be enjoined are being, or are to be, performed or made pursuant to any contract to which the corporation is a

3.4.3.3.4.3 Stock and dividends

Under Delaware law every corporation may issue stocks.[1352] Stocks represent proportionate part of the share capital bringing stockholders right for distribution but stock ownership only does not mean creditors position.[1353] Stockholder is entitled also to voting rights unless certificate of incorporation specifically prescribes otherwise.[1354] The corporations are also granted the power to issue different share classes.[1355]

Any stock may be made subject to redemption.[1356] However according to the main rule after any redemption the corporation shall have outstanding at least 1 share that has full voting powers.[1357] This means in practice that each Delaware corporation must have at least one class of non-redeemable common stock. Redemption of redeemable stocks may take place for cash, property or rights or even for securities of the same or another corporation.[1358]

The holders of preferred stock shall have right to receive dividends.[1359] The number of dividends shall be stated in the certificate of incorporation or alternatively in the resolution providing for the issue of such stock. The dividends on preferred stock shall be cumulative if so expressly stated in the certificate of incorporation.[1360]

Under DGCL shares of stock with par value may be issued for a consideration that has value at least the par value.[1361] Shares of stock without par value and treasury shares may also be issued if stated so in the certificate of incorporation.[1362] Treasury shares with par value can be issued even below par as there is no requirement to demand par value consideration twice.[1363] If according to the certificate of incorporation the shareholders shall decide the consideration for the issue of any shares, at least majority vote out of the outstanding stock is required.[1364] The certificate of incorporation can prescribe even higher vote requirement.

It is possible for a corporation to determine that only a part of the consideration received for any of the issued shares shall be capital. In case of par value shares the capital, amount needs

---

party, the court may, if all of the parties to the contract are parties to the proceeding and if it deems the same to be equitable, set aside and enjoin the performance of such contract, and in so doing may allow to the corporation or to the other parties to the contract, as the case may be, such compensation as may be equitable for the loss or damage sustained by any of them which may result from the action of the court in setting aside and enjoining the performance of such contract, but anticipated profits to be derived from the performance of the contract shall not be awarded by the court as a loss or damage sustained;
(2) In a proceeding by the corporation, whether acting directly or through a receiver, trustee or other legal representative, or through stockholders in a representative suit, against an incumbent or former officer or director of the corporation, for loss or damage due to such incumbent or former officer's or director's unauthorized act;
(3) In a proceeding by the Attorney General to dissolve the corporation, or to enjoin the corporation from the transaction of unauthorized business".

[1352] Subchapter V, Section 151(a) of the Delaware General Corporation Law.
[1353] Welch, E.P. et al. (2016), pp. CGL-473 and CGL-474.
[1354] Welch, E.P. et al. (2016), p. CGL-474 where also exceptions from the main rule are mentioned.
[1355] See Knight, J.F. (2016), pp. 1002-1003, according to which the explicitly granted power to issue multiple classes of stocks is an example of regulation favoured by investors.
[1356] Subchapter V, Section 151(b) of the Delaware General Corporation Law.
[1357] Welch, E.P. et al. (2016), p. CGL-480.
[1358] As referred to in Subchapter V, Section 151 (a) of the Delaware General Corporation Law.
[1359] Subchapter V, Section 151(c) of the Delaware General Corporation Law.
[1360] Welch, E.P. et al. (2016), p. CGL-485.
[1361] Subchapter V, Section 153(a) of the Delaware General Corporation Law.
[1362] Subchapter V, Section 153(b) and (c) of the Delaware General Corporation Law.
[1363] Welch, E.P. et al. (2016), p. CGL-502.
[1364] Subchapter V, Section 153(d) of the Delaware General Corporation Law.

to be at the minimum equal to the aggregate par value of such shares.[1365] The board of directors shall define in dollars the part of consideration that shall be capital. The board of directors has a possibility to determine that at the time of issue of any shares of the capital stock issued for cash. Alternatively, the board has possibility to determine that within 60 days after the issue of any shares of the capital stock of the corporation issued for consideration other than cash. The capital amount shall be equal to the aggregate par value of shares having a par value.

There are also specific rules on rights and options respecting stock. Under DGCL corporation may issue rights or options entitling the holders of the rights and options to acquire from the corporation its shares.[1366] This possibility to issue rights and options shall be prescribed in the certificate of incorporation and approved by the board of directors. The issuance may take place when the issue and sale of any shares of stock or other securities of the corporation happens.

The terms of the rights and options including consideration to be paid for the shares in case of exercising the right or option shall be defined in the certificate of incorporation or in the relevant resolution of the board of directors.[1367] The calculation formula to be used in the consideration calculation can tie the consideration to be paid in the market prices.[1368] If the shares to be issued shall have par value, the consideration to be paid shall have value equalling at least the par value.[1369] If the shares to be issued shall not have par value, the consideration to be paid shall be determined as in case of a normal share issuance.[1370]

Stock rights and options are used in some companies as part of remuneration for key personnel. Delaware courts have been earlier critical in assessing whether the company is sufficiently compensated when such arrangements are done.[1371] The trend has however changed[1372]

Delaware corporation may acquire, own and dispose its own shares taking into consideration limitations as stated in the law.[1373] For example corporation shall not purchase or redeem its own shares when the capital of the corporation is impaired or when such transaction would cause such an impairment.[1374] As an exception other than a nonstock corporation[1375] may purchase or redeem its own shares subject to that such shares will be retired at the acquisition and the corporation capital is reduced accordingly.[1376] As another example of the limitations in law corporation shall not purchase any of its redeemable shares for more than at the price they may be redeemed.[1377]

The above-mentioned does not limit a corporation to sell again any of its acquired shares which have not been retired for a consideration as decided the board of directors.[1378]

[1365] Subchapter V, Section 154 of the Delaware General Corporation Law.
[1366] Subchapter V, Section 157(a) of the Delaware General Corporation Law.
[1367] Subchapter V, Section 157(b) of the Delaware General Corporation Law.
[1368] Welch, E.P. et al. (2016), p. CGL-520, according to which *"The value of the consideration need not necessarily be set at or above a specified percentage of the fair market value of the stock."*
[1369] Subchapter V, Section 157(d) of the Delaware General Corporation Law.
[1370] As referred to in Subchapter V, Section 153 of the Delaware General Corporation Law.
[1371] Kraus, H. (2005), p. 2-3
[1372] Kraakman, R. et al. (2017), p. 66.
[1373] Subchapter V, Section 160(a) of the Delaware General Corporation Law.
[1374] According to Welch, E.P. et al. (2016), p. CGL-540 impairment of corporation capital means that the value of net assets is below the aggregate amount represented by all the shares of the capital stock. See more about the impairment definition Welch, E.P. et al. (2016), pp. CGL-540 and CGL-541.
[1375] Nonstock companies here refer to companies not authorised to issue capital stock. See Huber, W. D. (2016), pp. 1-6 and Subchapter I, Sections 102 and 114 of the Delaware General Corporation Law.
[1376] As referred to in Subchapter VIII, Sections 243 and 244 of the Delaware General Corporation Law.
[1377] Welch, E.P. et al. (2016), p. CGL-539.
[1378] Subchapter V, Section 160(b) of the Delaware General Corporation Law.

Corporation cannot vote based on the ownership of its own shares and such shares shall neither be counted for quorum purposes.[1379] Shares that have already been called for redemption do not entitle for voting.[1380]

A subscription for a stock shall not be enforceable against a subscriber unless the subscription is done in writing.[1381]

Corporations may pay dividends upon the shares of their capital stock on two alternative conditions: out of the surplus[1382] or, if there is no surplus, out of net profits for the fiscal year based on which the dividend is declared and/or the preceding fiscal year.[1383] However if the capital of the corporation[1384] shall have been diminished by depreciation, losses or otherwise to an amount below the total capital amount represented by the outstanding stock having a preference upon the distribution no dividend pay-out is allowed until the deficiency of all classes having a preference has been repaired.

The directors of a corporation may build up a reserve or reserves out of funds available for dividends.[1385] This means that establishing reserves influences also to the amount that can be distributed. For preference shares owners having non-cumulative dividend right the possibility for board to build-up cash reserves and avoid dividend payment for several financial years constitutes a risk. In such a case if dividend is later paid out of the reserved cash the preference shares are entitled only to dividends from the last time period.[1386]

Under DGCL dividend payment may take place in cash, in property or in shares of the capital stock.[1387] When the dividend is paid in form of shares the company must have unissued capital stock or alternatively stock shares are distributed pursuant to corporation stock split-up or division.

In case of unissued capital stock, the total par value amount of the par value shares distributed shall be at the maximum equal the amount of unissued capital. The board of directors shall decide the amount when shares without par value are being declared as a dividend. This kind of decision is not needed if corporation distributes shares due to a division or split-up of stock and not as dividend payment.

3.4.3.3.4.4 Changes in Capital and Capital Stock

A corporation may retire such shares that are issued but are not outstanding.[1388] A retired share shall keep the status of an authorized and unissued share if the certificate of incorporation does not prescribe otherwise.[1389] If the reissuance of such share is not allowed

[1379] Subchapter V, Section 160(c) of the Delaware General Corporation Law.
[1380] Subchapter V, Section 160(d) of the Delaware General Corporation Law.
[1381] Subchapter V, Section 166 of the Delaware General Corporation Law.
[1382] As referred to in Subchapter V, Section 154 and Subchapter VIII, Sections 244 of the Delaware General Corporation Law.
[1383] Subchapter V, Section 170(a) of the Delaware General Corporation Law.
[1384] As referred to in Subchapter V, Section 154 and Subchapter VIII, Sections 244 of the Delaware General Corporation Law.
[1385] Subchapter V, Section 171 of the Delaware General Corporation Law.
[1386] Walther, B. (2014), p. 16, footnote 35 according to which *"Absent extraordinary facts, a rational person would never purchase non-cumulative preferred, and hence it will be assumed that all preferred stock is cumulative."*
[1387] Subchapter V, Section 173 of the Delaware General Corporation Law.
[1388] Subchapter VIII, Section 243(a) of the Delaware General Corporation Law.
[1389] Subchapter VIII, Section 243(b) of the Delaware General Corporation Law.

according to the certificate of incorporation, a certificate stating that reissuance of such share is prohibited shall be prepared, filed and become valid according to the law.[1390]

When the corporation reduces its capital due to the retirement of shares, the reduction of capital shall be effected according to the specific capital reduction rules.[1391] A corporation may reduce its capital by the amount

- represented by retired shares of capital stock
- used for the redemption or purchase of outstanding shares of capital stock
- used for conversion and/or exchange of outstanding shares of capital stock
- transferred as surplus and
    - not represented by any class of its capital stock
    - is more than the aggregate par value of shares or
    - is part of the capital represented by shares without par value.[1392]

It is not possible to make any capital reduction unless the assets of the corporation after that are enough to pay the outstanding debts.[1393] The capital reduction shall not release any payment obligation of such shareholder whose shares have not been paid in full.

3.4.3.4 Other countries

3.4.3.4.1 UK

3.4.3.4.1.1 About the UK legal system

The United Kingdom of Great Britain and Northern Ireland (UK) consists of four countries: England, Wales, Scotland and Northern Ireland. The creation of UK took place in 1801 with the union of Great Britain and Ireland.[1394] The country in its present form was established in 1922 when Ireland was divided and the independent Irish Free State (later the Republic of Ireland) was established.[1395] The UK has three legal systems:[1396]

- English law applied in England and Wales based on common law principle

[1390] As referred to in Subchapter I, Section 103 of the Delaware General Corporation Law.
[1391] Subchapter VIII, Section 243(c) of the Delaware General Corporation Law.
[1392] Subchapter VIII, Section 244(a) of the Delaware General Corporation Law.
[1393] Subchapter VIII, Section 244(b) of the Delaware General Corporation Law. See Gevurtz, F. (2010), p. 159 according to which this restriction has little relevance as capital reduction is *"simply a paper transaction"*.
[1394] The legislative agreement uniting Great Britain (England and Scotland) and Ireland is called the Act of Union and became effective on January 1, 1801. See for more details Aughey, A. and Oakland, J. (2013), pp. 10-12.
[1395] The partition of Ireland refers to the division of the island of Ireland into two distinct territories: Northern Ireland and Southern Ireland. It took place in 1921 but following the War of Independence and the Anglo-Irish Treaty the southern part became independent as the Irish Free State in 1922. See for more details Aughey, A. and Oakland, J. (2013), pp. 15-20.
[1396] Feldman, D. (2009), p. 12.

- Northern Ireland law applied in Northern Ireland based on common law principle
- Scots law applied in Scotland based on civil-law principles including elements of common law.[1397]

The UK joined the European Economic Community (now the EU) in 1973 and thus the EU legislation is incorporated into UK law. It is also requirement to recognise the jurisdiction of the European Court of Justice in matters of EU law.

Although there are several legal systems some significant fields of law apply across the UK. Main sources of UK law are legislation created by legislature, common law and European Union law.[1398]

There is no single written constitution in the UK.[1399] The constitutional law comprises many statutes, judicial decisions, conventions and treaties that can be jointly referred to as the British Constitution.[1400] For example the relationship between the Queen and Parliament has more conventional than statutory basis.[1401] Even though the Queen is the Head of State she does not take part in the actual law-making.[1402] In practice the Queen´s supreme authority is exercised by the government of the day led by the Prime Minister.

The principal legislature is the London based UK Parliament. The UK Parliament is bicameral and consists of the House of Commons and the House of Lords. The parliament is the only body that has the power to pass laws that are applicable in all four countries.

3.4.3.4.1.2 Companies Act 2006

The present Companies Act became in force in 2006-2009.[1403] The legislation introduced some important new concepts into British law. The law simplified the company regulation especially in case of smaller firms. The Act also codified the duties of directors earlier stated in the case law and gave more than before emphasis on stakeholders and longer-term view in decision-making.[1404] The Companies Act provides as well detailed rules on the constitution and maintenance of capital. All in all, it is a massive regulation package consisting of 47 parts and 1300 sections.[1405]

[1397] Le Sueur, A. et al. (2013), p. 12.
[1398] About the sources of English law in general see Slapper, G. and Kelly, D. (2015), Chapters 3-5.
[1399] Partington, M. (2015), p. 12.
[1400] Cabinet Office (2011), p. 2.
[1401] About the constitutional conventions in general see Webley, L. and Samuels, H. (2015), Chapter 12, pp. 365-393.
[1402] Partington, M. (2015), p. 30.
[1403] The law became into force in several stages. A first portion of the Act came into effect on Royal Assent in November 2006 and the last Act into force with effect from October 2009.
[1404] UK Department of Trade and Industry (2005), p. 5.
[1405] The Companies Act 2006 is divided in 48 parts as follows:
Part 1 General introductory provisions, pp. 1-6
Part 2 Company formation, pp. 7-16
Part 3 A company's constitution, pp. 17-38
Part 4 A company's capacity and related matters, pp. 39-52
Part 5 A company's name, pp. 53-85
Part 6 A company's registered office, pp. 86-88
Part 7 Re-registration as a means of altering a company's status, pp. 89-111
Part 8 A company's members, pp. 112-144
Part 9 Exercise of members' rights, pp. 145-153
Part 10 A company's directors, pp. 154-259

Types of company

The Companies Act identifies three types of limited and unlimited companies. In case of limited company, the liability of the shareholders is limited according to the constitution.[1406] In company *"limited by shares"* the liability is limited to the amount, if any, unpaid on the shares held by them.[1407] In company *"limited by guarantee"* the liability is limited to an amount the shareholders undertake to contribute to the company if the company is being wound up.[1408] In the *"unlimited company"* there is no such cap on the liability of its members.[1409]

The companies are additionally either *"private companies"* or *"public companies"*. A private company means any company that is not a public company.[1410] A private company limited by shares or guarantee and having a share capital is not allowed to offer to the public any

---

Part 11 Derivative claims and proceedings by members, pp. 260-269
Part 12 Company secretaries, pp. 270-280
Part 13 Resolutions and meetings, pp. 281-361
Part 14 Control of political donations and expenditure, pp. 362-379
Part 15 Accounts and reports, pp. 380-474
Part 16 Audit, pp. 475-539
Part 17 A company's share capital, pp. 540-657
Part 18 Acquisition by limited company of its own shares, pp. 658-737
Part 19 Debentures, pp. 738-754
Part 20 Private and public companies, pp. 755-767
Part 21 Certification and transfer of securities, pp. 768-790
Part 21A Information about people with significant control, pp. 790A-790ZG
Part 22 Information about interests in a company's shares, pp. 791-828
Part 23 Distributions, pp. 829-853
Part 24 Annual confirmation of accuracy of information on register, pp. 853A-859
Part 25 Company charges, pp. 860-894
Part 26 Arrangements and reconstructions, pp. 895-901
Part 27 Mergers and divisions of public companies, pp. 902-941
Part 28 Takeovers etc., pp. 942-992
Part 29 Fraudulent trading, p. 993
Part 30 Protection of members against unfair prejudice, pp. 994-999
Part 31 Dissolution and restoration to the register, pp. 1000-1035
Part 32 Company investigations: amendments, pp. 1035-1039
Part 33 UK companies not formed under companies legislation, pp. 1040-1043
Part 34 Overseas companies, pp. 1044-1059
Part 35 The registrar of companies, pp. 1060
Part 36 Offences under the Companies Acts, pp. 1121-1133
Part 37 Companies: supplementary provisions, pp. 1134-1157
Part 38 Companies: interpretation, pp. 1158-1174
Part 39 Companies: minor amendments, pp. 1175-1181
Part 40 Company directors: foreign disqualification etc, pp. 1182-1191
Part 41 Business names, pp. 1192-1208
Part 42 Statutory auditors, pp. 1209-1264
Part 43 Transparency obligations and related matters, pp. 1265-1273
Part 44 Miscellaneous provisions, pp. 1274-1283
Part 45 Northern Ireland pp. 1284-1287
Part 46 General and supplementary provisions, pp. 1288-1292
Part 47 Final provisions, pp. 1298-1300
Schedules 1-16

[1406] Part 1, Section 3(1) of the Companies Act 2006.
[1407] Part 1, Section 3(2) of the Companies Act 2006.
[1408] Part 1, Section 3(3) of the Companies Act 2006.
[1409] Part 1, Section 3(4) of the Companies Act 2006.
[1410] Part 1, Section 4(1) of the Companies Act 2006.

securities[1411] of the company.[1412] A public company on the other hand is a company limited by shares or limited by guarantee and having a share capital.[1413] Additionally in its certificate of incorporation must be stated that it is a public company.

Under the law the name of a limited company that is a public company must end with *"public limited company"* or *"p.l.c."*[1414] The name of a limited company that is a private company must end with *"limited"* or *"ltd."*[1415].

Share capital

In the Companies Acts term *"share"* refers to share in the company's share capital.[1416] In a limited company having a share capital each share has to have a fixed nominal value.[1417] A share allotment without a fixed nominal value is void.[1418] In a limited company it is possible to denominate shares that have a share capital in any currency and additionally different share classes may be denominated in different currencies.[1419] The rule about currencies means including an common law rule in the statute format.[1420]

In a private company with only one share class the directors have power to allot shares, grant rights to subscribe for or to convert any security into shares subject to that it is not forbidden in company´s articles.[1421] If directors by purpose act against the rule it may lead to criminal offence.[1422] The directors may have power to allot shares or grant the above-mentioned rights also in other situations if they get the relevant authority in the company's articles or by company resolution.[1423] Such an authorisation may be received for a particular purpose or for general use and authorisation may be unconditional or subject to conditions.[1424] The authorisation must include details like the maximum amount of shares to be allotted and may be valid for a period of five years at the maximum.[1425] Especially in public companies it is common to grant the power to directors by the decision of the general meeting.[1426]

Under the Companies Act shares shall not be allotted at a discount.[1427] The rationality of the rule is to make sure that company share capital is not overstated.[1428]

A company can issue shares for consideration that is cash or other than cash. According to general rule shares allotted by a company including any premium may be paid up in money or

---

[1411] Here *"securities"* means shares or debentures as defined in Part 20, Chapter 1, Section 755(5) of the Companies Act 2006.
[1412] Part 20, Chapter 1, Section 755(1) of the Companies Act 2006. About more detailed criteria on *"offer to the public"* see Part 20, Chapter 1, Sections 755(2-4) and 756.
[1413] Part 1, Section 4(2) of the Companies Act 2006.
[1414] Part 5, Chapter 2, Section 58(1). According to Section 58(2) in the case of a Welsh company the name may instead end with *"cwmni cyfyngedig cyhoeddus"* or *"c.c.c."*.
[1415] Part 5, Chapter 2, Section 59(1). According to Section 59(2) in the case of a Welsh company, its name may instead end with *"cyfyngedig"* or *"cyf."*. Section 59(3) referring to Section 60 identifies also some exceptions from the obligation to use of *"limited"* like charity companies.
[1416] Part 17, Chapter 1, Section 540(1) of the Companies Act 2006.
[1417] Part 17, Chapter 1, Section 542(1) of the Companies Act 2006.
[1418] Part 17, Chapter 1, Section 542(2) of the Companies Act 2006.
[1419] Part 17, Chapter 1, Section 542(3) of the Companies Act 2006.
[1420] Sheikh, S. (2008), p. 619.
[1421] Part 17, Chapter 1, Section 550 of the Companies Act 2006.
[1422] Ferran, E. and Ho, L.C. (2014), p. 111.
[1423] Part 17, Chapter 1, Section 551(1) of the Companies Act 2006.
[1424] Part 17, Chapter 1, Section 551(2) of the Companies Act 2006.
[1425] Part 17, Chapter 1, Section 551(3) of the Companies Act 2006.
[1426] Ferran, E. and Ho, L.C. (2014), p. 113.
[1427] Part 17, Chapter 5, Section 580(1) of the Companies Act 2006.
[1428] Birds, J. et al. eds (2010), p. 712.

money's worth including also goodwill and know-how.[1429] A share is judged to be paid in cash if the consideration received is a cash consideration.[1430] According to the statute a cash consideration is in question when payment is received in form of cash, cheque, a release of liability, an undertaking to pay later at a specific date or payment by other means giving rise to a payment in cash.[1431]

It is possible for a public company to allot shares and accept other than cash payment for that only in certain circumstances.[1432] The law identifies three requirements that must be fulfilled before share allotment for a non-cash consideration can be done. These requirements are applied even if part of the allotment is paid up otherwise than in cash.[1433] Other than cash consideration is allowed when the consideration has been independently valued, the valuation report is at the maximum six months old and the report has been sent to the proposed allottee. Valuation rules regarding a non-cash consideration are not applicable when company allots shares as part of a merger or division of public companies if an expert´s report is prepared.[1434]

A limited company having a share capital may only change its share capital by increasing it when allotting new shares or by reducing it.[1435]

Shares are of one class if the rights attached to them are in all respects uniform.[1436] Even if the rights attached to shares do not have the same dividend rights in period of twelve months after the allotment than the rights attached to other shares that alone does not constitute different classes.[1437] As such there are several ways to establish different classes of shares. The classes can be created among other things based on the different voting, dividend or redemption terms.[1438]

The authorised minimum share capital of a public company is GBP 50,000 or the similar amount in euros.[1439] The reference to euros derives from the EU directive[1440].[1441]

Debentures

The Companies Act has specific rules on debentures. According to the statute the definition *"debenture"* includes debenture stock, bonds and any other company´s securities regardless

[1429] Part 17, Chapter 5, Section 582(1) of the Companies Act 2006.
[1430] Part 17, Chapter 5, Section 583(2) of the Companies Act 2006.
[1431] Part 17, Chapter 5, Section 583(3) of the Companies Act 2006 according to which "*A "cash consideration" means*
(a) cash received by the company,
(b) a cheque received by the company in good faith that the directors have no reason for suspecting will not be paid,
(c) a release of a liability of the company for a liquidated sum,
(d) an undertaking to pay cash to the company at a future date, or
(e) payment by any other means giving rise to a present or future entitlement (of the company or a person acting on the company's behalf) to a payment, or credit equivalent to payment, in cash."
[1432] Part 17, Chapter 6, Section 593(1) of the Companies Act 2006.
[1433] Birds, J. et al. eds (2010), p. 722.
[1434] Part 17, Chapter 6, Section 595(1) of the Companies Act 2006.
[1435] Part 17, Chapter 8, Section 617(1-2) of the Companies Act 2006 in which is also referred to that the share capital reduction shall take place according to the rules set in Chapter 10.
[1436] Part 17, Chapter 9, Section 629(1) of the Companies Act 2006.
[1437] Part 17, Chapter 9, Section 629(2) of the Companies Act 2006.
[1438] Ferran, E. and Ho, L.C. (2014), pp. 142-143.
[1439] Part 20, Chapter 2, Section 763(1) of the Companies Act 2006.
[1440] Directive (EU) 2017/1132.
[1441] Birds, J. et al. eds (2010), p. 879.

whether a charge on the assets is established.[1442] Although not specifically written out in the law the general understanding is that debentures refer to any kind of security instrument.[1443]

An allotment of debentures must be registered by a company without delay and within two months after the date of the allotment at the latest.[1444] If this does not take place the company and every responsible officer of the company commit to an offence.[1445]

Certificates on allotment and transfer

A company must complete and have ready for delivery the debentures allotted within two months after the allotment.[1446] This is not applicable if the conditions of issue provide otherwise or in the case of allotment to a financial institution.[1447]

A company must also complete and be ready to deliver the debentures transferred within two months after a transfer of any of them is lodged with the company.[1448] The transfer referred here means a transfer stamped and valid or an exempt transfer in accordance to the Stock Transfer Act[1449].[1450] The requirement described above does however not apply when the issue conditions provide otherwise or in the case of allotment to a financial institution[1451].[1452]

Squeeze-out and sell-out

Sometimes the majority owner wants to get full control over company. An offer to acquire shares in a company is a takeover offer as referred to in the Companies Act if both two conditions mentioned below are fulfilled:[1453]

1) The offer regards the acquisition of all the shares or - in case there is more than one share class - all the shares of one or more classes.[1454]

2) The offer terms are the same for all the shares or - in case of there is more than one share class - all the shares of each class.[1455]

[1442] Part 19, Section 738 of the Companies Act 2006.
[1443] Gullifer, L. and Payne, J. (2015), pp. 635-637 and Birds, J. et al. eds (2010), p. 879. See about the interpretation also Tjio, H. (2014).
[1444] Part 19, Section 741(1) of the Companies Act 2006.
[1445] Part 19, Section 741(2) of the Companies Act 2006.
[1446] Part 21, Chapter 1, Section 769(1) of the Companies Act 2006.
[1447] Part 21, Chapter 1, Section 769(2) of the Companies Act 2006. The financial institution is defined in Part 21, Chapter 1, Section 778(2) of the Companies Act 2006 as follows:
"A "financial institution" means here
(a) a recognised clearing house acting in relation to a recognised investment exchange or
(b) a nominee of
- *a recognised clearing house acting in that way, or*
- *a recognised investment exchange,*

designated for the purposes of this section in the rules of the recognised investment exchange in question."
[1448] Part 21, Chapter 1, Section 776(1) of the Companies Act 2006.
[1449] As referred to in Chapter 41 of the Stock Transfer Act 1982.
[1450] Part 21, Chapter 1, Section 776(2) of the Companies Act 2006.
[1451] Financial institution here means as referred to in Part 21, Chapter 1, Section 778(2) of the Companies Act 2006. See above footnote 1447.
[1452] Part 21, Chapter 1, Section 776(3) of the Companies Act 2006.
[1453] Part 28, Chapter 3, Section 974(1) of the Companies Act 2006.
[1454] Part 28, Chapter 3, Section 974(2) of the Companies Act 2006.
[1455] Part 28, Chapter 3, Section 974(3) of the Companies Act 2006. See also Sheikh, S. (2008), p. 1129 about the variations in value between the shares of the same class.

When somebody has acquired or unconditionally contracted to acquire

(a) at the minimum 90% of the shares and

(b) in case of voting shares at the minimum 90% of the voting rights of the shares,

he may give a buy-out (squeeze-out) notice.[1456] This notice would be given to the holders of shares which the offer concerns. The described procedure applies to a takeover offer not related to shares of different classes.[1457] In practice when the acquirer absolutely wants 100 % ownership of the company, the initial acquisition offer is set to be subject acceptance level of 90 % at the minimum in order it to be possible to use squeeze-out rules later.[1458]

Regarding a case where a takeover offer concerns shares of different classes the procedure is different.[1459] If the offeror has acquired or unconditionally contracted to acquire at the minimum 90%

(a) of the shares of any class which the offer concerns and

(b) of the voting rights of those shares in case the shares in question have voting rights,

he may also give a buy-out (squeeze-out) notice.[1460] This notice would be given to the holder of any shares of that class with which the offer connects.

For the majority owner the squeeze-out right gives possibility to prevent the minority to take advantage of their hold up power subject to that the majority owner has opportunity to acquire 100 % ownership.[1461]

The holder of any voting shares who has not approved the offer may anyhow require acquisition of those shares on certain conditions.[1462] Firstly the offeror must in accordance with the approvals of the offer acquire or unconditionally contract to acquire some of the shares which the offer concerns. Secondly those shares which he has acquired or contracted to acquire shall amount at the minimum 90% in value of all the voting shares and they shall carry not less than 90% of the voting rights. If conditions are fulfilled the sell-out notice can be done by the holder of voting shares.

In case of non-voting shares, the holder of shares may require the offeror to acquire shares on slightly different conditions.[1463] Firstly the offeror must in accordance with approvals of the offer acquire or unconditionally contract to acquire some of the shares which the offer concerns. Secondly those shares which he has acquired or contracted to acquire shall amount at the minimum 90% in value of all the company´s shares. If conditions are fulfilled the sell-out notice can be done by the holder of non-voting shares.

What is mentioned about sell-out requirements above applies in a case where a takeover offer regards all the shares in a company.[1464]

[1456] Part 28, Chapter 3, Section 979(2) of the Companies Act 2006.
[1457] Part 28, Chapter 3, Section 979(1) of the Companies Act 2006.
[1458] Payne, J. (2014), p 10.
[1459] Part 28, Chapter 3, Section 979(3) of the Companies Act 2006.
[1460] Part 28, Chapter 3, Section 979(4) of the Companies Act 2006.
[1461] Payne, J. (2014), p. 8.
[1462] Part 28, Chapter 3, Section 983(2) of the Companies Act 2006.
[1463] Part 28, Chapter 3, Section 983(3) of the Companies Act 2006.
[1464] Part 28, Chapter 3, Section 983(1) of the Companies Act 2006.

For the purposes of the above-mentioned squeeze-out and sell-out rules securities of a company are treated as shares if they are convertible into or entitle the holder to share subscription.[1465] This means that takeover offer described above can also be made for convertible securities.[1466]

For the purposes of the above-mentioned squeeze-out and sell-out rules also debentures are treated as shares if debentures carry voting rights.[1467] An additional requirement is that debentures are issued by a company having voting shares or debentures with voting rights, that are traded on a regulated market.[1468]

3.4.3.4.2 Germany

3.4.3.4.2.1 About the German legal system and limited liability regulation

Federal Republic of Germany has a federal system of government that is based on democratic principles. The judicial system is established and governed by the constitution which is called the Basic Law of the Federal Republic of Germany (Grundgesetz für die Bundesrepublik Deutschland). The constitution was adopted in the Western Germany 1949[1469] and later for the unified country in 1990.[1470] The Basic Law states the leading principles of the state and basic rights. All the laws must comply with the constitution.[1471]

The highest legislative bodies are the two chambers of parliament: Bundestag and the Bundesrat. The Federal Constitutional Court is the highest judiciary body and the Federal President and the Federal Government are the highest state executive bodies. The country is divided in 16 Länder (federal states) and the legislative, judiciary and executive structure of the country is also mirrored at the level of the Länder. Each Land has its own state parliament, state constitutional courts and state governor and government. The biggest workload of the legal administration is in the Länder as all trial and intermediate courts are located in the states.[1472]

The German legal tradition has been influenced from Roman Law and German law is codified law. The codification has its roots in the period of European Enlightenment during the 17th and 18th centuries and it has led to the creation of law codes for all the major law areas.[1473]

There are two formally accepted sources of German law: statutes (Gesetz) and customary law (Gewohnheitsrecht).[1474] Statutory law is the central and primary source and it contains the constitution, statutes and executive orders, regulations, decrees and charters. As Germany is a member state of the European Union since its beginning, EU legislation is also part of German law sources. Court decisions are also legal sources but without any precedent function i.e. courts are not obliged to follow the decisions of higher courts. Courts are obliged to act according to the law rather than according to the precedents. As custom is generally

[1465] Part 28, Chapter 3, Section 989(1) of the Companies Act 2006.
[1466] Birds, J. et al. eds (2010), p. 1117.
[1467] Part 28, Chapter 3, Section 990(1) of the Companies Act 2006.
[1468] Part 28, Chapter 3, Section 990(2) of the Companies Act 2006.
[1469] The Parliamentary Council approved the Basic Law for the Federal Republic of Germany on May 8, 1949. After ratification of the parliaments of more than 2/3 of the participating German Länder, the Parliamentary Council confirmed on May 23, 1949 that the Basic Law for the Federal Republic of Germany was valid.
[1470] Kommers, D.P. and Miller, R.A. (2012), p. 1.
[1471] Article 20(3) of the Basic Law.
[1472] Kommers, D.P. and Miller, R.A. (2012), p. 3.
[1473] See about the German legal tradition in general Zartner, D. (2014), pp. 89-92.
[1474] Foster, N.G. and Sule, S. (2010), p. 49.

recognized to be the other major formal source of the law also interpretations of the law are relevant.

The legal regime for limited liability companies in Germany is provided by the Limited Liability Companies Act (Gesellschaftsrecht)[1475] which regulates a company with limited liability (Gesellschaft mit beschränkter Haftung "GmbH"). On top of that there is the German Stock Corporation Act (Aktiengesetz)[1476] which regulates the limited liability stock corporations (Aktiengesellschaft *"AG"* and Kommanditgesellschaft auf Aktien *"KGaA"*). The Limited Liability Companies Act is less complex and most of the companies in Germany are GmbHs.[1477]

3.4.3.4.2.2 German Limited Liability Companies Act

A company with limited liability (Gesellschaft mit beschränkter Haftung, GmbH) may be formed by one or more persons.[1478] The company's share capital must be at the minimum 25,000 euros.[1479] Each share must have a nominal value of a full euro amount.[1480] It is possible for a shareholder to subscribe several shares in formation of the company. The nominal values of the individual shares may be variously determined.[1481] This means that an individual

[1475] The Limited Liability Companies Act (Gesetz betreffend die Gesellschaften mit beschränkter Haftung, GmbHG) of April 20, 1892 consists of 88 Sections split in 6 Parts as follows:
Part I Formation of the company
Part II Legal relations of the company and its shareholders
Part III Representation and management
Part IV Amendments to the articles of association
Part V Dissolution and nullity of the company
Part VI Regulatory, criminal and administrative fines provisions
[1476] The Stock Corporation Act (Aktiengesetz) of September 6, 1965 consists of Sections 1-410 and is split in four books and several parts as follows:
Book 1: Stock corporation
Part 1: General regulations
Part 2: Formation of the company
Part 3: Legal relationships of the company and the shareholders
Part 4: Constitution of the stock corporation
Part 5: Accounting. Appropriation of Profits
Part 6: Amendment of the by-laws. Measures serving the procurement of capital and the reduction of capital
Part 7: Nullity of resolutions adopted by the general meeting and of the annual accounts as approved and established. Special audit for impermissible understatement
Part 8: Dissolution and declaration of the company´s nullity
Book 2: Public partly limited partnership
Book 3: Affiliated Enterprises
Part 1: Inter-company agreements
Part 2: Power of direction as well as liability and responsibilities in the case of controlled enterprises
Part 3: Integrated companies
Part 4: Expulsion of minority stockholders
Part 5: Cross-shareholding enterprises
Part 6: Group accounting
Book 4: Specific provisions, penal provisions and final provisions
Part 1: Specific provisions applying to cases in which local authorities hold an ownership interest
Part 2: Dissolution by the court
Part 3: Provisions regarding punitive fines and administrative fines. Final provisions
[1477] Destatis (2017).
[1478] Part 1, Section 1 of the Limited Liability Companies Act.
[1479] Part 1, Section 5(1) of the Limited Liability Companies Act.
[1480] Part 1, Section 5(2) of the Limited Liability Companies Act.
[1481] Part 1, Section 5(3) of the Limited Liability Companies Act

shareholder may have shares with different nominal values.[1482] The total sum of the nominal values of the shares must be anyhow equal the amount of the share capital. When contributions in kind are made, both the contribution object and the nominal value of the share must be specified in the articles of association.[1483] In such a case the shareholders shall describe in a report the material conditions that establish the appropriateness of the payments for contributions in kind.[1484] In case an enterprise is transferred to the company as a contribution in kind the annual results of the two previous financial years of that enterprise shall also be stated.

The GmbH structure provides legal shield against personal liabilities of the shareholders.[1485] This together with the relatively low costs of establishing the company are key arguments for the popularity of this company form.[1486]

Under the law a capital contribution shall be paid for each share.[1487] The exact amount of the capital contribution shall be prescribed in the articles of association. When the capital is increased the capital contribution to be paid is determined in the declaration of subscription. The capital contribution shall always be determined based on the nominal value of the share. In practice this means that the total nominal value of the shares and total share capital are equal.[1488]

When payments for the capital contributions are made that shall happen in proportion to the contributions in cash.[1489] There is no possibility to deviate from the shareholders´ obligation to pay the capital contributions.[1490] However the shareholders may be released from the payment obligation based on a capital reduction if share capital has been reduced. This exempt is possible up to the amount of that contribution by which the share capital is reduced.[1491] Relevant bookings in the balance sheet are the required.[1492]

It is possible to prescribe in the articles of association that the shareholders may decide on calling in additional payments on top of the nominal values of the share.[1493] The payment of the additional contributions shall take place in proportion to the shares.[1494] The payment obligation can be either unlimited[1495] or limited[1496]. Prescriptions of additional payment obligations in the GmbH articles of association are not very common and in case of additional capital needs borrowing or increase of share capital are more preferred alternatives.[1497]

According to the capital maintenance rules a GmbH may pay dividends to its shareholders if such payment does not lead to reduction of company capital below the minimum share capital.[1498] This means that the company may not distribute the assets it needs to maintain its

[1482] Bartl, H. et al. (2013), p. 63.
[1483] Part 1, Section 5(4) of the Limited Liability Companies Act.
[1484] Verspay, H.-P. (2014), p. 22 and Weitnauer, W. et al. (2016), p. 233. About the challenges related to contributions in kind see also Weitnauer, W. et al. (2016), pp. 290-293.
[1485] Part 1, Section 13(2) of the Limited Liability Companies Act.
[1486] Fleischer, H. (2015), p. 8.
[1487] Part 2, Section 14 of the Limited Liability Companies Act.
[1488] Bartl, H. et al. (2013), p. 211.
[1489] Part 2, Section 19(1) of the Limited Liability Companies Act.
[1490] Part 2, Section 19(2) of the Limited Liability Companies Act.
[1491] Part 2, Section 19(3) of the Limited Liability Companies Act.
[1492] Verspay, H.-P. (2014), p. 15.
[1493] Part 2, Section 26(1) of the Limited Liability Companies Act.
[1494] Part 2, Section 26(2) of the Limited Liability Companies Act.
[1495] Part 2, Section 27 of the Limited Liability Companies Act.
[1496] Part 2, Section 28 of the Limited Liability Companies Act.
[1497] Rocco, J. (2004), p. 170 and Verspay, H.-P. (2014), p. 189.
[1498] Sismangil, H.E. (2014), p. 140.

share capital.[1499] This shall however not restrict the payments that are made based on a control or profit transfer agreement[1500]. The restriction is not either applicable to payments that are covered by a full claim to counter performance or restitution against the shareholder. This means that even if company has an adverse balance status, shareholders can be benefited subject to existence of fully recoverable claims against those shareholders.[1501] Also repayment of a shareholder loan and payments against claims arising from legal acts corresponding economically to a shareholder loan are allowed. The law allows additionally repayment of any paid in additional contributions to the shareholder subject to that such contributions are not needed to cover a loss in share capital.[1502]

If payments have been made against the Limited Liability Companies Act the payments must be reimbursed to the company.[1503] This reimbursement obligation applies also for shareholders who have received payments in contravention to the law.[1504] In such a situation the recipient was getting the payment in good faith, reimbursement is possible only to the extent it is required to satisfy the creditors.[1505] If it is not possible to get the reimbursement from the recipient, the other shareholders shall be liable to cover the uncollected part.[1506] The reimbursement shall take then place in proportion to the shares of the shareholders and only to the extent it is needed to satisfy the creditors. Also in this situation that part of the reimbursement, that is not possible to collect from individual shareholders, shall be collected from the remaining shareholders in the proportion of their share ownership as described above.

A shareholders' approval shall be required for any amendment to the articles of association.[1507] The decision requires a majority of ¾ of the votes cast and the decision must also be notarised. The articles of association may include also additional requirements.[1508] To be able to increase such obligations of the shareholders which are mentioned in the articles of association a stricter decision-making requirement is set. Such an increase decision may be approved only with the consent of all the involved shareholders.[1509]

The increase of share capital requires also amendment of the articles of the association.[1510] When such a decision to increase share capital has been made, a notarised or notarially certified declaration is required by the person being the subscriber.[1511] This requirement concerns each subscribed share. The company may permit former shareholders or other persons willing to join the company by making the subscription to subscribe to a share.[1512] The notarised or notarially certified declaration as described above shall indicate the nominal value of the share. Also, here other obligations in accordance with the articles of association - if any - must be fulfilled.[1513] When a current shareholder subscribes to a share in the increased capital he shall acquire an additional share.[1514]

[1499] Part 2, Section 30(1) of the Limited Liability Companies Act.
[1500] As referred to in Book Three, Division One, Section 291 of the Stock Corporation Act.
[1501] Sismangil, H.E. (2014), p. 140.
[1502] Part 2, Section 30(2) of the Limited Liability Companies Act.
[1503] Part 2, Section 31(1) of the Limited Liability Companies Act.
[1504] Verspay, H.-P. (2014), p. 167.
[1505] Part 2, Section 31(2) of the Limited Liability Companies Act.
[1506] Part 2, Section 31(3) of the Limited Liability Companies Act.
[1507] Part 4, Section 53(1) of the Limited Liability Companies Act.
[1508] Part 4, Section 53(2) of the Limited Liability Companies Act.
[1509] Part 4, Section 53(3) of the Limited Liability Companies Act.
[1510] Bartl, H. et al. (2013), p. 583.
[1511] Part 4, Section 55(1) of the Limited Liability Companies Act.
[1512] Part 4, Section 55(2) of the Limited Liability Companies Act.
[1513] Verspay, H.-P. (2014), p. 197.
[1514] Part 4, Section 55(3) of the Limited Liability Companies Act.

It is possible to increase the share capital of the company by transforming reserves into share capital.[1515] In practice this means increasing capital from company funds.

The increase of share capital may be done by creating new shares or by increasing the nominal value of the shares.[1516] When decision to increase share capital is made the type of the capital increase must be stated in the resolution.[1517]

The new shares shall be available to the shareholders in proportion to their existing share ownership. It is not possible to deviate from this requirement. Any contrary resolution of the shareholders would be null and void.[1518]

The share capital increase shall not influence the relation between the rights associated with the shares.[1519] In case individual rights of shares have been paid partially they are determined by the capital contribution paid per share. In such a situation these rights shall be given to the shareholders only in the amount of the paid capital contributions plus the percentage of the increase in the share capital added to the nominal value of the share capital.[1520] According to the law this regards any profit sharing or voting rights. Any further payments shall increase these rights accordingly. The capital increase shall not influence the economic content of contracts which are dependent on the distribution of profits, the value of the shares, share capital or the previous capital and earnings ratio.[1521]

3.4.3.4.2.3 German Stock Corporation Act

The German Stock Corporation Act (Aktiengesetz) regulates the German limited liability stock corporations. Such company forms are "Aktiengesellschaft" (AG) and partnership limited by shares "Kommanditgesellschaft auf Aktien" (KGaA). The main difference of the two company forms is that in AG all shareholders have limited liability but in KGaA at least one partner has unlimited liability regarding the creditors of the company.[1522] All references below to regulation and practice concerning the German limited liability stock corporations relate to company form "Aktiengesellschaft" only unless specifically otherwise mentioned.

According to the German Stock Corporation Act a stock corporation constitutes a separate legal entity.[1523] This means that the stock corporation in Germany can have its own rights and obligations independent from its shareholders.[1524] The company assets set the limit for the company liability to creditors. The company shall have a capital divided into shares.[1525]

AG may be quoted on the stock exchange but this is not obligatory. According to the act the stock exchange listed corporations are corporations whose shares are in a market that is

[1515] Part 4, Section 57c(1) of the Limited Liability Companies Act.
[1516] Part 4, Section 57h(1) of the Limited Liability Companies Act.
[1517] Part 4, Section 57h(2) of the Limited Liability Companies Act.
[1518] Part 4, Section 57j of the Limited Liability Companies Act.
[1519] Part 4, Section 57m(1) of the Limited Liability Companies Act.
[1520] Part 4, Section 57m(2) of the Limited Liability Companies Act.
[1521] Part 4, Section 57m(3) of the Limited Liability Companies Act.
[1522] The nature of the partnership limited by shares is defined in Book 2, Section 278 of the Stock Corporation Act. According to the law the partnership limited by shares is a separate legal entity in which at the minimum one partner has unlimited liability towards the company creditors. The other shareholders have limited liability. The legal relations between the general partners, limited liability shareholders and third parties are governed by the General Commercial Code (Allgemeines Deutsches Handelgesetzbuch) of 1861. Otherwise the provisions of the Stock Corporation Act shall apply.
[1523] Book 1, Division 1, Section 1(1) of the Stock Corporation Act.
[1524] Bürgers, T. and Körber, T. (2017), p. 38, Frodermann, J. and Jannott, D. (2017), p. 22 and Stein, P. (2016), p. 3.
[1525] Book 1, Part 1, Section 1(2) of the Stock Corporation Act.

regulated and supervised by state recognized authorities.[1526] Additional requirement is that the market operates regularly and is accessible to the public directly or indirectly.

The company shall have the designation *"Aktiengesellschaft"* or its generally understood abbreviation[1527] in its business name.[1528] The minimum amount of the share capital shall be 50,000 euros.[1529] There is no legal obligation to exceed that amount.[1530] The company shares may be established either as par or non-par.[1531] The proportion of an individual share out of the total share capital depends on the share type.[1532] In case of par shares the par value divided by the share capital determines that proportion. In case of non-par shares, the share capital divided by the number of shares determines that proportion. Because of that it is obligatory to include in the articles of the company information on the number of shares.[1533]

Shares may constitute different kind of rights for the distribution of profits and assets.[1534] In case shares have identical rights they shall constitute one class.

The articles of the company shall include among other things business name and domicile, purpose of the enterprise[1535], amount of the share capital and division of share capital in par and non-par shares.[1536]

If special benefits are granted to individual shareholders or any other that benefit shall be specified in the articles of the company.[1537] The receiver of the benefit shall also be identified. To include such a special clause in the articles of company requires consent of all the founders of the company.[1538]

The principle of equal treatment shall be applied according to the German Stock Corporation Act. This means that all shareholders shall be treated equally under equivalent circumstances.[1539] The regulation protects shareholders from unequal treatment by the company.[1540]

The shareholders of the company do not have other obligations to make contributions than the contributions related to the share issue price.[1541] The payment obligation regards also the share premium known as agio (= part of the price that exceeds the nominal value of the share or in case of a non-par share its relative portion out of the share capital).[1542] The share issue shall be paid in cash unless the articles allow also contributions in kind.[1543]

[1526] Book 1, Part 1, Section 3(2) of the Stock Corporation Act.
[1527] The generally used abbreviation of *"Aktiengesellschaft"* is *"AG"*.
[1528] Book 1, Part 1, Section 4 of the Stock Corporation Act.
[1529] Book 1, Part 1, Section 7 of the Stock Corporation Act.
[1530] Weitnauer, W. et al. (2016), p. 146.
[1531] Book 1, Part 1, Section 8(1) of the Stock Corporation Act.
[1532] Book 1, Part 1, Section 8(4) of the Stock Corporation Act.
[1533] Stein, P. (2016), p. 5.
[1534] Book 1, Part 1, Section 11 of the Stock Corporation Act.
[1535] About the purpose of the enterprise see Bürgers, T. and Körber, T. (2017), pp. 236-237 and Stein, P. (2016), pp. 14-15.
[1536] Book 1, Part 2, Section 23(3) of the Stock Corporation Act.
[1537] Book 1, Part 2, Section 26(1) of the Stock Corporation Act.
[1538] Bürgers, T. and Körber, T. (2017), p. 257.
[1539] Book 1, Part 3, Section 53a of the Stock Corporation Act.
[1540] Frodermann, J. and Jannott, D. (2017), p. 81.
[1541] Book 1, Part 3, Section 54(1) of the Stock Corporation Act.
[1542] Stein, P. (2016), p. 200 and Baums, T. (2011), pp. 2-4.
[1543] Book 1, Part 3, Section 54(2) of the Stock Corporation Act.

The shareholders are entitled to profit distribution according to the law.[1544] This specific rule in the Stock Corporation Act is the basis of the monetary right that shareholder has towards the company.[1545]

The shareholders´ right to the company profits is dependent on the proportion of their shares in the share capital.[1546] In case contributions to share capital are not made proportionally between the shares, distribution equalling 4 % of the contribution made shall first be paid from the distributable profit.[1547] If there is not enough profit to make such payment, the lower percentage amount separately decided shall be paid. If contributions to share capital have been made during the financial year the distribution shall be done taking into consideration also the time passed since the contributions. There is possibility to deviate from the above-mentioned distribution payment rules in the articles of the company.[1548]

Shares having a preference right with respect to the profit distribution may be issued without voting rights.[1549] The preference right towards the dividend payment can be seen as a compensation for the lost voting right.[1550] The maximum amount of these non-voting preferred shares shall however be limited. These shares can exist only up to an amount which is equal to half of the share capital.[1551] A motive for a company to issue preference shares is a possibility to use financing the repayment of which does not influence to the annual profit unlike the interest payments of traditional borrowing.[1552]

Apart from the voting rights the non-voting preferred shares shall have the same rights as the other shares.[1553] However if the dividend is not fully paid for the preferred shares according to the law or articles of association the holders of preferred shares shall have right to vote until the sums in arrear have been fully paid.[1554] When having voting rights due to arrear the preferred shares shall also be included in calculations when majority is calculated according to the law or the articles of association.

When amendment of the articles is done it shall require a decision the shareholders' meeting.[1555] Such a decision requires a majority of 3/4 of the shares represented in the meeting if not otherwise prescribed in the articles of association.[1556] A specific rule applies also for situations where changing the relationship of more than one class of shares causes disadvantage to any class. In such a case the decision of the shareholders' meeting to be effective shall require the consent of the shareholders unfavourably affected.[1557] The consent shall be decided in a separate resolution. Also, in the meeting of the shareholders unfavourably affected a majority of 3/4 of the shares represented in the meeting is required unless otherwise prescribed in the articles of association. This majority requirement is milder than the general rule requiring all shareholders content if ancillary obligations were imposed on them.[1558]

[1544] Book 1, Part 3, Section 58(4) of the Stock Corporation Act.
[1545] Frodermann, J. and Jannott, D. (2017), p. 77.
[1546] Book 1, Part 3, Section 60(1) of the Stock Corporation Act.
[1547] Book 1, Part 3, Section 60(2) of the Stock Corporation Act.
[1548] Book 1, Part 3, Section 60(3) of the Stock Corporation Act.
[1549] Book 1, Part 3, Section 139(1) of the Stock Corporation Act.
[1550] Frodermann, J. and Jannott, D. (2017), p. 48.
[1551] Book 1, Part 3, Section 139(2) of the Stock Corporation Act.
[1552] Frodermann, J. and Jannott, D. (2017), p. 48.
[1553] Book 1, Part 3, Section 140(1) of the Stock Corporation Act.
[1554] Book 1, Part 3, Section 140(2) of the Stock Corporation Act.
[1555] Book 1, Part 6, Section 179(1) of the Stock Corporation Act.
[1556] Book 1, Part 6, Section 179(2) of the Stock Corporation Act.
[1557] Book 1, Part 6, Section 179(3) of the Stock Corporation Act.
[1558] Bürgers, T. and Körber, T. (2017), p. 1466. The general rule is included in the Book 1, Part 6, Section 179(3) of the Stock Corporation Act.

The shareholders may decide also on conditional increase of share capital. It is possible to decide that such an increase shall be executed only to the extent that conversion rights or stock warrants are exercised.[1559] A conditional capital increase is possible only for purposes specifically mentioned in the law:[1560]

- to grant conversion rights or stock warrants
- to prepare a merger
- to grant rights to employees as a part of a profit sharing plan.

The par value of conditional capital may not exceed 1/2 of the share capital and the par value of the capital resolved according to the profit sharing plan may not exceed 1/10 of the share capital.[1561] The maximum limits are set to protect the shareholders from excess conditional capital.[1562] Any shareholders' meeting decision contradicting the resolution on the conditional capital increase shall be null and void.[1563]

To decide on the conditional capital increase shall require a majority of 3/4 of the share capital at the minimum represented in the decision-making.[1564] The articles of company may prescribe additional requirements.

Conditional capital shall increase in the same proportion as share capital is increased.[1565] A special regulation exists for the situations where the conditional capital is established to provide conversion rights to holders of convertible or warrant bonds. In such a situation a special reserve shall be created in an amount equal to the paid premium within the issue of share capital.[1566] The premium is the difference between the actual issue price of bonds and the minimum issue price of the new shares to be issued.

Convertible bonds, warrant bonds, dividend bonds and participation rights may only be issued based on the decision of the shareholders' meeting.[1567] The resolution shall require a majority of ¾ out of the share capital represented at the minimum. It is possible to prescribe in the articles of the company even stricter majority requirements. In the law dividend bonds are defined as bonds in which the rights of the holders depend on dividends paid to shareholders.[1568] Profit participation rights are contractual participations in a company allowing the investor to participate both in profits and losses of the company.[1569] The profit participation right does not constitute a shareholder position and thus does not bring voting rights.

It is possible to grant authority for the management board to issue convertible or warrant bonds for the period of five years at the maximum.[1570] Shareholders shall also have right to subscribe convertible bonds, warrant bonds, dividend bonds and participation rights like in

[1559] Book 1, Part 6, Section 192(1) of the Stock Corporation Act.
[1560] Book 1, Part 6, Section 192(2) of the Stock Corporation Act.
[1561] Book 1, Part 6, Section 192(3) of the Stock Corporation Act.
[1562] Bürgers, T. and Körber, T. (2017), p. 1597.
[1563] Book 1, Part 6, Section 192(4) of the Stock Corporation Act.
[1564] Book 1, Part 6, Section 193(1) of the Stock Corporation Act.
[1565] Book 1, Part 6, Section 218 of the Stock Corporation Act.
[1566] About the formation of the special reserve see Bürgers, T. and Körber, T. (2017), pp. 1720-1721.
[1567] Book 1, Part 6, Section 221(1) and (3) of the Stock Corporation Act.
[1568] Ibid.
[1569] Maisto, G. ed. (2012), pp. 567-568.
[1570] Book 1, Part 6, Section 221(2) of the Stock Corporation Act.

case of share issuance.[1571] This subscription right is analogic to the shareholders´ subscription right in share issuance and can also be excluded like in case of share issuance.[1572]

3.4.4 Freedom of contract

Freedom of contract is the doctrine stating that people have the right to legally bind themselves in an agreement with one or more other parties without governmental interference. It is generally considered to be a guiding principle in the contract law.[1573] In this judicial concept the contracts are based on agreement and free choice. According to this thinking people are able to fashion their relations by private agreements without external governmental interference. This idea was declared already in the early years of economic liberalism in 18th century.[1574] Liberalism has also been associated with the ideal of freedom of contract.[1575]

Freedom of contracts includes two main elements: freedom to decide whether or not to enter into a contract and with whom (freedom to contract or party freedom) and freedom to decide on the content of agreement (term freedom).[1576]

A contract is a binding agreement between two or more parties resulting normally in performance. The law of contract sets framework with the help of which contract parties can predict and control the given commitments. The state enforces the performance with its administrative and executive powers.[1577]

The freedom of contract has often been linked in the laissez-faire capitalism and therefore the critics of freedom of contract includes also criticism to laissez-faire capitalism.[1578] The market economy is however based on contracts. All the companies have several commitments based on the agreements and an organised society assumes performance according to the agreed terms. Although freedom of contract is without doubt a fundamental principle of contract law, it is generally understood that the agreement parties may not derogate from the mandatory rules and unreasonable conditions. This can even mean in the extreme situation that contract clauses depriving the rights of the weaker party are void.

All in all the tendency has been in the last decades to more and more deviate from the most liberal interpretations of freedom of contracts due to negative social consequences.[1579] Also consumer protection, anti-discrimination laws and labour protection regulation have among other things had impact on the development of freedom of contract during the last century.[1580] Going forward contract law is estimated to develop further to the direction where search for

---

[1571] Book 1, Part 6, Section 221(4) of the Stock Corporation Act.
[1572] Bürgers, T. and Körber, T. (2017), p. 1750.
[1573] Reich, N. (2014), p. 19.
[1574] See Smith, A. (1902), p. 197 describing in the text originally published in 1776 the *"property which man has in his own labor"* as inviolable and any hinder to employ it as *"a plain violation of this most sacred property"*.
[1575] Kimel, D. (2003), p. 117.
[1576] Stone, R. and Devenney, J. (2017), p. 7.
[1577] Brownsword, R. (2006), p. 50. The author sees that one main element of freedom of contract is also *"sanctity of contract"* i.e. contracts should be enforceable by the state institutions.
[1578] See about the different views regarding laissez-faire and freedom of contract Epstein, R.A. (1997).
[1579] Atiyah, P.S. (2003), pp. 681-779 and Atiyah, P.S. and Smith, S.A. (2006), pp. 11-20.
[1580] See Collins, H. (2013) who focuses in his article on the restrictions on freedom to select a contractual partner. Beatson, J. et al. (2016), pp. 6-7 lists also compulsory transactions - like utilities providers´ legal obligation to supply water or electricity to those who want to be supplied - as one example of limitation of full freedom of contract.

an optimal equilibrium between the parties is done through more nuanced mix of facilitative and regulatory rules.[1581]

A phenomenon which has during the last decades increasingly impacted on the concept of freedom of contract is no doubt the constitutionalization of the contract law. This means growing influence of certain constitutional human and fundamental rights in the private law.[1582] The need to counterbalance existing factual and social constraints making one contractual party significantly less free than the other is described as substantive understanding of this freedom.[1583]

All constitutions do not include direct references to freedom of contract but in some European countries the constitutional courts have this freedom as a fundamental right based on the constitutional provisions.[1584] There is also example of ECJ and European Court of Human Rights jurisprudence where fundamental rights and freedoms are prioritised over private law.[1585] According to the ECJ case law the freedom of contract is considered to be one essential element of freedom to conduct a business in general.[1586] In the USA the situation is somewhat different as there the constitutional support for the freedom of contract is more clearly in place and restrictions to this freedom are seen very often unconstitutional.[1587]

Additionally, it is to be noted that the UNIDROIT[1588] Principles of International Commercial Contracts contain also elements of principle of loyalty in their principles for international commercial contracts.[1589] The right to freely decide provisions of commercial contracts is specifically emphasised as the basis of a market-oriented economy by UNIDROIT.[1590]

The conclusion is that freedom of contract is still one of the core principles of contract law. However, the constitutionalization and aspects of social fairness sometimes may require that the weaker party is protected in order it to be allowed to enjoy the freedom of contract.[1591] And how it is done may vary depending on national interpretation.[1592] In commercial transactions like mezzanine financing arrangements - where consumers are not involved as direct agreement parties - the freedom of contract exists in its widest form and thus parties are free to agree on terms very freely. This gives possibility to almost unlimited range of structures.

[1581] See Grundmann, S. (2011) regarding the development in Europe.
[1582] Micklitz, H.-W. ed. (2014), p. 1.
[1583] Colombi Ciacchi, A. (2012), p. 68.
[1584] See Colombi Ciacchi, A. (2012), pp. 69-71 about the substantive freedom of contract in the German court practice.
[1585] Cherednychenko, O. (2007), pp. 163-226.
[1586] FRA (2015), p. 21.
[1587] See Edwards, C. (2009).
[1588] UNIDROIT is an independent intergovernmental organisation that was initially founded as an auxiliary organ of the League of Nations and later - after dissolution of the Leaque - refounded in 1940. According to UNIDROIT (2018), the purpose of the organisation is to *"study needs and methods for modernising, harmonising and co-ordinating private and in particular commercial law as between States and groups of States and to formulate uniform law instruments, principles and rules to achieve those objectives".*
[1589] UNIDROIT (2016), p. 7 highlights the paramount importance of the principle of freedom of contract in its first article of general provisions: *"Article 1.1 (Freedom of contract) The parties are free to enter into a contract and to determine its content."*
[1590] UNIDROIT (2016), p. 7 mentions in the comment of the Article 1.1 that *"… The right of business people to decide freely to whom they will offer their goods or services and by whom they wish to be supplied, as well as the possibility for them freely to agree on the terms of individual transactions, are the cornerstones of an open, market-oriented and competitive international economic order."*
[1591] Cherednychenko, O. (2007), p. 11.
[1592] See Micklitz, H.-W. (2015) about cultural differences in deciding conflicting contractual issues.

3.4.5 Principle of loyalty

The principle of loyalty refers to a contractual principle according to which contract parties have to respect and honour each other´s contractual interests.[1593] This obligation is understood to mean more certain kind of behaviour rather than wording of contract terms.[1594] This behaviour can take place when contract is negotiated, closed and executed.

A contract is the outcome of the co-operation of the contract parties. The principle of loyalty as a central principle of contract law enjoys general recognition. The core idea is that the contracting parties are required to take into consideration each other's interests and rights to the extent that is reasonable. The loyalty aspect emphasizes the cooperation in reaching the agreement and equality of the contracting parties. The contract parties are expected to be loyal towards each other and act according to good manners.

In Nordic the principle of loyalty is not directly expressed in any laws but the existence of the principle is widely recognised by scholars and courts.[1595] In Germany similar kind of loyalty or good faith principle (*"Treu und Glauben"*) is included in the German Civil Code (Bürgerliches Gesetzbuch).[1596] Estonian Law of Obligations Act includes similar kind of general clause connected to the doctrine of good faith as the German Civil Code.[1597]

In common law countries principle of loyalty is not applied in a same way. In UK the prevailing understanding has been for long time until the early 20th century that commercial needs for certainty shall be prioritised over requirements of good faith in performance.[1598] In practice substantive fairness has however been present in many situations.[1599] The widespread acceptance that the concept of fairness has in Continental European appears to be gradually winning more foothold also in UK.[1600] In the USA the doctrine of good faith was recognised already in the court practice to some extent since early 20th century.[1601]

[1593] Taxell, L.-E. (1972), pp. 81-82.
[1594] Munukka, J. (2005), p. 242 and Sund-Norrgård, P. et al. (2015), p. 192.
[1595] Sund-Norrgård, P. et al. (2015), p. 192 and Sund-Norrgård, P. (2011), p. 58. About the principle of loyalty in general see for example Sund-Norrgård, P. et al. (2015), Muukkonen, P. J. (1975), Muukkonen, P.J. (1993), Mähönen, J. (2000a), Mähönen, J. (2000b), Karhu, J. (2008) and Munukka, J. (2010). To be noted the present Chapter 3, Section 33 of the Finnish Contracts Act (228/1929) regulates as follows: "*A transaction that would otherwise be binding shall not be enforceable if it was entered into under circumstances that would make it incompatible with honour and good faith for anyone knowing of those circumstances to invoke the transaction and the person to whom the transaction was directed must be presumed to have known of the circumstances."* According to Karhu, J. (2008), p. 103 this section of law is an expression of the principle of loyalty. Additionally, the present Chapter 3, Section 36:1 of the Contracts Act (228/1929) regulates as follows: "*If a contract term is unfair or its application would lead to an unfair result, the term may be adjusted or set aside. In determining what is unfair, regard shall be had to the entire contents of the contract, the positions of the parties, the circumstances prevailing at and after the conclusion of the contract, and to other factors."* According to Sund-Norrgård, P. et al. (2015), p. 192 the principle of conscionability expressed in the law section mentioned above has close connection to the principle of loyalty.
[1596] Chapter 1, Section 242 of the German Civil Code of August 18, 1896.
[1597] Chapter 1, Section 6 of the Law of Obligations Act (RT I 2001, 81, 487). See also Kull, I. (2004), pp. 37-39. According to Kull *"Acting in good faith is the highest regulatory obligation and also a principle of law in Estonian law."*
[1598] See Kiefel, S. (2015), pp. 2-3. Kiefel refers also to a Court of Appeal decision on *James Spencer & Co Ltd v Tame Valley Padding Co. Ltd (Court of Appeal, 8th April 1998, unreported)* in which Lord Justice Potter commented that *"[t]here is no general doctrine of good faith in the English law of contract. The plaintiffs are free to act as they wish provided that they do not act in breach of a term of the contract."*
[1599] Atiyah, P.S. and Smith, S.A. (2006), pp. 296-305.
[1600] Stone, R. and Devenney, J. (2017), p. 26.
[1601] Summers, R.S. (1968), Summers, R.S. (2000) and Kiefel, S. (2015), pp. 7-8.

The principle of loyalty is as well identified by UNIDROIT Principles of International Commercial Contracts.[1602] The idea of fair dealing including good faith is understood as one of the central building blocks of the principles in question. Even without specific provisions of the contract the parties must act fairly.[1603] Additionally, it is not even possible to agree that the requirement of dealing fairly and fair acting would be excluded from a specific contractual relationship.[1604] This prohibition of contract clauses that would allow *"unfair dealing"* emphasizes the wide acceptance and compulsory nature of principle of loyalty.

What is the relevance of loyalty and fairness in individual contract relations depends on the factual conditions of the transaction in question.[1605] The contract parties have to anyhow recognise and understand these concepts. This would be important especially if contract parties at some point disagreed how to interpret the wording of their agreement.

3.4.6 Pacta sunt servanda

According to the pacta sunt servanda -principle parties of the agreement shall honour their obligations and shall be bound to fulfill their contractual commitments.[1606] Based on the classic approach the principle means that the contract parties shall have a goal to perform according to the agreed terms although it would be troublesome. This contractual principle has long history,[1607] is widely recognized internationally and it is in the core of several jurisdictions including EU[1608] and USA[1609]. Without possibility to rely on the fulfillment of contracts the efficiency of the legal system would be challenged.[1610]

It is fundamental for the market economy that contractual commitments are kept.[1611] If that were not the case long-term contracts could not be easily reached due to high risks of non-enforcement. This would increase inefficiency unnecessarily.[1612]

From the view of the mezzanine financing to apply pacta sunt servanda -principle is important as such contracts are typically long term and it is imperative for the contract parties to be able to rely on other parties´ engagement for the fulfillment of the contract. On the other hand, the

---

[1602] According to UNIDROIT (2016), p. 18 there are several provisions that constitute direct or indirect references to the principle of loyalty. Some of them are included for example in following articles: *"Article 1.7 (Good faith and fair dealing) (1) Each party must act in accordance with good faith and fair dealing in international trade. (2) The parties may not exclude or limit this duty.", "Article 1.8 (Inconsistent behaviour) A party cannot act inconsistently with an understanding it has caused the other party to have and upon which that other party reasonably has acted in reliance to its detriment."* and *"Article 2.1.15 (Negotiations in bad faith)(1) A party is free to negotiate and is not liable for failure to reach an agreement. (2) However, a party who negotiates or breaks off negotiations in bad faith is liable for the losses caused to the other party. (3) It is bad faith, in particular, for a party to enter into or continue negotiations when intending not to reach an agreement with the other party."*

[1603] UNIDROIT (2016), p. 18.

[1604] UNIDROIT (2016), p. 20-21.

[1605] See for example Mäntysaari, P. (2010b), pp. 112-113 in which he uses so-called qualified contract terms *("The rights and obligations of the parties have sometimes been qualified with words "reasonable", "approximately" or "best efforts".")* to illustrate how good faith and loyalty principle influence in interpretation of contracts in different countries.

[1606] Phrase *"pacta sunt servanda"* is latin language and according to Merriam-Webster (2018) the legal definition of the phrase is *"agreements must be kept"*.

[1607] Dörr, O. and Schmalenbach, K. eds (2018), pp. 468-469.

[1608] Jansen, N. and Zimmermann, R. eds (2018), p. 508.

[1609] Eisenberg, M. A. (2018), p. 174.

[1610] Eidenmüller, H. (2011), p. 2.

[1611] Maskow, D. (1992), p. 658.

[1612] See for example Cooter, R. and Ulen, T. (2016), pp. 276-372 who emphasize the efficiency of contracting.

long term of these contracts makes them sensitive for events which the parties are unable to anticipate at the moment of committing to the contract.

Pacta sunt servanda is also identified as basic principle of contract law by UNIDROIT Principles of International Commercial Contracts.[1613]

Although the obligation to honour the contractual commitments is the main rule especially in business-to-business relations, the pacta sunt servanda -principle is not applied without exceptions. There may be several reasons why contract clauses are not binding at the end.[1614] If the fulfillment of contract obligations is not considered any more fair and reasonable taking into consideration the circumstances as a whole, the execution could be restricted for instance due to collision with the principles of loyalty and fair dealing.

In Finland the terms may become nonbinding due to error that makes the statement different from what the contract party intended and the recipient knew of the mistake.[1615] If the contract was entered under circumstances which would not be considered honourable and not to be within good faith and the contract parties have known the circumstances, this may also lead to nonbinding contract.[1616] An additional reason for leading to nonbinding terms can be unreasonable contract terms.[1617]

In Finland the initial terms of debt payment contract can become nonbinding for corporates also due to debt restructuring in connection with the statutory corporate restructuring.[1618] In such a process - due to that debtor faces imminent insolvency or is already insolvent - the original payment terms are replaced by new ones according to the restructuring programme. In practice the alternatives are to change the payment schedule, reduce the obligation to pay credit costs or even reduce the balance of the unpaid debt.[1619]

[1613] According to UNIDROIT (2016), p. 9 the following provision is based on a principle of pacta sunt servanda: *"Article 1.3 (Binding character of contract) A contract validly entered into is binding upon the parties. It can only be modified or terminated in accordance with its terms or by agreement or as otherwise provided in these Principles."*

[1614] Mäntysaari, P. (2010b), pp. 114-115 lists several reasons why contract terms are not always binding: *"First, some terms may be contrary to mandatory provisions of law. Second, terms may not be binding as they have not been properly incorporated into the contract. Third, it is possible that the person representing the other party exceeded his powers…".* He also continues by writing as follows: *"Fourth, the partial invalidity or unenforceability of the contract may mean that even other terms of the contract (or the contract as a whole) become invalid or unenforceable. Fifth, some terms of the contract may not be enforceable due to bankruptcy or insolvency laws. Sixth, it is possible that the contract is not enforceable due to the matters relating to the jurisdiction of courts and restrictions on the recognition and enforcement of judgments"*

[1615] Chapter 3, Section 32 of the Contracts Act (228/1929).

[1616] Chapter 3, Section 33 of the Contracts Act (228/1929). See also above footnote 1595.

[1617] Chapter 3, Section 36 of the Contracts Act (228/1929). See also above footnote 1595.

[1618] Chapter 7, Section 44 of the Restructuring of Enterprises Act (47/1993).

[1619] According to Chapter 7, Section 44:2 of the Restructuring of Enterprises Act (47/1993) *"The debt arrangement may also incorporate the full or partial refinancing of the debt: (1) as an one-off payment with new debt taken for this purpose; or (2) with substitute performance that is reasonable in view of the creditor's field of activities and status."*

3.5 Accounting rules

3.5.1 IFRS and mezzanine

To get correct information from the company financials is most crucial for any investor.[1620] However there are lot of factors contributing to the worldwide accounting diversity. Accounting principles vary in different countries and the differences can originate from cultural reasons, legal system, providers of finance, taxation, external forces and the accounting profession itself.[1621] Cultural reasons may also influence how the rules are de facto interpreted.[1622]

It has been observed that in countries where role of shareholders is stronger than the role of lenders the financial reporting is more geared towards meeting the needs of the shareholders. This means that the financial reports are qualitative on higher level. The reason for this is that pressure for public accountability and information disclosure increases when financing is provided by external shareholders through stock exchanges and not by banks or by family sources.[1623] In the latter alternatives the information would be available more directly. This is since banks, insurance companies, the state and other institutional investors and family owners have less need for generally published information. These investors have better connections to confidential information of the company than external private investors. Without transparent high-level information all the owners and potential investors would not have access to relevant information regarding the company performance.

In countries where institutional investors have strong position, the reporting is more oriented towards creditor protection.[1624] It means that the strong balance sheet is prioritised over transparent reporting on performance and profitability of the business.

USA and UK are examples of the countries where shareholders have prominent role. Finland, Sweden, Estonia and Germany are examples on countries where traditional professional lenders have more dominating role in terms of granting financing to companies and thus having bigger impact on accounting and reporting routines. The specific features of accounting and reporting of these example countries are discussed later in more detail.

To harmonize accounting rules, the European Union has required European companies to use IFRS (International Financial Reporting Standards)[1625]. Having an international standard is important especially for such large companies that have subsidiaries in different countries. The requirement to use IFRS has been valid starting from the for financial reporting in 2005.[1626] Since then the global trend has been towards adoption of IFRS. The global adoption

[1620] Knüpfer, S. and Puttonen, V. (2014), p. 233.
[1621] Nobes, C. and Parker, R. (2012), pp. 27-54.
[1622] Radebaugh, L.H. et al. (2006), pp. 34-59.
[1623] Radebaugh, L.H. et al. (2006), p. 16.
[1624] Nobes, C. and Parker, R. (2012), p. 35.
[1625] International Financial Reporting Standards (IFRS) is a set of accounting standards developed by the International Accounting Standards Board (IASB), which is the independent standard-setting body of the IFRS Foundation. The goal of IFRS is to provide a general global framework for public companies to prepare and disclose their financial statements. The IASB was founded in 2001 and is the successor to the International Accounting Standards Committee (IASC). See for more information IFRS (2017).
[1626] The application of IFRS in EU takes place in stages according to an endorsement process as defined in Regulation (EC) No 1606/2002 of the European Parliament and of the Council of 19 July 2002 on the application of international accounting standards. At first stage IFRS was applied to the consolidated financial statements of publicly traded EU companies in 2005 and after that companies listed on secondary capital markets followed in 2007. The next phase in the implementation process includes the application of IFRS to

of IFRS brings significant benefits for investors, regulators and supervisors. They can easier assess the entities and markets they oversee. Investors are also able to compare the financial position of companies across borders which allows investors to allocate capital on a global basis more efficiently.[1627] Adopting a single set of world-wide standards will also help the companies themselves by simplifying accounting procedures while it is allowed to use one reporting language throughout. Greater compatibility of reports leads also to better access to international capital markets and a lower cost of capital.

Mezzanine financing has features of both debt and equity. This distinction between equity and debt is important especially taking into consideration the accounting perspective. From an accounting perspective mezzanine must create equity to strengthen the capital ratio. However not all mezzanine financing fulfils this requirement.

Under IFRS capital instruments are classified either as assets, liability or equity. According to IFRS 7 there is a requirement for the entity to disclose information about the significance of financial instruments and information about the nature and extent of risks stemming from financial instruments. IFRS does not however include a separate *"mezzanine equity"* classification that is used in US GAAP[1628]. Items that are classified as mezzanine equity under US GAAP are normally classified as financial liabilities in the IFRS system.[1629] If mezzanine instrument does not meet the definitions of financial asset or financial liability as defined according to IFRS rules, then the mezzanine instrument is equity in the IFRS classification.

3.5.2 Accounting in Finland

In Finland the essential regulation covering financial information is included in the provisions of the Accounting Act[1630], Accounting Decree[1631] and the provisions in Limited Liability Companies Act[1632]. These acts define how the financial statements and the annual report shall be prepared. Accounting regulation tells how liabilities are technically divided between debt and equity in the balance sheet of a limited liability company and the Limited Liability Companies Act defines the corporate nature of the capital input.[1633]

On top accounting and company laws the IFRS regulation has also major relevance for stakeholders operating in the securities market.[1634] However the Securities Markets Act[1635] in Finland contains only few rules regarding the financial statements which complement the actual accounting regulation of Accounting Act, Accounting Decree and IFRS.[1636] According to the Securities Market Act the issuer of a security[1637] shall make its annual financial

small and medium enterprises (SMEs). The SME application of IFRS is a modification and simplification of full IFRS. Unlike in case of full IFRS application for the public companies the EU leaves it to the member states to make individual decisions with respect to adoption of IFRS for SMEs.

[1627] Ball, R. (2006), p. 11.

[1628] Generally Accepted Accounting Principles in the USA adopted by the U.S. Securities and Exchange Commission (SEC).

[1629] PwC (2017b), p. 10-3.

[1630] Finnish Accounting Act (1336/1997).

[1631] Finnish Accounting Decree (1339/1997).

[1632] Limited Liability Companies Act (624/2006).

[1633] Mähönen, J. and Villa, S. (2012), p. 84.

[1634] IFRS-standards became part of the Finnish legislation with the Law amending the Finnish Accounting Act (1304/2004) which came into force on December 1, 2004.

[1635] Securities Markets Act (746/2012).

[1636] Myllymäki, J. (2013), p. 115.

[1637] According to Chapter 2, Section 2 of the Securities Markets Act (746/2012) security means among other things 1) a share and a depositary receipt in relation to such right; 2) a bond or other securitised debt as well as a depositary receipt in relation to such right; 3) any other security giving the right to acquire or sell a security

statement public without delay until three weeks before the general meeting, where the annual financial statement shall be presented for adoption and at the latest three months after the end of the financial period.[1638] This obligation would regard issuance of both debt and equity instruments and even securities having hybrid nature.[1639] All in all the rules of Securities Market Act can be seen as complement to the actual accounting regulation of Accounting Act, Accounting Decree and IFRS.[1640]

Although Accounting Act and Accounting Decree require the division of equity and debt in the financial information disclosure they do not define the criteria of division. The international IFRS rules however provide more detailed definitions for debt and equity instruments. The Accounting Act requires that company having issued securities to be traded in the regulated market in European Economic Area has to prepare its consolidated accounts in conformity with international accounting standards.[1641] With the *"international accounting standards"* is referred here to the totality of accounting standards as defined in the EU regulation on the application of IFRS.[1642] Even if there is no obligation for a company above to prepare consolidated accounts its financial statement has to be prepared in conformity with the international accounting standards.[1643] This means that the listed companies applying IFRS rules shall prepare their profit and loss and balance sheet formulas according to IAS 1 -standard[1644] and not according to the formulas of the Account Decree.[1645]

It shall be noted that also other companies than those who are obliged to use IFRS-standards can use IFRS-standards subject to that company financials are audited.[1646]

When applying IFRS-standards the issuer must classify the financial instruments as financial assets, financial liabilities or equity instruments.[1647] In order to do that financial assets must be recognised and measured and disclosed according to the standards.[1648]

According to IFRS rules a financial liability can be any liability containing a contractual obligation to deliver financial asset or to exchange financial assets or liabilities or a contract that will or may be settled in the entity's own equity instruments.[1649] A financial instrument that fulfils the criteria of financial liability shall be classified as an equity instrument if it meets the specific conditions set in the standards.[1650] In case of mezzanine financing there may sometimes be a problem to differentiate between liabilities and equity due to mezzanine

---

referred to in points 1 or 2 above or a security giving rise to a cash settlement determined by reference to a security, currency, interest rate or yield, commodity or other index or measure.

[1638] Chapter 7, Section 5 of Securities Markets Act (746/2012).

[1639] Myllymäki, J. (2013), p. 115.

[1640] Myllymäki, J. (2013), p. 115.

[1641] Chapter 7a, Section 2:1 of the Finnish Accounting Act (1336/1997).

[1642] According to Article 2 of the Regulation (EC) No 1606/2002 of the European Parliament and of the Council of 19 July 2002 *"international accounting standards"* shall mean International Accounting Standards (IAS), International Financial Reporting Standards (IFRS) and related Interpretations (SIC-IFRIC interpretations), subsequent amendments to those standards and related interpretations, future standards and related interpretations issued or adopted by the International Accounting Standards Board (IASB). See above also footnotes 1625 and 1626.

[1643] Chapter 7a, Section 2:2 of the Finnish Accounting Act (1336/1997).

[1644] About IAS 1 -standard see for example PKF (2017), pp. 43-60.

[1645] Chapter 7a, Section 4 of the Finnish Accounting Act (1336/1997) and Chapter 5a, Section 2 of the Finnish Accounting Decree.

[1646] Chapter 7a, Section 3:2 of the Finnish Accounting Act (1336/1997).

[1647] IAS 32.2 and IAS 32.15.

[1648] IAS 32.3 refers to the principles of IAS 32 as being complement standards of IFRS 9 *Financial Instruments* and IFRS 7 *Financial Instruments: Disclosures.* IFRS 9 includes the principles for recognising and measuring financial assets and financial liabilities and IFRS 7 regards disclosing information about them.

[1649] IAS 32.11.

[1650] IAS 32.16.

instrument having equity characteristics in substance but debt characteristics from the legal point of view. An example of a compound instrument that contains both liability and equity components is a convertible bond. Such components must be classified as financial assets, financial liabilities or equity instruments separately.[1651] However in general mezzanine instruments like capital loan and debentures are normally classified as liabilities in IFRS financials.[1652]

Accounting Act regulates that such a capital loan that would be classified as equity in the IFRS financials can also be booked as equity in the financial statements not to be done according to IFRS.[1653] The logic here is to harmonize the practice between the companies using international accounting standards with those applying local standards. The rule - which came into force on January 1, 2016 in the latest major amendment of the Accounting Act - provides an option for the borrower and is not compulsory.[1654] If this option is not used capital loan shall be recorded as an item in the liabilities. Before the referred amendment entered into force the Finnish Accounting Standards Board (KILA) has made a recommendation according to which capital loan shall be disclosed as a liability item in the balance sheet prepared according to the Accounting Act.[1655] That recommendation can still be considered valid unless the booking into equity based on the IFRS-argument is not done.

3.5.3 Accounting in other countries

3.5.3.1 Sweden

The Swedish regulation for accounting is based primarily on Bookkeeping Act[1656] and Annual Accounts Act[1657] . Both laws are general frameworks for accounting applying generally accepted accounting principles. In case of Sweden the generally accepted accounting principles refers to conducting bookkeeping in accordance with prevailing laws on the area, accepted practice and the Swedish Accounting Standards Board's (BFN)[1658] general guidelines. On top of that Swedish Financial Reporting Board (RFR)[1659] provides interpretation recommendations for companies applying IFRS regulations. This is an example of Swedish system of where framework legislation is complemented by regulation provided by specific authorised bodies.[1660]

[1651] IAS 32.15 and IAS 32.28. See also about the different components Haaramo, V. (2012), pp. 129-130.
[1652] Myllymäki, J. (2013), p. 117 and Government Bill for the Limited Liability Companies Act (HE 109/2005), p. 120.
[1653] Chapter 5, Section 5c of the Finnish Accounting Act (1336/1997).
[1654] Government Bill for the Law amending the Accounting Act (HE 89/2015), p. 88.
[1655] KILA 1787/2006.
[1656] Accounting Act (SFS 1999:1078).
[1657] Annual Accounts Act (SFS 1995:1554), in Swedish *"årsredovisningslagen"*.
[1658] The Swedish Accounting Standards Board (Bokföringsnämden, BNF) is the government's expert body in the field of accounting. The Board is responsible for developing generally accepted accounting principles. It issues general guidelines for provisions in the Bookkeeping Act and Annual Accounts Act. The Swedish Accounting Standards Board operates under Ministry of Finance and its members are appointed by the government.
[1659] The BFN has delegated to the private sector body Swedish Financial Reporting Board (Rådet för finansiell rapportering, RFR) the authority to develop interpretations of IFRS in Sweden. This includes additional mandatory disclosures to be included in consolidated financial statements of the Swedish listed companies.
[1660] Bjuvberg, J. (2010), p. 21.

For financial years starting after December 31, 2013 the annual reports of a limited company must be prepared in accordance with the so-called K-regulations issued by the BFN.[1661] As an EU-country also IFRS-standards are applied in Sweden since 2005.

In case of Swedish companies applying IFRS regulation the mezzanine instruments shall be classified in the financials based on the IAS 32[1662] and in some situations also the RFR 2 recommendations.[1663] In practice IAS rules are followed unless there is discrepancy with the Swedish law. As IAS 32 requires accounting of the item according to its economic characteristics and not according to its legal form there may be conflicting situations. In case of preference shares the instrument should be classified according to RFR 2 as equity due to the specific reference in the Annual Accounts Act even if the instrument fulfilled the characteristics of debt according to IAS 32.[1664] Any deviation from the IAS 32 must be separately disclosed in the financial statements.[1665]

For those companies that do not apply IFRS-standards the K-regulation of BFN is to be followed. The purpose of the K3-rules is to be the primary accounting regulatory framework for the companies that are obliged to prepare financial statements in accordance the Annual Accounts Act.[1666] It is mandatory regulation for all large non-public companies that do not choose to apply IFRS and RFR rules. In addition to that K3 is alternative of the K2 regulation for small non-public companies. The definition of a large company here originates from the Annual Accounts Act. According to that a company is large if it meets a minimum of two of the following criteria two consecutive years:[1667]

- more than 50 employees
- balance sheet total of more than 40 million SEK
- turnover above 80 million SEK.

According to K3-rules financial instruments shall be classified either to debt or equity.[1668] The split shall be done based on the instrument´s economical characteristics.[1669] For example instrument shall be considered debt if the company has obligation to repay the received financing before liquidation or if the repayable amount is limited to a certain maximum amount in the liquidation.[1670] An example of equity is instrument that has due to the subordination the lowest repayment priority and if it additionally means for the company obligation to repay proportional share out of the net assets only in case of liquidation.[1671] The K3 - just like RFR - does not allow deviation from the equity classification according to the

[1661] The purpose of the K-regulation is to simplify the financial reporting for smaller companies. There are four sets of accounting regulations from which a company will choose one to follow depending on the size of a company. The basis is the Annual Accounts Act and each of the four regulation sets target to meet the company's complexity level. The K-regulation categories are as follows:
- K1 (BFNAR 2006:1): Sole traders establishing simplified financial statements.
- K2 (BFNAR 2008:1): Annual reporting in small companies.
- K3 (BFNAR 2012:1): Annual reporting and consolidated financial statement.
- K4 is for companies who must or choose to follow IFRS.

[1662] PKF (2017), pp. 633-645.
[1663] See RFR 2 (2017), p. 7 about the applicability of IFRS and RFR 2 rules in general.
[1664] RFR 2 (2017), p. 23 and Skatteverket (2012), p. 74.
[1665] RFR 2 (2017), p. 23.
[1666] See about the applicability of BFN (2016), pp. 12-16.
[1667] Chapter 1, Section 3:1 of the Annual Accounts Act (1995:1554).
[1668] BFN (2016), pp. 200-201.
[1669] BFN (2016), pp. 201-202.
[1670] Ibid.
[1671] BFN (2016), p. 202.

Annual Accounts Act.[1672] This means that preference shares should be classified as equity due to the specific reference in the Annual Accounts Act even if the instrument fulfilled the economical characteristics of debt.

3.5.3.2 Estonia

The general principles of accounting in Estonia are set out in the Accounting Act[1673]. The regulation provides legal bases for organizing accounting and financial reporting pursuant to internationally recognised principles.[1674] According to the Accounting Act commercial undertakings may decide whether to prepare their annual financial statements according to Estonian Accounting Standards (accounting principles generally accepted in Estonia i.e. Estonian GAAP) or IFRS.[1675] Listed companies, credit institutions and insurance companies are required to follow IFRS. This means that the preparation of financial statements should be done in accordance with either IFRS adopted by EU or accounting principles generally accepted in Estonia (also known as Estonian GAAP). The Estonian Accounting Standards are provided by the Accounting Standards Board which acts under the supervision of the Ministry of Finance.[1676]

The present Estonian GAAP which is valid since 2013 has its basis on IFRS for Small and Medium- sized Entities (IFRS for SMEs).[1677] There are some differences compared to IFRS for SMEs with regard to accounting policies and to disclosure requirements but differences are limited.[1678] The main differences between new Estonian GAAP (2013) and the IFRS for SMEs are as follows:[1679]

- Estonian GAAP contains a possibility to choose the policy for development costs (either IFRS for SMEs or IFRS)
- Estonian GAAP contains a possibility to choose the policy for government grants (either IFRS for SMEs or IFRS) and
- some variance in disclosure requirements.

As a summary can be stated that the Estonian GAAP is a simplified version of IFRSs having the recognition and measurement rules based on IFRSs but less demanding disclosure requirements.[1680] For example the guideline RTJ 3 of the Estonian GAAP covering the classification of financial instruments is in compliance with the policies of IAS 32.[1681]

[1672] BFN (2016), pp. 202-203.
[1673] Accounting Act (RT I 2002, 102, 600).
[1674] Chapter 1, Section 1 of the Accounting Act (RT I 2002, 102, 600).
[1675] Chapter 3, Section 17:1 of the Accounting Act (RT I 2002, 102, 600).
[1676] According to Chapter 5, Section 32:1-2 of the Accounting Act (RT I 2002, 102, 600)
"(1) The Government of the Republic shall establish the Accounting Standards Board (hereinafter Standards Board) whose function is to issue accounting guidelines explaining and specifying this Act and to direct activities in the field of accounting.
(2) The Standards Board is an independent committee whose rules of procedure (hereinafter rules of procedure) shall be approved by the Government of the Republic on the proposal of the Minister of Finance. The Standards Board shall be served by the Ministry of Finance."
[1677] See more detail about the adoption process of Estonian GAAP more in detail Alver, L. et al. (2014).
[1678] Alver, L. et al. (2014), p. 249.
[1679] IFRS Foundation (2016c), p. 5.
[1680] Alver, L. et al. (2013), p. 3.
[1681] Strouhal, J. ed. (2011), p. 86.

3.5.3.3 USA

The national accounting traditions started to lose their strong position due to the globalisation when international capital markets and investors started to demand more informative financial reporting.[1682] As part of trying to create more global accounting standards IASC - the predecessor of IASB [1683] - started to increasingly cooperate with the US security regulators in the end of 1980´s.[1684] Due to the political pressures to liberalise the strict disclosure requirement also the Securities and Exchange Commission (SEC)[1685] in the USA was ready for the increased cooperation.[1686] SEC has been described to target then for a creation of international rules that would be acceptable to the USA.[1687]

The cooperation has continued also between IASB and the FASB[1688] in the new millennium. On September 2002 IASB and FASB signed a common agreement - also known as the Norwalk Agreement - where the parties set out the commitment to develop compatible, high-quality accounting standards to be used for both domestic and cross-border financial reporting.[1689] "The objective was not only meant to eliminate differences between IFRS and U.S. GAAP whenever possible, but to also achieve convergence in accounting standards that stood the test of time " as has been described by the SEC Chief Accountant.[1690] After the Norwalk Agreement the cooperation has continued, many individual standards have been converged but full convergence is still missing.[1691]

Today the SEC allows - but does not require - foreign private issuers to use IFRS in preparing their financial statements.[1692] However the SEC does not allow the domestic issuers to apply IFRS in preparing the financial statements but obliges them to use US GAAP.[1693] However even if local GAAP is used there may sometimes be need to convert the financials into IFRS

[1682] Camfferman, K. and Zeff, S.A. (2007), p. 14.
[1683] About IASC and IASB see above footnote 1625.
[1684] Crawford, L. et al. (2014), p. 306.
[1685] The Securities and Exchange Commission (SEC) is a U.S. government agency that regulates the securities markets, protects investors and monitors the corporate takeovers in the U.S. SEC administers statutes that promote full public disclosure and protect the investors against fraudulent and manipulative practices in the securities markets. The Chief Accountant (CO) of SEC is the principal adviser to the Commission related to accounting and auditing.

The CO Office assists the Commission in executing its responsibility to establish accounting principles, and for overseeing the process of private sector standards-setting. The CO Office works closely with the Financial Accounting Standards Board (FASB), whose accounting standards (also known as US GAAP) the Commission has acknowledged as generally accepted for purposes of the federal securities laws, the International Accounting Standards Board and the American Institute of Certified Public Accountants.

Additionally, the Commission is responsible for the approval or disapproval of auditing rules forwarded by the Public Company Accounting Oversight Board (PCAOB), which is a private-sector regulator founded by the Sarbanes-Oxley Act to supervise the auditors. The Commission approves the annual budget of PCAOB and has on top of that oversight responsibility of the Board activities. The Office of the Chief Accountant assists the Commission in the execution work and is the principal liaison with the PCAOB. Concerning the application of accounting and auditing standards and financial disclosure requirements the Office consults with registrants and auditors on a regular basis, too.
[1686] Hopwood, A.G. (1994), p. 244.
[1687] Hopwood, A.G. (1994), p. 244.
[1688] About FASB see above footnote 1685.
[1689] Gray, K. et al. (2016), p. 182.
[1690] Extract of the speech of Mr. James Schnurr, Chief Accountant of SEC given on May 7, 2015. The speech is published on SEC website. See SEC (2017).
[1691] Gray, K. et al. (2016), pp. 182-183.
[1692] IFRS Foundation (2017), p. 2.
[1693] Ibid.

language. Such a situation exists if the US company is owned by foreign parent applying IFRS rules.

Regarding mezzanine instruments there are some differences in accounting between IFRS and US GAAP. Accounting of convertible debts and puttable equity instruments are used here as two examples of different accounting approaches.

In case of convertible debt, the conversion option must be always separated from the debt part and both components must be recognised and accounted for separately according to IFRS.[1694] Under U.S. GAAP the separation is precluded unless certain specific conditions are fulfilled.[1695] To determine the proper accounting of the equity conversion option, a detailed analysis of the terms and conditions must be done.

Puttable equity instruments where the holder has right to exercise the put option are typically classified as equity under IFRS subject to fulfilment of the equity criteria of IAS 32.[1696] In case of US GAAP these kind of puttable equity instruments are also typically classified as equity, because redemption is not certain to occur.[1697] However there is also possibility to classify them as mezzanine equity due to mezzanine classification option in US GAAP. When a redemption term of a puttable instrument is not solely under the control of the issuer, an SEC registrant is required to present the instrument in the balance sheet between permanent equity and liabilities as *"temporary equity"* or *"mezzanine equity"*.[1698]

3.5.3.4 Other countries

3.5.3.4.1 UK

The UK company law provides the legislative framework according to which the companies must operate and several accounting requirements are included in the Companies Act.[1699] The Generally Accepted Accounting Principles in the UK (UK GAAP) broadly comprise the accounting regulation of the Companies Act and UK accounting standards adopted by the Financial Reporting Council (FRC)[1700] and its predecessors over many years. The latest accounting standards FRS 102 applicable in the UK and Republic of Ireland became effective for accounting periods beginning after January 1, 2015. FRS 102 is based on the IFRS for SMEs but with several modifications.[1701] Additionally under the EU regulation all listed companies in the UK must prepare their consolidated financial statements using IFRS as adopted in the EU.

The unlisted UK companies are permitted to choose whether to prepare their account according to IFRS or in accordance with UK GAAP. UK GAAP and IFRS have in certain areas

---

[1694] IAS 32:28-29.
[1695] PwC (2017b), p. 10-2.
[1696] PKF (2017), p. 635.
[1697] PwC (2017b), p. 10-2.
[1698] EY (2015), pp. 9-10.
[1699] Part 15 of the Companies Act 2006.
[1700] The Financial Reporting Council (FRC) is the UK's independent regulator responsible for promoting corporate governance and reporting to foster investment. FRC promotes high standards of corporate governance and sets standards for corporate reporting, audit and actuarial practice. FRC also monitors and enforces accounting and auditing standards. Under its responsibility belongs also overseeing the regulatory activities of the actuarial profession and the professional accountancy bodies.
[1701] IFRS Foundation (2016d), p. 6.

different approaches.[1702] However regarding liabilities and equity the differences are very limited and broadly UK GAAP is consistent with IAS 32.[1703]

3.5.3.4.2 Germany

As Germany is an EU member state and the German companies listed in an EU securities market follow IFRSs since 2005. For non-listed companies there is an option to prepare the consolidated financials according to the German Commercial Code (Handelsgesetzbuch, HGB)[1704] or IFRS. Regarding the individual financial statements, the companies must prepare financial statements in accordance with to the German Commercial Code which has been revised as an alternative to the IFRS for SMEs.[1705] For information reasons they may however also prepare financial statements in accordance with IFRS.[1706] Additionally the large corporations may use IFRSs instead of the German Commercial Code for publishing their individual financial statements in the Federal Gazette.

The Accounting Standards Committee of Germany (ASCG)/Deutsches Rechnungslegungs Standards Committee (DRSC) is the national accounting standardisation organisation recognised as responsible standardisation organisation for Germany by the Federal Ministry of Justice. The German GAAP is based on standards set by ASCG.[1707] The legal basis for its activities is included in the German Commercial Code.[1708]

Mezzanine financing aims to create equity from an accounting perspective to strengthen the capital ratio and debt from the taxation perspective to create tax deductible interest payment.[1709] According to the German GAAP - which has its basis in the German Commercial Code (HGB) - the mezzanine instruments shall be divided in the balance sheet into debt and/or equity. Disclosure as equity is possible only subject to fulfilment of all the following characteristics:[1710]

- repayment ranking priority only after all the other debts
- profit-related compensation and covering of losses up to the principal amount
- long term lending.

[1702] See about differences in general KPMG (2015b).
[1703] KPMG (2015b), pp. 180-191.
[1704] German Commercial Code (Handelsgesetzbuch) of May 10, 1897.
[1705] IFRS Foundation (2016e), p. 5.
[1706] Kreipl, M. et al. (2014), pp. 138-139.
[1707] ASCG (2018), sets following objectives for the ASCG:
"a.to develop recommendations for the application of principles for consolidated financial reporting;
b. to provide advice on planned legislation on accounting regulations at national and EU level;
c. to represent the Federal Republic of Germany in international accounting and financial reporting bodies;
d. to develop Interpretations of the international accounting standards within the meaning of Section 315e(1) of the Handelsgesetzbuch (HGB - German Commercial Code);
e. to enhance the quality of accounting and financial reporting;
f. to promote research and education in the above-mentioned areas."
[1708] See Book 3, Part 5, Section 342 of the German Commercial Code.
[1709] Siedler, N.-L. (2014), p. 19.
[1710] Brokamp, J. et al. (2011), p. 124.

3.6 Taxation rules

3.6.1 Mezzanine from taxation perspective

3.6.1.1 Thin capitalisation

The way how a company is capitalised can have a major impact on the profit to be reported. That on the other hand will impact to the amount of taxes to be paid. As companies are financed normally both buy debt and equity the absolute and relative amount of different financing forms has relevance. Tax regulations normally permit a deduction for the paid interest or payable in arriving at the tax measure of profit.[1711] The higher the amount of debt in a balance sheet the lower is the profit to be taxed. Therefore, debt is typically more efficient financing form than equity. The differences in tax treatment between interest and dividends leads to decreased tax payments for a company increasing its indebtedness.

A company is by definition thinly capitalised when it has high level of debt in relation to equity. Thinly capitalized companies are often referred to as highly leveraged or highly geared companies.[1712] If the debt causing abnormally high leverage is granted by the group company or by the party considered to be otherwise affiliated to the borrower the financing transaction becomes problematic from the taxation perspective.[1713] The so-called thin-capitalisation rules refer to restrictions on the deductibility of debt imposed by the governments.[1714]

Corporate thin capitalisation is often seen in a context of international groups as such groups are often in a position to structure their financing arrangements to maximise the tax benefits.[1715] They can establish a tax-efficient combination of equity and debt in borrowing countries and have chance to channel the interest to countries with low tax rates. As a company can normally not borrow more than an arm's length lender is willing to lend, in an intra-group lending the situation can be different. As the interest paid remains within the group the consolidated profitability will not be harmed and thus borrowing possibly even exceeding the *"arm´s length"* amount could be a financially tempting alternative as a part of tax planning scheme. This challenge is identified also by Base Erosion and Profit Shifting (BEPS) project by OECD.[1716]

However, it shall be noted that the absolute amount of interest to be paid is not the only decisive factor from the tax authority perspective when judging whether thin-capitalisation rules are breached. The amount of interest payable may be high for several reasons like interest rate, duration of lending, restrictions on repayment, currency risk, group policy.[1717] This means that all terms and conditions should be considered in a thin capitalisation review.

Thin-capitalisation rules are typically used in two ways:[1718]

[1711] OECD (2012), p. 3.
[1712] OECD (2012), p. 3.
[1713] Knuutinen, R, (2009), p. 437 and Helminen, M. (2010), p. 207.
[1714] Buettner, T. et al. (2012), p. 1.
[1715] Møen, J. et al. (2011), p. 2.
[1716] OECD (2017).
[1717] See HM Revenue & Customs (2016).
[1718] OECD (2012), p. 7.

- to determine a maximum amount of debt on which interest payment deduction is available and

- to determine a maximum amount of interest that may be deducted by reference to the ratio of paid or payable interest to another variable.

The thin-capitalisation regulation varies from country to country and some countries are without this kind of regulation.[1719] When company's debt exceeds its equity by a certain amount there is a risk that debt can be re-qualified as equity for tax purposes which would make making interest expenses on such debt non-deductible for tax purposes.

The costs of thin-capitalisation due to traditional financing has been used as one argument for the increased use of mezzanine financing forms.[1720]

3.6.1.2 Deductibility of interests

In most countries debt and equity are taxed differently for the purposes of the local laws.[1721] For corporations this means that they may deduct interest payments on their debt but are not allowed to deduct dividend payments on their equity.[1722] As interest on debt is generally a deductible expense for the interest payer the receiver of the income is taxed for that.[1723] However dividends and other equity returns are typically not deductible[1724] and are very often subject to different tax reliefs in form of an exemption or exclusion in the taxation of the dividend receiver.[1725] In general it can be concluded that debt is more favourable from taxation perspective than own equity.[1726]

The different tax treatment of interest and dividend paid by the corporations has not been always self-evident in America or Europe.[1727] The present interest deduction system favours debt financing over equity financing and can even be seen as one reason for the economic and financial crisis we are still facing today.[1728] Governments have however not been able to make major changes in the system and the present difference in tax treatment between interest payments and dividends remains in force.

All the companies do tax planning but the international groups have option to optimise the taxation taking into consideration regulation of several countries. Elements of tax planning can be among other things transfer pricing and international debt shifting.

Through transfer pricing profit can be relocated to lowly taxed group enterprises if pricing of intra-group transaction is not done according to the *"arm´s length principle"* i.e. according to the market price.[1729] There is however evidence that multinational profit shifting activities

[1719] See for a general overview of thin capitalisation rules Blouin, J. et al. (2014).
[1720] OECD (2013), p. 14.
[1721] OECD (2014), p. 6.
[1722] Bank, S.A. (2014), p. 1.
[1723] OECD (2014), p. 6.
[1724] Bärsch, S.-E. (2012), p. 26.
[1725] Ibid.
[1726] Knuutinen, R, (2009), p. 71.
[1727] See Seligman, E.R.A. (1914), p. 513.
[1728] See about interactions between tax policy and the financial crisis Hemmelgran, T. and Nicodeme, G. (2010).
[1729] See more about the transfer pricing and *"arm´s length principle"* OECD (2010).

have been significantly decreased after countries have introduced or tightened requirements of transfer pricing documentation.[1730]

The idea of debt shifting is to claim tax deductions on interest expenses in countries having high taxation and paying tax on interest income in countries having low taxation by using intragroup loans. This is technically done by parking the debt in the balance sheet of the preferred group entity through intra-group lending. These opportunities create competitive inequality between groups operating internationally and groups operating in the domestic market.[1731] This impacts negatively on capital ownership neutrality and creates a tax preference for foreign assets compared to those assets that are located on domestic ground.[1732]

Besides financial costs also reputational issues are nowadays taken into consideration by international groups more and more. As public information about tax avoidance erodes company image and affects thus directly its profits increasing attention is today paid to social responsibility including negative consequences of tax avoidance.[1733]

From mezzanine financing perspective the different tax treatment of interest and dividends is relevant as mezzanine financing has both features of debt and equity. The different features result in different tax treatment of related income or expense, so in the case of hybrid instruments like mezzanine the issue of classification would influence also to the applicable tax regime.[1734] The starting point in the classification is very often the legal form.[1735] However in some countries hybrid instruments and their returns are evaluated based on the actual economic and legal substance of the instruments. This *"substance-over-form"* doctrine means that interest of mezzanine type financing may be treated as a dividend if the substance of the instrument is closer to equity and the substance of the interest is closer to a dividend.[1736]

As it has become clear that governments must do more to keep the international taxation regulation more updated to keep the pace with globalisation and modern business practices. The governments of the G20 and Organisation of Economic Co-operation and Development (OECD) started the Base Erosion and Profit Shifting (BEPS) project in 2013 to modernise and improve the international tax rules to stop aggressive tax planning by multinational enterprises. In 2015 the OECD has delivered reports on each element of the 15-point BEPS Action Plan for the countries to be endorsed.[1737]

3.6.2 Taxation in Finland

There is no definition of equity and debt in the Finnish tax laws. This means also that the legislation does not provide any detailed guidance on the taxation of mezzanine financing form.[1738] In Finland the starting point is that business related interest expenses are deductible for the payer of the interest. This is based on the general rule of the Companies Income Tax Act.[1739] Also interest that is dependent on the profit of the company is deductible.[1740]

[1730] Lohse, T. and Riedel, N. (2013) p. 16.
[1731] Huizinga, H. et al. (2008), p. 81.
[1732] OECD (2014), p. 6.
[1733] Bauweraerts, J. and Vandernoot, J. (2013), p. 3.
[1734] Seminogovas, B. (2015), pp. 300-301.
[1735] Brown, P. (2012), p. 32.
[1736] Helminen, M. (2010), p. 169.
[1737] OECD (2015).
[1738] Linnanvirta, R. and Viitala, T. (2012), p. 278.
[1739] Division I, Chapter 2, Section 7 of the Companies Income Tax Act (360/1968).
[1740] Division II, Chapter 2, Section 18:1, point 2 of the Companies Income Tax Act (360/1968).

There are no actual thin capitalisation rules to be followed but there are some restrictions on interest deductions. These limitations of deductibility will apply to interest paid between related parties.[1741] The target of the regulation is primarily to limit tax planning of group´s which through highly leveraged investments transfer taxable income into low taxation countries.[1742] Firstly interest expenses are fully deductible corresponding to the received interest income. A company may however annually deduct up to 500,000 euros of interest expense without limitation. When company is able to prove that the proportion of its net assets represented by equity is at the minimum equally high as the consolidated equity to net assets ratio, the limitation rule will not be applied. If neither of these exemptions is applicable, the amount of deductible interest paid to related parties is 25 % of EBITDA at the maximum. Both domestic and cross-border interest expenses are subject to these limitations.[1743] Interest deduction limitation rules are not applied to credit, insurance and welfare institutions and to some extent to their affiliated bodies.[1744]

Although there is no taxation legislation specially designed for mezzanine financing, there are some decisions of the Supreme Administrative Court and tax authorities regarding the topic.

The Supreme Administrative Court has concluded that the interest expense of subordinated convertible loan[1745] and capital loan like debenture loan[1746] is deductible.

The Central Tax Board (KVL) has made a decision concerning the taxation of subordinated loan with options attached.[1747] In the decision it was stated that the interest accrued on the loan and recorded in borrower´s profit and loss account as an expense was deductible expense. The deduction concerns that fiscal year from which the financial statements - where the amount payable might have been used for the distribution of profit in accordance with the balance sheet - were adopted. The same applies for interest accrued on the loan that is recorded as compulsory provisions in the balance sheet for further payments. The statement regarding the deductibility applies also to capital loans without options.

It shall be noted that the referred Supreme Administrative Court and Central Tax Board decisions were done already during the previous Companies Act[1748] and before the previous Companies Act was amended with the capital loan regulation[1749]. The conclusions can however still be considered to be valid even during the present Companies Act as the interest payment criteria of the capital loan are very similar to the subordinated loans referred to in the discussed decisions. The Finnish Tax Administration also refers to the discussed Central Tax Board and Supreme Administrative Court decisions in its valid taxation instructions.[1750]

In case of capital loan the deductibility of interest costs is very clear.[1751] According to the Finnish taxation practice it can be also stated as a more general rule that interest expenses of any mezzanine financing booked as debt are deductible.[1752] Even if the loan instrument has

[1741] Division II, Chapter 2, Section 18a of the Companies Income Tax Act (360/1968). According to the regulation the interest expenses rules apply for financial years that end on or after January 1, 2014.
[1742] Government Bill for the Law amending the Companies Income Tax Act (HE 146/2012), pp. 15-17.
[1743] Government Bill for the Law amending the Companies Income Tax Act (HE 146/2012), pp. 16-17.
[1744] Division II, Chapter 2, Section 18a:4 of the Companies Income Tax Act (360/1968).
[1745] KHO 1995 T 3932.
[1746] KHO 1995 T 3933.
[1747] KVL 301/1995.
[1748] Limited Liability Companies Act (734/1978).
[1749] Law of Amending of Limited Liability Companies Act (145/1997).
[1750] Verohallinto (1997).
[1751] Tikka, M. et al. (2014), p. 189 and, Fagerstedt, J. and Kukkonen, M. (2015), p. 186.
[1752] Myllymäki, J. (2013), p. 120, Lautjärvi, K. (2015), pp. 182-184 and Knuutinen, R. (2015), pp. 112-115.

had features of equity courts have not considered such loans as equity.[1753] The Act on Assessment Procedure[1754] allows the Finnish tax authorities or courts to recharacterize any transaction based on the true nature of the arrangement but there is no recent Supreme Administrative Court decisions on recharacterizing of debt to equity.

3.6.3 Taxation in other countries

3.6.3.1 Sweden

In Sweden equity related expenses (i.e. dividends) cannot be deducted, whereas debt related expenses (i.e. interest) are generally deductible for the borrower company.[1755] Interest cost deduction for tax purpose requires that the loan is made on arm's length terms.[1756] This means that the rates must be at the open market interest rate. The preferred tax treatment of expenses connected to debt instruments creates incentives for taking loan rather than equity.

There are no separate thin-capitalization restrictions for tax purposes. Intra-group loans related interest costs are however not deductible with two exemptions known as the so-called *"ten-percent rule"* and *"business reason rule"*.

The *"ten percent rule"* means that the interest cost should be deductible if the interest income of the beneficial owner is taxed with at least 10 % and the primary reason for the debt is other than obtaining major tax advantage.[1757] According to the *"business reason rule"* the interest cost should be deductible if the debt is mostly motivated by business reasons and the beneficiary of the interest income is resident in the EEA or, under certain condition, in a state that has valid tax treaty with Sweden.[1758]

There is no withholding tax on interests levied in Sweden. This encourages to create a structure where the return on an investment is delivered in form of interest.[1759] This is naturally subject to that the above described interest deduction limitation rules are not applied.

Regarding mezzanine instruments relevant from the interest deduction point of view is whether the instrument shall be classified as debt or equity from the taxation perspective.[1760]

[1753] Knuutinen, R (2009), pp. 423-429 and Äimä, K. (2009), pp. 256-260. See also Supreme Administrative Court decision KHO 2014:119 on subordinated hybrid loan issued by a Finnish limited liability company to its Luxembourg-based shareholder. Opposite to the opinion of the tax authorities the Supreme Administrative Court considered the loan as debt from the taxation perspective and the interest paid was deductible expense for the issuer.

[1754] According to the Chapter 4, Section 28 of the Act on Assessment Procedure (1558/1995) if a transaction has been assigned a legal form which does not correspond with its actual character and meaning, taxation should take place as if the correct form had been adopted. In addition, it must be evident that the transaction has been entered into in order to avoid Finnish tax.

[1755] Chapter 16, Section 1 of the Income Tax Law (SFS 1999:1229).

[1756] The Swedish version of the arm´s length principle is included in the Chapter 14, Sections 19-20 of the Income Tax Law (SFS 1999:1229). This regulation functions as a rule of correction to be applied not only for loan interests but generally for all kind of transfer pricing items. See more about the transfer pricing and *"arm´s length principle"* OECD (2010) and Wittendorff, J. (2010).

[1757] Chapter 24, Section 10d of the Income Tax Law (SFS 1999:1229).

[1758] Chapter 24, Section 10e of the Income Tax Law (SFS 1999:1229).

[1759] Swedish Trade & Invest Council (2015), p. 2.

[1760] See Skatteverket (2012), pp. 82-84 according to which the applicable taxation shall be concluded based on two stages. First shall be assessed whether the instrument is debt or equity and thus is the cost to be paid to the investor interest or dividend. After that in the second stage shall be assessed whether the compensation to be paid is deductible or not.

According to this a basic convertible debt instrument should normally be classified as debt rather than equity by the borrower. However, in the recent decision of the Supreme Administrative Court a mandatory convertible debt instrument was considered equity unlike Swedish Tax Board had earlier concluded.[1761] The different views of the Swedish Tax Board and the Supreme Administrative Court illustrate the uncertainty characteristic in the classification of financial instruments as debt or equity.[1762]

For option loans and profit-sharing loans there are special rules in the Income Tax Law. According to the regulation borrower (= issuer) of the option loan is not allowed to deduct the difference of the emission price and the market price of the options.[1763] According to the general rule interest cost deduction is though possible. In case of profit-sharing loans the possible fixed rate part of interest is also deductible according to the general rule.[1764] The *"profit-sharing part"* of the interest, which is linked to the amount of dividends to be paid or to the borrower´s profit shall however only be deductible subject to that the loan has been initially offered for the general market.[1765] A profit-sharing loan from the borrower´s owner who has subscribed the loan by using the shareholder´s pre-emption priority does not create interest deduction right for the profit-sharing part of the interest.[1766]

3.6.3.2 Estonia

The Estonian corporate taxation regime deviates significantly from the Finnish and Swedish. The cash-flow taxation model applied can be considered unique even from the global perspective.[1767] In Estonia corporates are subject to income tax only in respect of all distributed profits including dividends distributed[1768], gifts and donations[1769] and payments unrelated to business[1770].

This means that retained earnings are not taxed until profit distributions are made.[1771] One of the consequence of taxing only distributed profits is also that interest cost deduction is not applied. This applies naturally both debt and equity like loans instruments. The corporate tax system in Estonia makes it in practice possible to postpone the taxation of corporate profits for an indefinite period. This tax regime is available to Estonian resident companies and permanent establishments of non-resident companies that are registered in Estonia.[1772]

There are no thin capitalization rules in Estonia. There is however some regulation on transfer pricing.[1773] When related parties carry out a transaction the value of which differs from the value of similar transactions between non-related parties, the difference is subject of income

[1761] HFD 2014, ref. 10.
[1762] Hilling, A. and Vilhelmsson, A. (2015), p. 700. See also Bjuvberg, J. (2014), Olsson, S. (2014) and Tivéus, U. (2014).
[1763] Chapter 24, Section 4 of the Income Tax Law (SFS 1999:1229).
[1764] Chapter 24, Section 5:3 of the Income Tax Law (SFS 1999:1229).
[1765] Chapter 24, Section 6:1 of the Income Tax Law (SFS 1999:1229).
[1766] Chapter 24, Section 6:1 of the Income Tax Law (SFS 1999:1229). See also Tivéus, U. (2010), p. 93.
[1767] See about the cash-flow taxation in general EU (2015).
[1768] Chapter 10, Section 50 of the Income Tax Act (RT I 1999, 101, 903).
[1769] Chapter 10, Section 49 of the Income Tax Act (RT I 1999, 101, 903).
[1770] Chapter 10, Section 51 of the Income Tax Act (RT I 1999, 101, 903).
[1771] See about the Estonian corporate taxation system in general Staehr, K. (2014).
[1772] Chapter 2, Section 6 of the Income Tax Act (RT I 1999, 101, 903).
[1773] Chapter 14, Sections 7-8 and Chapter 50, Sections 4-8 of the Income Tax Act (RT I 1999, 101, 903) and Minister of Finance (2006).

tax. It is up to the related companies to prove that the used pricing method is based on the arm's length principle.

3.6.3.3 USA

The United States has a complex tax system compared to many other countries. One of the main reasons for this is that corporates operating in the country must consider federal, state, and in some cases even local level taxation regulation. From federal perspective a corporation organized under the laws of any state is a domestic corporation. From state perspective, however, entities organized in that state are considered as domestic and entities organized outside that state are considered as foreign.

Interest expenses in relation to debt are generally deductible for the corporations in the USA.[1774] This provides an incentive to finance the operations rather through debt than equity particularly as the corporate tax rate is high.[1775]

Regarding mezzanine type financing the deductibility of interest expenses boils down to conclusion whether the financing form can be considered to be debt or equity. The challenge is however that the local legislation does not define clearly terms *"debt"* and *"equity"*.[1776] The tax regulation does not identify any other financing category either.[1777] According to tax rules among other things following factors shall be considered in determining with respect to a factual situation whether a debtor-creditor relationship exists:[1778]

- whether there is a written unconditional promise to repay the financing on a specified date and to pay interest
- whether there is subordination to any other debt
- the ratio of debt to equity
- whether there is convertibility into the stock of the corporation and
- the relationship between holdings of stock and the interest in question.

The classification of the instrument in question and the final taxation consequence is thus based on the substance of the investment and the analysis of all the circumstances.[1779]

Transfer pricing regulations require applying the arm's-length standard.[1780] It is generally met if the outcome of a transaction in question is consistent with results that would have been realized in a similar transaction under similar conditions by other taxpayers. If a company

[1774] 26 U.S. Code § 163. The law includes also several exceptions of the main rule.
[1775] According to OECD (2017b), the USA combined corporate tax rate of 39 % is the highest of the observed countries in 2017. Although high statutory rates the effective corporate tax rate is however lower among other things due to the deductions. See about this Mathur, A. (2016).
[1776] Ring, D. (2012), p. 780.
[1777] Schneider, S. R. (2015), p. 129.
[1778] 26 U.S. Code § 385.
[1779] Ring, D. (2012), pp. 780-781.
[1780] The legal framework for the transfer pricing in the USA includes in several sections of the Internal Revenue Code and in Internal Revenue Service (IRS) regulations, mostly in Internal Revenue Code (IRC) Section 482. See about IRS next footnote.

does not comply with the arm's-length principle, the Internal Revenue Service (IRS)[1781] may increase taxable income and thus also taxes payable.

Thin capitalization rules may also be applied to prevent companies from borrowing in excess with a purpose to reduce tax liability.[1782] The target of the regulation is to prohibit interest payments related to excess debt and to recharacterize such transactions as dividends. The rule limits tax deductions that companies can take on loans from related and unrelated parties and is applicable on both domestic and foreign-based firms. In practice the target is more on the subsidiaries owned by foreign companies as conducting business in the USA requires often financing from the parent company. The debt/equity ratio exceeding ratio 1.5:1 is considered to amount to thinning according to the law. It is possible to restrict the interest expense deduction if over 50% of the adjusted taxable income of a thinly capitalized corporation is protected by interest paid to such a related party that is not income taxed in the USA.[1783]

3.6.3.4 Other countries

3.6.3.4.1 UK

In the UK deduction of interest expenses is possible for the companies but there are many restrictions. The deductibility rules vary depending on whether the expense relates to a capital gain or to income and depending on the source of income.[1784] Among other things there is a major difference between the tax relieves given for expenses of companies trading in property compared to those investing in property.[1785] The taxation regulation includes also several specific rules dealing with types of reliefs.[1786]

To meet the OECD recommendations[1787] the UK has introduced also new general rules for restricting interest deductions.[1788] A significant limitation is the worldwide debt cap that restricts the net UK interest deductions for a group up to the level of worldwide consolidated group's net interest expense.[1789] The aim of the rules is to restrict a group's deductions for interest expense and other financing. The amounts that cannot be deducted in one accounting period may be carried forward for potential deduction in later accounting periods. The rules do not however apply to groups having less than GBP 2 million of net interest expense and other financing costs per annum.[1790]

There are also specific anti-avoidance provisions for arrangements where a main purpose is to secure a tax advantage.[1791] These rules disallow interest deductions relating to tax avoidance or non-business purposes.

[1781] The IRS is the U.S. government agency responsible for tax collection and tax law enforcement. It is a bureau of the Department of the Treasury.
[1782] 26 U.S. Code § 163 (j) and § 385.
[1783] PwC (2014), p. 7.
[1784] PwC (2016).
[1785] Ibid.
[1786] GovUK (2017).
[1787] OECD (2015).
[1788] New measures came into force effective April 1, 2017. They are included within Part 10 of Taxation (International and Other Provisions) Act 2010. See for more details also HM Revenue & Customs (2017).
[1789] The key elements of these rules include (i) a fixed ratio rule limiting corporate tax deductions for net interest expense to 30 % of a group's UK EBITDA and (ii) a group ratio rule based on the external net interest to EBITDA ratio for the worldwide group.
[1790] See for more details also HM Revenue & Customs (2017), p. 3 and p. 11.
[1791] HM Revenue & Customs (2017), pp. 320-324. See also HM Revenue & Customs (2016b).

According to UK tax regulation a company is thinly capitalised when debt exceeds the amount that the company either could or would borrow without receiving support from group and when acting solely in its own interests. The consequence of this is the possibility of excessive interest deductions compared to situation where the parties would act on arm's length terms.[1792] The transfer pricing rules[1793] restrict deductions to the amount of interest that would have been paid if all the parties where independent according to the arm's length principle.[1794] These restrictions do not however take in the consideration whether the income and assets supporting that interest are as such taxable.

The tax treatment of financing instruments in the UK follows generally the accounting treatment of the instruments.[1795] The consequence of this is that debt interest is deductible and equity interest is not deductible as dividend distribution. In case of convertible loan this means that interest payments of convertible loan are generally tax deductible.[1796]

3.6.3.4.2 Germany

In Germany, interest on debt is generally deductible for tax purposes with some restrictions. The major restriction is the interest deduction ceiling (Zinsschranke). According to this rule the annual net interest expense[1797] of group companies is deductible at the maximum up to 30% of EBITDA for corporation and trade tax purposes. This restriction covers all interests regardless whether a shareholder, related party or a third party is the lender.

The restriction is not applicable in following situations:[1798]

- the total net interest expense for the year is below 3 million euros or
- the net interest amount paid to any one shareholder owning more than 25 % - or paid to a related party - is at the maximum 10 % of the total and the equity to gross assets ratio of the company is at the maximum two percentage points below that of the group.

Any unused EBITDA potential may be carried forward five years at the maximum to cover future net interest expense exceeding 30 % of the current EBITDA.[1799]

The German Federal Fiscal Court[1800] has however held the interest limitation to be in breach of the constitution and has asked the German Constitutional Court[1801] to give a judgment on the compatibility of the Zinsschranke provision with the German constitution.[1802] The German Constitutional Court decision is not yet received.[1803]

It shall be noted that the above described interest limitation rule is additional to the German transfer pricing requirements. The transfer pricing regulation in the German tax legislation is

[1792] HM Revenue & Customs (2016c).
[1793] Part 4 of the Taxation (International and Other Provisions) Act 2010.
[1794] HM Revenue & Customs (2016d).
[1795] James, M. (2009), p. 17.
[1796] Harris, P. (2013), p. 207.
[1797] Net interest expense means the excess of interest paid over that received interest.
[1798] PwC (2015).
[1799] Ibid.
[1800] Bundesfinanzhof (BFH).
[1801] Bundesverfassungsgericht (BVerfG).
[1802] See German Federal Fiscal Court (Bundesfinanzhof) decision dated 14 October 2015 (I R 20/15) and published on 10 February 2016. The legal issue relates to the interpretation of Article 3 of the German Constitution which includes the equal treatment principle.
[1803] According to the situation until June 30, 2018.

included in different parts of the German tax laws.[1804] According to the key rule the related party transactions must comply with the arm's length principles.[1805] If intercompany transactions do not conform to the level that would have applied in a transaction between unrelated third parties, the tax authority may adjust the tax base leading to additional taxes and penalties.[1806]

The taxation of financing instruments in Germany follows generally the accounting principles of the instruments.[1807] Thus the tax classification of instruments as interest-generating debt or dividend-generating equity is decisive for the tax treatment.[1808] This means that interest payments deriving from instruments classified as interest-generating debt generally tax deductible for corporate income tax purposes.[1809] However hybrid financial instruments can be reclassified as equity subject to that both remuneration payments participate in the borrower´s profits and the capital repayment participates in the liquidation proceeds of the borrower´s capital.[1810] Although the reclassification of debt into equity is possible the reclassification in the reverse direction i.e. from equity to debt is not possible.[1811]

[1804] KPMG (2015b), p. 2.
[1805] Section 1 of the Foreign Transactions Tax Act (Aussensteuergesetz).
[1806] Section 162:4 of the General Tax Code (Abgabenordnung) and KPMG (2015b), p. 3.
[1807] Essers, P. et al. (2009), p. 33 and Fischer, H. and Lohbeck, A. (2012), p. 315.
[1808] Bärsch, S.-E. (2012), p. 148.
[1809] Bärsch, S.-E. (2012), p. 142.
[1810] Bärsch, S.-E. and Spengel, C (2013), p. 522.
[1811] Ibid.

4 DIFFERENT SYSTEMS OF MEZZANINE IN PRACTICAL MARKET

4.1 Venture capital companies

4.1.1 About venture capital in general

There is no scientifically exact definition of venture capital.[1812] It is often seen as a subset of private equity.[1813] Because of the variable terminology caution is advised when comparing different statistics related to venture capital and private equity. In this research definitions of venture capital and private equity are not differentiated and primarily term venture capital is used. According to that terms venture capital and private equity are used to mean the same issue unless otherwise expressed in the text part in question. Here both venture capital and private equity refer to investments in non-public growth companies and additional support to achieve maximum increase of the value of the target company. The money is provided to seed, early-stage and emerging growth companies or more established companies for optimisation and buy-out purposes.[1814] Venture capital financing can be understood to be one type of professional asset management where funding raised by investors are channelled to target companies having significant growth potential.[1815] By stepping in in the company the venture capitalists usually get a significant portion of the companies' ownership and thus also are able to significantly influence and control the target company decisions.[1816] In return the venture capital investor provides target company with valuable expertise and knowledge, business contacts and advice.[1817] Thus venture capital is about providing not only capital but also competence for the target companies. The competence offered by the investor includes among other things technological, market, and product expertise and networks.[1818]

[1812] For example, Invest Europe (2017) defines venture capital as follows: "*Venture capital is a type of private equity focused on start-up companies. Venture capital funds back entrepreneurs with innovative ideas for a product or service who need investment and expert help in growing their companies.*" According to NVCA (2016), p. 96 venture capital is "*a segment of the private equity industry which focuses on investing in new companies with high growth potential and accompanying high risk.*" European Commission (2015), p. 3 states that "*Venture capital investors provide finance to companies that are generally very small and new, often innovative start-ups, with strong growth potential. This type of investment, which often takes the form of temporary stakes in the capital of the companies, entails high risk since returns are linked to the success of newly created companies. For this reason, some venture capital investors also provide important non-financial support to these companies, such as consultancy services, financial advice, marketing strategy and training.*" See also OECD (2016), pp. 135-143.

[1813] For example, Invest Europe (2017) defines private equity as follows: "*Private equity is a form of equity investment into private companies not listed on the stock exchange. It is a medium to long-term investment, characterised by active ownership. Private equity builds better businesses by strengthening management expertise, delivering operational improvements and helping companies to access new markets*." See also footnote 1812 above about Invest Europe (2017) definition of venture capital. According to NVCA (2016), p. 92 private equity is described as follows: "*Private equity - equity investments in non-public companies, usually defined as being made up of venture capital funds and buyout funds. Real estate, oil and gas, and other such partnerships are sometimes included in the definition.* "In NVCA (2016), p. 62 is also shown an equation "*Private Equity = Venture Capital + Buyout/Mezzanine*". See also Cumming, D. ed. (2012), Cumming. D. ed. (2012b) and Metrick, A. and Yasuda, A. (2011).

[1814] Næss-Schmidt, S. et al. (2017), p. 9.

[1815] Da Rin, M. et al. (2011), p. 3.

[1816] Arnold, G. (2013), p. 406.

[1817] Metrick, A. and Yasuda, A. (2011), pp. 626-630 and Sørensen, M. (2007), pp. 2725-2726.

[1818] Norton, E. and Tenenbaum, B. (1993), p, 435.

Venture capital investments are primarily made as equity investments or using mezzanine funding.[1819] The financing package can occasionally also include senior debt.[1820] Venture capital financing is done usually without security. In case of certain mezzanine instruments like the Finnish capital loan security is not even allowed by the law.[1821] Contractual subordination of collateral i.e. agreement on using security for a debt - called *"second lien debt"* - on a second ranking basis is however possible.[1822] Venture capital financing is often provided in stages and convertible debt instruments are common instruments as the part of the financing package.[1823]

The intention of the venture capital investor is to grow the value of the company. The value growth is realised at the exit stage where the investor gives up its ownership in the target company. Successful exit can take place through profitable initial public offering (IPO)[1824] or trade sale of the company.[1825] The investment is already at the start conducted with a plan to exit within an agreed period which is normally 2-7 years.[1826]

Venture capital can be attractive for new companies with limited operational history. Some small and medium-sized unlisted companies may find themselves in a situation where they are unable to get a bank loan and owners do not have ability to provide additional finance either.[1827] Such companies may also find it difficult to raise capital in the public markets. There is usually no repayment during the term of investment and usually no interest costs. This means that venture capital investment does not have similar detrimental impact on cash flow than normal senior debt financing like bank loans.[1828]

Interesting target companies are also those having a prospect of major growth. They are often in the initial stages of their corporate existence but alternatively can also have longer history. In a situation of having a strong potential for growth and expansion they may attract venture capital financing. [1829]

Below are listed examples of different stages/situations when venture capital investor can step in in the target companies:[1830]

Seed corn

- financing of research, assessment and development of an initial business concept

Start-up

- financing provided to companies for product development of an initial business concept and marketing

[1819] Bender, M. (2011), p. 11.
[1820] Mäntysaari, P. (2010c), p. 289.
[1821] See above section *3.4.2.2.4 Capital structure* and footnote 622.
[1822] Mäntysaari, P. (2010c), pp. 298-299.
[1823] See about stage financing and convertible debt instruments in venture capital Cornelli, F. and Yosha, O. (2003).
[1824] Gompers, P.A. and Lerner, J. (2004), p. 28.
[1825] Cumming, D. ed. (2010), p. 146.
[1826] Cumming, D. and Johan, s. (2014), p. 5.
[1827] Coyle, B. (2000), p. 15
[1828] About the differences between bank financing and venture capital financing see also Weitnauer, W. et al. (2016), pp. 3-5.
[1829] Weitnauer, W. et al. (2016), p. 15.
[1830] Arnold, G. (2013), pp. 402-403.

Other early stages

- financing of companies being in process of being set up but having not commercialised their products yet

Expansion

- financing to companies for the growth and expansion (like to increase production capacity or to get working capital)

Management buyout (MBO)

- financing to existing management to enable them to acquire existing business or part of it

Management buyin (MBI)

- financing to new management from outside the company to acquire the company or part of it

Leveraged buyout (LBO)

- financing the buy-out of an existing company with the high amount of debt[1831]

Secondary purchase

- financing an acquisition of a company having venture capital funding to a new venture capitalist[1832]

Public to private

- financing to operative management of a listed company to enable the management to acquire the shares of the company and unquote the shares.

It shall be noted that very often the venture capital funding forms a part of a larger financing package needed for the transactions. Especially in large transactions - besides the debt, equity and mezzanine provided by venture capital financiers - the major part of the total debt comes typically from non-venture capital financiers like banks.[1833]

The process to raise venture capital financing is intensive and lengthy with many phases including screening, analysis, due diligence and can thus last several months.[1834] During the actual deal structuring liquidity events are discussed and valuation plays a key role. The venture capital investors require a minimum rate of return – so-called hurdle rate - for their investment. This hurdle rate relates to the risks associated with the investment. Due to the risk profile of the venture capital investment the required rate exceeds clearly the interest

[1831] Leveraged buyout transaction means here financing of companies that are majority owned or controlled by private equity fund or other investment companies having same similar operating model. According to Arnold, G. (2013), p. 402 the capital raised for LBOs is *"…between 60 per cent and 90 per cent debt finance"*. About the leveraged lending in general see also OCC (2013), which is a joint statement of U.S federal bank regulators on leveraged lending. It shall be noted that based on the researcher´s own experience LBO transactions majority financed by equity are also done.

[1832] According to Arnold, G. (2013), p. 402 secondary purchase is *"…one of the exit strategies, where the first private equity fund can make a capital gain by selling its equity in the company to another private equity fund"*.

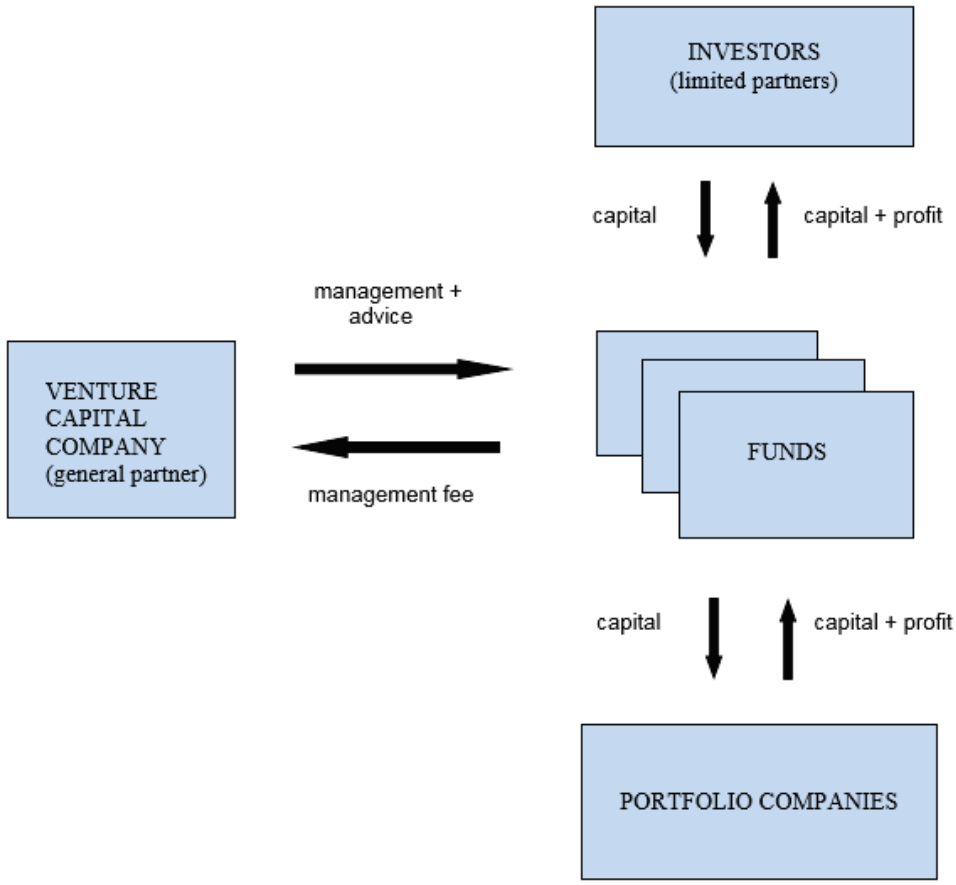
[1833] See above footnote 1831.

[1834] Mäntysaari, P. (2010c), p. 289.

requirement of the senior lender. successful final negotiations the investment deal contract is signed. In case of target company having chance to cooperate with central and well-connected venture capital companies increases the likelihood to achieve successful exit.[1835]

Venture capital companies are primarily owned by companies and private persons that administrate capital to be invested. Normally venture capital firms do not invest their own money to target companies but sometimes they do. Capital for venture capital investments is often raised from institutional investors such as pension funds, insurance companies and large corporations or wealthy individuals through vehicles called funds. These independent venture capital funds are often established by creating a pool of funds managed by specialist fund managers.[1836] The role of fund managers is then to decide how to invest in the business ventures with the chosen financing instrument. A venture capital company acts thus as a management company that collects commitments from the institutional or other investors through fundraising and searches for potential investment objects.

Figure 7: The fund structure



[1835] Ozmel, U. et al. (2013), p. 657.
[1836] Landstöm, H. and Mason C. eds (2012), p. 46.

The legal structure typically used by venture and private equity funds is the limited partnership.[1837] The partnership is usually a fixed-life[1838] investment vehicle consisting of a general partner and limited partners. In this setup the management firm acts as the general partner managing the investments and having unlimited liability. The financial investors are not involved in the daily operations and have limited liability. The general partner selects the portfolio companies, mentors, monitors and provides value added services and after exiting from the companies distributes the returns to limited partners. The general partner receives a management fee and additionally a percentage of the profits. The limited partners receive income and capital gains and furthermore tax benefits. A limited partnership agreement establishes all the relevant rights and duties between the general partner and limited partners. Above is presented an example of a fund structure (see Figure 7 above).

The capital flow from the initial investors to target companies follows thus two-step process.[1839] Limited partners provide capital and the venture capital company manages the funds by allocating capital to several portfolio investments. Due to the complex structure and several investment targets the administration duties can also be complex. The funds require among other things detailed reporting. This sets also significant compliance requirements for the fund management.

Important principles in fund creation include tax transparency and non-permanent structures to encourage foreign investors.[1840] Non-permanent structures are favourable to avoid taxation for the fund itself and for the investors of that country where the management operates.[1841]

Some countries have standard solutions for establishing and operating domestic funds.[1842] In the following sections are reviewed the venture capital activities in Finland and in some other countries.

4.1.2 Venture capital in Finland

The Finnish development companies that in 1960´s and 1970´s started to make minority investments from their own balance to target companies sheet are considered the venture capital pioneers of the country.[1843] The capital for the investors was mostly sourced from the banks and major corporations.[1844] In 1980`s some more venture capital companies were founded but many of them operated more on regional basis.[1845] The true activity started only in the next decade.

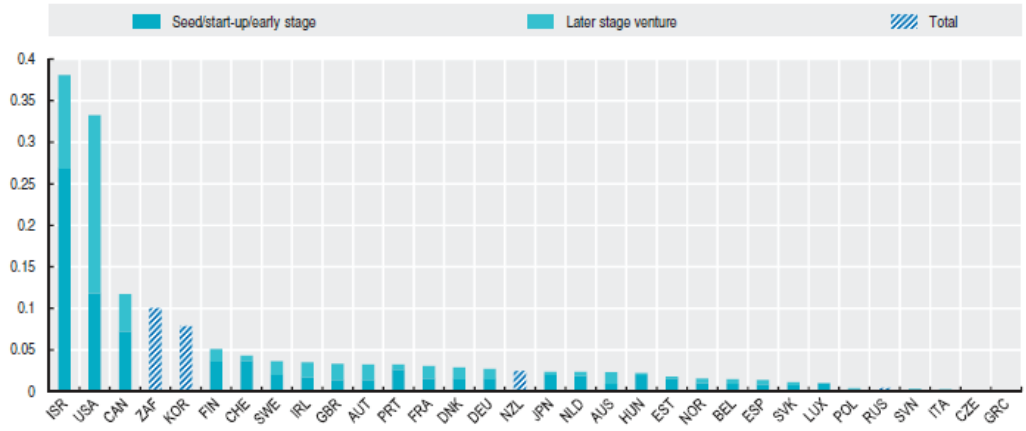
The Finnish venture capital market became more professional in the beginning of 1990´s and experienced intensive growth in term of both investors and operations during the latter half of that decade.[1846] The Finnish Venture Capital Association (FVCA) was established in 1990 and the growth of industry also increased quickly the number of members in the association, which aims to promote venture capital activities and good practice in Finland. The association

[1837] Cumming, D. and Johan, s. (2014), p. 145 and Fabozzi, F.J. (2015), p. 198.
[1838] Loader, D. (2007), p. 53, Invest Europe (2015), p. 4 and NVCA (2016), p. 16.
[1839] Cumming, D. ed. (2012), p. 31.
[1840] EVCA (2010), pp. 4-5.
[1841] EVCA (2010), p. 5.
[1842] EVCA (2010), p. 2.
[1843] Luukkonen, T. (2006), p. 2.
[1844] Ibid.
[1845] OECD (2003), pp. 180-181.
[1846] See Seppä, M. (2000), p. 61 about two Finnish pioneer companies in venture capital industry: Sponsor Capital Oy and CapMan Capital Management Oy.

was established in 1990 by 18 founding members.[1847] Now FVCA has 61 full members (private equity houses and venture capital companies) and 43 associate members.[1848]

The Finnish venture capital firms invested in total MEUR 452 in 265 growth companies in 2016.[1849] The foreign venture capital companies invested in total MEUR 271 in the 19 Finnish target companies in 2016.[1850] In international comparison Finland is very active in the venture capital financing as can be seen in the figure below (Figure 8).

Figure 8: Venture capital investments as a percentage of GDP (percentage, 2015 or latest available year)



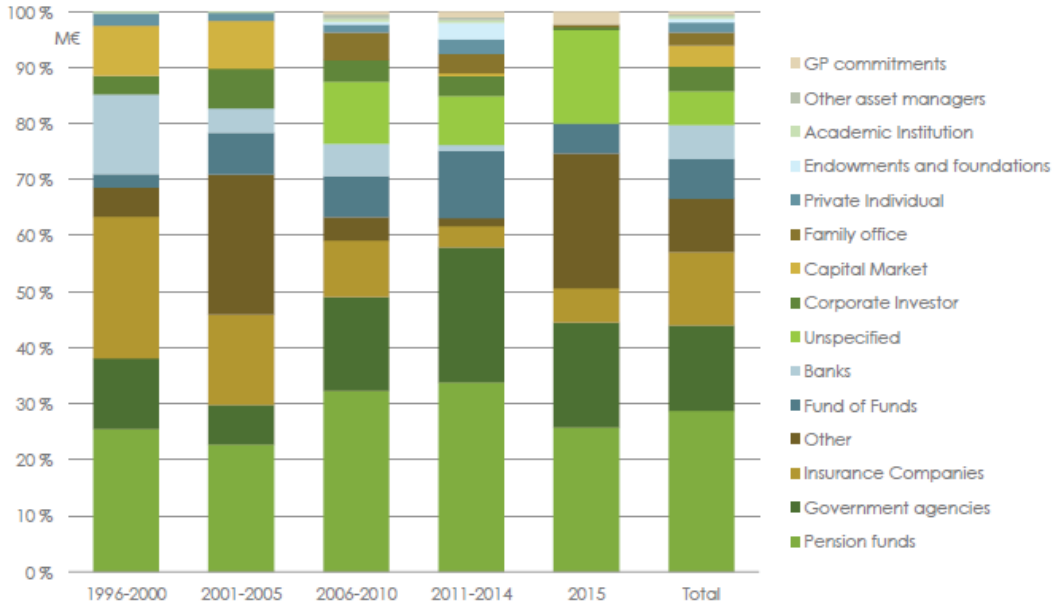
Source: OECD (2016)

One of the special features of the Finnish venture capital history has been the strong role of the government in the emergence of the country´s venture capital industry. Even today public involvement in venture capital companies have an important role.[1851] For example SITRA (the Finnish Innovation Fund) that was founded in 1967 by the Bank of Finland and is today still run by government and supervised by the Finnish Parliament Sitra invests in domestic early stage companies mainly through venture capital funds. Other important publicly-funded institutions operating in the venture capital field are Tekes (the Finnish Funding Agency for Innovation) and Finnvera (the official Export Credit Agency of Finland) and Suomen Teollisuussijoitus Oy (Finnish Industry Investment Ltd). See also table below about the role of Finnish governmental agencies in general in the venture capital market in Finland (Figure 9).

[1847] Lovio, R. (1993), p. 227.
[1848] FVCA (2017).
[1849] FVCA (2017b), p. 3.
[1850] FVCA (2017b), p. 22 and FVCA (2017c), p. 25.
[1851] The important role of government as investor in the venture capital industry is typical in Nordic countries. See Gregoriou, G. N. et al. eds (2007), p. 29.

Although governmental agencies have earlier pioneered the Finnish ventue capital investing today the private sector accounts for most of the markets. The Finnish venture capital market has also become more international during the years attracting foreign investors as can be conluded from the total foreign investments 2015 as described above.

Figure 9: New funds raised by Finnish venture capital companies divided by the investor (limited partner) type in 1996-2015[1852]



Source: FVCA (2016), p. 9.

4.1.3 Foreign venture capital markets

4.1.3.1 Sweden

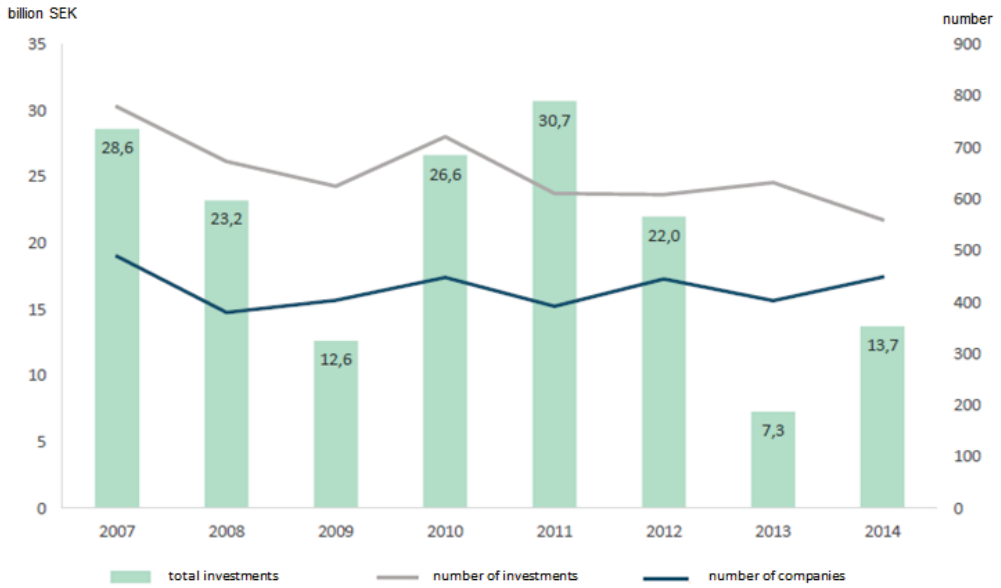
The birth of the Swedish venture capital industry is linked to the initiatives of government decision to support small and medium sized companies. As the industrial production fell radically due to the oil crisis in the 1970´s the Swedish government considered venture capital

[1852] According to FVCA this figure shows funds raised by Finnish private equity firms. As in this research the term *"venture capital"* is prioritised over the synonym *"private equity"* also the title is formulated accordingly.

to be one instrument to support enterprises to lift the country out of the recession.[1853] The oldest Swedish VC firm Företagskapital was founded by the state and the commercial banks in 1973. The purpose of the company was to provide financial support for generation changes in family owned enterprises.[1854] Företagskapital was gradually developed into a venture capital company.

Also, several other specific regional development funds were established in 1970s and 1980´s to support SME sector with financing and advice.[1855] Besides the government also private sector became active in 1980´s by establishing several new venture capital funds.[1856] This time until the stock downturn in 1989 starting the Swedish financial crisis is considered the first venture capital boom in Swedish history.[1857] The early 1990s was the start of the second prosperous period for venture capital. The government once more started to promote the growth of SMEs and venture capital became once again a more important tool.[1858]

Figure 10: Private Equity investments in Sweden



Source: SVCA (2015), p. 7.

There are several factors explaining the growth of the Swedish venture capital market in the 1980s and 1990s. Some examples are legislative and institutional changes like allowing

[1853] Cetindamar, D. ed. (2003), p. 125.
[1854] Lerner, J. and Tåg, J. (2013), p. 166.
[1855] Gregoriou, G. N. et al. eds (2007), p. 148 and Karaömerlioglu, D.C. and Jacobsson, S. (2000), p. 68.
[1856] Isaksson, A. (2006), p. 26.
[1857] Ibid.
[1858] Cetindamar, D. ed. (2003), p. 127.

pension funds to invest in start-up companies, development of incentive structures for managers, favourable changes in the tax legislation and creation of over-the-counter (OTC) market supported the growth of the Swedish venture capital industry.[1859] Additionally a stable economic environment and political certainty related to regulation has had relevance in this respect.[1860]

The stock market has an important part in the development of venture capital industry. To have possibility for an exit for the investments in initial public offerings is a very important element in a well-functioning investment environment.[1861] Especially in good economic times stock markets are major point of interest. In Sweden this became clearly visible when the stock market crashed in 2001. Before the crash the venture capital market continued to grow consisting of 160 active venture capital firms in 2000 but having only around 80 firms in the market during the deep phase of the recession in 2005.[1862] The Swedish venture capital industry has gradually recovered after 2005 and today the Swedish Venture Capital Association has 155 members (79 ordinary and 76 associate members).[1863]

Besides increase in number of venture capital firms Sweden is also very active in the venture capital financing in terms of financing volumes as can be seen in the Figure 8 and Figure 10 above. The total amount of new investments made by the Swedish venture capital companies was 13.7 billion SEK in companies in 2014 and those funds were channelled to more than 450 target companies.[1864]

4.1.3.2 Estonia

Since Estonia reinstated its independence in 1990 it has shown remarkable economic growth (see Figure 11 below). The development of the venture capital market started in the first decade of the new independence era with the support of international institutions. U.S. government-sponsored the Baltic American Enterprise Fund (BalAEF), European Bank for Reconstruction and Development (EBRD) and the Nordic Investment Bank (NIB) are examples of financial institutions that provided support in developing the Estonian capital markets including helping the nation to learn the venture capital business.[1865]

In the beginning of the new millennium Estonia demonstrated strong economic growth which lasted until the global financial crisis in 2008. Besides international institutions also some local investors became more active after being able to accumulate capital because of the rapid economic growth of the country over the last few years. Many of the local investors were formally not structured as traditional venture capital funds but in their way of sourcing, evaluating and executing financing the deals achieved remarkable returns.[1866]

During the last ten years the Estonian economy has gradually recovered but as being a small nation of only 1.4 million inhabitants the total private equity investment volumes in the country are small and the number of active investors is small. The venture capital market is not yet fully developed and depends significantly on public funding.[1867] The amount of private equity investments in Estonia totalled to MEUR 40 and they were channelled in total to 8

[1859] Cetindamar, D. ed. (2003), pp. 127-128.
[1860] Næss-Schmidt, S. et al. (2017), p. 53.
[1861] Lerner, J. and Tåg, J. (2013), p. 158.
[1862] Isaksson, A. (2006), p. 29.
[1863] SVCA (2017).
[1864] SVCA (2015), p. 7.
[1865] Sabaliauskas, L. (2015), p. 126.
[1866] Sabaliauskas, L. (2015), p. 127.
[1867] European Commission (2016), p. 51.

companies in 2014 (for comparison MEUR 5 to 10 companies in 2009).[1868] Out of the invested capital 77 % in 2014 came from abroad.[1869] All in all low amount of funds are raised and only few investments are made leading to lack of money for early stage and follow-on investments.[1870] In relation to country´s GDP venture capital activity in Estonia is behind Sweden and Finland as can be seen in Figure 8 above. The Estonian Venture Capital Association (EstVCA) has 38 members (14 ordinary and 24 associate members).[1871]

Figure 11: Estonian GDP



Source: Trading Economics (2017)

A recent example of the positive development of the Estonian venture capital market is the signing of a Funding Agreement by the European Investment Fund (EIF)[1872], KredEx[1873] and the Estonian Ministry of Economic Affairs and Communications to establish a new MEUR 60 risk capital fund EstFund on March 1, 2016.[1874] EstFund is a fund-of-funds established for investing in several risk capital funds targeting primarily in Estonian enterprises. It is the first

[1868] EVCA (2015), p. 13-14.
[1869] EstVCA (2015), p. 19.
[1870] As an example, see EVCA (2015), p. 21.
[1871] EstVCA (2017).
[1872] The European Investment Fund (EIF) being part of the European Investment Bank (EIB) supports the European small and medium-sized businesses (SMEs) to access finance. As the European Union's bank EIB works closely with other EU institutions to implement EU policy.
[1873] KredEx is an Estonian state owned financial institution helping Estonian enterprises to grow and expand more to foreign markets by offering venture capital, loans, credit insurance and guarantees with state guarantee. See also chapter 4.2.4.4 below.
[1874] According to European Comission press release on March 1, 2016 *"The EstFund will finance SMEs via three selected risk capital funds with combined resources of EstFund and co-investment by EIF allocated indicatively as follows: 1.EUR 30m Venture Capital Fund; 2.EUR 15m Expansion Capital Fund; 3.EUR 15m Business Angels Co-Investment Fund."*

Structural Fund-supported fund-of-funds that EIF will invest into based on the EU Investment Plan for Europe[1875].

4.1.3.3 USA

The USA is the country which can be considered the birth place of venture capital. The first modern venture capital firm is considered to be American Research and Development Corporation (ARD) which was founded in 1946 targeting to finance commercial applications of technologies developed during World War II.[1876] ARD completed the first major venture capital success story when its 1957 investment of USD 70,000 in the computer manufacturer Digital Equipment Corporation (DEC) paid off. The investment would be valued at over USD 355 million after the IPO of DEC in 1968 and by the time the value of the DEC stock was fully realized in 1971.[1877] This represents a return of over 5,000 times on the investment and an annualized rate of return of over 100 %![1878]

In 1958 the Federal government stepped in the financing and development of small firms by establishing new small business investment companies (SBICs).[1879] These government funded SBICs channelled early stage financing for companies in different industries. The activity was in the beginning major and until the mid-1960 SBICs provided most of all risk capital invested in the country. However, in the later decades SBICs role has dramatically decreased due to prioritising of debt financing instead of equity for the target companies leading to low survival rates during downturns.[1880]

The USA venture capital industry started to really boom in 1980´s when pension funds were allowed to invest in the high risk assets as venture capital.[1881] From around 250 venture capital companies at the start of the decade there were over 1,000 firms operating in the industry by the end of the 1990s.[1882] As the economy slowed due to the recession during the end of the 1980s and the beginning of the 1990s commitments to venture capital funds declined but recovered strongly during the latter half of the 1990s.[1883] Some of the most successful venture capital investments of that time period were made to Apple, Microsoft, Cisco, Netscape, Staples and Starbucks.

Simultaneously with the growth of the industry in the 1980´s more standardised types of private equity funds were established in a form of limited partnerships. Venture capital firms started to more and more organise themselves in limited partnerships where the managing

[1875] The EU Investment Plan for Europe focuses on making better use of existing and new financial resources and trying to remove obstacles to investments and provide visibility and technical assistance to investment projects. The plan to achieve these goals is activated in three areas: 1) investments of at least 315 billion euros in three years, 2) supporting the real economy investments and 3) creating an investment friendly environment.
[1876] Gompers P.A. (1994), p. 5.
[1877] Hsu, D.H. and Kenney, M. (2005), p. 599
[1878] About the significance of ARDs investment in DEC for the development of the venture capital industry in general see Nicholas, T. (2015).
[1879] Gompers P.A. (1994), p. 6-7.
[1880] Gompers P.A. (1994), p. 7-8.
[1881] Employee Retirement Income Security Act of 1974 originally prohibited pension funds to provide substantial funds to venture capital. The rule was changed in 1979. See Gompers, P.A. (1994), p. 12-13 according to which that was the single most important factor for the increase for the increased money flows to venture capital sector in 1980´s.
[1882] Etzkowitz, H. (2002), p. 99.
[1883] Lerner, J. and Tåg, J. (2013), p. 164.

investment experts act as general partners and the investors putting up the capital act as passive limited partners.

The new millennium started with positive mood in the USA venture capital industry before having its low point soon after the start of the global financial crisis in 2009. After that the industry has recovered and continued to grow again several consecutive years.[1884] The overall volumes of the venture capital investments of the country are superior compared to any other country as can be concluded also in the Figures 8 above and 13 below. Capital under management[1885] of the country´s venture capital firms were at the level of 165 billion USD in the end of 2015 as can be seen in statistics below (Figure 12). The amount of total investments was 59,1 billion USD in 2015.[1886] That is the highest annual investment amount since 2000 as is visible in the table below (Figure 13). Those funds were invested in total to 3709 companies.[1887]

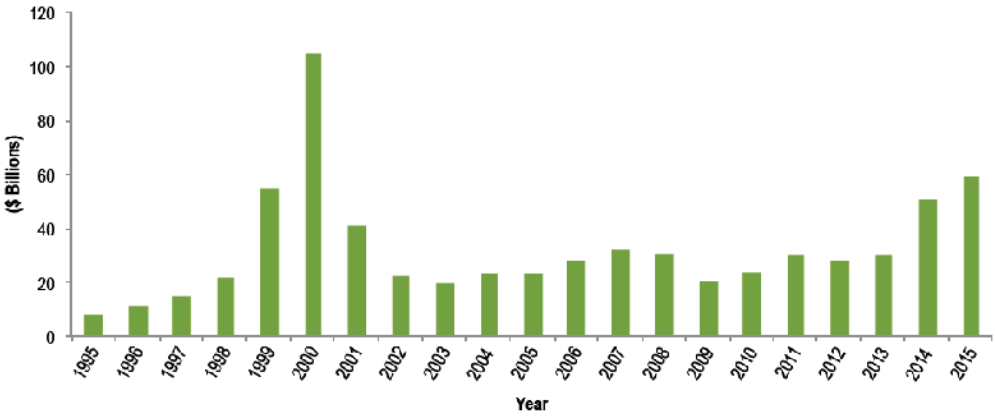
Figure 12: Venture Capital Under Management Summary Statistics

	1995	2005	2015
No. of VC Firms in Existence	425	1,009	798
No. of VC Funds in Existence	688	1,764	1,224
No. of First Time VC Funds Raised	38	43	93
No. of VC Funds Raising Money This Year	161	233	236
VC Capital Raised This Year ($B)	9.4	30.1	28.2
VC Capital Under Management ($B)	38.9	278.2	165.3
Avg VC Capital Under Mgt per Firm ($M)	91.5	275.7	207.1
Avg VC Fund Size to Date ($M)	44.4	98.0	135.0
Avg VC Fund Size Raised This Year ($M)	58.3	129.1	119.6
Largest VC Fund Raised to Date ($M)	5,600	10,025	21,700

Source: NVCA (2016), p. 9.

[1884] NVCA (2016), p. 9.
[1885] According to the NVCA methodology capital under management means the *"cumulative total of committed capital less liquidated funds or those funds that have completed their life cycle".* See more about the definition NVCA (2016), p. 16.
[1886] NVCA (2016), pp. 26-27.
[1887] Ibid.

Figure 13: Venture Capital investments in the USA 1995-2015



Source: NVCA (2016), p. 27.

4.1.3.4 Other countries

4.1.3.4.1 UK

The history of UK venture capital industry goes back to 1945 when the UK government established Industrial and Commercial Financial Corporation (ICFC)[1888] to provide long-term capital to small and medium sized businesses.[1889] The actual growth in the industry started in 1970´s when managers having gained venture capital experience in the USA came in to the United Kingdom and drew in funding from the US market.[1890] In the 1980´s the growth continued very strongly. This could be verified by the increase of the number of private venture capital funds from around 20 to over 150 and growth of their total investments from around GBP 10 million up to over GBP 1 billion in around 10 years since the end of 1970´s.[1891]

Also, since 1990s the UK venture capital industry has continued to show big investment volumes. Today there are over 250 active UK private equity firms operating in this sector.[1892] British Private Equity and Venture Capital Association BVCA, the industry body for the UK private equity and venture capital industry, has more than 600 member firms.[1893] The global investment by BVCA members increased to GBP 16.9 billion globally in 2015 (GBP 13.4 billion

[1888] ICFC became later 3i which is a major international investment manager focusing among other things on private equity. See about the history of the company Coopey, R. and Clarke, D. (1995).
[1889] Mayer, C. (2002), pp. 321-322.
[1890] Gregoriou, G. N. et al. eds (2007), p. 4.
[1891] Green, M.B. ed. (1991), p. 205.
[1892] BVCA (2012), p. 7.
[1893] BVCA (2016).

in 2014).[1894] Out of that domestic investments of BVCA members into the UK grew to GBP 4.7 billion in 2014 (GBP 4.1 billion in 2013) as can be seen in table below (Figure 14). The numbers mean that besides UK being itself significant place for new investments the country is also seen as the gateway to the investments for the other parts of Europe and to investments outside Europe.

Figure 14: Investments of BVCA members by country

Country	Number of companies			% of companies			Amount Invested (£m)			% of amount Invested		
	2015	2014	2013	2015	2014	2013	2015	2014	2013	2015	2014	2013
UK	795	728	710	82	82	83	5,990	4,720	4,109	35	35	41
US	57	43	35	6	5	4	2,408	1,634	1,673	14	12	17
Europe	99	104	103	10	12	12	7,584	6,404	4,053	45	48	40
Rest of World	14	16	9	1	2	1	937	606	291	6	5	3
Total	965	891	857	100	100	100	16,919	13,363	10,127	100	100	100

Source: BVCA (2016b), p. 4

This reflects the high level of industry knowledge, favourable regulatory environment and access to capital in the UK.[1895]

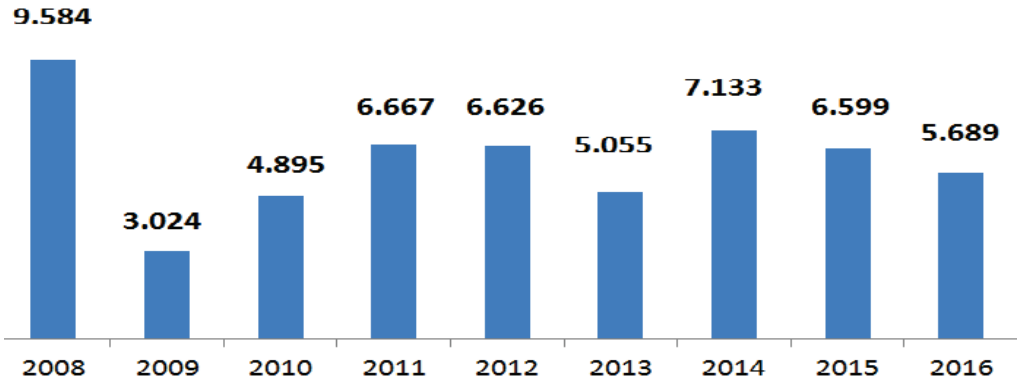
4.1.3.4.2 Germany

The birth of German venture capital industry can be traced back to 1965 when first Kapitalbeteiligungsgesellschaften KBGs were established.[1896] These corporations founded by banks represented to some extent the American venture capital philosophy by providing funding mainly to profitable medium-sized companies funding.[1897] However KBGs were not focusing on managerial support.[1898]

Next phase in the development of the German venture capital industry took place in 1975 when the Deutsche Wagnisfinanzierungsgesellschaft WFG was founded by private banks and government.[1899] The purpose was to fund innovative and technologically oriented companies but WFG track record was poor and it never succeeded in inducing larger market development.[1900]

[1894] BVCA (2016b), pp. 3-4.
[1895] PwC (2008), p. 2.
[1896] Wupperfeld, U. (1997), p. 153 and Plagge, A. (2006), p. 38
[1897] Fohlin, C. (2006), p. 7.
[1898] Ibid.
[1899] Plagge, A. (2006), pp. 39-40.
[1900] See about the history and performance of company Becker, R. and Helmann, T. (2003). According to the authors the failure WFG was due to 1) inappropriate contractual instruments and governance relationships between the venture capital fund and the entrepreneurs, 2) conflicting objectives of its own investors, the government and the established banks, 3) the lack of high quality entrepreneurs and entrepreneurial incentives and 4) non-sufficient environment for incentives to become entrepreneurs.

Figure 15: Private Equity investments in Germany (billion EUR)



Source: BVK (2017)

The first venture capital like activities in Germany were initiated by large institutions and governmental support.[1901] It is fair to say that despite the earlier attempts to create venture capital market in Germany a venture capital industry did not practically exist before the early 1980s.[1902] The economic upturn of the 1980s which was boosted in the end of the decade also by the German unification created favourable conditions for increased venture capital activities.[1903] Another boom phase took place in the end of 1990s when focus was more than earlier in early-stage investments and in computer-, communication- and biotechnology.[1904]

In the new millennium the German venture capital industry continued to have important role in contributing to the development of the country´s businesses as can be seen in the table above (Figure 15). The private equity today has significant business volumes and achieved investments of EUR 5.7 billion in 1011 companies during 2016.[1905] The German Private Equity and Venture Capital Association e.V. (BVK) has around 300 members out of which nearly 200 are private equity firms providing venture capital investments in German companies.[1906]

[1901] Fohlin, C. (2006), p. 9.
[1902] Franzke, S. et al. (2003), p. 8.
[1903] Jung-Senssfelder, K. (2005), p. 14.
[1904] Jung-Senssfelder, K. (2005), p. 15.
[1905] BVK (2017b).
[1906] BVK (2017c).

4.1.4 Venture capital and mezzanine

Venture capital financing is a type of professional asset management where funding raised by investors are channelled to target companies having significant growth potential.[1907] Venture capitalists provide capital to enterprises that are not listed on a stock market. Examples of such financing arrangements are financing of seed corn[1908] and start-up[1909] phases. Venture capital investments are often provided also in Management Buy-Out (MBO) and Management Buy-In transactions.

The goal of the venture capital investor is to grow the value of the company through the investment. The value growth is realised at the exit stage where the investor gives up its holdings in the target company. Successful exit can take place through profitable IPO or trade sale of the company. The investment is already at the start made with a plan to exit within an agreed period which is normally 2-7 years.

Venture capitalists choose their financing objects very carefully. The process to raise venture capital financing takes months and includes several phases. After screening, analysis, due diligence it is time to conclude whether investment will be done. Portfolio companies must generate returns well above traditional senior financing and right valuation of the target company is very important. If the required rate of return can be achieved the negotiations can be closed by signing the investment deal. Well-connected venture capital companies benefit the target company and increase the likelihood of successful exit after the investment period.

The venture capital investor earns much of its return through fees that are tied to the performance of the target company. Therefore, venture capital financier wants to see predictable cash flow as the source of repayment for their investments. They want to also be assured of the future profitability of the business they have invested in - just like any other new shareholder. Besides the financial figures also the quality of the management in the target company is closely evaluated by venture capital investors. This is one reason why venture capital investors want ownership in target companies and participate in the management of the target company. The participation takes normally place through membership in the board. All in all, the involvement of the venture capital investor means participation in the success of the company together with the other owners.

For the management of the investee company venture capital investors require normally compensation package that is tied to profits and value appreciation of the firm. This is one way of tying the management to the business so that there is no doubt of appropriate commitment of the key personnel. A monthly salary without any incentive for business success is not a desired way of compensation from a mezzanine financier's perspective.

Venture capital companies are primarily owned by private persons and companies administrating the capital to be invested. Sometimes venture capital firms even invest their own money to target companies. The role of fund managers is to decide what business ventures are financed and which financing instruments shall be used. Venture capital companies act as management companies collecting commitments from investors through fundraising and place the funds to chosen investment objects.

The legal structure generally used by most venture and private equity funds is the a fixed-life limited partnership. In this setup belong a general partner managing the investments and

[1907] In this research the terms venture capital and private equity are used to mean the same issue unless otherwise expressed in the text part in question.
[1908] Seedcorn refers to financing of research, assessment and development of an initial business concept.
[1909] Start-up refers to financing provided to companies for product development of an initial business concept and marketing.

having unlimited liability. On top of that limited partnership has limited partners. The general partner is entitled to a management fee and receives a percentage of the profits. The limited partners receive income, capital gains and benefits in taxation.

The financing of young and growing firms is risky. These firms are often strained by the uncertainty of the future. This affects the possibility of getting additional capital. Debt and equity holders may feel that providing additional capital is not possible because of the unsatisfying risk/return -ratio. This leads to the problem of financial distress where obligations to creditors are difficult to fulfil. The cost of financial distress increases with high gearing and this shrinks the value of the firm.

Venture capital financiers can cope with the above-mentioned information problems. They evaluate and monitor investee companies closely before and after financing and this way have *"nonmonetary"* tools for controlling information gaps and capital constraints. They have also organisational capacity and expertise for this kind of monitoring. Taking that expertise and operating model into consideration these financiers can provide sometimes money when banks and other equity financiers are not willing.

4.2 Banks

4.2.1 About bank financing in general

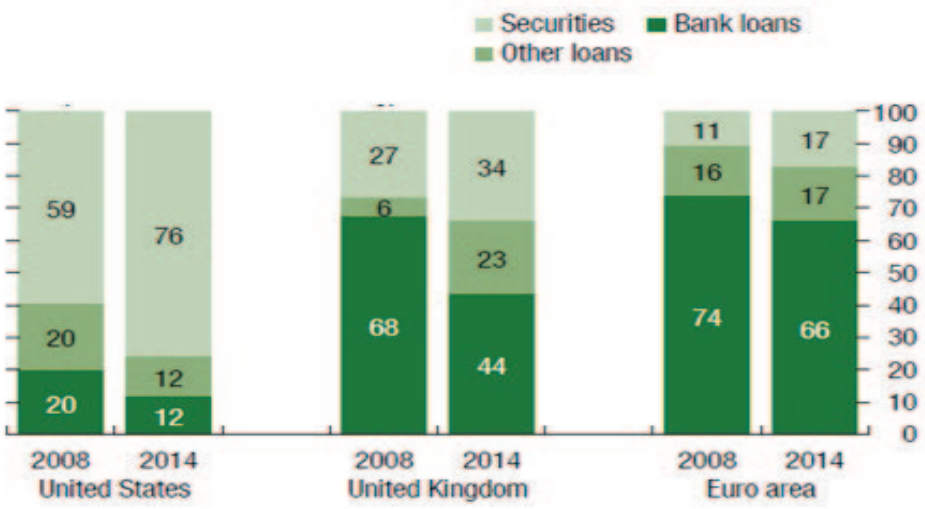
The development of any country depends on its economic development. To have financial growth investments and increased production is needed. The role of financial intermediates in supporting investments is crucial as investing needs financing and many major investments need external financing. Banks grant credits, receive deposits, transfer payments and manage the customers´ assets. The role of bank loans is significant in company finance as can be seen in the table below (Figure 16). For large credit worthy companies also, the capital markets are a relevant option. Especially in the USA the role of capital markets as a source of financing is major. For SMEs in European Union bank financing is clearly the most dominating financing source (see Figure 17 below).

Financial system performs the role of channelling funds from savers to those wanting to spend i.e. borrowers. In direct finance borrowers get funding directly from lenders in the financial markets by selling securities. In indirect finance a financial intermediary has the role of channelling funds from the savers to the lenders. This is the most important business of banks.[1910] The financial markets and intermediaries are thus performing the same function but in different ways. The flow of funds in direct and indirect financing are not always separate either as participants and instruments used can be the same.[1911] Banks play a critical role in the network of financial system besides being part of the network but also because of influencing the intermediaries in the network.[1912] This is in line with the financial intermediation theory of banking according to which the banks collect deposits and then lend these out.[1913]

[1910] Andoh, S.K. (2014), p. 93.
[1911] Andoh, S.K. (2014), p. 12.
[1912] Ashraf, Q. et al. (2016), p. 2.
[1913] Werner, R.A. (2015), p. 362. In his article the author reviews the three different theories of banking that have been dominating at different times. According to p. 361 *"(1) The currently prevalent financial intermediation theory of banking says that banks collect deposits and then lend these out, just like other non-bank financial intermediaries.*

The difference between the costs of taking deposits and revenues received through lending those funds further is the major income source for the banks.[1914] The pricing of bank lending exceeds the pricing of bank borrowing i.e. pricing of savings. The present low-interest environment has narrowed this earning possibility during the last years which has forced banks to streamline their activities and look for also other income sources like advisory and risk management services.[1915]

Figure 16: Corporate borrowing (percent of total borrowing)



Source: IMF (2014), p. 29.

Bank loans are normally secured senior loans or unsecured senior loans with low risk lending risk. This means lower interest costs for the borrower than in case of mezzanine financing. However, bank financing may not be the best alternative for a fast-growing new company with a higher risk-return profile or being in the middle of a major structural change. The recent financial crisis has forced some companies to increase their leverage levels in order them to survive. Taking into consideration that simultaneously banks have been restructuring their own operating models and balance sheets to meet the stricter banking regulation demands fears for credit crunch have emerged. Especially SME sector is concerned on the financial

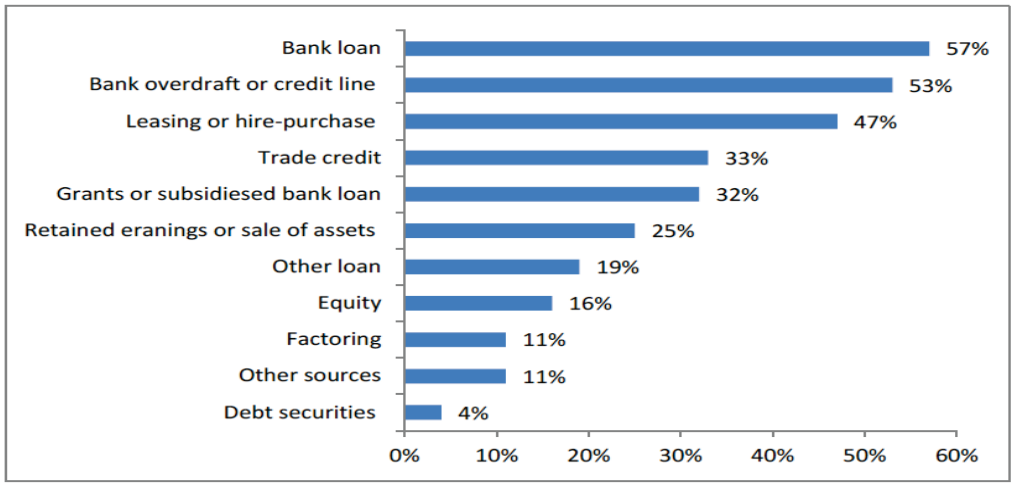
(2) The older fractional reserve theory of banking says that each individual bank is a financial intermediary without
the power to create money, but the banking system collectively is able to create money through the process of 'multiple deposit expansion' (the 'moneymultiplier'). (3) The credit creation theory of banking, predominant a century ago, does not consider banks as financial intermediaries that gather deposits to lend out, but instead argues that each individual bank creates credit and money newly when granting a bank loan."

[1914] Krugman, P. (2015).

[1915] About the role of intermediaries in risk trading see Allen F. and Santomero, A.M. (1998), pp. 1478-1480.

reforms as they are more dependent on bank finance and have less ability to adapt than the larger corporates.[1916]

Figure 17: Share of financing type of SMEs in European Union based on ECB/EC survey 2014 (percent of companies)



Source: OECD (2015b), p. 32.

4.2.2 Banks in Finland

In the Finnish banking market operate more than 200 banks consisting of domestic deposit banks, investment banks and foreign credit institution owned branches and subsidiaries.[1917] Deposit Banks operating in Finland are OP Group, Nordea Bank Finland, Danske Bank, Aktia Bank, Savings Banks Group, Ålandsbanken, POP Bank Group, Evli Bank, S-Bank, The Mortgage Society of Finland and Oma Säästöpankki.[1918] The biggest branches of foreign deposit banks operating in Finland are owned by Svenska Handelsbanken, Skandinaviska Enskilda Banken and Forex Bank.[1919]

The most important law governing banks in Finland is the Act on Credit Institutions.[1920] On top of that a credit institution in the form of a limited company, a savings bank, a credit institution in the form of a cooperative and a mortgage society shall be governed by special laws.[1921] Compliance with the laws and regulations including fulfilment of capital adequacy

[1916] OECD (2015b), p. 11
[1917] FFI (2016).
[1918] FFI (2016b).
[1919] Ibid.
[1920] Act on Credit Institutions (610/2014), Government Bill for the Act on Credit Institutions (HE 39/2014).
[1921] According to Chapter 1, Section 2:2 of the Act on Credit Institutions (610/2014) a credit institution in the form of a limited company shall be governed by the Act on Commercial Banks and Other Credit Institutions in the Form of a Limited Company (1501/2001), a savings bank by the Savings Bank Act (1502/2001), a credit

requirements is overseen by the Financial Supervisory Authority and the European Central Bank (ECB). The three largest banks - OP Group, Nordea Bank Finland and Danske Bank Finland - are directly supervised by the ECB and the smaller banks are supervised by the Financial Supervisory Authority.[1922] Deposit banks and credit societies are credit institutions if they accept repayable funds from the public.[1923] Such credit institution activity is subject to authorisation.[1924]

The Finnish banking market faces significant challenges among other things in a form of narrowed deposit and lending interest rates.[1925] Also the overall macroeconomic environment has been weak during the last years and growth forecasts are modest.[1926] Despite of that the Finnish banking sector can be considered to be strong.[1927]

Banking financing remains the most important external financing source for corporates covering around 65-75% of the total external financing needs.[1928] In 2015 the corporate loan portfolio including housing companies grew by 6 % which figure exceeds the average growth in the euro area.[1929] At the end of the same year the average interest rate of the corporate financing was 1.78% per annum.[1930] This is below the euro area average.[1931]

The company´s profitability, solvency and outlook for the future are the relevant factors on which the financing decision is based. Even though company´s cash flow must always be sufficient, a collateral (e.g. real estate) is normally required. The collateral lowers bank´s credit risk and therefore also to pricing of the loan.

The single most important element in assessing the borrower´s credit worthiness is borrower's ability to service its commitment out of its future cash flow. This repayment ability covers not only customers normal operative cash flow but also its capability to attract additional capital and realise assets if needed. The balance sheet of the borrower should show sufficient liquidity to tolerate negative business conditions including even prolonged negative cash flow.

Banking financing granted to corporate customers is traditionally secured senior financing and unsecured senior financing. Thus mezzanine/hybrid type of financing does not normally belong to low-risk bank´s product portfolio.

Out of the three biggest Finnish banks - OP Group, Nordea Bank and Danske Bank Finland representing in total over 70 % lending market share in the Finnish banking market[1932] - only OP Group markets openly on its web pages possibility for financing that can considered to fall under mezzanine/hybrid financing category. OP Group markets possibility junior financing. The junior financing in question is always part of the total financing package including always also senior financing. The junior loan is not however granted by the bank but the non-life

institution in the form of a cooperative by the Act on Cooperative Banks and Other Credit Institutions in the Form of a Cooperative (423/2013), and a mortgage society by the Act on Mortgage Societies (936/1978).

[1922] The Single Supervisory Mechanism (SSM) - the system of financial supervision in euro area countries - comprises both the European Central Bank (ECB) and the national competent authorities (NCAs). The ECB directly supervises significant banks, whereas the NCAs are responsible of supervising less significant banks. See for more details ECB (2015).

[1923] Chapter 1, Sections 5 and 7 of the Act on Credit Institutions (610/2014).

[1924] Chapter 2, Section 1 of the Act on Credit Institutions (610/2014).

[1925] Putkuri, H. and Savolainen, E, (2016).

[1926] About the latest Bank of Finland forecasts including some past years growth statistics see BoF (2015) and BoF (2016).

[1927] FFI (2016c).

[1928] Suomen Pankki (2015), figure 6, p. 10.

[1929] FFI (2016c), p. 6.

[1930] Ibid.

[1931] Pylkkönen, P. (2015), p. 28.

[1932] FFI (2016c), p. 4.

insurance business arm of the OP Group.[1933] The product was launched in the market in 2015. The demand of the junior financing in question has been very low and the volumes of the junior financing are statistically insignificant.[1934]

4.2.3 Banks in other countries

4.2.3.1 Sweden

There are more than 100 banks operating in Sweden consisting of commercial banks, foreign banks, savings banks and cooperative banks.[1935] The largest banks in the country are the commercial banks Nordea, Swedbank, Handelsbanken and SEB. The market share of *"the four big banks"* in the corporate finance has been decreasing during the last years but still is more than 65 %.[1936] The long tradition of easily accessible and attractively priced bank funding in comparison to other external financing sources is visible here.

The Swedish Banking and Financing Business Act is the fundamental act regulating the banking business.[1937] The act governs the operations of all forms of banks as well as includes rules on their supervision. The act includes requirements to obtain a licence to conduct banking and financing business and defines also what kind of financial operations licence holders may perform.[1938] Besides the above-mentioned rules which cover all types of banks the Swedish Banking and Financing Business Act contains also specific rules for the formation and organisation of the limited liability banks.[1939] According to the rules of supervision the Swedish Financial Supervisory Authority (Finansinspektionen) has a direct responsibility to supervise the individual institutions on the financial market. The Swedish Financial Supervisory monitors compliance with the laws and regulations together with the Swedish central bank (Riksbanken) to maintain the stable conditions in the financial market.[1940]

Out of the four biggest banks in Sweden - Nordea, Swedbank, Handelsbanken and SEB - no one markets openly on their web pages possibility for mezzanine type financing. It is not known for the author that any other bank in Sweden would mass market mezzanine financing either as a potential bank lending form.

4.2.3.2 Estonia

Estonian banking market comprises 15 banks including 6 domestic banks and 9 foreign-controlled bank branches and subsidiaries.[1941] The Estonian banking market is dominated by

[1933] See for more details OP Group (2017).
[1934] Helsingin Sanomat (2016).
[1935] SBA (2017), p. 5.
[1936] Konkurrensverket (2016), pp. 40-42.
[1937] Banking and Financing Business Act (SFS 2004:297).
[1938] SBA (2017), p. 15.
[1939] Formation and organisation of savings banks is regulated in the Savings Bank Act (SFS 1987:619) and formation and organisation of cooperative banks is regulated in the Members´ Banks Act (SFS 1995:1570).
[1940] SBA (2017), p. 14.
[1941] TheBanks.eu (2017).

the Nordic banking groups. In corporate financing the four biggest banks - Swedbank, SEB, Nordea and Danske Bank - have market share of over 80 %.[1942]

The banks registered in Estonia are under the supervision of the Estonian banking supervision authorities and branches of banks registered elsewhere are subject to the supervision of the countries where they are registered.[1943] The key act regulating the foundation, activities, dissolution, liabilities and supervision of credit institutions is the Credit Institutions Act[1944].

None of the four biggest banks - Swedbank, SEB, Nordea and Danske Bank - markets openly on their web pages possibility for mezzanine type financing. It is not known for the author that any other bank operating in Estonia would mass market mezzanine financing either as a potential bank lending form.

4.2.3.3 USA

In the USA there are more than 5,000 commercial banks.[1945] The biggest banks based on the consolidated assets are JPMorgan Chase, Wells Fargo, Bank of America and Citigroup.[1946] Banks can choose to be chartered i.e. get the legal authorization for their business at either the state or federal level by their primary regulator.[1947] The possibility was introduced in the legislation by the National Bank Act in 1863. On top of that banks having holding company can register themselves as financial holding companies allowing a bank to offer financial services through subsidiaries

Figure 18: Banking Institutions Charter Grantors, Examiners and Supervisors in the USA

Banking Institution Charter Type	Charter Grantor	Examiner/Supervisor
National, Federal	OCC	OCC
State	State financial services departments	State financial services regulator and FDIC or regional Federal Reserve Bank
Holding companies	Federal Reserve Board/ state corporate departments	Federal Reserve Board

Source: ABA (2014), p. 47.

The Office of the Comptroller of the Currency (OCC) within the Treasury Department oversees federally chartered banks, the Federal Reserve oversees state banks being members of the

[1942] Finantsinspektsioon (2017), p. 22. It is noted that Nordea and DNB combined their Baltic banking operations in October 2017 and continued to operate under name Luminor in each Baltic country including Estonia. In October 2018 Nordea and DnB announced that they have sold jointly 60 % of Luminor to a consortium led by private equity funds managed by Blackstone.
[1943] Republic of Estonia (2016).
[1944] Credit Institutions Act (RT I 1999, 23, 349).
[1945] According to Ycharts (2017) the number of commercial banks in the USA was 5.083 in Q4/2016.
[1946] Federal Reserve (2016).
[1947] ABA (2014), p. 47.

Federal Reserve and supervises bank holding companies, the Federal Deposit Insurance Corporation (FDIC) is the primary federal banking supervisor of non-Fed member banks and the State financial services regulators examine state-chartered banks (see Figure 18 above).[1948]

Mezzanine financing is not used as a mass lending product by the banks in the corporate financing in the USA either. However, among the more than 5,000 banks in the country there are also banks that can provide tailor-made financing solutions including also mezzanine instruments as a part of their service portfolio.[1949] On top of that many bigger banks have specialised Investment Bank units that provide advisory services to corporate customers among other things in the field of capital raising, risk management and trade finance services. Such services are targeted to help customers to achieve objectives like acquisitions, buy-outs, share repurchase or investments with the relevant financing package which can include also mezzanine debt.[1950]

4.2.3.4 Other countries

4.2.3.4.1 UK

UK banking market consists of more than 300 banks (including 200 branches and subsidiaries of foreign banks).[1951] The market is dominated by a few large banks the four major ones according to the total assets being HSBC, Barclays, the Royal Bank of Scotland and Lloyds Group.[1952]

According the Financial Services Act[1953] there are two regulatory authorities: the Prudential Regulation Authority (PRA) and the Financial Conduct Authority (FCA). PRA, which is part of the Bank of England, is responsible for the prudential regulation and supervision of banks. Banks are required to apply to the PRA for authorisation. The Financial Conduct Authority (FCA) is separate from the Bank of England and its responsibility is to ensure that financial markets work effectively and that the conduct of companies in financial markets is acceptable and meets the legislative standards. Banking Act [1954] regulates the powers of act of the regulators in protecting the financial stability.

Mezzanine is not mass bank product in UK either but - as in the USA - the investment bank arms of the biggest UK banks provide advisory or financing structuring services for the corporate customers which may involve mezzanine type of financing products. In such cases the actual lender of the mezzanine financing is normally not the bank itself but mezzanine funds, private equity houses, private business angels[1955] etc.

However, there are also some banks in the market which provide mezzanine financing as a part of their own product portfolio. The target group of such financing is normally narrower

---

[1948] ABA (2014), p. 48.
[1949] For example, Silicon Valley Bank (SVB) - the 39th biggest US bank based on the consolidated assets according to Federal Reserve (2016) - provides targeted financial services for venture capital and private equity industry. See for more details SVB (2017). SVB has been involved in providing 15 MUSD mezzanine debt to IPG, an Atlanta, Georgia based provider of device benefit management solutions. See for more details IPG (2016).
[1950] See JPMorgan Chase (2017), Wells Fargo (2017), Bank of America (2017) and Citigroup (2017).
[1951] PRA (2016), p. 15.
[1952] Statista (2017).
[1953] Financial Services Act 2012.
[1954] Banking Act 2009.
[1955] About business angels see Weitnauer, W. et al. (2016), p. 8.

than in case of normal corporate loan products.[1956] The focus can be also on other areas which deviate from the traditional commercial banking criteria.[1957]

4.2.3.4.2 Germany

The German banking sector is very heterogeneous. It consists of more than 1.700 banks comprising

- privately owned global players like Commerzbank, Deutsche Bank, Deutsche Postbank
- regional savings banks including their central institutions Landesbanken and
- large number of cooperative banks and
- mortgage and other smaller banks.[1958]

The Banking Act (Kreditwesengesetz)[1959] contains the main regulations that apply to banks. It also sets the legal basis for the banking supervision in Germany. The supervisory duties are divided between the Bundesbank and the Federal Financial Supervisory Authority (BaFin). BaFin has the authority to grant banking licenses.[1960]

In the past German banks have over the years taken part into mezzanine financing schemes.[1961] Presently such activities by the banks are much more limited. KfW Bankengruppe is an example of a bank that is also today involved in mezzanine financing structures.[1962]

4.3 Other financiers - some examples

4.3.1 Finnvera

Finnvera is a specialised financing company owned 100 % by the State of Finland and operates also as the official Export Credit Agency (ECA) of Finland. Finnvera supplements the financial services of the other financiers in the market by providing loans, guarantees, venture capital investments and export credit guarantees for its customers.

The legal background for the activities of Finnvera can be found from the Act on the State-Owned Specialised Financing Company.[1963] According to the law the purpose of Finnvera is provide financing services to promote and develop especially the business of SMEs and to

---

[1956] See Santander UK (2016). On their web pages the bank markets its Breakthrough Finance for customers having *"a turnover of between £500,000 and £50 million per annum while posting annual growth of around 20% or more in a combination of turnover, profit or employment."*

[1957] See Triodos UK (2016). On their web pages bank refers in structuring and raising different types of finance including *"secured and unsecured debt in the form of bonds or mezzanine finance".* About Triodos Bank as mezzanine provider see also European Commission (2007), p. 14.

[1958] IMF (2016), p. 54. See about the German banking system also Behr, B. and Schmidt, R.H. (2015).

[1959] Banking Act (Kreditwesengesetz) of July 10, 1961.

[1960] Part III, Division 1, Section 32 of the Banking Act (Kreditwesengesetz).

[1961] See OECD (2013), pp. 33-34.

[1962] See more about KfW involvement below in section *4.3.6 German Investment Corporation DEG*.

[1963] Act on the State-Owned Specialised Financing Company (443/1998).

promote and develop the exports and internationalization of the Finish companies.[1964] Finnvera shall do this by granting credits, guarantees, other contingent liabilities and providing to enterprises development assistance, services and advice.[1965]

As being fully state owned special purpose company Finnvera´s own debt obligations are explicitly guaranteed by the Republic of Finland. This means that also rating of debt obligations the same as those of Finland.[1966] The company is administratively under the Ministry of Employment and the Economy and majority its supervisory board consists of members of the Parliament[1967].

In April 2016 Finnvera added into its product selection a new loan product - the Growth Loan - which is a debt-based mezzanine financing product combining the features of both equity and debt financing.[1968] According to the Finnvera´s product description

> *"The Growth Loan is a debt-based mezzanine financing product. The company's self-financing portion must always be at least 20% and the share contributed to the total financing by other financiers than Finnvera must be at least 50%. Project profitability and eligibility for financing is assessed on a case-specific basis together with other financiers."* [1969]

The Growth Loan is by its nature junior loan i.e. it is not equity but it is subordinated in relation to senior loans.[1970] Target group is defined to be SMEs and midcap companies which are in major growth and internationalisation projects or corporate reorganisation.[1971] As the product is new it is too early to draw final conclusions on its popularity in market but so far, the demand has been very limited.[1972] The Growth Loan programme was launched to be valid until the end of 2018 and totals max MEUR 300.[1973]

4.3.2 Garantia

Garantia Insurance Company Ltd is a Finnish privately owned non-life insurance company specialising in guaranty insurance.[1974] The company is part of the Taaleri Group a wholly-owned as a wholly owned subsidiary of Taaleri Plc.[1975] As an non-life insurance company Garantia is supervised by the Finnish Financial Supervisory Authority.[1976] The product

[1964] Section 1of the Act on the State-Owned Specialised Financing Company (443/1998).
[1965] Section 1of the Act on the State-Owned Specialised Financing Company (443/1998)
[1966] See Finnvera (2016), p. 7 according to which the rating of Finnvera is Aa1 by Moody's and AA+ by Standard & Poor's as of August 8, 2016.
[1967] Finnvera (2016b), pp. 4-5.
[1968] Finnvera (2016c).
[1969] Ibid.
[1970] Suokas, J. (2016), pp. 21-22.
[1971] Finnvera (2016d). According to the same source *"A Growth Loan may be granted to SMEs and midcap companies which have been in operation for over three years. The Growth Loan is a debt-based mezzanine financing product. The company's self-financing portion must always be at least 20% and the share contributed to the total financing by other financiers than Finnvera must be at least 50%. Project profitability and eligibility for financing is assessed on a case-specific basis together with other financiers."*
[1972] Helsingin Sanomat (2016).
[1973] Suokas, J. (2016), p. 21.
[1974] Garantia (2016).
[1975] Garantia (2016b), p. 3. Taaleri is a financial group, whose parent company Taaleri Plc's share is listed on the main list of the Helsinki Stock Exchange.
[1976] Garantia (2016).

portfolio of the company includes among other things corporate guaranties, commercial bonds and investment guaranties.[1977] Garantia has credit rating A- issued by Standard & Poor's.[1978]

Garantia provides guarantees for any type of debt or equity financing.[1979] The purpose of the guaranty insurance is to make it easier for the guaranteed company to access funding as from the financiers' perspective Garantia covers part of the credit risk. The exact split of the guarantees between debt and equity financing is not disclosed but the total guarantee exposure of Garantia was MEUR 1,164 in 12/2015.[1980]

4.3.3 ALMI

Almi Företagspartner AB (Almi) is the state owned Swedish development bank. It is the parent company of a group including 16 regional subsidiaries, which are 51 % owned by the parent company.[1981] County councils, regional authorities and municipal cooperative bodies are other owners.[1982] The boards of the subsidiary companies are therefore also partially made up of politicians.[1983] Operations are to the large extent run by the regional companies.[1984] Almi's operations are self-financed including annual grants from the owners.[1985]

The company operations are structured in three business areas which are Advisory Services, Loans and Venture Capital.[1986] Almi offers loans and venture capital financing to SMEs when the private capital market actors like banks consider the investments to be of high risk.[1987] Therefore also the interest rate charged by Almi is normally higher than the average interest rate offered by banks. Almi's lending transactions are often done in cooperation with banks or other financiers in the market. The target group of Almi loans are companies in all industries having at the maximum 250 employees.[1988]

Almi Invest AB is the venture capital arm of the Almi Group. Almi Invest strategy is to invest in companies with scalable business concepts and forecasts for long-term capital growth.[1989] The company invests in different phases of the target enterprises starting from the seed phase to the expansion phase.[1990]

Almi Group is an example of publicly owned special financier that is involved in mezzanine financing through its venture capital business area. One of the other business areas of the group - business area Loans - is involved in *"risk bearing loans"*[1991] and operates also outside the comfort zone of traditional senior financing providers like banks. Although these high risk

---

[1977] Ibid.
[1978] Ibid.
[1979] Garantia (2016c),
[1980] Garantia (2016b), p. 4.
[1981] Almi (2016), p. 10.
[1982] Almi (2016), pp. 70-80.
[1983] Bellini, N. et al eds (2012), p. 293.
[1984] Ibid.
[1985] Almi (2016), p. 81.
[1986] Almi (2016b).
[1987] Ibid. According to company´s webpages *"Almi complements the market by providing risk bearing loans where nobody else does. Almi's role is to take slightly larger risks".*
[1988] Ibid.
[1989] Almi (2016c).
[1990] Ibid.
[1991] According to Almi (2016b*) "Almi complements the market by providing risk bearing loans where nobody else does. Almi's role is to take slightly larger risks".*

loans may not exactly be within the definition of mezzanine loans they are anyhow complementing the scarce risk financing offering in the market.

4.3.4 KredEx

KredEx foundation is a financing institution owned by the state of Estonia. In practice the foundation activities are controlled by the Ministry of Economic Affairs and Communications.[1992] The purpose of KredEx is to support the development of Estonian enterprises through providing loans, venture capital financing, credit insurance and guarantees[1993]. The foundation operates as a non-profit organization and its obligations are guaranteed by the state of Estonia.[1994]

Kredex supports companies among other things by providing capital loans. According to the product description

> *"A capital loan is helpful if the company wishes to finance its fast growth with loan capital, but the level of self-financing is too small or the collateral insufficient for obtaining a bank loan. Similarly, to the owner, KredEx will give into the use of the company capital, which due to its subordination increases the level of self-financing in the eyes of other financiers."*[1995]

Besides being subordinated loan, the interest of the capital loan may be dependent on the borrower´s performance.[1996] Both subordination and performance-linked are common features of mezzanine type financing.

4.3.5 British Business Bank

The British Business Bank plc is a state-owned economic development bank established and owned by the UK Government.[1997] As being the government owned development bank it is not authorised or regulated neither by the Prudential Regulation Authority (PRA) or the Financial Conduct Authority (FCA).[1998] The bank targets to increase the supply of credit to small and medium sized enterprises and provide business advice services as well.[1999] The British Business Bank does not lend or invest directly but operates with several partners like such as banks, leasing companies and venture capital funds.[2000]

[1992] KredEx (2016), p. 8.
[1993] KredEx (2016), p. 7.
[1994] KredEx (2016), p. 8.
[1995] Kredex (2016b).
[1996] KredEx (2016c). According to the product description the interest is described as follows: *"Generally 8.5 - 15%. Final interest depends on the risk level of the company, the project, and the provided collateral. Interest may comprise two components: fixed interest and interest depending on the company's performance. As a rule, fixed interest payments are made on a monthly basis, with the share of regularly payable interest being approx. 67% of total interest. The interest, which depends on the performance of the company, is paid at the end of the loan term."*
[1997] British Business Bank (2016b).
[1998] Ibid.
[1999] British Business Bank (2016).
[2000] British Business Bank (2016c).

In its financing options presentation the British Business Bank describes growth finance as one potential financing form for the SMEs growth finance.[2001] This refers to tailor-made mezzanine type debt financing where the repayment matches the forecasted cash generation of the borrower.[2002] Growth finance may rank below senior loans and it may also include option for the lender to convert the loan into equity if the loan is not repaid according to the repayment plan.[2003]

4.3.6 German Investment Corporation DEG

Deutsche Investitions- und Entwicklungsgesellschaft (DEG) is a German development bank having its mission in promoting business initiative in developing and emerging market countries.[2004] DEG is a member of KfW Bank Group (KfW Bankengruppe) which is the promotional bank of the Federal Republic of German.[2005] DEG finances investments in developing and emerging-market countries by providing tailor-made financing among other things in form of equity capital, mezzanine finance, loans and guarantees.[2006] Financing is provided to start-ups as well as extension and modernization investments.[2007] On top of financing DEG provides customer advisory services.[2008] Customers can be both German and non-German enterprises.[2009]

DEG lists following features for the mezzanine financing it offers:[2010]

- financing form between equity capital and third-party capital
- project-specific arrangement
- subordinated security
- risk-oriented yield
- conversion options.

[2001] British Business Bank (2016d).
[2002] British Business Bank (2016d), p. 20.
[2003] Ibid. According to the product description growth finance *forms "are most appropriate for financing high-growth businesses, and are typically used to finance the expansion of existing companies by VC investors - for product developments, penetration of new markets, infrastructure investments, or for strategic acquisitions."*
[2004] DEG (2016) according to which the mission of DEG is *"to promote business initiative in developing and emerging market countries as a contribution to sustainable growth and improved living conditions of the local population."*
[2005] KfW (2017) according to which KfW was initially involved in conducting reconstruction in Germany and later became on behalf of the German government active in promoting economy in other countries. In the KfW Bank Group it is the specific role of DEG to invest in developing countries.
[2006] DEG (2016c), pp. 8-9.
[2007] DEG (2016d).
[2008] DEG (2016b).
[2009] DEG (2016d).
[2010] DEG (2016c), p. 9.

4.4 The interests of lender and borrower

4.4.1 What does the mezzanine financier want?

Mezzanine is a financing form between equity capital and external debt capital. Mezzanine is used as a combination of the debt funding provided by senior lenders and the equity funding provided by stockholders. It is therefore sometimes seen as halfway between debt and equity in terms of risk and reward. Mezzanine is usually high interest-bearing debt, which often ranks behind the receivables of the senior debtors as far as repayment and security is concerned. This means that mezzanine provider takes a subordinate position and is thus second in line to receive repayment if the financed company defaults on repayment. As a conclusion the return demand of mezzanine loan is higher than in case of the traditional senior debt.

Because of the subordination the financier risk increases. This is also the reason why mezzanine financier assesses its financier risks very carefully and requires from the potential borrower a solid track record and strong cash flow forecasts before providing the funding. To be able to do the assessment prudently the mezzanine financier benefits also from the special expertise of the borrower´s industry in question.[2011] A solid track record is subject to already established product or service and good reputation which form the basis for the historical profitability. To get financier´s confidence for the positive cash flow forecasts requires viable business plans which may include among other things organic growth and/or acquisitions. To implement such plans requires also managerial skills. Without confidence on the borrower´s management no serious financier is ready to grant any significant financing. And even after providing the funding mezzanine debt lender continues to actively monitor the borrower your company's financial performance and fulfilment of covenants.

Mezzanine is a good financing alternative for stable and growing companies with consistent and predictable cash flows. However, mezzanine is not always the best suitable financing alternative in such situations where there is doubt whether the borrower is able to generate enough cash flow to meet its other debt obligations. For example, start-up companies lack historical track record showing strong enough cash flow and normally also miss the capital available to make monthly principal and interest payments. In order a mezzanine provider to step in into a project the financier would have to believe in the borrower´s ability to generate enough cash flow to meet both the higher priority ranked senior payment obligations and also the mezzanine debt payments. This is what private equity funds using mezzanine instruments focus on finding out when analysing the potential target companies.

The fundamental rationale of large pension funds, insurance companies, banks and other institutions to invest in private equity funds is to improve the investment portfolio´s risk and reward profile. Private equity investments offer the investor an opportunity to generate higher returns and give a chance to improve portfolio diversification. It is a matter of applying the diversification principle.[2012] Mezzanine gives possibility to return which does not correlate significantly with the returns of equities or bonds.[2013]

In an investment portfolio private equity investment besides publicly listed securities can further improve diversification. This is the case provided that private equity has lower correlation of returns between publicly listed securities than the correlation between listed

[2011] See Mello, A. and Quintin, E. (2015), according to which in real estate management industry mezzanine lenders tend to be industry specialists.
[2012] Bodie, Z. and Merton R. C. (2000), pp. 298-304.
[2013] Stefanova, M. (2015), p. 267.

securities with each other.[2014] By adding private equity to portfolio the investor can reduce volatility and improve the portfolio´s risk profile. In this way higher targeted returns without risk increase or alternatively even with risk reduction would be possible if the target rate of return stays the same.

Mezzanine providers seek yields higher than senior loan financiers. The interest rate clauses may contain obligation to pay fixed interest rate or fixed margin on top of the chosen base rate. Sometimes also additional interest in the form of PIK interest[2015] and equity warrants[2016] can be included in the financing package. Target yield of the mezzanine financier can vary approximately between 15% and 25% per annum.[2017]

The long-term returns of private equity have been long time higher than the returns of public equity. This has been the case in USA and Europe for decades with some exceptions.[2018] A premium over more conventional asset classes justifies the investments to private equity funds for institutional investors. However lately have been published some academic researches concluding that the trend of private equity outperforming public equity in terms of returns has changed.[2019]

4.4.2 The borrower´s point of view

Companies choose mezzanine financing often in situations where alternative financing forms are not available or the usage of them would not be the best possible alternative. Bank financing might not be in some situations any more accessible due to high leverage ratios and getting financing through public offering might not be realistic due to costs of the process. However also mezzanine financing structures are expensive and not always worth the costs.[2020]

Although mezzanine financing has some advantages it is not necessarily a suitable funding source for all kinds of businesses. For example, private equity funds require control over business decisions and unsecured creditor expects regular reporting of business performance. Some entrepreneurs may feel uncomfortable with such requirements.

If a company is interested in getting mezzanine financing it should contact mezzanine investor for further discussions. Also, a senior lender like bank may suggest a mezzanine investor if lender is not willing to satisfy the new financing needs of the company. In preliminary screening is the determined whether mezzanine financing is a relevant financing alternative for the company.

Especially the financing of young companies and companies under restructuring is risky. These corporations are often strained by the uncertainty of the future. This affects the

---

[2014] If an investor does not have any knowledge of the correlations of securities and private equity, the diversification is random. See Sharpe, W. et al. (1999), p. 190.
[2015] PIK (payment-in-kind) interest is accumulated during the life of the loan and paid at final maturity. The PIK interest element does not affect cash flow up to the point of repayment.
[2016] Equity warrant is a certificate issued with a security giving the holder the option of buying a stock at a specified price up to a specified expiration date.
[2017] Silbernagel, C. and Vaitkunas, D. (2016), p. 5.
[2018] Harris, R.S. et al. (2015).
[2019] See researches made by Appelbaum, E. and Batt, R. (2016) and L'Her, J-F et al. (2016) focusing on the private equity fund performance in the US market. One of the conclusion of Appelbaum, E. and Batt, R. is that *"…In the past, the promise of high returns served to justify investing in PE buyout funds. Today, promises of high returns are mostly empty."*
[2020] See Baker, H.K. et al. eds (2015), p. 89 according to which in real estate financing the high costs discourage the usage of mezzanine in smaller deals.

possibility of getting additional capital. Debt and equity holders may feel that providing additional capital is not possible due to unsatisfying risk/return-ratio. This leads to the problem of financial distress where obligations to creditors are difficult to fulfil.[2021] The cost of financial distress increases with high gearing and this shrinks also the value of the firm. Other burdens for creditors stemming from the high leverage are agency costs, which are the lender´s direct and indirect costs of making sure that the managers of the borrower company act as lender´s *"agents"*.[2022] The lender tries to ensure that the agent acts in the interest of the lender.

From the borrower´s point of view there are luckily financiers who can cope with the above-mentioned challenges. Specialised financiers have resources to evaluate and monitor investee companies closely before and after financing and this way have *"nonmonetary"* tools for controlling information gaps and capital constraints.[2023] An example of these kind of specialised financiers are venture capital firms who have capacity and expertise for this kind of monitoring. Companies in growth phase may often need expertise to understand the business opportunities and to develop commercial skills.[2024] With that expertise the venture capital financiers can provide sometimes money when banks and equity financiers are not willing to finance.

Banks often look positively on companies that are backed by mezzanine lenders. This means that financing risk is shared with another financier. Mezzanine lenders take also active role which may enhance the business success of the company.

To be attractive target for potential financiers a company must be ready for an investment. The more of below listed criteria are fulfilled the better:

- skilled management
- clear strategies
- a good business plan
- favourable market conditions
- history of profits
- good cash flow
- audited accounts and regular financial statements
- separation of personal and business affairs.

The list is not complete and the weight of single points may vary in different cases. However, from the investee company´s point of view it is important to recognise the *"sour points"* of the business. Without this understanding the company may lose a possibility to receive new investments.

The companies need to take into consideration the positive and negative features of the mezzanine debt. Among the positive features of the mezzanine is that it improves the capital structure by making the balance sheet stronger. Mezzanine financing - once received - helps

[2021] Arnold, G. (2013), pp. 793-798.
[2022] Arnold, G. (2013), pp. 798-799.
[2023] Lerner, J. and Hardymon, F. (2002), p.5.
[2024] Fraser, S. et al. (2015), p. 74.

the company also to get easier access to additional loan or equity financing. If the mezzanine provider believes in the company it strengthens also the entrepreneurs' faith in her own business further. When the mezzanine provider believes in the company it lowers the hurdle for additional financiers to come along, too.

If the entrepreneurs have faith in their business it is easier to convince also a new financier to come on board. Maybe the best way to convince financiers that the entrepreneur is seriously involved is the amount of their own capital injection to the firm. If the founder uses all her savings and is also ready to take personal loans to back up the firm, it is a strong signal of commitment for the business. If this were not the case why would then any third party believe in the business either?

Mezzanine financiers have also interest to agree with the entrepreneurs and the target company management the incentives that remunerate based on the increase of the company value. A monthly salary without any incentive for business success is not a desired way of compensation from a mezzanine financier´s perspective. The more results the target company management shows the better it is paid. It is therefore also interest of the potential borrower to accept this approach.

One point that also needs to be discussed is the exact form of the financing needed. Very often start-up companies and growing companies have a weak balance sheet. The solidity can be low due to small amount of equity input at the starting phase and lack of profits due to high operating costs. In these situations, it is not irrelevant whether the financier is offering senior debt or equity ranked financing - like capital loan in Finland. Because equity ranked financing improves the equity ratio, the borrower company is more likely ready to pay higher interest rate on that financing form than on traditional senior debt. If the loan were in any case unsecured the profit increase of the lender may more than compensate the increasing financing risk related to the lower repayment priority. This is the case then if in the event of default, the unsecured claim was in all situations not to be repaid regardless of the repayment priority. Some examples of this are presented later.[2025]

From the borrower´s perspective at its best the mezzanine financing strengthens the balance sheet structure as there is no need to dilute equity holdings or give up ownership rights. It can however still also give possibility to tax-deductible interest payments. If amortisations are not required before the ultimate maturity i.e. loan is given in a form of a bullet, the borrower has more flexibility in reinvest its cash flow before loan matures. Mezzanine facilities are often structured to match the cash flow of the borrower company taking into consideration also the senior debt payments.[2026]

The possibility to tailor-made the mezzanine financing package to be suitable for many different situations is an absolute positive feature for the borrower.[2027]

[2025] See below section *5 Mezzanine in bank lending.*
[2026] Silbernagel, C. and Vaitkunas, D. (2016), pp. 9-10.
[2027] Stefanova, M. (2015), p. 267.

5 MEZZANINE IN BANK LENDING

5.1 The market need

The financing options available today for single companies are many. Based on the repayment priority in the case of default the financing alternatives start with common equity for which the investor expects to get the highest yield. The alternatives end to senior debt financing which requires security. Normally common equity is the most expensive form of financing and senior debt is the least expensive form. There is a range of different financial instruments between common equity and senior debt like preferred stock, capital loans, convertible loans, loans with rights to purchase shares (options) and junior loans.

The financial instruments that belong between common equity and senior debt - and are to be repaid - are defined as mezzanine instruments. This definition excludes preferred shares. For the borrower company mezzanine financing is a way to raise equity like financing without giving up majority equity position. Although mezzanine financing is priced higher that senior debt it is much cheaper than traditional equity sources.

As reviewed above there are several mezzanine financing providers in the market.[2028] The demand for structured finance like mezzanine does exist and the overall knowledge of tailor-made financing among corporations of different sizes is quite wide. However, banks are not very major players in providing mezzanine financing.

The impact of post financial crisis banking regulation including Basel III will force banks to think even more carefully how to use their lending capacity.[2029] The tightening requirements for own capital and liquidity reserves make it harder and less profitable to finance corporate business. Because of this some banks have withdrawn themselves from certain areas of corporate lending.[2030] This leaves on the other hand more room for strong banks and non-bank investors like hedge funds or private equity funds to operate in the challenging area of corporate financing. And no-doubt mezzanine products will have a role in that activity.

5.2 Financing of healthy customers

Credit granting is not based on the customer's current situation only but also its outlook. When granting corporate credit prudent lender examines the industry outlook and customer´s business forecasts. The analysis shall be based on quantitative as well as qualitative elements considering among other things the assessment of the company management. It is important to understand the sensitivities to changes in the business environment. The summary outcome from the evaluation is relevant when drawing conclusion whether to grant the credit or not.

When considering granting credits lenders are focusing on understanding whether the borrower will be able to repay the loan. The ability of the customer to service its commitments out of its future cash flow is extremely important.[2031] When assessing this repayment ability, the customer's capability to attract new capital and realise assets - if needed - is also in potential lender´s focus. The balance sheet of the customer should demonstrate strength to

[2028] See above sections *4.2 Banks* and *4.3 Other financiers - some examples*.
[2029] See more about Basel regulation below in section *5.4 Impact of Basel III.*
[2030] See Drezner, D.W. (2014), p. 98.
[2031] Vernimmen, P. et al. (2017), p. 708.

tolerate negative surprises like rising interest rates and unexpected business losses which may cause even temporary negative cash flow.

The primary route out of a credit transaction should always be via internally generated cash flow. To have a second way out collaterals are sometimes taken.[2032]

Covenants in credit agreements are additional obligations that the borrower undertakes to comply during the loan maturity.[2033] They do not substitute collaterals but rather complement both secured and unsecured commitments. The more sizeable and complex the transaction the more relevant it is for the lender to include in the financing package appropriate covenants. Financial covenants should be designed to capture critical developments in time. This would give chance for both the lender and borrower to evaluate the situation if the financial development deviates from the business plan.

The longer the loan maturity the greater the financing risks normally are due to difficulty to forecast future development. The price charged for a credit depends also on the agreed loan period: the longer the maturity the higher the cost of the loan for the borrower.

When granting credits to healthy corporate customers that have strong balance sheet and cash flow banks manage fairly well with the traditional senior banking loans. However, banks involved in corporate financing are frequently providing lending without fully secured loans. Traditionally the bank´s return on money lent on traditional debt financing instrument is - even with these cases - very much the same as on a secured bank loan. The risk-based loan price concept[2034] which considers different elements of risks like default risk, credit concentration risk, collateral risk and recovery risk is not always easy apply in a tight market conditions. It is obvious that pricing not properly taking into consideration customer specific lending risks is unsatisfactory. When banks lend money without fully secured loans, the pricing should be higher than in case of fully secured loans. The bank´s return should match better with the actual risk involved. The question is could mezzanine instruments have a role in this?

When looking for an answer to the question of usefulness of mezzanine instruments as potential bank lending products, let us first analyse two example cases. In the first case *"Subordinated financing for a healthy customer"* the customer has shortage of total shareholder´s equity. In the second case *"Profit-linked interest for a healthy customer"* there is not a shortage of total shareholder´s equity but customer company is otherwise in need of money. In neither of the example cases there are collaterals available for the requested new financing.

[2032] Vernimmen, P. et al. (2017), pp. 707-708.
[2033] About covenants in general see Tirole, J. (2006), pp. 80-90 and Tay, K. (2016), p. 172-177.
[2034] Ghosh, A. (2012), p. 271.

EXAMPLE CASE: SUBORDINATED FINANCING FOR A HEALTHY CUSTOMER

- ***customer has shortage of equity***
- ***customer needs new financing***
- ***customer has no new collateral to offer***

If an enterprise wants to increase the amount of total equity/subordinated financing from external sources there are in most cases four theoretical alternatives:

1. *Banks*
2. *Venture capital funds*
3. *Business angels*
4. *IPO*

Business angels are hard to find and IPO at least for SMEs is rarely suitable due to its costly, lengthy and complex process. This would leave in practice two "easy" alternatives left: bank financing and venture capital funds. When comparing the differences of the operating models of banks and venture capital companies four major differences can be identified:

- *Bank does not seek ownership in the target companies unlike venture capital companies.*
- *Bank acts only as a lender and does not seek to participate in the ownership or management of the borrower unlike venture capital company.*
- *The rate of return requirement of the bank is substantially lower than that of the venture capital fund.*
- *Bank strives to maintain long lasting customer relations while venture capitalists plan to exit normally within five years.*

A bank could provide only subordinated financing as the instrument to increase the amount of non-senior funding but a venture capitalist can also provide direct equity investment. However, both financing forms offer similar kind of financing cushion against losses and against threat of liquidation. This means that if both financing alternatives were really available and the company would not want or need the management support provided by venture capitalist, the subordinated bank loan would be more attractive financing alternative for the customer. Pricing of subordinated loan is higher than pricing of senior loan due to the lower repayment priority. However, getting additional financing cushion between equity and senior financing justifies the higher price.

If a bank was in any case in a role of risk financier (customer has no collateral to offer), the subordinated financing would not increase bank´s risk de facto. This can be illustrated by two simplified examples:

Example # 1

Company Alpha

Assets	*MEUR 1.0 (liquidation value)*
Loans	*MEUR 1.0 (secured senior loan)*
	MEUR 1.0 (unsecured) - new loan

In case of bankruptcy the unsecured loan is not repaid regardless of the seniority of the new loan.

Example # 2

Company Bravo

Assets	*MEUR 1.5 (liquidation value)*
Loans	*MEUR 1.0 (secured senior loan)*
	MEUR 1.0 (unsecured) - new loan

In case of bankruptcy 50 % of the unsecured loan is not repaid regardless of the seniority of the new loan.

The conclusion based on these two examples # 1 and # 2 is that

- *if all assets of the borrower company are already pledged or*
- *if there is only one creditor*

the seniority does not have any influence on the actual risk position of the bank.

In the situations above it would make sense for the bank to use the benefit of the higher interest income of the subordinated loan.

Advantages of the subordinated loan for the customer are among other things the following:

- *increases liquidity and reduces vulnerability to economic fluctuations*
- *increases credibility with subcontractors and suppliers*
- *may contribute to the customer´s earnings because of stronger balance sheet*
- *reduces the need for interest-bearing senior loans*
- *improves opportunities for other financing*
- *does not bind company´s assets for being security.*

EXAMPLE CASE: PROFIT-LINKED INTEREST FOR A HEALTHY CUSTOMER

- ***customer has no shortage of equity***
- ***customer needs new financing***
- ***customer has no new collateral to offer***

If an enterprise does not want to increase the amount of total equity/subordinated financing but wants to receive otherwise new capital there are in most cases four theoretical alternatives:

1. *Banks*
2. *Venture capital funds*
3. *Business angels*
4. *IPO*

Business angels are hard to find and IPO at least for SMEs is rarely suitable due to its costly, lengthy and complex process. This would leave in practice two "easy" alternatives left: bank financing and venture capital funds. When comparing the differences of the operating models of banks and venture capital companies four major differences can be identified:

- *Bank does not seek ownership in the target companies unlike venture capital companies.*
- *Bank acts only as a lender and does not seek to participate in the ownership or management of the borrower unlike venture capital company.*
- *The rate of return requirement of the bank is substantially lower than that of the venture capital fund.*
- *Bank strives to maintain long lasting customer relations while venture capitalists plan to exit normally within five years.*

A bank could provide financing in the form of non-subordinated senior debt as a venture capitalist. This means that if both financing sources were really available and the company would not want or need the management support provided by venture capitalist, the bank loan would be more attractive financing alternative for the customer. While there is lack of security it might be in the lender´s benefit to agree on interest terms that reflects the borrower´s real ability to pay interest. An example of this loan type is profit-sharing (also known as profit-participation) loan.

In the profit-sharing loan the interest to be paid is linked to financial indicators (like profit) calculated from the borrower´s financials. Often the profit-linked component forms part of the total interest paid on top of the normal loan interest payment.[2035]

[2035] OECD (2014b), p. 56 and Bußalb, J.P. (2015).

From the lender´s perspective the above-mentioned special interest clause makes it easier to agree pricing on higher level than by using the pricing clause of traditional senior debt with fixed interest margin or fixed total interest rate.

If a bank was in any case in a role of risk financier (customer has no collateral to offer), the use of special profit-linked interest payment clauses would not increase bank´s risk de facto. This can be illustrated by two simplified examples:

Example # 3

Company Charlie

Assets	*MEUR 1.0 (liquidation value)*
Loans	*MEUR 1.0 (secured senior loan)*
	MEUR 1.0 (unsecured with special profit sharing/value-appreciation interest clause) - new loan

In case of bankruptcy the unsecured loan is not repaid regardless of the type of interest clause of the new loan.

Example # 4

Company Delta

Assets	*MEUR 1.5 (liquidation value)*
Loans	*MEUR 1.0 (secured senior loan)*
	MEUR 1.0 (unsecured with special profit sharing/value-appreciation interest clause) - new loan

In case of bankruptcy 50 % of the unsecured loan is not repaid regardless of the type of interest clause of the new loan.

The conclusion based on these two examples # 3 and # 4 is that the special profit-linked interest clause does not have any influence on the actual risk position of the bank.

In the situations above it would make sense for the bank to use the benefit of the higher interest income of the profit-sharing/profit-participation loan.

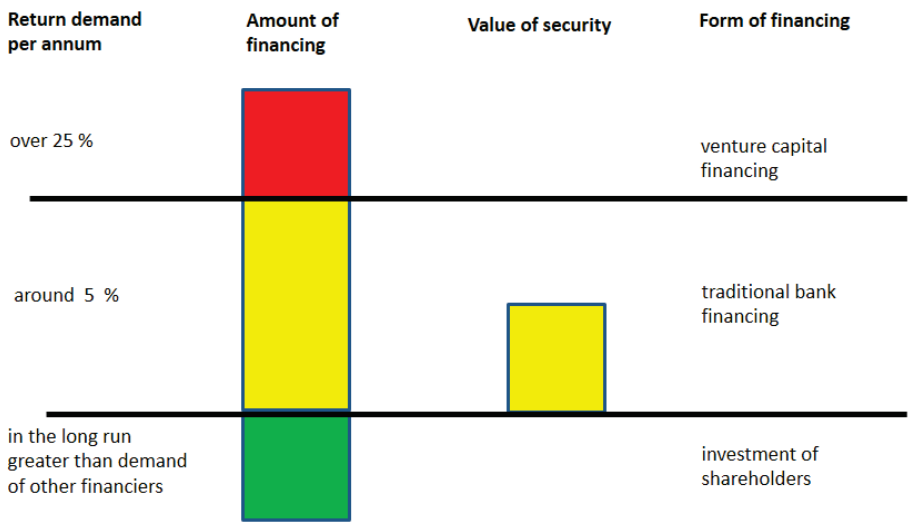
Advantages of the unsecured loan for the customer are among other things the following:

- *increases liquidity and reduces vulnerability to economic fluctuations*
- *increases credibility with subcontractors and suppliers*
- *improves opportunities for other financing*
- *when interest clause is agreed with special terms to include profit-sharing component it may permit bank financing even in such situations where traditional senior debt financing is not possible.*

We have discussed earlier about the problem of financial distress where obligations to creditors are not easy to fulfil.[2036] This has negative impact on company´s chances to get new financing. If potential investors are not pleased with the risk/return -ratio they do not want to invest. Specialised financiers like venture capitalists evaluate and monitor investee companies closely and they are more used to deal in complicated structured finance cases with this risk/return issue. Traditionally banks have been unable to do the same for several reasons. Among other things banking regulations has limited possibility to use equity as funding instrument[2037], tough price competition has made bank customers used to low pricing and banks have not had resources and incentive systems to back up such a risk/return -monitoring required here.[2038]

There are also several other differences between venture capital and bank financing.[2039] However market conditions do change among other things due to new regulations and developing operating models of banks. Banking regulations do not prohibit usage of subordinated or profit-sharing loans as financing instruments, new resources can be recruited and incentive systems can be developed. In addition to that also customer habits do change. Taking all that into consideration mezzanine financing could add banks´ lending alternatives and support their profitability improvement targets. Below are presented two figures (Figures 19 and 20) to illustrate that.

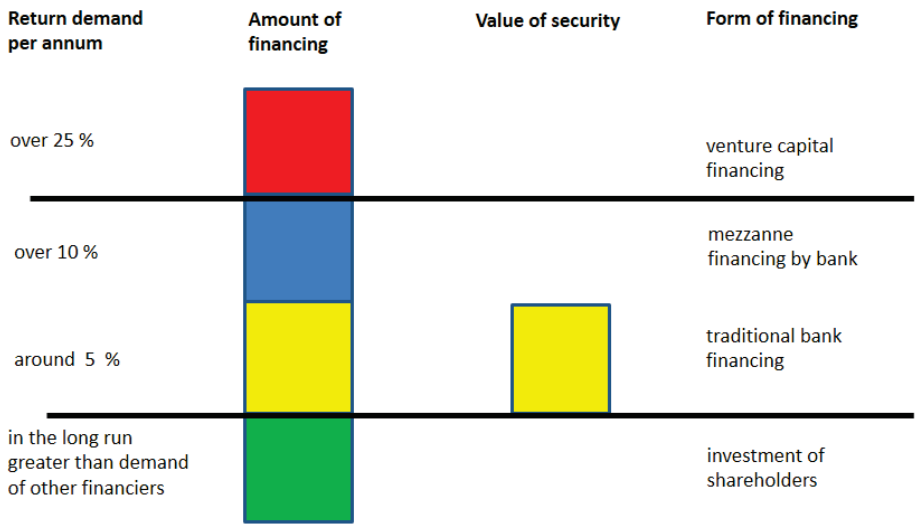
Figure 19: An example of the traditional bank lending today



[2036] See above section *4.4.2 The borrower´s point of view.*
[2037] For example, the already repealed Credit Institution Act 21 § (1340/1997) in Finland set some limitations for the use of equity and equity linked instruments in corporate finance. See about the restrictions in the US banking regulation Hellmann, T. et al. (2008), pp. 518-519.
[2038] Lerner, J. and Hardymon, F. (2002), pp. 5-6.
[2039] Winton, A. and Yerramilli, V. (2008), p. 52.

The figures are only simplified examples and the presented return demands are only rough estimates. It must be also taken into consideration that the variety of return demands is in real life much greater depending on the borrower specific circumstances in the market. The message of the two figures is however that mezzanine financing could be used as a bank financing instrument in situations where customer has sufficient repayment ability, there is not security available and when the bank based on its own assessment would anyhow be prepared to carry the credit risk even with the traditional senior debt instruments.

Figure 20: An example of the possible bank lending with mezzanine instruments



From the bank´s perspective the rationality to use mezzanine instruments comes from the possibility to price the risk involved more correctly than with the traditional senior loan forms. For a prudently operating bank price never justifies the granting of credit to customers that are not creditworthy. However, when decision to grant credit is made the price of the credit should reflect the risk attached to the customer.

5.3 Handling of distressed customers

For a lender to identify when an existing borrower has a deteriorating risk profile and to act to reduce the risk is very important. To react early enough is very essential to reduce the losses. The earlier an increased risk is identified and relevant mitigating actions are done the better are also the possibilities to avoid final losses.[2040]

[2040] McKinsey (2012), p. 3.

For any lender prudent risk management practices require systematic follow-up and monitoring of the borrower´s behaviour. If signs of increased risk - which in case of not managed properly could even lead to borrower´s inability to repay the loan - are not identified early enough risk of credit losses increase. Such early warning signs can be categorised in several ways but they include both external and internal factors influencing the customer's behaviour, cash flow and repayment capacity.

Internal factors can include a profit warning or significant failure to comply with profit target or a loss of a major customer. Likewise, a sudden change in top management or ownership or losing key people can be internal early warning signs. Additional examples could be sales of a significant part of the business and poor disclosure of financial information.

External factors can include aggressive actions by other lenders, industry specific downturns, change of auditors, damaging lawsuits, negative impact of new legislation.

Below (Figure 21) is presented one example of systemizing the early warning signs with the categories

- Operations
- Behavioural and management aspects
- Reporting
- Investing activities
- Financing activities.

In case of individual borrower many of the signs listed above may not alone indicate severe problems but the combinations of signs may reveal status of distress.[2041] If customer shows signs of problems which after more detailed scrutiny reveal forthcoming or existing financial problems prudent lender must start to consider possible restructuring steps. At this stage it is also relevant to double check whether the credit documents contain any legal risks.

Legal matters may have particular relevance for borrowers identified as distressed. This means that credit documents should always be reviewed and checked to make sure that they are legally valid.[2042] To make sure that there are no legal failures in the documentation that could result in a loss is one of the absolute corner stones of risk management. It is also in the interest of the creditors to review whether there have been any such transactions involving the borrower in the past that have favoured one creditor at the cost of other creditors. Such transactions can even be cancelled on certain circumstances.[2043]

[2041] IFC (2011), p. 4.
[2042] Banks, E. (1993), p. 55.
[2043] As an example the Finnish Act on Recovery (758/1991) imposes several material boundaries on restructuring transactions. For example if a borrower has favoured one creditor before borrower´s bankruptcy or statutory restructuring the transaction can be recovered within a certain time limit ranging even up to 5 years.

Figure 21: An example of systemizing the early warning signs



Source: IFC (2011), p. 5.

In corporate restructuring the company´s business or financial structure is reviewed. The purpose is to provide added value for the lender. The corporate restructurings can take place as privately arranged voluntary restructuring procedures or according to statutory corporate

restructuring regulation which varies country by country.[2044] A voluntary restructuring is better alternative for creditors as long as creditors' claims are better covered than in the statutory restructuring. In a voluntary restructuring it is in the borrower´s interest to convince creditors than they would be financially better off in voluntary restructuring than in the statutory corporate restructuring or in bankruptcy.

A voluntary restructuring often leads to a better overall result than the formal corporate restructuring procedures among other things due to more flexible structuring process and thus smaller process costs. In all situations voluntary restructuring process is however not possible due to the several reasons like big number of creditors or non-cooperating parties. If there are several creditors with different repayment priority status (trade creditors, senior creditor with collateral, senior creditor without collateral, junior creditors etc.) it may be challenging to combine different interests to common restructuring plan. In case direct negotiations between creditors, borrower´s management and shareholders do not lead to acceptable results, more compelling statutory restructuring process may be the only alternative.

The corporate restructuring is typically separated in two areas: financial restructuring and operational restructuring. The financial restructuring aims to improve the capital structure of the firm. The operational restructuring aims to increase the economic viability of the existing business operations.

The financial restructuring can mean several different elements which are very often used simultaneously as a part of larger package. Such financial restructuring elements are following:

- Adjustment of the interest payment scheme by rescheduling, prolonging, agreeing on standstill etc.
- Adjustment of the amortization plan for the principal by deferring instalments, prolonging maturity, agreeing on standstill etc.
- Reduction of margins, interest rate, commissions or other mandatory costs
- Waiving of financial covenants or agreeing a new one with softer terms
- Refinancing by new loans replacing old loans.

From the bank´s perspective the mezzanine instruments are part of the toolbox available for handling of financially distressed corporate customers. Sometimes as a part of financial restructuring existing bank loans can be converted into subordinated loans to support the distressed borrower´s balance sheet. Also, a profit-sharing component in the tailor-made interest clause can be used to give bank an option for upside if the customer presently in financial difficulties will achieve a turnaround in the future. This upside - if received later - would be a compensation for the risk bank has taken at the moment of restructuring.

When corporate customer becomes unable to fulfil its payment obligations bank faces real risk of loss. If bank is in any case in risk of losing its receivable the loan restructuring by using

[2044] In Finland the statutory corporate restructuring is governed by Restructuring of Enterprises Act (47/1993). The purpose of proceedings under the law is to keep an insolvent company, which is nevertheless considered ultimately as a viable business, as a going concern. Through a special administration such a company is allowed allow to continue its business and to repay a larger part of its debts than would have been possible in the case of bankruptcy of the company. The most famous statutory restructuring regulation is probably the Chapter 11of the United States Bankruptcy Code (11 U.S. Code, Chapter 11). The Chapter 11 is available both to individuals and corporations. It is generally used by larger businesses requiring restructuring their debt.

mezzanine product does not - if done prudently - worsen bank´s risk position further. However, by using tailor-made interest rate clauses with profit-sharing element or equity kickers in form of options the restructuring would not increase bank´s risk de facto.

When looking for an answer to the question of usefulness of mezzanine instruments as a potential bank lending product for distressed corporate customers, let us analyse two example cases below. In the example case *"Subordinated financing for a distressed customer"* there is a shortage of total shareholder´s equity. In the example case *"Profit-linked interest clause for a distressed customer"* there is not a shortage of total shareholder´s equity but company is otherwise in need of liquidity improvement. In neither of the example cases there are new collaterals available.

EXAMPLE CASE: SUBORDINATED FINANCING FOR A DISTRESSED CUSTOMER

- ***shortage of equity***
- ***no new financing needed***
- ***no collateral***

If a distressed enterprise under debt restructuring needs to increase the amount of total equity/subordinated financing from external sources there are in most cases four theoretical alternatives:

1. *Forgiveness of debt*
2. *Banks*
3. *Venture capital funds*
4. *Business angels*
5. *IPO*

Forgiveness of receivables by a creditor is booked as one-off income in the profit and loss - account and converts thus into balance sheet as increase of borrower´s profit. Forgiveness is the last option for creditors as it means final loss of receivable without possibility for future recovery. In practice a creditor is ready to consider this only for part of its receivables and only if it meant increased probability to recover the remaining (non-forgiven) part of the receivable. Additional venture capital, business angels and bank funding for distressed company is hard to find and IPO is not realistic for a corporate customer under restructuring, even. Even if venture capital funds, business angels or banks were already existing investors of the distressed customer additional financial input from them would be very difficult to get. In practice additional financing from existing financiers would make sense only if the add-on improved the total position of the financier in form of decreased loss. Sometimes additional financial input might help the borrower´s recovery and repayment of earlier granted loans.

A bank could under certain circumstances provide subordinated financing as the instrument to convert existing unsecured senior funding subject to that the restructuring plan as a whole were acceptable for the bank. This financing form offers in practice similar kind of financing cushion against losses and against threat of liquidation as equity input. This means that subordinated bank financing could be very attractive financing alternative for the customer. Pricing of subordinated loan is higher than pricing of senior loan due to the lower repayment priority. However, getting additional financing cushion between equity and senior financing and getting the senior financing on lower level would justify the higher price for the borrower.

If a bank was in any case in a role of risk financier (customer has no collateral to offer) and the customer was unable to repay the existing financing according to the existing terms, the subordinated financing would not necessarily increase bank´s risk de facto. This can be clarified by two simplified examples:

Example # 5

Company Echo under financial restructuring

Assets	*MEUR 1.0 (liquidation value)*
Loans	*MEUR 1.0 (secured senior loan)*
	MEUR 1.0 (unsecured)

In case of bankruptcy the unsecured loan is not repaid regardless of the seniority of the loan.

Example # 6

Company Foxtrot under financial restructuring

Assets	*MEUR 1.5 (liquidation value)*
Loans	*MEUR 1.0 (secured senior loan)*
	MEUR 1.0 (unsecured)

In case of bankruptcy 50 % of the unsecured loan is not repaid regardless of the seniority of the loan.

The conclusion based on these two examples # 5 and # 6 is that

- *if all assets of the borrower company are already pledged or*
- *if there is only one creditor*

the seniority does not have any influence on the actual risk position of the bank.

In the situations above it would make sense for the bank to try to support the financial restructuring of the company by converting unsecured part of the senior loan to subordinated loan. It would also provide possibility to benefit of the higher interest income of the subordinated loan in case of successful restructuring leading to the borrower´s recovery.

Advantages of the subordinated loan for the customer as a part of financial restructuring are among other things the following:

- *reduces vulnerability to economic fluctuations*
- *increases credibility with subcontractors and suppliers*
- *may contribute to the customer´s earnings because of stronger balance sheet*

- *reduces the amount of interest-bearing senior loans and reduces thus interest costs to be paid regardless the borrower´s financials*[2045]
- *improves opportunities for other financing*
- *may make restructuring programme possible.*

[2045] Interest costs of senior loans have to be paid according to the agreed schedule regardless of the financials of the borrower unlike interest costs of subordinated loan. For example, in case of the Finnish capital loan the principal and interest are subordinated to all other debts. This means that the principal of capital loan may be repaid and interest paid only with some restrictions. Payments can be done only subject to that the total sum of the unrestricted equity and all the capital loans of the company at the time of payment exceed the loss on the balance sheet. For further details see above section *3.4.2.2.4 Capital structure.*

EXAMPLE CASE: PROFIT-LINKED INTEREST CLAUSE FOR A DISTRESSED CUSTOMER

- ***no shortage of equity***
- ***new financing needed***
- ***no collateral***

If a distressed enterprise does not need to increase the amount of total equity/subordinated financing but needs otherwise new capital there are in most cases four theoretical alternative sources:

1. *Banks*
2. *Venture capital funds*
3. *Business angels*
4. *IPO*

Venture capital, business angels and bank funding for distressed company is hard to find and IPO is not realistic for a corporate customer under restructuring, even. Even if venture capital funds, business angels or banks were already existing investors of the distressed customer additional financial input from them would be very difficult to get. In practice additional financing from existing financiers would make sense only if the add-on improved the total position of the financier in form of decreased loss. Sometimes additional financial input might help the borrower´s recovery and repayment of earlier granted loans.

A bank could under certain circumstances provide financing in the form of non-subordinated senior debt subject to that the restructuring plan as a whole was acceptable for the bank. While there is lack of security it might be in the lender´s benefit to agree on interest terms that reflects the borrower´s real ability to pay interest. An example of this loan type is a profit-sharing (also known as profit-participation) loan.

In the profit-sharing loan the interest to be paid is linked to financial indicators (like profit) calculated from the borrower´s financials. Often the profit-linked component forms part of the total interest paid on top of the normal loan interest payment.[2046]

From the lender´s perspective the above-mentioned special interest payment clause makes it easier to agree pricing on higher level than by using the pricing clause of traditional senior debt with fixed interest margin or fixed total interest rate.

If a bank was in any case in a role of risk financier (customer has no collateral to offer) and the customer was unable to repay the existing financing according to the existing terms, the use of special profit-linked interest payment clauses would not increase bank´s risk de facto. This can be clarified by two simplified examples:

[2046] OECD (2014b), p. 56 and Bußalb, J.P. (2015).

Example # 7

Company Golf under financial restructuring

Assets	*MEUR 1.0 (liquidation value)*
Loans	*MEUR 1.0 (secured senior loan)*
	MEUR 1.0 (unsecured with special profit sharing/value-appreciation interest clause)

In case of bankruptcy the unsecured loan is not repaid regardless of the type of interest clause of the loan.

Example # 8

Company Hotel under financial restructuring

Assets	*MEUR 1.5 (liquidation value)*
Loans	*MEUR 1.0 (secured senior loan)*
	MEUR 1.0 (unsecured with special profit sharing/value-appreciation interest clause)

In case of bankruptcy 50 % of the unsecured loan is not repaid regardless of the type of interest clause of the loan.

The conclusion based on these two examples is that the special profit-linked interest clause does not have any influence on the actual risk position of the bank.

In the situations above it would make sense for the bank to try to support the financial restructuring of the company by converting unsecured part of the senior loan to profit-sharing/profit-participation loan. It would also provide possibility to use the benefit of the higher interest income of the profit-sharing/profit-participation loan. Without this pricing possibility the conversion might not make sense.

Advantages of the above-mentioned conversion of the unsecured loan for the customer as a part of financial restructuring are among other things the following:

- *increases credibility with subcontractors and suppliers*
- *improves opportunities for other financing*
- *when interest clause is agreed with special terms to include profit-sharing component it may permit bank financing even in such situations where traditional senior debt financing is not possible*
- *improves opportunities for other financing*
- *may make restructuring programme possible.*

5.4 Impact of Basel III

Banks must take into consideration in their daily operations the rules of the Basel Committee on Banking Supervision (BCBS).[2047] The Basel Committee does not have any formal supranational supervisory authority and its conclusions do not have legal force. However, its supervisory standards, guidelines and recommended statements of best practices and decisions are - de facto - followed by banks.

The main purpose of modern financial service regulation is to make sure that financial institutions have enough capital to withstand also worsened market conditions.[2048] Basel Regime focuses on making sure that banks are properly capitalised to cover the risks of banking business. These international regulatory capital standards have been developed through many capital accords and related publications.

Basel I regulation was launched in 1988 and it set out the minimum capital requirements of financial institutions in order to minimize credit risk. According to Basel I internationally operating banks are obliged to maintain a minimum amount of capital based on risk-weighted assets. In case of corporate lending the capital required was 8 % of the exposure.[2049]

More sophisticated Basel II regulation was launched in 2004. One of the central elements of that is the concept of risk-based capital requirements. The capital amount that a bank has to hold against a given exposure is a function of the estimated credit risk of that exposure. According to the IRB (internal ratings -based) approach the estimated credit risk depends on four parameters:

- probability of default (PD)
- loss given default (LGD)
- exposure at default (EAD)
- maturity (M).[2050]

When using the Advanced IRB, the bank is obliged to provide all four parameters based on its own internal models.[2051] In case of Foundation IRB the bank is obliged to provide only the PD parameter and the other parameters are set by the Basel committee.[2052]

Basel III was introduced in 2014 to correct some of the shortcomings of the earlier Basel rules which became apparent in the financial crisis of 2007-2009.[2053] Basel III is even more comprehensive package of reform measures to strengthen the regulation, risk management and supervision of the banking industry. The measures include both liquidity and capital reforms. The IRB approach remains in a more sophisticated form requiring from the banks among other things more capital buffers for leverage risks, sufficient liquidity buffers and improved risk management and governance.[2054]

[2047] See about BCBS in general BCBS (2017).
[2048] McNeil, A.J. et al. (2015), p. 16.
[2049] Murphy, D. (2008), pp. 65-67. For more details see also BIS (1998).
[2050] Chofaras, D.N. (2004), pp. 3-13. For more details see also BIS (2006).
[2051] Kashyap, A.K. and Stein, J.C. (2004), p. 18.
[2052] Ibid.
[2053] McNeil, A.J. et al. (2015), p. 17-18.
[2054] McNeil, A.J. et al. (2015), p. 24-25. For more details see also BIS (2016).

Like Basel II also Basel III consists of three Pillars:

- minimum capital
- supervisory review and
- market discipline.

Under Pillar 1 banks can use their own statistical data to estimate their credit, market and operational risk. Under Pillar 2 supervision authorities have discretion to impose certain measures including even additional capital requirements to address weaknesses in the banks´ governance and risk management processes and practices. The Pillar 3 focuses on regulatory disclosures of the bank. On top of that there are liquidity requirements. As a summary, Basel III requirements do not cover only balance-sheet risks but also risks related to non-sufficient liquidity and governance practices.[2055]

The benefits of the new regulation of financial services like improved governance and tighter capital and liquidity requirements are widely understood. The political pressure to put more regulation on banks after the financial crisis does exist. However, some voices are also raised against the new rules as some points - like increased capital requirements, high implementation cost and complexity - may according to some views lead to higher loan prices and decreasing lending volumes.[2056]

There has been continuing revision discussion of the calculation methods for risk-weighted assets and some planned new standards from the Basel Committee. For example plans have been published for revised standardised approach to credit risk in 2014 and revised internal rating model floors in 2016.[2057] Finally the Basel Committee finalised Basel III reforms on December 2017.[2058] Although officially it is the last element of Basel III according to the Basel Committee many banks see the latest standards as "Basel IV" regulation due to the significant differences from the original Basel III.[2059] The challenges of implementing these new modifications are considered to be major for the banking industry.[2060]

The new Basel III rules were initially expected to be implemented in stages until 2019.[2061] In the last reform update on December 2017 the Basel Committee however postponed the final implementation date to be January 1, 2022.[2062]

The Basel regulation reflects the fact that there has been a trend in the competitive banking industry to take the costs of risk into account more explicitly. This requires specially designed risk adjusted measures that are used both in the decision-making and in internal and external performance reporting. A bank that would not use such measures in managing the business, could potentially be disadvantaged.

[2055] See about the role of capital supporting banking stability Moloney, N. et al eds (2015), pp. 334-363.
[2056] See about the criticism McNeil, A.J. et al. (2015), pp. 28-30.
[2057] Schneider, S. et al. (2017), p. 6.
[2058] The Basel Committee published the final Basel III reform documents on December 7, 2017. See for more details BIS (2017).
[2059] Finanssiala (2016).
[2060] According to Schneider, S. et al. (2016), p. 5 *"This is a game changer for the European banking industry."*
[2061] BIS (2013).
[2062] As an exception the implementation of a specific *"output floor"* of 72,5 % can however be done in phases until January 1, 2027. The output floor sets a limit on the regulatory capital benefit that a bank using internal model can receive in comparison to a bank using the standardised approach. See for more details BIS (2017), pp. 137-139.

Banking regulators require banks to hold a minimum amount of capital to guard against potential losses. The Basel regulation allows the use of internal risk measurement frameworks to determine the required risk capital.[2063] Special credit rating and collateral coverage models are therefore designed based on these risk measures. These models form the basis of such frameworks enabling customer level differentiation of risk. Building on such a framework to deliver risk adjusted measures will enable banks to turn a compliance cost into a business benefit. The availability of new credit rating and collateral coverage models will be used in day-to-day approval and pricing decisions. In practice this means that the pricing spread between good and poor companies will increase.

Mezzanine instruments could be one way to help banks to price its corporate lending activities so that pricing would better reflect the financing risk involved and the return requirements of the bank´s capital base.

5.5 Regulatory compliance aspects

5.5.1 Regulatory pressure

As the aftermath of the financial crisis of 2007-2009 lot of new regulation has been established by the authorities targeting to strengthen and safeguard the banking sector. This regulation influences significantly the whole industry. Banks face a challenge to create, implement and manage a business model that will be acceptable to all important stakeholders: owners, investors, customers and supervisors. The amount of change will be huge, costly and complex to manage. The ultimate goal of the supervisors is to make banks and the whole banking system more resilient. The identification of the regulation, the design process to act according to the regulation and the actual implementation work is a huge task that requires significant resources and managerial focus. What brings additional challenges to both banks and the supervision authorities is that this is not a one-off exercise. The management of regulation is a continuous process that in the environment of an increasing regulatory pressure.[2064]

Banks will have to maintain sufficient returns in an environment where both capital demands and the cost of compliance increasing. This means that banks need to rethink and reshape strategy, improve asset efficiency and streamline costs.[2065]

On top of this the regulatory change will have implications for culture, structure and organisation. It shall be essential for the management of the financial institution to be able to make right decisions on how to comply and compete in these circumstances.

Among the significant new regulations for banks to take into consideration are

- Basel III regulation
- MiFID II/MiFIR regime
- SREP

[2063] The last Basel III reform of December 2017 from the Basel Committee sets however some new constrains for the use of the internal models as described in the previous footnote. About the challenges of internal market risk models used by European banks see also Breuer, T. (2017).
[2064] See about the regulatory pressure in the banking industry KPMG (2015).
[2065] EY (2015b), p. 4.

- Volcker Rule
- MAD/MAR
- Guidance on leveraged transactions.

The Basel III regulation has been covered above.[2066] The other examples of new regulations are briefly reviewed below.

5.5.2 MiFID II/MiFIR regime

The MiFID II (Markets in Financial Instruments Directive)[2067] and MiFIR (Markets in Financial Instruments Regulation)[2068] regime has become in force on January 3, 2018.[2069] The regulation addresses investment service providers conduct through the transparency of pricing, trading and payments. New regulation represents a major overhaul and extension of the existing requirements[2070]. The purpose of the regulation is to ensure a high level of client protection for customers receiving advice and buying investment services (shares, fund, bond and derivatives transactions) and also regulate how to manage conflicts of interest and provide best executions to clients. The purpose is to establish a more transparent financial system, competitive EU financial market and strengthening the framework of investor protection further.[2071]

MiFID II and MiFIR apply to investment firms, trading venues, providers of data reporting services and third country firms providing investment services within the EU and cover a very wide range of investment and capital markets products. MiFID II and MiFIR require banks to gather and use a considerably more data than the previous rules which focused more on equity products.[2072]

5.5.3 SREP

Supervisor authorities shall regularly assess and measure the risks of the banks. This periodic examination in EU area is called the Supervisory Review and Evaluation Process (SREP). The purpose of the SREP is to find out what is the bank' s position in terms of capital requirements and how the bank manages its risks. This process is part of the Pillar 2 of the Basel Regulation.[2073]

[2066] See above section *5.4 Impact of Basel III*.
[2067] Directive 2014/65/EU of the European Parliament and of the Council of 15 May 2014 on markets in financial instruments and amending Directive 2002/92/EC and Directive 2011/61/EU Text with EEA relevance.
[2068] Regulation (EU) No 600/2014 of the European Parliament and of the Council of 15 May 2014 on markets in financial instruments and amending Regulation (EU) No 648/2012 Text with EEA relevance.
[2069] MiFID II is a directive suggesting guidelines and norms are subject to the discretion of member states, to be translated into national rules. MiFIR is regulation with immediate applicability across all EU countries.
[2070] The existing regulation known as MiFID I (Markets in Financial Instruments Directive, 2004/39/EY) is an EU Directive that was implemented into national laws and regulations in 2007 to harmonize the requirements for investment activities. The purpose of the regulation is to protect customers receiving advice and buying investment services. MiFID II/MiFIR is aimed at closing some gaps in the regulatory framework and highlighting areas which need reinforcement or revision.
[2071] EC (2016), p. 4.
[2072] KPMG (2016), p. 14.
[2073] Baglioni, A. (2016), p. 51.

The SREP focuses on following points of the bank under review:[2074]

- Business model: supervisors assess the sustainability of each bank's set-up.
- Governance and risk management: supervisors consider a bank's organisational structure by monitoring its management bodies and risk management.
- Risk to capital: supervisors analyse whether a bank has a sufficient safety net to absorb losses arising from different kind of operational or market incidents like cyber-attacks, sudden change of commodity prices, non-repayment of bank loans etc.
- Risk to liquidity and funding: supervisors investigate bank's ability to cover sudden liquidity needs like in case of depositors starting to withdraw deposits much more than normally.

As the outcome of the each SREP process the supervisor shall provide to the bank a specific decision where items to be corrected are listed and timetable to do so is set.[2075] The supervisor authorities have several different alternatives to act against the banks if needed. The authorities may require a bank to hold more capital, strengthen their organisation or restrict certain activities.[2076] In an extreme case the supervisor may even ask a bank to change its management.[2077]

Each SREP decision is made taking into consideration the supervised bank´s special features. One of the major benefits of the process is that there is one common methodology and timeline being applied to all significant banks in the EU area.[2078]

5.5.4 MAD/MAR

In 2014 a new Market Abuse Regulation (MAR)[2079] was published together with a new directive with respect to criminal sanctions, the Criminal Sanctions for Market Abuse Directive (MAD)[2080]. This legislation became applicable in Europe in 2016.[2081]

The Market Abuse Directive (MAD) is a comprehensive framework targeting to address situations where investors have been unreasonably disadvantaged. Along the globalization of the financial markets new trading platforms and technologies have been established and new forms of market manipulation have developed in conjunction with that.[2082] After manipulation of certain benchmarks such as LIBOR (London Interbank Offered Rate)[2083] the European

[2074] ECB (2016).
[2075] Boccuzzi, G. (2016), p. 43.
[2076] Boccuzzi, G. (2016), p. 42.
[2077] ECB (2016).
[2078] Ibid.
[2079] Regulation (EU) No 596/2014 of the European Parliament and of the Council of 16 April 2014 on market abuse (market abuse regulation) and repealing Directive 2003/6/EC of the European Parliament and of the Council and Commission Directives 2003/124/EC, 2003/125/EC and 2004/72/EC Text with EEA relevance
[2080] Directive 2014/57/EU of the European Parliament and of the Council of 16 April 2014 on criminal sanctions for market abuse (Market Abuse Directive).
[2081] MAD is a directive suggesting guidelines and norms are subject to the discretion of member states, to be translated into national rules. MAR is regulation with immediate applicability across all EU countries.
[2082] EC (2013).
[2083] See for more details about the LIBOR manipulation Hou, D. and Skeie, D. (2014). According to the authors regulators and market observers noted in 2007 that LIBOR had failed to behave in line with expectations given

Commission introduced a set of new regulations as part of efforts to create sounder and more transparent financial markets.

MAR targets to enhance and harmonize the EU regime on market abuse. The regulation requires member states to present common definitions of criminal offences of insider dealing and market manipulation and to execute maximum criminal consequences for those market abuse offences that are the most serious. Each member state must make sure that such behaviour is a criminal offence and should be punished with effective sanctions everywhere in Europe.[2084]

For banks to make sure that they are compliant with the new regulations requires lot of work and in some cases even significant rationalisation of the organisation.[2085]

5.5.5 Volcker rule

The Volcker Rule refers to § 619[2086] of the Dodd-Frank Wall Street Reform and Consumer Protection Act[2087]. This rule imposes limits for banks in proprietary trading[2088] or acquiring or retaining any ownership in or sponsoring a hedge fund or private equity fund. The Volcker Rule applies also to U.S. banks´ proprietary trading and fund activities irrespective of where the trading or activities take place. For non-U.S. banks however the Volcker Rule would apply only to proprietary trading and fund activities in the USA or such activities outside the USA, if they involve securities offering to a U.S. resident.[2089]

The Volcker Rule requires an affected bank to comply with several demands:

- effective compliance and reporting standards
- comprehensive data gathering and reporting structures
- compensation and governance and
- communication and culture.[2090]

The ultimate purpose of the Volcker Rule is to prevent banks from making such speculative investments that contributed to the outcome of the financial crisis in 2008.[2091]

---

other market prices and rates. Investigations of regulators uncovered explicit manipulation by banks to influence rate fixings. Barclays, UBS, RBS, and Rabobank had to pay combined settlements upward of $3.5 billion.

[2084] Moloney, N. (2014), p. 766.

[2085] EY (2016).

[2086] The Volcker Rule is codified at 12 U.S.C. § 1851.

[2087] Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010.

[2088] According to the 12 U.S.C. § 1851(h)(4) proprietary trading means any transaction where bank is engaged as a principal for the trading account *"... to purchase or sell, or otherwise acquire or dispose of, any security, any derivative, any contract of sale of a commodity for future delivery, any option of any such security, derivative, or contract or any other security or financial instrument."*

[2089] As an example of the challenges of non-U.S. banks in relation to the Volcker Rule see Henry, C.P. (2016) where focus is on the German banks.

[2090] Culp, S. (2013).

[2091] A key driver for the Dodd-Frank Wall Street Reform and Consumer Protection Act in general was to implement wide-reaching legislation touching banking law and financial services industry in order to promote financial stability and avoid another financial crisis. See for more details White House (2016).

5.5.6 Guidance on leveraged transactions

ECB published its guidance to banks on leveraged transactions on May 2017.[2092] The guidance became applicable in November 2017 for significant institutions under ECB supervision.

The purpose of the guidance is to facilitate the identification of leveraged transactions by giving senior management a comprehensive overview of banks' leveraged lending activities.[2093] It also sets frame for the risk management processes and reporting requirements to improve the overall risk management of leveraged lending exposures. Ultimately this targets to support banks' ability to operate during an economic downturn and thus enable lending to leveraged borrowers through the business cycle.

In ECB guidance leveraged transaction is defined as transaction meeting one of the conditions below:

- loan or credit exposure, where the borrower's post-financing leverage exceeds ratio Total Debt[2094]/EBITDA 4.0 or
- loan or credit exposure, where the borrower is owned by one or more financial sponsors[2095].[2096]

In the USA the three U.S. federal banking regulatory agencies - the Office of the Comptroller of the Currency, the Board of Governors of the Federal Reserve System and the Federal Deposit Insurance Corporation - have published their joint guidance covering leveraged lending activities in 2013.[2097] In this Interagency Guidance on Leveraged Lending in the U.S. authorities describe expectations for the prudent risk management activities in the area of leveraged lending. Among other things the financial institutions are required to develop and maintain transaction structures reflecting sound business ground, proper capital structure and reasonable leverage and cash flow.[2098] According to the U.S. guidance leveraged lending can have following features:

- proceeds are used for acquisitions, buyouts or capital distributions and
- Total Debt/EBITDA (earnings before interest, taxes, depreciation, and amortization) or Senior Debt/EBITDA ratio of the borrower exceeds 3.0.[2099]

For the banks the discussed leveraged lending guidance means among other things increasing reporting requirements which also leads to additional resource needs and growing costs.

[2092] ECB (2017).
[2093] ECB (2017b).
[2094] According to ECB (2017), p. 4, footnote 6 *"The term "Total Debt" refers to total committed debt (including drawn and undrawn debt) and to any additional debt permitted by loan agreements. Committed undrawn liquidity facilities, according to the Basel Committee on Banking Supervision's Basel III: The Liquidity Coverage Ratio and liquidity risk monitoring tools (BCBS 238), are excluded. Cash should not be netted against debt. "*
[2095] According to ECB (2017), p. 4, footnote 11 *"The term "financial sponsor" refers to an investment firm that undertakes private equity investments in and/or leveraged buyouts of companies with the intention of exiting those investments on a mediumterm basis."*
[2096] ECB (2017), p. 4.
[2097] Federal Reserve (2013).
[2098] Federal Reserve (2013), p. 2.
[2099] Federal Reserve (2013), p. 4.

5.5.7 The impact of regulation on lending

During the past few years legislation within the financial services sector has multiplied because of the financial crisis. This is a global phenomenon and regards heavily also EU and USA.[2100] Regulation and supervisory actions related to that have significant role in both upholding the stability of the economy and reinforcing the market. On top of that regulation has role in protecting investors and consumers. Unfortunately, simultaneously the increasing amount of legislative measures has resulted in many areas to partially overlapping regulations and even to some extent contradictory, overly detailed or even redundant regulations.[2101] The *"tsunami of regulations"* has raised concerns in the banks.[2102] That is why the initiative put forward by the European Commission to review the regulation and processes[2103] is welcomed by the banking sector.[2104]

There are lot of challenges like increased volume of regulations, short implementation times and very detailed regulations. The interpretation and adoption of the new regulations is challenging merely by the huge amount of the new regulations. Further challenges exist due to significant amount of evaluation and judgements required to be performed to implement the new regulation correctly.

The increased amount of new regulations affects organizations differently depending on their size. Large banks may even have competitive advantages compared to smaller banks as the small ones may find it more challenging to find the resources to become compliant. Economies of scale has relevance here.[2105]

The efficiency decreases as the extensive amount of regulation requires more resources and time. To ensure that the regulations are followed the right way the banks need to allocate increasing amount of resources for the implementation of increasing regulation.

The new norms influence also to bank's supply of services and products. Some services and products bring with them significant regulatory costs and could thus be a potential drain on the resources of the bank. In some situations, it could be even beneficial for a bank to redesign or omit completely the products and services that requires compliance with too detailed regulations. The regulation has impact also on the risk management activities in the organization. This can lead even to structural changes of the legal entities to comply with the new regulations.[2106]

Banks must cover somehow the increased costs of regulation in general and the additional capital requirements set by Basel regulation. There are basically three options to do that: increase of capital, retention of earnings and deleveraging through downsizing of risk weighted assets.[2107]

As every option means in practice increase of equity capital this in practice also raises the cost of bank lending. This consequently increases the risk of prolonged low-level loan supply.[2108] Especially capital-constrained banks tend to collect outstanding loans or are otherwise

[2100] KPMG (2015).
[2101] EBF (2016).
[2102] See Maisch, M. et al. (2015).
[2103] EC (2015).
[2104] EBF (2016), p. 1. See also BBA (2016).
[2105] Laeven, L. et al. (2014), pp. 10 and 24-25.
[2106] EY (2014), pp. 62-63.
[2107] Nagel, J. (2011), p. 7.
[2108] Wehinger, G. (2014), p. 10.

reluctant to approve new lending.[2109] This does not support the recovery of the economy. In the public discussion specifically, the negative effect of the new regulations on banks' ability to lend to small businesses has been highlighted.[2110]

Mezzanine instruments could have a role in helping banks to fulfil the return requirements of the bank´s increased capital base.

5.6 Banks and mezzanine

Banks as financial intermediates grant credits, receive deposits, manage assets of the customers and transfer payments. The role of bank loans is significant in company finance. For SMEs in European Union bank financing is clearly the most dominating financing source.[2111] For large companies also the capital markets are a relevant option and in the USA securities are the major sources of financing for large companies.[2112]

Financial system performs the role of channelling funds from savers to borrowers. In indirect finance a financial intermediary has the role of channelling funds. This is the core business of banks and they play a critical role in the total network of financial system.

Major banks in Finland provide a wide selection of financing services. The same applies for the major banks in Sweden, Estonia, USA, UK and Germany. Corporate loans granted by banks are in practice secured senior loans and unsecured senior loans. The financing decision is based on company´s profitability, solvency and future forecasts. Even though company´s cash flow must always be enough for repayment also collaterals have relevance. Sufficient collateral like real estate decreases bank´s credit risk, may lower the capital requirement of the bank and therefore also lowers the pricing of the loan.[2113]

During the prolonged period of very low interest rates lending as banking business area is not easy. The low interest rate levels press the profitability of the lending activities as banks interest rate margins are also under stress.[2114] Especially if banks have scarcity of capital, they will focus on business areas that bring more profitability.[2115] By focusing on servicing or products that do not require so much capital is interesting alternative for traditional lending. Additionally, focus could be put more on lending transactions which are more profitable than basic senior lending assuming good collateral. Higher income could be generated in leveraged

[2109] Hyun, J.S. and Rhee, B.K. (2011).
[2110] Hyun, J.S. and Rhee, B.K. (2011) and Miller, S. M. et al. (2016).
[2111] OECD (2015b), p. 32 and ECB (2016b), p. 9.
[2112] IMF (2014), p. 29.
[2113] In the bank´s capital calculation certain types of collaterals can be accepted as credit risk mitigation. This kind of eligibility of the collateral type must fulfil the local regulatory requirement. The worldwide standard on capital adequacy is based on the framework given by Basel Committee on Banking Supervision (BCBS). In the EU the Basel framework is implemented through the Capital Requirements Directive (Directive 2013/36/EU of the European Parliament and of the Council of 26 June 2013 on access to the activity of credit institutions and the prudential supervision of credit institutions and investment firms, amending Directive 2002/87/EC and repealing Directives 2006/48/EC and 2006/49/EC Text with EEA relevance) and Capital Requirement Regulation (Regulation (EU) No 575/2013 of the European Parliament and of the Council of 26 June 2013 on prudential requirements for credit institutions and investment firms and amending Regulation (EU) No 648/2012 Text with EEA relevance). About the eligibility requirements see specifically Articles 193-215 of Capital Requirement Regulation.
[2114] Borio, C. and Gambacorta, L. (2017), p. 3.
[2115] Ibid.

lending[2116] and leveraged buyout[2117] transactions. For the bank the return can be higher but at the same time these transactions bring clearly higher risk.

During the last years after the financial crisis the banking regulation has focused on limiting the risk taken by individual banks. The existing regulation including Basel III forces banks to consider with care how to allocate their lending capacity.[2118] The stricter regulatory demands around capital adequacy and liquidity reserves make it more and more challenging to finance corporate business. The possibility to achieve the set profitability requirements becomes tougher. Due to this some banks have even withdrawn themselves from certain areas of corporate lending.[2119] This leaves more opportunities to strong banks and non-bank investors like hedge funds or private equity funds to manoeuvre in the highly competed sector of corporate lending. This specific change of the lending market brings possibilities for innovative and out-of-box solutions and mezzanine products could thus have more relevance in such a development.

As has been described above there is demand for structured finance like mezzanine in the market. Although absolute mezzanine financing volumes are on the low side there are borrowers and lenders who have found these tailor-made financing arrangements suitable for their needs. It can also be said that the knowledge about this tailor-made financing form among the professionals of the financial sector is generally good. However, banks are not the most significant providers of mezzanine financing. Although in the market it can be found also other forms of bank financing than traditional senior loans the role of these other forms is very small. The tailor-made mezzanine products provided by banks are meant for limited customer base and therefore also total financing volumes are limited. The general conclusion is that mezzanine/hybrid type of financing does not normally belong to low-risk bank´s product portfolio. Bigger banks have however specialised Investment Bank units that provide advisory to larger areas like capital raising. Such services are targeted to help customers to achieve objectives like acquisitions, buy-outs, share repurchase or investments. In these transactions mezzanine debt can be part of the financing package but source for mezzanine funding is not normally the advisor bank itself.

As banks have strategy to act only as lenders and do not seek to acquire ownerships of the borrowers they are not used to operate with the *"venture capital type instruments"* like mezzanine. A traditionally functioning bank does not want to participate in the borrower company´s administration and therefore the financier´s control should be done more remote by other means. In such a situation the role of covenants becomes even more important than in traditional senior financing. Another big difference between the operating model of a traditional bank and a venture capital financier relates to the length of the customer relationship. While venture capitalist supposes total exit possibility in 5-7 years at the latest traditional banks are commonly striving to maintain longer lasting customer relationships. Because of the reasons above increased usage of mezzanine instruments in bank lending would require different kind of operating model for the banks. Traditionally operating banks' lending activities focus on senior debt products assuming collateral and long-lasting customer relationships. This way of running lending business is not the best for encouraging the usage of mezzanine finance for growing and healthy corporate customers.

The mezzanine instruments are however part of the toolbox available for handling of financially distressed corporate customers already today. Sometimes as a part of financial

[2116] Leveraged lending transactions refer here to financing of non-investment grade companies having high leverage. About the ECB definition see ECB (2017), pp. 4-5.
[2117] Leveraged buyout transactions refer here to financing of companies that are majority owned or controlled by private equity fund or other investment companies having same similar operating model. About the ECB definition see ECB (2017), p. 4-5.
[2118] See more about Basel regulation below in section *5.4 Impact of Basel III.*
[2119] See Drezner, D.W. (2014), p. 98.

restructuring of distressed customer existing bank loans can be converted into subordinated loans to support the distressed borrower´s balance sheet. Also, a profit-sharing component in the tailor-made interest clause can be used to give bank an option for upside if the customer presently in financial difficulties will achieve a turnaround in the future. This upside - if received later - would be a compensation for the risk bank has taken at the moment of restructuring.

When corporate customer becomes unable to fulfil its payment obligations bank faces real risk of loss. If bank is in any case in risk of losing its receivable the loan restructuring by using mezzanine product does not - if done prudently - worsen bank´s risk position further. However, by using tailor-made interest rate clauses with profit-sharing element or equity kickers in form of options the restructuring would not increase bank´s risk de facto. Bank could under certain circumstances provide subordinated financing as the instrument to convert existing unsecured senior funding subject to that the restructuring plan were acceptable for the bank. This financing form offers in practice similar kind of financing cushion against losses and against threat of liquidation as equity input. This means that subordinated bank financing could be very attractive financing alternative for the customer. Pricing of subordinated loan is higher than pricing of senior loan due to the lower repayment priority. However, getting additional financing cushion between equity and senior financing and getting the senior financing on lower level would justify the higher price for the borrower.

If a bank was in any case in a role of a risk financier (i.e. customer has no collateral to offer) and its customer was unable to repay the existing financing according to the existing terms, the conversion to subordinated financing would not increase bank´s risk even if the customer were under financial distress. If all assets of the borrower company are already pledged or if bank is the only creditor the seniority does not have any influence on the actual risk position of the bank. In such situations it would make sense for the bank to try to support the financial restructuring of the company by converting unsecured part of the senior loan to subordinated loan. It would also provide possibility to benefit of the higher interest income of the subordinated loan in case of successful restructuring leading to the borrower´s recovery.

A bank could under certain circumstances provide financing in the form of non-subordinated senior debt subject to that the restructuring plan were acceptable for the bank. While there is lack of security it might be in the lender´s benefit to agree on interest terms that reflects the borrower´s real ability to pay interest. An example of this loan type is profit-sharing (also known as profit-participation) loan.

In the profit-sharing loan the interest to be paid is linked to financial indicators (like profit) calculated from the borrower´s financials. Often the profit-linked component forms part of the total interest paid on top of the normal loan interest payment. From the lender´s perspective the above-mentioned special interest clause makes it easier to agree pricing on higher level than by using the pricing clause of traditional senior debt with fixed interest margin or fixed total interest rate. Especially when the borrower has no collateral to offer, the use of special profit-linked interest payment clauses would be beneficial for the bank, as such an interest clause would not deteriorate the actual risk position of the bank. In the situations above it would make sense for the bank to try to support the financial restructuring of the company by converting unsecured part of the senior loan to profit-sharing/profit-participation loan. It would also provide possibility to use the benefit of the higher interest income of the profit-sharing/profit-participation loan. Without this pricing possibility the conversion might not make sense.

5.7 Is there a need for mezzanine from banks?

Commercial banks provide services to their private and corporate customers by offering deposits, lending and payment services.[2120] Customers draw deposits on demand and borrow and repay at an agreed time. This system of financial intermediation allows customers to invest and therefore they also accept the lower rates of return on deposits compared to the higher interest costs of borrowing.[2121] Banks have also important role in providing payment services as electronic payments are becoming increasingly important and customers use less cash. All these liquidity supporting services provided by the banks support market economy.

Banks can benefit the economies of scale in pricing the services. This happens by cooperating with large number of customers and being active in capital markets. It is extremely important to be active in capital markets among other to manage the surpluses or shortages of liquidity. Additional economies of scale can be found in credit risk assessment and loan portfolio management which also supports the synergies of bank liquidity provision.[2122]

There are nowadays several different financing options available for companies in the market. Taking into consideration that the capital structure is the composition of debt and equity the financing needs can also be covered with equity and debt. In terms of the repayment ranking the financing alternatives start from the common equity for which the investor expects to get the highest return. The other end of the financing alternatives is the senior ranked debt. Common equity is typically the most expensive financing form and senior debt is normally the least expensive financing form. There is a wide range of different financial instruments like preferred stock, capital loans, convertible loans, loans with right to purchase stock options etc between common equity and senior debt. The various debt obligations can also have different seniority rankings or priority of payment. Most senior or highest-ranking debt has the first claim on the company´s cash flow and assets. Debt can also be secured or unsecured. In the event of default unsecured claims are ranked below those of secured creditors.

Mezzanine instruments fall between debt and equity and thus any financial instrument that has characteristics of equity and debt can be described as mezzanine instrument. This financing form has its pros and cons. It may make financing possible even without security. On the other hand, it is not necessarily a suitable funding source for all types of businesses. Venture capital financier´s requirement of control over business decisions and unsecured creditor´s requirement of regular reporting of business performance may not suit to all customers. Here a bank as a financier with comparable financing form but different control and reporting requirements could have a business opportunity.

The analysis contained in this thesis has shown that mezzanine instruments could have relevance as banking financing products in certain situations for non-distressed healthy corporate customers. Banks product portfolio could thus well include both subordinated mezzanine loans and non-subordinated, senior mezzanine loans.

Banks could provide subordinated financing as the instrument to increase the amount of non-senior funding. This financing form offers similar kind of financing cushion against losses and against threat of liquidation as equity. This means that if both bank financing and venture capital financing alternatives were really available and the company would not want or need the management support provided by venture capitalist, the subordinated bank loan would be more attractive financing alternative for the customer. Pricing of subordinated loan is higher

[2120] Kumar, R. (2014), p. 20.
[2121] Milne, A. and Parboteeah, P. (2016), p. 19.
[2122] Sum, K. (2016), pp. 1-3.

than pricing of senior loan due to the lower repayment priority. However, getting additional financing cushion between equity and senior financing would justify the higher price.

From lender´s perspective when customer has no collateral to offer, the subordinated financing would not necessarily increase bank´s risk in practice. If all assets of the borrower company are already pledged or if there is only one creditor the seniority does not have any influence on the actual risk position of the bank. In such situations it would make sense for the bank to use the benefit of getting the higher interest income of the subordinated loan.

A bank can naturally provide financing in the form of non-subordinated senior debt as alternative to mezzanine finance just as the venture capitalists. From the borrower company´s perspective this means that if both financing sources were really available and the company would not want or need the management support provided by venture capitalist, the bank loan would be more attractive financing alternative for the customer. While there is lack of security it might be in the lender´s benefit to agree on interest terms that reflects the borrower´s real ability to pay interest. An example of this loan type is a profit-sharing (also known as profit-participation) loan.

In the profit-sharing loan the interest to be paid is linked to financial indicators (like profit) calculated from the borrower´s financials. Often the profit-linked component forms part of the total interest paid on top of the normal loan interest payment. The above-mentioned special interest clause may make it easier to agree pricing on higher level than the traditional pricing clause of traditional senior debt including fixed interest margin or fixed total interest rate. The use of special profit-linked interest payment clauses would not necessarily increase bank´s risk either especially when customer has no collateral to offer. This is the situation as the special profit-linked interest clause does not have any influence on the actual risk position of the bank as discussed earlier but rather provides *"option"* for higher return. In the situations without full collateral coverage it would make sense for the bank to use the benefit of the higher interest income of the profit-sharing/profit-participation loan.

The feature that is maybe emphasized too little among the small and medium sized enterprises is the fact that mezzanine can also be subordinated. Very often new or growing companies have a weak balance sheet. The solidity can be low due to small amounts of starting equity. Whether the financier is offering senior debt or subordinated debt is not irrelevant. Because of the restrictions of the repayment[2123] the company is more likely to pay higher interest rate on subordinated financing form than on traditional debt. Additionally, if the loan were in any case unsecured[2124] the profit increase of the lender may more than compensate the increasing financing risk. This is the situation if in the event of default the unsecured claim was in all cases not repaid regardless of the repayment priority. Besides repayment conditions being tied on the strength of the balance sheet there would be also other major arguments for the customer to use the subordinated loan. Among other things such a loan increases credibility with both subcontractors and suppliers and may even contribute to the customer´s earnings because of the stronger balance sheet.

Banks must run their daily operations according to the rules of the Basel Committee on Banking Supervision (BCBS). The Basel Committee formulates supervisory standards, guidelines and recommends statements of best practices and its decisions are followed by banks. The main purpose of the financial service regulation is to make sure that financial

[2123] In case of the Finnish capital loan the principal may be repaid and interest paid only subject to fulfilling the conditions set by the law. Payment is possible only up to such amount that after the payment the total amount of the unrestricted equity and all the capital loans at the time of payment exceed the loss on the balance sheet to be adopted for the latest financial period or more recent financial statements. For further details see below section *3.4.2.2.4 Capital structure.*

[2124] See case example *Subordinated financing for a healthy customer* above in section *5.2 Financing of healthy customers.*

institutions have enough capital to guard against potential losses. Basel regime focuses on making sure that banks are properly capitalised to withstand also worsened market conditions and to cover the risks of banking business. The Basel regulation encourages the use of internal risk measurement frameworks to determine the required risk capital. Based on these risk measures special credit rating and collateral coverage models are created. This enables customer-level differentiation of risk. To be able to build on this kind of framework makes it possible for the banks to turn a compliance cost into a business benefit. One outcome of the usage of new credit rating and collateral coverage models is that the pricing spread between good and poor companies will increase. The financing risk of the lender will and shall be priced more accurately than earlier.

Banks involved in corporate financing are frequently in the position of risk financier i.e. financing is granted without fully secured loans. Traditionally the bank´s return on money lent on traditional debt financing instrument is - even with these cases - very often on the same level as on secured bank loan. It is obvious that such a starting point is unsatisfying and against financial theories concerning risk/return -relations. When bank grants money without fully secured loans, the pricing should be higher than in case of fully secured loans. The bank´s return should conform better with the risks involved. Mezzanine instruments could be one way to help banks to price their lending so that pricing would better reflect the financing risk involved.

If an enterprise wants to get new financing from external sources there are in most cases four theoretical alternatives: banks, venture capital firms, business angels and capital markets. As business angels are hard to find and sourcing financing from capital markets is costly and complex there are in most cases two *"easy"* alternatives left: banks and venture capital funds.

When company is choosing between banks and venture capital companies there are four significant differences that company, its management and shareholders should be aware of: Firstly, bank does not seek ownership in the target companies unlike venture capital companies. Secondly, bank acts only as a lender and does not seek to participate in the ownership or management of the borrower unlike venture capital company. Thirdly, the rate of return requirement of the bank is substantially lower than that of the venture capital fund. Fourthly, bank strives to maintain long lasting customer relations while venture capitalists plan to exit normally within five to seven years.

In practice banks provide today only senior ranked financing. Subordinated bank financing is extremely rare and direct equity investments are not a bank financing option. However, venture capitalists do also provide subordinated financing and direct equity investments. Both subordinated financing and equity offer similar kind of protection against loss for the financial period and against threat of liquidation.

If both financing alternatives - venture capital and banking financing - are really available and the company does not want or need the management support provided by venture capitalist, loan from the bank is normally more attractive financing alternative. However, in case of shortage of equity banks do not have much to offer today. This means that in case of equity need or need of subordinated financing venture capital funds have clear advantage. In case banks did have subordinated financing in their active tool box they could give alternative options. In case of shortage of equity, the Finnish type capital loan could be relevant financing instrument. Its pricing would naturally be higher than pricing of a senior ranked financing instrument due to the buffer it gives against losses i.e. repayment priority ranks behind that of senior loan. If customer had no collateral to offer and as bank was thus in any case in a role of a risk financier capital loan would not in fact increase bank´s risk. If all assets of the borrower company are already pledged or if there is only one lender the seniority of the loan does not have any impact on the actual risk position of the bank.

In case of no shortage of equity subordinated loan is not necessarily needed. If there is lack of security it might be in lender´s benefit to agree on interest terms that reflect the borrower´s real ability to pay interest. Two examples of this kind of financing are profit-sharing loan and value-appreciation loan. With these instruments that have special interest terms the pricing is easier to agree on higher level than pricing of traditional senior debt. Also here - if customer has no collateral to offer - the use of unsecured loan with special interest payment clauses would in fact not increase bank´s risk.

Specialised financiers like venture capitalists evaluate and monitor investee companies closely and they have a way of dealing with the risk/return -issue. Traditionally banks have been unable to do the same because of several reasons. Banking regulation has limited the possibility to use equity as financing instrument. Also, tough price competition in banking market has made customers used to low pricing. Additionally, banks have not had resources and incentive systems to back up such a risk/return -monitoring required here.

However, systems and practices can be changed. Banking regulations do not restrict the use of subordinated loans as funding instruments, new resources can be recruited and incentive systems can be developed. In addition to that customer habits do also change. Based on this thinking mezzanine instruments could add bank´s financing alternatives and support aim to price financing risk more correctly. Mezzanine instruments could thus be one way to help banks to price its corporate lending activities so that pricing would better reflect the financing risk involved and the return requirements of the bank´s capital base.

The conclusion is that mezzanine could be used as bank financing instrument especially in situations where there is lack of security and when bank in any case would be prepared to finance even with traditional debt instruments.

5.8 Definition of target companies

Banks are primarily senior loan lenders and this shall be the case also in the future. Mezzanine finance should be one tool in the toolbox of many bank financing instruments. One starting point should be that bank provides mezzanine financing only for customers to whom it has provided or at the same time provides senior loan. Mezzanine should be thus supplementary financing form.

A credit may be granted only if there is a good reason to assume that the borrower is able and willing to fulfil its repayment obligations. This applies to all lending and also to mezzanine finance. The borrower´s repayment ability is an essential prerequisite for lending. To be able to assess the repayment capacity of the potential borrower it is important to have up-to-date financial information thoroughly analysed.

Mezzanine financing suits primarily for companies that are healthy, profitable companies with good growth prospects. The operative management must also have proven capabilities to perform. The cash flow must be predictable which makes companies in non-cyclical industries more favourable financing objects. The borrower companies must have strong market position and their products must not be subject to rapid technological change. It is also good if the balance sheet has room for additional leverage even after bank´s mezzanine arrangement. In addition to that all liabilities of the target company must be quantifiable.

Because mezzanine finance is structured finance the credit arrangements are costlier than finance with standard terms. Documentation is extensive and in every mezzanine arrangement it is in practice also a lawyer involved besides the customer relationship manager. In practice not only involvement of a legal expert but also input from a dedicated financial analyst with

relevant industry expertise is needed. Therefore, the size of the loan transaction in terms of loan principal must exceed a certain threshold in order the transaction to be profitable for the financier. The exact breakeven level depends on the cost structure of the bank in question. However, as a thumb rule can be stated that structured mezzanine loans smaller than TEUR 100 are hardly very profitable for the financier.

Even with mezzanine products the starting point shall be that bank´s financing risk should be lower than that of venture capital companies. Therefore, also the demand of return in bank´s credit arrangements is lower. Reason for this is - like already discussed - that banks do not have market tradition, resources, organisational setups nor incentive systems to handle risk/return issues of high risk -transactions like venture capitalists have.

Below are listed some key features of the companies that could be suitable targets of mezzanine financing provided by the banks:

- limited liability companies
- good and reliable management
- strong market position
- profitable business
- sufficient and predictable cash flow
- ability to provide regular reporting and reliable information
- no sufficient collateral to offer
- non-cyclical industry.

6 DIFFERENCES OF MEZZANINE MARKETS BETWEEN FINLAND AND OTHER COUNTRIES

6.1 Regulation and size of market

When observing mezzanine finance related differences between Finland, Sweden, Estonia, USA, UK and Germany following items can be raised:

- company legislation
- accounting rules
- taxation rules and
- size of market.

Each item is discussed more in detail in separate appendices (see Appendices 2-5 below).

6.2 Transaction examples

Additionally, in separate appendices are illustrated different mezzanine related transactions with the help of two financing examples related to

- subordinated debt (see Appendix 6 below) and
- senior ranked convertible debt (see Appendix 7 below).

6.3 Case example: how mezzanine can be concretely used?

The usage of mezzanine financing can be illustrated with the help of an imaginary example case *"Pekka IT Group"*. The presented financing structure is a combination of elements that have been included in several different real-life financing transactions from several different industries. The Pekka IT Group does not have any real life equivalent and is totally fictional group. Any possible similarities to any real-life companies are purely coincidental.

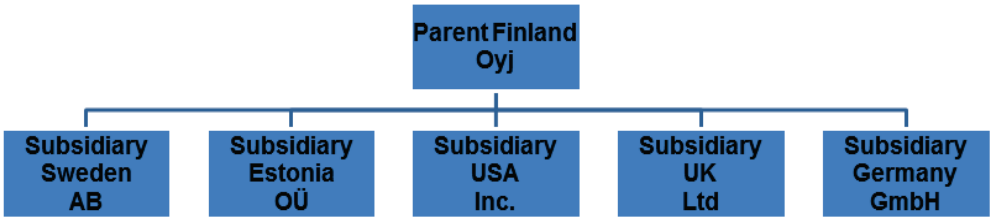
The example case demonstrates challenges related to financing arrangements of a group of limited liability companies operating in several countries. Here the countries in focus are Finland, Sweden, Estonia, USA, UK and Germany. The emphasis is on conversion of senior ranked shareholder loan to subordinated loan and how it changes the balance sheet structure. Also, some tax implications in the observed countries are commented.

6.3.1 Group structure

The Pekka IT Group case regards IT services group that provides its services specifically for financial and public sector. All six main subsidiaries operate in the same industry. Each of

them have a geographically defined responsibility area without major overlaps. The simplified group structure shows the parent company and the main subsidiaries (see Figure 22 below). Each subsidiary owns also some individual smaller companies which means that he main subsidiaries shown in the group structure are also themselves parent companies of subgroups. Pekka IT Group consists all in all of 36 legal entities.

Figure 22: Group structure of Pekka IT Group



The parent company Parent Finland Oyj is listed on the Helsinki Stock Exchange - Nasdaq OMX Helsinki - with a market cap of MEUR 500. Mr. Pekka Virtanen is the largest owner with a 30 % shareholding. Other shareholdings are split between hundreds of shareholders all having individually less than 4 % of the shares. Three Nordic banks are the main banks of the group. Additionally, each subsidiary is served by 2-3 smaller banks located in each subsidiary´s home country.

6.3.2 Description of the financing structure

The main priorities of Pekka IT Group for the coming years are to conserve liquidity and address its capital structure. Due to the positive outlook of the industry and strong market position the group also wants to prepare itself for a major acquisition. As of December 31, 2017, the total interest-bearing debt of the group was MEUR 312, consisting of

- MEUR 200 in bank debt
- MEUR 40 in vendor debt and
- MEUR 72 in bond debt.

All external non-current debt including all vendor and bond debt is in the balance sheet of the parent company Parent Finland Oyj. Out of the total debt MEUR 100 of bank debt and MEUR 72 of bond debt matures within the next three years. As alternative for just turning to the bank and bond markets for new financing the group is negotiating a restructuring solution with the existing bank syndicate and bondholders. In addition, the group is looking at possibility to attract new capital in the amount of at least MEUR 100 to secure sufficient liquidity through 2022. The new capital of min. MEUR 100 would be subordinated to senior financing. The vendor debt provided by the business partner has longer maturity with small amortisations and needs not to be restructured.

The balance sheets of the subsidiaries are without external long-term bank debt. The banking needs of subsidiaries are limited mostly to cash management and trade finance[2125] services. The subsidiaries are financed by parental equity input and shareholder loans from the parent. Additionally, the managements of the subsidiaries have been rewarded with minor amount of preference shares issued by the respective subsidiary in the past. The preferred shares have fixed dividend and mandatory redemption feature at a future date. On top of that holders of the preferred shares have right to claim for redemption at certain limited time annually.

The parental equity input to the subsidiaries has been traditionally very low and the granted shareholder loans having senior debt terms have pushed down the equity ratios further. The parent company has also had policy of not supporting the financing needs of the subsidiaries with parental guarantees. This strategy has led to increasing challenges to get external financing services - like short-term credit limits in relation to cash management services and bank guarantees - for the subsidiaries from the local banks. Also, business partners of the subsidiaries have started to react to the weak balance sheet structures of the subsidiaries and communicated their wish to see stronger support from the strong owner. Due to this pressure from trade finance banks and external vendors there is a need to reconsider also the balance sheet structure of the subsidiaries. The group management has therefore planned to convert the senior ranked shareholder loans to subordinated shareholder loans to provide more comfort to business partners. The conversion of senior ranked shareholder loans to subordinated financing would communicate to external stakeholders that owner is taking more financial risk of their subsidiaries and simultaneously reducing the risk of business partners.

Pekka IT Group is planning now to execute the recapitalisation plan which shall be implemented in two steps:

1. creating a stable platform and

2. recapitalisation.

The first plan is to create a stable platform in the interim period. This should be done by extending maturity of the parent company bank credit facilities until December 2020. The second step - a recapitalisation - would be completed after that.

The group and banks have been working on the recapitalisation plan since several months and have made good progress over the last months. An agreement will most likely soon be reached on most of the key elements. The key elements of the recapitalisation are as follows:

- refinancing of bonds through new bond issuance with targeted maturities not earlier than 2025

- five-year maturity extension for all existing bank facilities, however no facility will mature later than December 2024.

- amortisation relief of approx. 40% for all bank facilities.

In return Pekka IT Group will plan to act as follows:

- raise an amount of minimum MEUR 100 in new funding subordinated to the secured bank facilities and with maturity after the secured bank facilities

[2125] Trade finance refers to financing products used to manage the risks related to import and exports activities of the company. The term covers such products like documentary collections, documentary credits, guarantees and standby letters of credits (L/Cs) having normally maturity less than one year.

- agree to cross collateralisation of all the secured bank facilities
- agree to increase the minimum liquidity covenant[2126] from MEUR 25 to MEUR 50
- increase the margin on the secured bank facilities with 100 bps[2127]
- convert existing shareholder loans to five subsidiaries totalling MEUR 5 into subordinated loans.

The recapitalisation plan is complex due to the number of stakeholders and the complex company structure. There are still a number of details to be agreed between Pekka IT Group and the banks. The remaining issues are mainly related to intercreditor issues between the new secured notes and the secured bank facilities, restrictive covenants as well as cash pooling[2128] arrangements.

The next step for the group is to initiate a dialog with the unsecured bondholders. The initial proposal of Pekka IT Group is to exchange all the bonds into 4 new EUR bonds where 1/4 will mature in 2025, 2026, 2027 and 2028. In terms of priority ranking the bonds would be behind the secured bank facilities and new secured notes.

Mr. Pekka Virtanen has stated that he will commit to his pro-rata share of the new subordinated bond issue based on his current ownership in Pekka IT Group i.e. to the amount of MEUR 30. The company has had initial discussions with potential investors and based on those discussions Pekka IT Group is confident in raising at least MEUR 100 new subordinated funding.

By completing the described recapitalisation plan, the company believes it will have a capital structure and liquidity position providing a runway through 2022. These measures will also give the group the ability to take part in a major acquisition or consolidation arrangement in its industry.

6.3.3 Ownership and management

Mr. Pekka Virtanen is the largest and controlling shareholder with a 30 % ownership. He has shown strong financial support to Pekka IT Group and to his other investments in the past and has committed to his pro rata share in any capital raise in the upcoming process. He has on the other hand noted that he is not willing at stage to provide pure equity to Pekka Shipping Group.

Other key people of the Pekka IT Group are CEO Liisa Nieminen and CFO Roy Jones. Mrs Nieminen has been the CEO of the group since 2013. All key people are considered experienced and competent both within the IT industry and the capital markets (see Figure 23 below).

[2126] The liquidity covenant refers to commitment of the borrower to keep highly liquid assets in the bank. The purpose is to ensure that the borrower has at all times the necessary liquidity to cover its short-term liabilities.
[2127] Abbreviation bps refers to *"basis point"*, which is a common unit of measure for interest rates and other percentages in finance. One basis point is equal to 0.01% (1/100th of a percent) or 0.0001 in form of decimal.
[2128] A cash pool is a structure for holding company funds at bank. Cash pooling aggregates customer´s credit and debit positions of several accounts into one account. This helps to manage account balances of a corporate customer having several accounts.

Figure 23: Key people of Pekka IT Group

Title	Name	Age / Born	Years with the Company	Years in the Industry
Chairman	Pekka Virtanen	66	25	25
CEO	Liisa Nieminen	52	8	20
CFO	Roy Jones	49	1	10

Ownership and management risk can be considered to be low. Pekka IT Group´s management team is competent and experienced industry professionals with deep understanding of the IT services market. The main owner Pekka Virtanen reduced his ownership share down to 30 % through the initial public offering (IPO) in 2015. The IPO strengthened the capital structure of the group and improved financial flexibility.

6.3.4 Business

Pekka IT Group is a result of several mergers and acquisitions. Geographically the turnover is divided between Finland (40 %), Sweden (30 %), Estonia (10 %), USA (8 %), UK (6 %) and Germany (6 %). Number of FTEs was approximately 6100 as of Q4 2017.

The overview of individual companies of the group is as follows:

Parent Finland Oyj addresses public sector customers and financial service customers. Services involve outsourcing of IT operations, consulting services and development projects.

Subsidiary Sweden AB addresses also public sector and financial service customers. Services involve IT operations, application management and providing software solutions.

Subsidiary Estonia OÜ focuses on bank and finance customers. It offers a complete suite of software solutions to the industry including core banking and payment solutions. Services cover additionally outsourcing of IT operations.

Subsidiary USA Inc. works with public sector and financial service customers. It provides secure identity and access control services and software solutions. Also outsourcing of IT operations and development projects are part of the service portfolio of the U.S. subsidiary.

Subsidiary UK Ltd addresses public sector, financial service and retail customers. The company offers software solutions including both core banking and payment solutions. An additional specialty of this subsidiary is secure identity and access control services for both physical and online access.

Subsidiary Germany GmbH addresses public sector customers and financial service customers. Services involve outsourcing of IT operations, consulting services and development projects with public sector and financial service customers.

6.3.5 Industry and enterprise risk

Industry risk is moderate. The IT services markets expects healthy growth rates in all countries Pekka IT Group is involved. Both the technological innovation, increased complexity in IT needs and strong outsourcing trend drive for the positive outlook. IT investments in banking and financial services is expected to grow further. Also, IT outsourcing has shown resilience towards business cycles due to cost saving incentives. Competition within the industry is fierce dominated by large international players.

Enterprise risk is moderate. Pekka IT Group holds strong positions within public sector and financial services in all its market areas. In-depth industry competence, broad service offering and a strong local presence are competitive of the group. During the last years the group has been challenged by increased price pressure and some loss of contracts. Nevertheless, dependency on individual big customers has been reduced during the last years. Also, operational stability has been improved leading to improved customer satisfaction. Pekka IT Group has fairly large and diversified customer base including approximately 6000 customers with long-term contracts having typical maturity 2-4 years. This provides satisfactory earnings visibility.

6.3.6 Financials

The presented financials are based on the audited IFRS statement of Pekka IT Group. The reporting currency is EUR. The functional currency of each subsidiary is the currency of the primary economic environment in which entity operates.

The financials are strong and the financial standing is stable (see Figure 24 below). Forecast for 2018 represents the management view assuming no major acquisitions. The overall business volumes and profitability are fairly stable.

Figure 24: Financials of Pekka IT Group

INCOME STATEMENT, MEUR	2015	2016	2017	Forecast 2018
Net sales	1 531	1 538	1 446	1 482
Operating profit (EBIT)	424	395	356	370
Total income	372	298	246	265

BALANCE SHEET, MEUR	2015	2016	2017	Forecast 2018
Non-current assets	536	490	450	459
Current assets	780	739	667	788
Total assets	1 316	1 229	1 117	1 247
Equity	452	626	649	729
Non-current liabilities	536	431	312	357
Current liabilities	328	172	156	161
Total equity and liabilities	1 316	1 229	1 117	1 247

STATEMENT OF CASH FLOW, MEUR	2015	2016	2017	Forecast 2018
Cash generated from operations	347	395	329	344
Net cash flow after operations[2129]	262	360	266	289
Total net cash used in investing activities[2130]	-211	-201	-230	-229
Total net cash used in financing activities[2131]	-6	-160	-54	40
Change in cash and cash equivalents	45	-1	-18	100
Cash and cash equivalents at the end of period	343	342	324	424

KEY RATIOS	2015	2016	2017	Forecast 2018
Operating margin, %	27.7	25.7	24.6	24.9
Return on equity, %	41.8	30.7	27.8	30.1
Return on capital employed, %	54.2	38.4	32.4	35.1
Interest Coverage[2132]	32.6	21.1	23.0	31.3
Equity ratio, %	34.3	50.9	58.1	58.4
Debt/EBITDA[2133]	1.0	1.1	1.0	1.0

In the forecast the following assumptions are made with regards to Pekka IT Group debt:

1. All bank maturities and amortisation profiles are extended by 3 years.
2. Maturity of the bond debt of 72 MEUR will be extended by 3 years
3. Group can raise an amount of minimum MEUR 100 in new bond debt subordinated to the secured bank facilities and with maturity after the secured bank facilities.
4. Interest is assumed to be increased by 100 bps and bond interest becomes PIK.
5. Terms of vendor financing are unchanged.

[2129] Deloitte (2017b) describes that according to IAS 7.14 operating activities are the main revenue-producing activities including cash received from the customers and cash paid to suppliers and employees. Investing or financing activities are excluded from the operating activities.
[2130] Deloitte (2017b) states that according to IAS 7.6 investing activities are the acquisition and disposal of long-term assets and other investments that are not considered to be cash equivalents.
[2131] According to Deloitte (2017b) the IAS 7.6 financing activities are all activities that change amount of equity or borrowing structure of the company.
[2132] Here interest coverage ratio is equal to earnings before interest, taxes, depreciation and amortization (=EBITDA) divided by interest expenses for the same time period. This ratio measures borrower´s ability to meet its interest payments.
[2133] Debt/EBITDA ratio illustrates the amount of interest-bearing debt in relation to borrower´s earnings before interest, taxes, depreciation and amortization. This ratio tells about the company's ability to pay its interest-bearing long term financial obligations.

The planned restructuring will give the group a sufficient runway through 2020 given the assumed market outlook and gives also possibility to plan acquisition transaction. The raising of new capital in a form of subordinated financing is important part of the recapitalisation as the capital injection improves the liquidity further and provides thus additional possibilities for the management to manoeuvre.

Main assets in 2017 included goodwill of MEUR 320, other intangible assets of MEUR 61 (mainly own-developed software), tangible assets of MEUR 67 (mainly IT equipment) and accounts receivables of MEUR 160. Book equity was increased to 58.1 % although major dividend payment of MEUR 173.

6.3.7 Security

The security package Pekka IT Group includes 1st priority pledge in those shares of Parent Finland Oyj that are owned by Pekka Virtanen i.e. 30 % of all the shares of the company. On top of that the security package includes 1st priority pledges to other material group companies i.e. the subsidiaries in Sweden, Estonia, USA, UK and Germany to the extent it is legally possible.[2134]

Parent Finland Oyj is listed on Nasdaq OMX Helsinki and as a public limited liability company has its shares registered in a securities register. Therefore, also the security over the shares of the company is perfected by registration in that security's register.

6.3.8 Covenants

The loan agreements of Pekka IT Group contain mechanisms for regular reporting of operational and financial performance to financiers regularly. The reporting obligation includes also reporting of financial covenants on quarterly basis.

The facilities of Pekka IT Group carry a maintenance covenants on leverage and interest coverage, which are tested on quarterly basis. The leverage covenant Debt/EBITDA is set at the level of max. 2.50x and interest coverage covenant EBITDA/Net Financial items is set on the level min. 10.00x. Both covenant levels are easily achieved here.

Loan agreements include also restriction for the borrowers to commit to actions which are not commonly agreed. Such clauses include negative pledge[2135] and restrictions on financial indebtedness, disposals and mergers.

[2134] The legal limitations for getting the subsidiary shares as collateral stem often from the so-called financial assistance rules. Financial assistance in law means the assistance given by a company for the purchase of its own shares or the shares of its holding companies. In Finland and in many other jurisdictions such an assistance is prohibited or restricted. For instance, the financial assistance prohibition under the Chapter 13, Section 10:1 of the Finnish Limited Liability Companies Act (624/2006) applies to all limited liability companies, whether public or private companies. The rule restricts the granting of a guarantee or security for the financing of the acquisition of shares in the acquired entity or its parent company. Therefore, a new acquisition debt is often secured by first ranking pledges over the shares in the target company, because pledges in the operating assets are normally restricted by financial assistance regulations. Additionally, to get operating assets as collateral is normally costlier than pledging of subsidiary shares.

[2135] Negative pledge covenant forbids a borrower to create security or otherwise encumber its assets without the consent of the lender. The purpose of such a covenant is to ensure that the lender´s position is not negatively affected in relation to other creditors.

6.3.9 Company specific implementation of the recapitalisation plan

6.3.9.1 Parent Finland Oyj

The recapitalisation of the liabilities of the parent company Parent Finland Oyj includes refinancing of bonds through new bond issuance, extension of maturities for the bank facilities and amortisation relief for part of the bank facilities. Extension of maturities and amortisation relieves do not impact directly on the balance sheet items at the moment of extension and relieves. Neither does the refinancing of bonds through new bond issuance influence the balance sheet if refinancing extends only maturity and increases interest level. However, the additional new subordinated bond financing of MEUR 100 in a form of Finnish capital loan would bring new element in the balance sheet of the parent company prepared according to IFRS (see Figures 48, 48 and 49 below).

In order subordinated financing to fulfil the criteria of capital loan as defined in the Finnish Limited Liability Companies Act the transaction must include certain conditions:

- principal and interest are subordinated to other debts in borrower´s liquidation and bankruptcy
- principal may be repaid and interest paid only in so far as the total amount of the unrestricted equity and the capital loans at the moment of payment exceed the loss on the balance sheet and
- company or a subsidiary shall not provide security for the payments.[2136]

Additionally, law requires that

- capital loan contract shall be concluded in writing
- interest that cannot be paid shall be postponed to be paid based on the first such financial statements that allow the payment and
- capital loans shall be shown as a separate item in the borrower´s balance sheet.[2137]

Figure 25: Simplified split of equity and liabilities in the balance sheet of Parent Finland Oyj before the recapitalisation

Equity
• Share capital
• Retained earnings
Liabilities
• Non-current liabilities o Bank loans MEUR 200 o Vendor loans MEUR 40 o Bonds MEUR 72
• Current liabilities

[2136] Chapter 12, Section 1 of the Limited Liability Companies Act (624/2006).
[2137] Chapter 12, Section 2 of the Limited Liability Companies Act (624/2006).

Figure 26: Simplified split of equity and liabilities in the balance sheet of Parent Finland Oyj after the recapitalisation if subordinated bond does not fulfil the capital loan criteria

Equity
• Share capital
• Retained earnings
Liabilities
• Non-current liabilities o Bank loans MEUR 200 o Vendor loans MEUR 40 o Bonds MEUR 172
• Current liabilities

Figure 27: Simplified split of equity and liabilities in the balance sheet of Parent Finland Oyj after the recapitalisation if subordinated bond fulfilled the capital loan criteria

Equity
• Share capital
• Retained earnings
Liabilities
• Non-current liabilities o Bank loans MEUR 200 o Vendor loans MEUR 40 o Bonds MEUR 72
• Capital loan o Bonds MEUR 100
• Current liabilities

The bond financing in the form of capital loan can contain also additional terms but minimum requirements described in the law must be satisfied. The other terms shall not be contradictory with the minimum requirements set in the law.[2138]

Interest expenses of loans including capital loans are deductible in Finland. The bond element in a capital loan does not influence to the deduction right.[2139]

6.3.9.2 Subsidiary Sweden AB

Parent Finland Oyj has granted a shareholder loan of MEUR 1 in Swedish crowns to its Swedish subsidiary Subsidiary Sweden AB. The recapitalisation plan of Pekka IT Group includes plan to convert the senior ranked shareholder loan to subordinated financing.

[2138] Government Bill for the Limited Liability Companies Act (HE 109/2005), p. 120.

[2139] According to the Finnish taxation practice interest expenses of capital loan and also other type of mezzanine financing booked as debt are considered to be deductible. See for more details above section *3.6.2 Taxation in Finland.*

Therefore, the CFO of the parent has asked the CFO of Subsidiary Sweden AB to present a proposal to convert the existing shareholder loan in a loan comparable to the Finnish capital loan. The challenge of the Swedish management is however that there is no specific regulation in the Swedish company law about subordinated financing forms directly comparable to the Finnish capital loan. As an answer the Swedish CFO suggests a solution where the shareholder loan is converted to a special form of financing known in Sweden as *"villkorat aktieägartillskott"*. This kind of direct financial support in a form of a conditional shareholder contribution is not directly regulated in company law or taxation law but it is commonly used and known in the Swedish company practice.[2140] The idea is to let the shareholders provide the company with capital and improve its financials.

The terms of the conditional shareholder contribution allow repayment of the contribution once the borrower is demonstrating free own capital in the balance sheet. This means that the contribution in question is not a traditional loan but rather an equity linked investment which can be returned to the parent once the Swedish subsidiary has enough own capital in the balance sheet. Repayment requires decision of the general meeting and is thus comparable to dividend payment. Due to the nature of the transaction the interest to be paid for the contribution is not deductible. The interest to be paid is deductible only starting from the moment the general meeting has made decision to repay the loan.[2141]

It is possible to structure the conditional shareholder contribution so that it is booked as an equity item.[2142] The conversion of the senior term shareholder loan to subordinated capital input in a form equal to the Swedish conditional shareholder contribution would then change the balance sheet structure of the Swedish subsidiary preparing its financials according to the IFRS rules (see Figures 51, 52 and 53 below).

Subsidiary Sweden AB applies IFRS regulation and the Swedish RFR 2 rules in its financial statements. This means that the company shall apply in its loan instrument classification the IAS 32[2143] and the Swedish RFR 2 recommendations.[2144] Unless inconsistency with the Swedish law is identified IAS rules are normally followed. Decisive is the accounting of the item according to its economic characteristics. The legal form as such is not relevant. In case there are deviations from the IAS 32 that has to be separately revealed in the financial statements of the borrowing company.[2145] Here in case of preference shares the instrument shall be classified according to RFR 2 as equity due to the specific reference in the Swedish Annual Accounts Act[2146] even if the instrument fulfils the characteristics of debt according to IAS 32.[2147] The deviation from the IAS 32 is separately disclosed in the financial statements according to the Swedish requirements.[2148]

[2140] Skatteverket (2017).
[2141] See Swedish Supreme Administrative Court decision RÅ 1987, ref. 145.
[2142] About the fulfilment of equity criteria in relation to *"villkorat aktieägartillskott"* see Swedish Supreme Court decision NJA 1988, p. 620.
[2143] PKF (2017), pp. 633-645.
[2144] See RFR 2 (2017), p. 7 about the applicability of IFRS and RFR 2 rules in general.
[2145] RFR 2 (2017), p. 23.
[2146] Annual Accounts Act (1995:1554).
[2147] RFR 2 (2017), p. 23 and Skatteverket (2012), p. 74.
[2148] RFR 2 (2017), p. 23.

Figure 28: Simplified split of equity and liabilities in the balance sheet of Subsidiary Sweden AB before the recapitalisation

Equity
• Share capital
• Retained earnings
• Preference shares
Liabilities
• Non-current liabilities o Shareholder loan MEUR 1
• Current liabilities

Figure 29: Simplified split of equity and liabilities in the balance sheet of Subsidiary Sweden AB after the recapitalisation if conditional shareholder contribution does not fulfil equity criteria

Equity
• Share capital
• Retained earnings
• Preference shares
Liabilities
• Non-current liabilities o Conditional shareholder contribution MEUR 1
• Current liabilities

Figure 30: Simplified split of equity and liabilities in the balance sheet of Subsidiary Sweden AB after the recapitalisation if conditional shareholder contribution does fulfil equity criteria

Equity
• Share capital
• Retained earnings
• Preference shares
• Conditional shareholder contribution MEUR 1
Liabilities
• Non-current liabilities
• Current liabilities

What is said about the accounting classification above does not directly lead to similar conclusions in taxation. From the taxation angle the status of a financing instrument shall be assessed separately. If the financing instrument shall be classified as debt or equity in taxation depends on taxation rules. The taxation treatment to be applied is based on two step processes.

Firstly, is assessed whether the instrument is debt or equity and is the payment to the lender interest or dividend. Secondly is concluded whether the compensation paid is deductible or not.[2149] In non-standard financing arrangements like tailor-made capital loan transactions there may be some uncertainty.[2150] If financing instrument is classified as debt from taxation viewpoint the interest is deductible expense when lender is credit institutions and other third-party lender. However, it shall be noted that interest costs relating to intra-group loans - like the shareholder loan here - are not deductible with some exemptions.[2151] This interest deduction restriction would be applicable even if the intra group loan were pure senior ranked debt.

6.3.9.3 Subsidiary Estonia OÜ

Parent Finland Oyj has granted a shareholder loan of MEUR 1 to its Estonian subsidiary Subsidiary Estonia OÜ. As the recapitalisation plan of Pekka IT Group includes plan to convert the senior ranked shareholder loans to subordinated financing this shall be applied also for the Estonian subsidiary. Because of this the CFO of the parent has asked the CFO of Subsidiary Estonia OÜ to present a proposal to convert the existing shareholder loan in a loan comparable to the Finnish capital loan. The concern of the Estonian management is however that there is no specific regulation in the Estonian company law about subordinated financing forms directly comparable to the Finnish capital loan. The Estonian CFO reacts by suggesting a solution where the shareholder loan is converted to subordinated shareholder loan according to the Finnish capital loan parameters. This kind of financing form is not directly regulated in company law or taxation law but subordination as such is commonly used and known in the Estonian company practice. Lender and borrower can agree on loan subordination within the general freedom of contract.[2152]

The Estonian Accounting Act allows companies to choose whether the Estonian Accounting Standards (Estonian GAAP) or IFRS is applied in preparation of their financial statements.[2153] As the Estonian GAAP is in compliance with the instrument classification rules of IAS the classification of financial instruments is in practice always done according to IAS.[2154] The loan type similar to the Finnish capital loan is normally classified as liability in IFRS.

The conversion of the shareholder loan to subordinated loan in a form equal to the Finnish capital loan would change the balance sheet structure of the Estonian subsidiary according to the IFRS rules only if the subordination led to classification of the instrument to equity (see Figures 54, 55 and 56 below). This would in practice require more *"equity like"* elements as linking the interest level to the borrower´s profitability (profit sharing element) and agreeing on credit terms which de facto put lender more to a shareholder like position (right to appoint members of management, right to participate in major decisions, right to get financial information of the borrower etc.).[2155] It shall be however noted that the main target of the

---

[2149] Skatteverket (2012), pp. 82-84.
[2150] The Swedish Tax Board and the Supreme Administrative Court have also had different views related to the classification of financial instruments as debt or equity. See Hilling, A. and Vilhelmsson, A. (2015), p. 700 and also Bjuvberg, J. (2014), Olsson, S. (2014) and Tivéus, U. (2014).
[2151] Chapter 24, Section 10d of the Income Tax Law (SFS 1999:1229).
[2152] About freedom of contract in general see above section *3.4.4 Freedom of contract*. See also Vutt, A. (2008).
[2153] Chapter 3, Section 17:1 of the Accounting Act (RT I 2002, 102, 600). According to Section 17:2 Listed companies, credit institutions and insurance companies are obliged to follow IFRS.
[2154] Strouhal, J. ed. (2011), p. 86.
[2155] Immonen, R. and Villa, S. (2017). The authors write about the IFRS classification of the Finnish capital loan in accounting. Although the article focuses on Finnish practice the IFRS related comments can be relevant also in other countries applying IFRS regulation.

parent - subordination of the shareholder loan - will be valid regardless of the classification of the shareholder loan in subsidiary´s accounting.

Figure 31: Simplified split of equity and liabilities in the balance sheet of Subsidiary Estonia OÜ before the recapitalisation

Equity
• Share capital
• Retained earnings
Liabilities
• Non-current liabilities o Shareholder loan MEUR 1 o Preference shares
• Current liabilities

Figure 32: Simplified split of equity and liabilities in the balance sheet of Subsidiary Estonia OÜ after the recapitalisation if subordinated shareholder loan does not fulfil equity criteria

Equity
• Share capital
• Retained earnings
Liabilities
• Non-current liabilities o Shareholder loan MEUR 1 o Preference shares
• Current liabilities

Figure 33: Simplified split of equity and liabilities in the balance sheet of Subsidiary Estonia OÜ after the recapitalisation if subordinated shareholder loan does fulfil equity criteria

Equity
• Share capital
• Retained earnings
• Shareholder loan MEUR 1
Liabilities
• Non-current liabilities
o Preference shares
• Current liabilities

The existing preference shares that have fixed dividend and mandatory redemption feature at a future date are liabilities according to IFRS and shall be classified accordingly.[2156]

As in Estonia interest cost deduction is not applied therefore interest expenses are not either deductible.[2157]

6.3.9.4 Subsidiary USA Inc.

Parent Finland Oyj has granted a shareholder loan also to Subsidiary USA Inc. which is the subsidiary having its domicile in Delaware, USA. The loan is granted in USDs equalling the amount of MEUR 1. The recapitalisation plan of Pekka IT Group includes plan to convert the senior ranked shareholder loans to subordinated financing also in Delaware. Therefore, the CFO of the parent has given to the CFO of Subsidiary USA Inc. a task to present a proposal of converting the existing shareholder loan in a loan comparable to the Finnish capital loan. Like his colleagues in Sweden and in Estonia also the American CFO does not have comparable instrument in the local company legislation. After some brainstorming he decides to propose a transaction where the shareholder loan is converted to subordinated shareholder loan which is in terms of priority ranking and repayment identical to the Finnish capital loan. In the legal environment of Delaware, it is possible to structure a subordinated loan with such terms although the US company legislation does not directly regulate such loan type. Creating a transaction including subordinated loan structure is possible within the general freedom of contract.[2158]

Subsidiary USA Inc prepares its financial statements both according to IFRS and US GAAP.[2159] According to US GAAP the conversion of the senior term shareholder loan to a subordinated loan as described above would change the balance sheet structure of Subsidiary USA Inc. only if the subordinated loan would be booked as equity (see Figures 57, 58 and 59 below). However subordinated loan type is normally classified as liability according to US GAAP.[2160] Regardless of the accounting in the balance sheet the main target of the parent - subordination of the shareholder loan - will still become valid when subordination clause is included in the credit agreement.

According to the US GAAP when a puttable instrument[2161] has a redemption feature that is not solely within the control of the issuer, the issuer is required to present the instrument in the balance sheet between permanent equity and liabilities in a section entitled *"temporary equity"* or *"mezzanine equity"*.[2162] The preferred shares issued by Subsidiary USA Inc. have fixed dividend and also mandatory redemption feature at a future date. On top of that the

---

[2156] IAS 32.18.

[2157] The Estonian corporates are subject to income tax only in respect of all distributed profits including dividends distributed, gifts and donations and payments unrelated to business. The consequence of this is that retained earnings are not taxed until profit distributions are made. This means that interest cost deduction is not applied. See more about the Estonian corporate taxation system in Staehr, K. (2014).

[2158] About freedom of contract in general see above section *3.4.4 Freedom of contract*.

[2159] Many US companies have investors or stakeholders outside the US. Also, many companies operating in the USA have foreign parent company. These foreign parties do often require financial reporting under IFRS and for such purposes relevant US GAAP financials are additionally converted to IFRS language.

[2160] Stice, J.D. and Stice, E.K. (2014), p. 12-52 in which is referred to FASB Accounting Standards Codification (ASC) paragraph 470-10-599-2.

[2161] According to Deloitte (2017c) puttable instrument means *"a financial instrument that gives the holder the right to put the instrument back to the issuer for cash or another financial asset or is automatically put back to the issuer on occurrence of an uncertain future event or the death or retirement of the instrument holder".*

[2162] Deloitte (2017) in which is referred to FASB Accounting Standards Codification (ASC) paragraph 480-10-S99-3A.

holders of the preferred shares have right to claim for redemption at certain limited time period annually. Because of these redemption terms the preference shares issued by Subsidiary USA Inc. are not classified as pure equity or pure liability in the company balance sheet. The preference shares can be booked as mezzanine equity between equity and liabilities.

Interest expenses of debt are generally deductible for the corporations in the USA.[2163] Regarding mezzanine financing the deductibility of interest is possible if the financing form can be considered to be debt. On top of that transfer pricing regulations require applying arm's-length standard[2164] and thin capitalisation rules[2165].

Figure 34: Simplified split of equity and liabilities in the balance sheet of Subsidiary USA Inc. before the recapitalisation

Equity
• Share capital
• Retained earnings
Mezzanine equity
• Preference shares
Liabilities
• Non-current liabilities o Shareholder loan MEUR 1
• Current liabilities

Figure 35: Simplified split of equity and liabilities in the balance sheet of Subsidiary USA Inc. after the recapitalisation if subordinated shareholder loan does not fulfil equity criteria

Equity
• Share capital
• Retained earnings
Mezzanine equity
• Preference shares
Liabilities
• Non-current liabilities o Shareholder loan MEUR 1
• Current liabilities

[2163] 26 U.S. Code § 163. The law includes also several exceptions of the main rule.

[2164] The legal framework for the transfer pricing in the USA includes in several sections of the Internal Revenue Code and in Internal Revenue Service (IRS) regulations, mostly in Internal Revenue Code (IRC) Section 482. The arm's-length standard is normally considered to be met if outcome is consistent with the outcome of a similar transaction completed by arm´s length parties. IRS may increase taxes payable if the arm's-length standard requirement is violated.

[2165] Thin capitalization rules aim to disallow interest payments related to excess debt and to recharacterize such payments as dividends. The rule limits tax deductions of companies and targets among other things on the US subsidiaries of foreign owned companies. See also above section 3.*6.3.3 USA*.

Figure 36: Simplified split of equity and liabilities in the balance sheet of Subsidiary USA Inc. after the recapitalisation if subordinated shareholder loan does fulfil equity criteria

Equity
• Share capital
• Retained earnings
• Shareholder loan MEUR 1
Mezzanine equity
• Preference shares
Liabilities
• Non-current liabilities
• Current liabilities

6.3.9.5 Subsidiary UK Ltd

Also, Subsidiary UK Ltd has received financial support from its owner Parent Finland Oyj in a form of a shareholder loan. The loan is granted in a currency of GBP equalling the amount of MEUR 1. As the recapitalisation plan of Pekka IT Group includes plan to convert the senior ranked shareholder loan to subordinated financing necessary steps must be taken. Just like with the other main subsidiaries the CFO of the parent has asked the CFO of Subsidiary UK Ltd to present a proposal to convert the existing shareholder loan in a loan comparable to the Finnish capital loan. Also, the UK management faces the challenge that the local company law does not have specific regulation about subordinated financing forms directly comparable to the Finnish capital loan. As a resolution the UK CFO suggests that the shareholder loan is converted to subordinated shareholder loan according to the Finnish capital loan parameters. Although this kind of financing form is not directly regulated in the UK company law or taxation law the loan subordination is commonly known in the market practice. Lender and borrower can agree also in UK on loan subordination within the general freedom of contract.[2166]

The UK company law provides the legal framework according to which the companies must operate and many of the accounting requirements are included in the Companies Act.[2167] The unlisted UK companies are permitted to choose whether to prepare their account according to IFRS or in accordance with UK GAAP. UK GAAP and IFRS have in certain areas different approaches.[2168] However about classifying liabilities and equity the differences are very limited and broadly UK GAAP is consistent with IAS 32.[2169] Subsidiary UK Ltd prepares its consolidated financials according to the IFRS.

The conversion of the shareholder loan to subordinated loan in a form equal to the Finnish capital loan would change the balance sheet structure of the UK subsidiary according to the

[2166] About freedom of contract in general see above section *3.4.4 Freedom of contract*.
[2167] Part 15 of the Companies Act 2006. On top of that under the EU regulation all listed companies in the UK must prepare their consolidated financial statements using IFRS as adopted in the EU.
[2168] See about differences in general KPMG (2015b).
[2169] KPMG (2015b), pp. 180-191.

IFRS rules only if the subordination led to classification of the instrument to equity (see Figures 60, 61 and 62 below). Like in case of other countries applying IFRS rules a subordinated loan having only such features that are mentioned in the Finnish company law[2170] hardly qualifies for an equity item in the UK. On the other hand if *"basic"* capital loan features are supplemented by additional equity like add-ons like binding the interest on the borrower´s profitability (profit sharing element) and agreeing on credit terms which de facto put lender more to a shareholder like position (right to appoint members of management, right to participate in major decisions, right to get financial information of the borrower etc.) the subordinated loan could become equity item.[2171] It shall be however noted again here that the main target of the parent - subordination of the shareholder loan - will be valid regardless of the classification of the instrument in subsidiary´s accounting.

The existing preference shares having fixed dividend and mandatory redemption feature at a future date remain as liabilities in IFRS financials.[2172]

Figure 37: Simplified split of equity and liabilities in the balance sheet of Subsidiary UK Ltd before the recapitalisation

Equity
• Share capital
• Retained earnings
Liabilities
• Non-current liabilities o Shareholder loan MEUR 1 o Preference shares
• Current liabilities

Figure 38: Simplified split of equity and liabilities in the balance sheet of Subsidiary UK Ltd after the recapitalisation if subordinated shareholder loan does not fulfil equity criteria

Equity
• Share capital
• Retained earnings
Liabilities
• Non-current liabilities o Shareholder loan MEUR 1 o Preference shares
• Current liabilities

[2170] Chapter 12 of the Limited Liability Companies Act (624/2006).
[2171] Immonen, R. and Villa, S. (2017). The authors write about the IFRS classification of the Finnish capital loan in accounting. Although the article focuses on Finnish practice the IFRS related comments can be relevant also in other countries applying IFRS regulation.
[2172] IAS 32.18.

Figure 39: Simplified split of equity and liabilities in the balance sheet of Subsidiary UK Ltd after the recapitalisation if subordinated shareholder loan does fulfil equity criteria

Equity
• Share capital
• Retained earnings
• Shareholder loan MEUR 1
Liabilities
• Non-current liabilities
○ Preference shares
• Current liabilities

In the UK the taxation rules of financing instruments follow normally the accounting rules.[2173] This means that it is possible to deduct the debt interest but equity interest is not deductible due to being considered as dividend distribution. There are however several deduction restrictions related to source of income concerned, types of reliefs and maximum amount of deduction.[2174] Additionally specific anti-avoidance regulation provisions disallow interest deductions which relate to tax avoidance or non-business purposes.[2175] Also the transfer pricing rules restrict deductions up to the amount that would be possible if all the parties where independent according to the arm's length principle.[2176]

6.3.9.6 Subsidiary Germany GmbH

Parent Finland Oyj has granted a shareholder loan of MEUR 1 also to its German subsidiary Subsidiary Germany GmbH. The recapitalisation plan of Pekka IT Group regards also the German subsidiary because of the plan to convert the senior ranked shareholder loan to subordinated financing in all subgroups in five countries. As in case of other main subsidiaries the CFO of the parent has asked the CFO of Subsidiary Germany GmbH to present a proposal to convert the existing shareholder loan in a loan comparable to the Finnish capital loan. Also, the German management faces the challenge that the local company law does not have specific regulation about subordinated financing forms directly comparable to the Finnish capital loan.[2177] As a solution the German CFO advocates that the shareholder loan is converted to subordinated shareholder loan according to the Finnish capital loan parameters. Although this kind of financing form is not directly regulated in the German company laws or taxation law the loan subordination is commonly known in the market practice. Lender and borrower can agree also in Germany on loan subordination within the general freedom of contract.[2178]

[2173] James, M. (2009), p. 17.
[2174] See also above section *3.6.3.4.1 UK*.
[2175] HM Revenue & Customs (2017), pp. 320-324. See also HM Revenue & Customs (2016b).
[2176] See HM Revenue & Customs (2016d) according to which the transfer pricing rules *"require multinationals to calculate their taxable profit as if transactions between companies within the group were carried out at the prices that would be charged between two entirely independent companies (known as the arm's length price)"*.
[2177] A subordinated loan is considered legally a normal loan under the German Civil Code (Bürgerliches Gesetzbuch). The basic regulation in this respect is Chapter 1, Section 488 of the German Civil Code of August 18, 1896. See Mäntysaari, P. (2010c), p. 295.
[2178] About freedom of contract in general see above section *3.4.4 Freedom of contract*.

For non-listed companies there is an option to prepare the consolidated financials according to the German Commercial Code[2179] or IFRS. Regarding the individual financial statements, the companies must prepare financial statements in accordance to the German Commercial Code.[2180] Subsidiary Germany GmbH being itself a parent of the subgroup prepares its consolidated financial statements according to the IFRS.

The conversion of the shareholder loan to subordinated loan in a form equal to the Finnish capital loan would change the balance sheet structure of the German subsidiary according to the IFRS rules only if the subordination led to classification of the instrument to equity (see Figures 40, 41 and 42 below). Like in case of other countries applying IFRS rules a subordinated loan having only such features that are mentioned in the Finnish company law[2181] hardly qualifies for an equity item in Germany either. On the other hand if *"basic"* capital loan features are supplemented by additional equity like add-ons like agreeing on the interest payment dependent on the borrower´s profitability (profit sharing element) and agreeing on credit terms which de facto put lender more to a shareholder like position (right to appoint members of management, right to participate in major decisions, right to get financial information of the borrower etc.) the subordinated loan could become equity item.[2182] It shall be however emphasized here as well that the main target of the parent - subordination of the shareholder loan - will be valid regardless of the classification of the instrument in subsidiary´s accounting.

The existing preference shares having fixed dividend and mandatory redemption feature at a future date remain as liabilities in IFRS financials.[2183]

The taxation of financing instruments in the country follow normally the accounting principles of the instruments i.e. the classification of instruments as debt or equity is decisive for the tax treatment.[2184] In Germany the debt interest is generally deductible with some restrictions. The major restrictions stem from the interest deduction ceiling (Zinsschranke) and transfer pricing rules. According to the deduction ceiling regulation the annual net interest expense of group companies is deductible only up to the amount of 30% of EBITDA at the maximum for corporation and trade tax purposes.[2185] According to the transfer pricing rule the related party transactions must comply with the arm's length principles.[2186]

[2179] German Commercial Code (Handelsgesetzbuch) May 10, 1897.
[2180] IFRS Foundation (2016e), p. 5.
[2181] Chapter 12 of the Limited Liability Companies Act (624/2006).
[2182] Immonen, R. and Villa, S. (2017). The authors write about the IFRS classification of the Finnish capital loan in accounting. Although the article focuses on Finnish practice the IFRS related comments can be relevant also in other countries applying IFRS regulation.
[2183] IAS 32.18.
[2184] Bärsch, S.-E. (2012), p. 148.
[2185] See for more details above section *3.6.3.4.2 Germany.*
[2186] Section 1 of the Foreign Transactions Tax Act (Aussensteuergesetz). See for more details also above section *3.6.3.4.2 Germany*.

Figure 40: Simplified split of equity and liabilities in the balance sheet of Subsidiary Germany GmbH before the recapitalisation

Equity
• Share capital
• Retained earnings
Liabilities
• Non-current liabilities o Shareholder loan MEUR 1 o Preference shares
• Current liabilities

Figure 41: Simplified split of equity and liabilities in the balance sheet of Subsidiary Germany GmbH after the recapitalisation if subordinated shareholder loan does not fulfil equity criteria

Equity
• Share capital
• Retained earnings
Liabilities
• Non-current liabilities o Shareholder loan MEUR 1 o Preference shares
• Current liabilities

Figure 42: Simplified split of equity and liabilities in the balance sheet of Subsidiary Germany GmbH after the recapitalisation if subordinated shareholder loan does fulfil equity criteria

Equity
• Share capital
• Retained earnings
• Shareholder loan MEUR 1
Liabilities
• Non-current liabilities
o Preference shares
• Current liabilities

6.3.9.7 Case example conclusions

The bigger the company group the more complex the management of operations becomes. An international group complying with regulation of several countries requires resources and coordination work. This increases normally costs although economies of scale can also bring significant savings for example in a form of centralised services common for the whole group.

The presented case example illustrates some of the challenges related to the restructuring of the liabilities and equity in the balance sheet of an internationally operating group. In

corporate financing transaction the choices made by the parties involved are determined by several different aspects. These aspects are related to the corporations themselves and the surrounding environment including among other things valid regulation and existing market participants. In case of company groups operating in several countries it is not enough to know the regulation of only one country but all countries where business activities take place.

Important drivers of capital structure are among other things taxes and transactions costs but also operative targets of the company receiving the funding. Naturally also availability of internal or external finance in general, size of the company and its industry have significant role. For example, smaller and new companies have normally more challenges to get external finance because on average financiers consider them to be riskier. Providers of financing want to have proof that potential borrower has ability to repay the financing granted and new and small have usually less historical evidence to back up their plans on sufficient future cashflow. Bigger and older companies on the other hand may have already had chance to accumulate assets over the years and create a customer relationship with the potential financiers.

When thinking about the position of the company seeking for new capital relevant is to know who are the potential suppliers of the needed funding. Company can normally finance its operations through issuing shares, borrowing or retained profits.[2187] Internal financing in a form of retained earnings is typically preferred over external financing.[2188] However external financing is also normally needed at some point and then questions like funding availability in general, potential financiers, financing instruments and concrete forms become relevant.

The example company group operates in the industry of IT services and provides its services specifically for financial and public sector. The discussed financing transactions of the case are such that they could be completed regardless of the industry subject to that the borrower has the size and repayment ability comparable to Pekka IT Group.

All external non-current debt is in the balance sheet of the parent company. The overall business volumes and profitability is on constant level and the outlook for the ongoing financial period is fairly constant. A significant element of the restructuring consists of the raising of new capital in a form of subordinated financing. This step is planned to improve the liquidity which gives for the management additional possibilities to take care of the daily operations.

The additional new subordinated bond financing of MEUR 100 in a form of Finnish capital loan would also generate extra cash buffers. In the balance sheet of the group such item should be shown as a separate item according to Figure 27 above.

The recapitalisation plan of Pekka IT Group includes also plan to convert the senior ranked shareholder loans provided to the subsidiaries to subordinated financing. Here the differences between the local regulations of the domiciles of the subsidiaries becomes clearly visible. Firstly, the capital loan regulation in the Finnish companies act[2189] is unique as there is not exactly similar regulation in the company laws of the other observed countries. Secondly the accounting and taxation treatment of capital loan like financial instruments do also vary country by country. Additionally, what is said about the accounting classification does not directly lead to similar conclusions in taxation. Regardless the accounting treatment whether a financing instrument shall be classified as debt or equity in taxation depends on taxation rules. In practice this means that borrowers with foreign holding company have to be

[2187] Ferran, E. and Ho, L.C. (2014), p. 42.
[2188] Watson, D. and Head, A. (2010), p. 5. See also Brealey, R. A. et al. (2014), pp. 472-474, Allen, F. and Gale, D. (2000), pp. 15-16 and Tirole, J. (2006), p. 96.
[2189] Chapter 12 of the Limited Liability Companies Act (624/2006).

extremely careful in considering is the interest paid on intercompany loans tax deductible or not.

As the case example shows the company laws, accounting regulation and taxation regulations of individual countries do vary. This leads to different conclusions among other things in relation to the terms of financing transactions, balance sheet structure and deductibility of interest costs. Managing of a multinational group brings challenges that cannot be solved only by acting according to the regulation applicable for the parent company. Also, local regulation of domiciles of the subsidiaries has be known and followed. Usage of mezzanine financing in international environment is subject to knowing the several rules. The multinational dimension creates no doubt a field of activity with lots of complexity.

It is important to highlight here that in all countries observed the conversion agreement leading to subordination of the shareholder loan is valid regardless of how the shareholder loan is classified in accounting or taxation. This means that irrespective whether the subordinated shareholder loan is considered to be equity, debt or having elements of both categories, the conditions can be prepared so that the subordination term remains valid and binding towards the parties. Consequently, if the primary goal of the parent company is to achieve subordination binding the lender and borrower, the accounting and taxation classifications do not have direct impact on that. In practice however, the management of the group deciding on the recapitalisation details will assess the rationality of the subordination transaction taking into consideration all relevant points. If subordination of the shareholder loan led to losing right to deduct interest costs of the loan, the subordination might not be financially reasonable.

As the case conclusion summary can be stated that

- there are several factors influencing how the combination of debt and equity are used to finance company assets
- legal system including taxation and accounting rules have influence to the chosen capital structures of the individual companies and
- borrowers having a foreign holding company must consider cautiously whether the interest expense of intra-group loans will be tax deductible at all
- environment where companies operate is influenced not only by the regulation but also by the market participants
- structuring balance sheet of a multinational group the regulation and market conditions applicable both for the parent company and the subsidiaries must be taken into consideration.

7 CONCLUDING THOUGHTS

7.1 General

As described in the beginning the purpose of this research is to answer to following questions:

1. What is the company law background concerning the use of mezzanine financing?

2. What are the main differences of company law regulation, accounting and taxation rules and local market sizes and conclusions?

3. How mezzanine could be used in bank lending going forward in order to support functioning capital markets?

The main focus is in Finland and comparison is done to Sweden, Estonia, USA, UK and Germany. The review of country specific legal frameworks and markets in relation to the discussed financing form are part of the analysis done. Also, EU company regulation and some relevant EU court practice has been reviewed and analysed. All the countries in scope of the research apart from USA are members of the EU and are also directly or indirectly influenced by the regulation of the community.[2190]

This research is by its nature both legal and commercial and belongs thus under the category of commercial law. The primary research methodology applied here is comparative law.[2191] This method is used for comparing company laws, accounting rules and taxation rules in the discussed topic and finding out the relevant differences and similarities.

To be able to answer to the research questions it is discussed what is meant by mezzanine financing.[2192] To understand mezzanine financing is subject to understanding also basic elements of limited liability company´s capital structure, key features of mezzanine financing (i.e. when financing becomes *"mezzanine financing"*) and main types of mezzanine financing contracts. Capital structuring is analysed with the help of concept of limited liability and different funding alternatives consisting of retained earnings, equity financing and debt financing.[2193] Also cost of capital concept and capital maintenance rules are important elements of understanding aspects of limited liability company capital structure. The nature of mezzanine financing is opened among other things by defining some key terminology and discussing repayment priority, subordination, equity kickers and role of rating agencies.[2194] Additionally bilateral contracts, intercreditor agreements, club loans, syndicated loans and LMA and LSTA documentation are identified and discussed as well as different types of financing contracts.[2195]

To find answers to the questions 1-2 the research is additionally focusing on reviewing and analysing among other things the regulatory framework of EU, legal systems of the countries, content of company laws and mezzanine specific norms in company laws.[2196] On top of that handling of mezzanine instruments from accounting perspective[2197] and taxation

---

[2190] About the influence of EU regulation to member states see above section *3.4.1.1 Regulatory systematics of EU legislation*.
[2191] Husa, J. (2013), p. 27. About the method of comparative law see Eberle, E.J. (2009).
[2192] See above section *3 Mezzanine financing framework*
[2193] See above section *3.1 Capital structure of limited liability company.*
[2194] See above section *3.2 About the nature of mezzanine financing.*
[2195] See above section *3.3 Types of contract.*
[2196] See above section *3.4 The company law framework.*
[2197] See above section *3.5 Accounting rules.*

perspective[2198] and country specific mezzanine market conditions[2199] is analysed. Also a case example is used to illustrate some of the challenges related to the use of mezzanine instruments by an internationally operating group [2200]

To be able to reply to the question 3 the research has additionally focused on reviewing and analysing among other things the regulatory environment of banking business and how banks lend mezzanine today.[2201]

The summary of the answers to each of the three research questions is presented below.

7.2 What is the company law background concerning the use of mezzanine financing?

Law can be based on written law or practice. If practices are regularly given normative significance by the community they can also become norms.[2202] The company law regulation concerning mezzanine reflects the legal history and practice of the jurisdictions in question. Due to differences of legal families, histories and market practices also the company laws between countries and mezzanine specific rules in the company laws vary. Some of the key differences are reviewed below.

Finland

The Finnish legal system originates from the Nordic legal tradition. Finland has been a full member of the European Union since 1 January 1995 and EU law is an integral part of the country´s legal system.

In Finland the valid company law for all types of limited liability companies - both private and public - is the Finnish Limited Liability Companies Act.[2203] The essential principles of the Limited Liability Companies Act of Finland are the provisions on the purpose of a company, majority rule, equal treatment of the shareholders, duty of care and loyalty, legal personality, permanence of the capital, limited liability of shareholders, transferability of shares and freedom of contract.

The law contains special provisions on a specific loan type called capital loan which has features of both debt and equity.[2204] On top of that it includes regulations on how option loans and convertible loans can be issued.[2205] These financing instruments can be considered to belong with the category of mezzanine instruments.

The interest and principal of the Finnish capital loan can be paid back within the limits of the unrestricted equity of the borrower only as defined in the law. This loan is additionally subordinated to all the other loans of the company. The company or a subsidiary shall not provide security for the principal and interest payment. A contract on a capital loan shall be

[2198] See above section *3.6 Taxation rules.*
[2199] See above section *4 Different systems of mezzanine in practical market.*
[2200] See above section *6.3 Case example: how mezzanine can be concretely used?*
[2201] See above section *5 Mezzanine in bank lending.*
[2202] Husa, J. (2015), pp. 203-204.
[2203] Limited Liability Companies Act (624/2006), Government Bill for the Limited Liability Companies Act (HE 109/2005). The law entered into force on September 1, 2006.
[2204] Chapter 12, Section 1 of the Limited Liability Companies Act (624/2006).
[2205] Chapter 10, Section 1:1-2 of the Limited Liability Companies Act (624/2006).

concluded in writing and these loans shall be shown on the company balance sheet as a separate item.

Sweden

The Swedish legal system derives also from the Nordic legal tradition, which has its roots on the German civil law tradition. Sweden has been a full member of the European Union since 1 January 1995 and therefore EU law is also an integral part of the Swedish legal system.

The Swedish Companies Act[2206] applies both to private and public limited liability companies. Among the basic principles for the limited liability companies in Sweden is that shareholders of a company shall bear no personal liability for the company's obligations.[2207] Another important principle applied is that all shares shall carry equal rights.[2208]

The act recognises dividend-linked participating debentures and principal-linked participating debentures as specific instrument types for corporate financing. These dividend-linked participating debentures refer to specific type of profit-sharing loans (*"vinstandelslån"*) and principal-linked participating debentures refer to specific type of value-appreciation loan (*"kapitalandelslån"*). The names of the financing forms are not specifically mentioned but the decision-making process of such loans is described in the law text.[2209]

The Swedish company regulation allows limited liability company also to issue option right entitling to new shares against payment.[2210] When issued to a creditor of the company the debt becomes basically an option loan. The company can also to issue convertible loans.[2211]

Estonia

The Estonian legal system has its roots in the Roman law and is thus part of continental European legal tradition. Estonia became a full member of the European Union since May 1, 2004 and therefore EU law is also an integral part of the Estonian legal system.

In Estonia the Commercial Code[2212] applies both to private and public limited liability companies. The law regulates any type of company formation in Estonia.

The law includes regulation on convertible loans and subscription rights i.e. options. Both in case of private and public limited liability companies the shareholders may decide on the conditional increase of the share capital in a form of convertible bond.[2213] The shareholders and in case of public limited company the management board may also decide on a conditional increase of the share capital in the form of subscription rights i.e. option rights as described in the law.[2214]

[2206] Companies Act (SFS 2005:551), Government Proposal for the Companies Act (Prop. 2004/05:85).
[2207] Chapter 1, Section 3:1 of the Companies Act (SFS 2005:551) and Government Proposal for the Companies Act (Prop. 2004/05:85), p. 196. See also Bergström, C. and Samuelsson, P. (2015), p. 67.
[2208] Chapter 4, Section 1 of the Companies Act (SFS 2005:551), Sandström, T. (2015), p. 237 and Andersson, J. and Pehrson, L. (2008), p. 118.
[2209] Chapter 11, Section 11 of the Companies Act (SFS 2005:551).
[2210] Chapter 14 of the Companies Act (SFS 2005:551).
[2211] Chapter 15 of the Companies Act (SFS 2005:551).
[2212] Commercial Code (RT I 1995, 26, 355).
[2213] Chapter 19, Section 167^2:1 and Chapter 24, Section 241:1 of the Commercial Code (RT I 1995, 26, 355).
[2214] Chapter 21, Section 195^1:2 of the Commercial Code (RT I 1995, 26, 355) and Chapter 29, Sections 351-351^2 of the Commercial Code (RT I 1995, 26, 355).

USA

The USA is a common law country. Each of the 50 states has a legal system that is based on the common law except Louisiana.[2215] There is limited statutory basis and judges establish common law through written opinions that bind the lower courts in their future decision-making.

The federal law sets the minimum standards for many activities of corporations like in securities[2216], auditing[2217] and consumer protection[2218]. Additionally, there are different corporate laws in each state. This means that the US corporations are subject to dual regulation consisting of both federal law and state law. However, most statutes applied in daily operations are created by states.[2219]

Especially larger companies incorporate in states that have favourable regulation. Based on that two most important state level regulations are Model Business Corporation Act (MBCA)[2220] and Delaware General Corporation Law (DGCL)[2221]. MBCA is the model statute drafted the American Bar Association and basis for company regulation for several states. Delaware General Corporation Law is the company regulation of state of Delaware under which more than half of the US corporations are incorporated.

According to the MBCA shareholders can decide on issuance of securities convertible into or rights exercisable for shares.[2222] As stated by DGCL the certificate of incorporation may contain provisions granting to the stockholders of the corporation the pre-emptive right to subscribe to stock or to any securities of the corporation convertible into such stock.[2223] DGCL allows corporations also to create and issue rights or options permitting the holders thereof to acquire from the corporation any shares of its capital stock.[2224]

UK

The United Kingdom of Great Britain and Northern Ireland (UK) consists of four countries: England, Wales, Scotland and Northern Ireland. The UK has three jurisdictions:

- England and Wales based on common law principle
- Northern Ireland based on common law principle
- Scotland based on a pluralistic system including civil-law principles with common law elements.[2225]

The EU legislation is part of the UK law as the country joined the European Economic Community (now the EU) in 1973.

[2215] Palmer, V.V. (2012), pp. 277- 353.
[2216] Securities Act of 1933 and Securities and Exchange Act of 1934.
[2217] Sarbanes-Oxley Act of 2002.
[2218] Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010.
[2219] Cross, F.B. and Prentice, R.A. (2007), p. 12
[2220] The Model Business Corporation Act (MBCA) is a model set of law prepared by the Committee on Corporate Laws of the Section of Business Law of the American Bar Association.
[2221] Title 8, Chapter 1 of the Delaware Code.
[2222] Chapter 6, Subchapter B, Section 6.21.(f) of the Model Business Corporation Act.
[2223] Subchapter I, Section 102(b) of the Delaware General Corporation Law.
[2224] Subchapter V, Section 157(a) of the Delaware General Corporation Law.
[2225] Feldman, D. (2009), p. 12 and Le Sueur, A. et al. (2013), p. 12.

The present Companies Act[2226] in UK is regulation that applies both to private companies and public companies. The act gives the directors power to grant rights to subscribe for or to convert any security into shares.[2227] The directors can do so if they are authorised for it by the company's articles or by company resolution. In case of a private company that has only one class of shares the directors have that power to grant rights in question unless the directors are specifically prohibited from doing so. The above-mentioned means that the UK company law specifically identifies option and convertible loan.

Germany

The German legal tradition has been influenced from Roman Law and German law is codified law. Germany is a member state of the European Union since its beginning and thus EU legislation is also part of German legal system.

The legal regime for limited liability companies in Germany is provided by the Limited Liability Companies Act (Gesellschaftsrecht)[2228] and German Stock Corporation Act (Aktiengesetz)[2229]. The former law regulates a company with private limited liability and the latter limited liability stock corporations.

The private limited liability companies cannot issue convertible loans and options due to the German company law not including the concept of conditional capital.[2230] This means that only public limited liability companies can issue convertible loans and options/option loans.

The German company law for public limited liability companies specifically identifies option and convertible loan. In case of limited liability stock corporations, the shareholders' meeting may approve an increase of share capital which shall be executed only insofar that conversion rights or stock warrants are exercised.[2231] Such a resolution on a conditional capital increase may be adopted among other things for the purpose to grant exchange rights or stock warrants to holders of convertible or warrant bonds.[2232]

7.3 What are the main differences of company law regulation, accounting and taxation rules and local market sizes and conclusions?

7.3.1 Differences of company law regulation

One major outcome of the research is that there are significant mezzanine related differences in the company laws between the observed countries.

Firstly, the company laws do not define the term *"mezzanine"* as such in any of the observed countries. Secondly - although company laws of each country recognise some instruments that fall in the mezzanine category - the mezzanine instrument types that are mentioned in the local company laws are not the same.

[2226] Companies Act 2006.
[2227] Part 17, Chapter 1, Sections 550 and 551(1) of the Companies Act 2006.
[2228] Limited Liability Companies Act (Gesetz betreffend die Gesellschaften mit beschränkter Haftung, GmbHG) of April 20, 1892.
[2229] Stock Corporation Act (Aktiengesetz) of September 6, 1965.
[2230] Mäntysaari, P. (2010c), p. 301.
[2231] Book 1, Part 6, Section 192(1) of the Stock Corporation Act.
[2232] Book 1, Part 6, Section 192(2) of the Stock Corporation Act.

The company laws in Finland, Sweden, Estonia, USA[2233], UK and Germany all identify either directly or indirectly option loan and convertible loan. Indirect identification means here that the instrument in question is not specifically mentioned in the law but the text refers to usage of such instruments. A good example is the Finnish company law which gives possibility for the companies to issue option rights and other special rights entitling to shares.[2234] According to the law text such rights may be issued also to a creditor of the company on the condition that the creditor´s receivable is to be set off against the share´s subscription price.[2235] This means that the debt is actually converted to a convertible loan although this instrument type is not specifically mentioned in the law.[2236]

In case of Germany the option loan and convertible loan is identified in the company law for public limited liability companies but not in the company law of private limited companies.[2237]

The Finnish company law contains also special provisions on a specific loan type called capital loan.[2238] It has typical mezzanine features of both debt and equity and is also subordinated to all the other loans of the company. The repayment is subject to balance sheet related requirements. Interest and principal of a capital loan can be paid back only within the limits of the unrestricted equity of the company. The borrower of the capital loan may not post security for the payment of the principal and interest.

The Swedish company law includes specific rules related to dividend-linked participating debentures and principal-linked participating debentures. In these loans the interest or the amount to repaid is dependent on dividends, price changes of the shares or borrowers´ financial position.[2239] The dividend-linked participating debenture loan is called in the Swedish tax law *"vinstandelslån"*[2240] and principal-linked participating debentures refers to a value-appreciation loan *"kapitalandelslån"*[2241].

The above presented case example *"Pekka IT Group"* shows that company laws of individual countries are different.[2242] This leads to country specific conclusions among other things in relation to the terms of financing transactions. Managing of a multinational group brings challenges that cannot be always solved by applying regulation of the parent company´s home country. As well regulation applicable for the foreign of domiciles must be complied with. This means that mezzanine financing in cross-border circumstances requires knowledge of many regulations.

[2233] The company law in the USA refers here to Model Business Corporation Act (MBCA) and Delaware General Corporation Law (DGCL).
[2234] Chapter 10, Section 1:1 of the Limited Liability Companies Act (624/2006).
[2235] Chapter 10, Section 1:2 of the Limited Liability Companies Act (624/2006).
[2236] Government Bill for the Limited Liability Companies Act (HE 109/2005), p. 113.
[2237] In Germany the private limited liability companies can not issue convertible loans and options as the German Limited Liability Companies Act (Gesellschaftsrecht) does not contain the concept of conditional capital.
[2238] Chapter 12, Section 1 of the Limited Liability Companies Act (624/2006).
[2239] Chapter 11, Section 11:1 of the Companies Act (SFS 2005:551).
[2240] Chapter 24, Sections 5-10 of the Income Tax Law (SFS 1999:1229).
[2241] In the Government Bill for the Swedish Companies Act (Regeringens proposition 2004/05:85, Ny aktiebolagslag) both terms *"vinstandelslån"* and *"kapitalandelslån"* were used but not in the final Swedish Companies Act. See Government Bill for the Swedish Companies Act (Regeringens proposition 2004/05:85, Ny aktiebolagslag), pp. 367-369.
[2242] See above section *6.3 Case example: how mezzanine can be concretely used?*

7.3.2 Differences of accounting

A conclusion of the research is also that accounting practices do somewhat differ between countries due to different accounting regulation.

The Finnish Accounting Act[2243] requires that company having issued securities to be traded in the regulated market in European Economic Area must prepare its consolidated accounts according to the IFRS rules.[2244] Even if there is no obligation to prepare consolidated accounts the financial statement of the company must be prepared anyhow in conformity with the IFRS.[2245]

The annual reports of a limited company must be prepared in accordance with the so-called K-regulations issued by the Swedish Accounting Standards Board (BFN).[2246] In practice IAS rules are followed.

Those companies that do not apply IFRS-standards follow the K-regulation of Swedish Accounting Standards Board (BFN). According to K3-rules financial instruments shall be classified either to debt or equity based on the instrument´s economical characteristic.[2247]

In Estonia the companies may choose whether to prepare the annual financial statements according to Estonian Accounting Standards (Estonian GAAP) or IFRS.[2248] In practice the classification of financial instruments is always done according to IAS as also the Estonian GAAP follows the instrument classification rules of IAS.[2249]

The accounting rules in the USA deviate significantly from the other observed countries. The Securities and Exchange Commission (SEC) does not permit domestic issuers to apply IFRS but allows foreign private issuers to do so.[2250] If according to that IFRS is not applicable US GAAP is to be used instead. [2251] There are some differences between the two standards on how mezzanine instruments shall be handled in accounting. As an example, in case of convertible debt the conversion option must be always separated from the debt part under IFRS.[2252] However this kind of separation is prohibited under U.S. GAAP according to the main rule.[2253]

All listed companies in the UK must prepare their consolidated financial statements by using IFRS. For non-listed companies are there is an option to choose whether to prepare their account according to IFRS or in accordance with UK GAAP. Although some differences exist

---

[2243] Finnish Accounting Act (1336/1997).
[2244] Chapter 7a, Section 2:1 of the Finnish Accounting Act (1336/1997).
[2245] Chapter 7a, Section 2:2 of the Finnish Accounting Act (1336/1997).
[2246] The purpose of the K-regulation is to simplify the financial reporting for smaller companies. There are four sets of accounting regulations from which a company will choose one to follow depending on the size of a company. The basis is the Annual Accounts Act and each of the four regulation sets target to meet the company's complexity level. The K-regulation categories are as follows:

- K1 (BFNAR 2006:1): Sole traders establishing simplified financial statements.
- K2 (BFNAR 2008:1): Annual reporting in small companies.
- K3 (BFNAR 2012:1): Annual reporting and consolidated financial statement.
- K4 is for companies who must or choose to follow IFRS.

[2247] BFN (2016), pp. 201-202.
[2248] Chapter 3, Section 17:1 of the Accounting Act (RT I 2002, 102, 600).
[2249] Strouhal, J. ed. (2011), p. 86.
[2250] IFRS Foundation (2017), p. 2.
[2251] Ibid.
[2252] IAS 32:28-29.
[2253] PwC (2017b), p. 10-2.

between UK GAAP and IFRS the standards are broadly consistent with each other regarding accounting of liabilities and equity.[2254]

In Germany companies listed in an EU securities market shall follow IFRS. For non-listed companies there is an option to prepare the consolidated financials according to the German Commercial Code (Handelsgesetzbuch, HGB)[2255] or IFRS. Regarding the individual financial statements, the companies must prepare financial statements in accordance to the German Commercial Code.[2256] According to the German GAAP basing on the German Commercial Code (HGB) the mezzanine instruments shall be split into debt and/or equity subject to specific criteria [2257] which differ from IFRS.

Regulation (EC) No 1606/2002 of the European Parliament and of the Council of 19 July 2002 on the application of international accounting standards defines when listed companies in EU are required to follow IFRS standards when preparing their financial statements.[2258] The regulation means that in EU countries Finland, Sweden, Estonia, UK and Germany companies having issued securities to be traded in the regulated market in European Economic Area have to prepare their consolidated accounts according to the IFRS rules. Even in cases where local GAAP is applied instead of IFRS rules the classification of financial instruments is in practice mostly done according to IAS/IFRS in Finland, Sweden, Estonia and UK.[2259] However the above-mentioned German GAAP requirement to split of the mezzanine instruments into debt and/or equity is a deviation from IFRS.

In general mezzanine instruments like capital loan and debentures are normally classified as liabilities in IFRS financials.[2260] According to the IFRS rules however a compound instrument that contains both liability and equity components must be classified as financial assets, financial liabilities or equity instruments separately.[2261] A convertible bond is an example of such a compound financing instrument.

As the case example *"Pekka IT Group"* demonstrates accounting regulation varies between the countries.[2262] The jurisdiction of the borrower has impact on the balance sheet structure as mezzanine instruments are not treated with respect to accounting identically in all countries. This brings additional complexity in the management of an international group.

7.3.3 Differences of taxation

Taxation practices have also country specific variations and they are not always dependent on the accounting decisions.[2263] All of this leads to different conclusions in different countries among other things in relation to the terms of financing transactions, balance sheet structure and deductibility of interest costs. This means also that usage of mezzanine financing in international environment is subject to knowing the several rules and practices in commercial

[2254] KPMG (2015b), pp. 180-191.
[2255] German Commercial Code (Handelsgesetzbuch) May 10, 1897.
[2256] IFRS Foundation (2016e), p. 5.
[2257] Brokamp, J. et al. (2011), p. 124.
[2258] According to the Article 4 main rule IFRS shall be applied to the consolidated financial statements of EU companies whose securities are traded on a regulated EU market. According to the Article 5 EU countries can decide to extend the use of IFRS to annual financial statements and non-listed companies, too.
[2259] For example, in Estonia the local GAAP is in compliance with the instrument classification rules of IAS.
[2260] IAS 32.11.
[2261] IAS 32.15 and IAS 32.28. See also about the different components Haaramo, V. (2012), pp. 129-130.
[2262] See above section *6.3 Case example: how mezzanine can be concretely used?*
[2263] See Helminen, M. (2010), p. 170 according to which in general countries apply case by case -approach in taxation of the hybrid financing instruments.

law bringing along additional difficulties. As an exaqmple, when managing financing transactions of multinational company groups regulation of several countries must be known and applied which increases complexity and challenges further.

Corporations in Finland are subject to unlimited tax liability. The taxation system in corporate taxation focuses on taxation of net profit. According to this the main rule is that all costs incurred in the pursuance of taxable income shall be deductible costs for the payer of the interest.[2264] This includes also interest that is dependent on the profit of the company.[2265] There are however some exceptions to this rule. One of the most significant exception relates to deductibility of interest paid between related parties.[2266] Although there are no actual thin capitalisation rules in Finland there are some restrictions on interest deductions. These limitations of deductibility will apply to interest paid between related parties.[2267]

Sweden´s tax framework allows deduction of interest expenses for the borrower company.[2268] This generally means deductibility of interest costs for tax purposes regardless of the purpose of the cost. Like in Finland there are no separate thin capitalization restrictions for tax purposes. Interest costs relating to intra-group loans are however not deductible with some exemptions.[2269] In case of mezzanine type instruments relevant from the interest deduction point of view is the debt/equity -status i.e. whether the instrument shall be classified as debt or equity from the taxation perspective. If mezzanine financing can be considered to be debt the compensation paid by the borrower to the lender can be deductible interest expenses. On the other hand, a company owner who has subscribed the profit-sharing loan by using the shareholder´s pre-emption priority is not entitled to deduct the profit-sharing part of the interest costs.[2270]

The Estonian corporate taxation system deviates radically from the taxation system of the other observed countries. There is no corporate income tax on retained and reinvested profits. The Estonian corporates are subject to income tax only in respect of all distributed profits.[2271] This means that the retained earnings are not taxed until profit distributions are made and interest cost deduction is not applied. There are no thin capitalization rules in Estonia. There is however some regulation on transfer pricing. In case the value of a transaction executed between related parties is different from the value of comparable transactions between non-related parties, the difference is subject of income tax.[2272]

The tax system in the USA is complex due to the federal and state level taxation authorities and regulations. Companies are largely allowed to deduct the ordinary business expenses in taxation. This means that interest expenses of debt are generally deductible for the companies.[2273] Regarding mezzanine financing the deductibility of interest is possible if the financing form can be considered to be debt. Thin capitalization rules may also be applied to prevent companies from borrowing in excess with a view to reduce their tax liability.[2274] In such a case some limitations on interest deductions would also be applied.

[2264] Division I, Chapter 2, Section 7 of the Companies Income Tax Act (360/1968).
[2265] Division II, Chapter 2, Section 18:1, point 2 of the Companies Income Tax Act (360/1968).
[2266] Division II, Chapter 2, Section 18a of the Companies Income Tax Act (360/1968).
[2267] Division II, Chapter 2, Section 18a of the Companies Income Tax Act (360/1968).
[2268] Chapter 16, Section 1 of the Income Tax Law (SFS 1999:1229).
[2269] Chapter 24, Section 10d of the Income Tax Law (SFS 1999:1229).
[2270] Chapter 24, Section 6:1 of the Income Tax Law (SFS 1999:1229).
[2271] Chapter 10, Sections 49-51 of the Income Tax Act (RT I 1999, 101, 903). Distributed profits include among other things distributed corporate profits, gifts, donations and representation expenses.
[2272] Chapter 14, Sections 7-8 and Chapter 50, Sections 4-8 of the Income Tax Act (RT I 1999, 101, 903) and Minister of Finance (2006).
[2273] 26 U.S. Code § 163. The law includes also several exceptions of the main rule.
[2274] 26 U.S. Code § 163 (j) and § 385.

Also in the UK the debt interest is generally deductible. For mezzanine financing this means that the interest is deductible if the financing form can be considered to be debt. The tax treatment of financing instruments in the UK is normally aligned with the accounting treatment of the instruments.[2275] There are no actual thin capitalisation rules in the country but limitations of tax deductions for interest expense will in certain situations apply to interest paid between related parties.[2276]

For German companies the debt interest is generally deductible with some restrictions.[2277] The taxation of financing instruments in Germany follows generally the accounting principles of the instruments. This means that the classification of instruments as debt or equity is decisive for the tax treatment.[2278] According to the transfer pricing rule the related party transactions must comply with the arm's length principles.[2279]

Based on the above described some conclusions on differences in taxation rules can be drawn in relation to

- deductibility of the interest costs paid for mezzanine finance and
- thin capitalisation rules/limitations of deductibility.

In Finland, Sweden, USA, UK and Germany the main rule is that business related interest expenses are deductible for the payer of the interest. In case of mezzanine instruments the deductibility of interest is possible if the financing form can be considered to be debt. Also, interest that is dependent on the profit of the company can be deductible. However, in Sweden a profit-sharing loan from a shareholder who has subscribed the loan by using the shareholder´s pre-emption priority does not create interest deduction right for the profit-sharing part of the interest.[2280]

There are no separate thin capitalization rules in Finland, Sweden, Estonia and UK. However, limitations of deductibility are applied to interest paid between related parties both in Finland, Sweden and UK. In the USA thin capitalization rules may be applied to prevent companies from borrowing excessively with a view to reduce their tax liability. In Germany there are also some restrictions of interest deductibility. The major one of which is the interest deduction ceiling (Zinsschranke). According to this rule the net interest expense deduction is possible up to 30% of borrower´s EBITDA.[2281] .

In Estonia corporates are subject to income tax only in respect of all distributed profits. This means that the retained earnings are not taxed until profit distributions are made and interest cost deduction is not applied.

In the case example *"Pekka IT Group"* was illustrated that taxation regulations of individual countries do vary.[2282] Particularly when the legislation of several jurisdictions has to be taken into consideration tax planning can be complex. Careful planning and implementation is needed to achieve tax-efficient end results. This may mean that mezzanine transaction making sense in one country is not rational in another country for example from the perspective of the

---

[2275] James, M. (2009), p. 17.
[2276] HM Revenue & Customs (2016d).
[2277] A major exception from the main rule is the interest deduction ceiling (Zinsschranke) regulation. See for more details above section *3.6.3.4.2 Germany*.
[2278] Bärsch, S.-E. (2012), p. 148.
[2279] Section 1 of the Foreign Transactions Tax Act (Aussensteuergesetz).
[2280] Chapter 24, Section 6:1 of the Income Tax Law (SFS 1999:1229). See also Tivéus, U. (2010), p. 93.
[2281] There are several more detailed rules complementing the Zinsschranke-regulation. See for more details above section *3.6.3.4.2 Germany.*
[2282] See above section *6.3 Case example: how mezzanine can be concretely used?*

deductiblity of interest costs. Managing of a multinational group brings challenges that cannot be solved only by acting according to the regulation applicable for the parent company. Regulation applicable for the subsidiaries has be identified, too. This increases complexity.

7.3.4 Relevance of freedom of contract, principle of loyalty and pacta sunt servanda

Regardless whether the capital input received by the company is at the end of the day considered to be equity, debt or having elements of both categories, the transaction conditions can be prepared so that the agreed terms remain valid and binding towards the parties. If the parties of the mezzanine transaction (lender and the borrower) want to agree on subordination of a mezzanine loan they can do so within the freedom of contract.[2283] Irrespective of the accounting and taxation classification of the mezzanine loan the subordination remains legitimate if parties so want. The accounting and taxation regulations do not have direct impact on the validity of the repayment priority. Another issue is however that in practice the parties must consider the rationality of the subordination transaction taking into consideration all relevant points. If subordination led to losing right to deduct interest costs of the loan this consequence would be one element in the holistic assessment of the rationality of the planned transaction.

In the last decades the concept of freedom of contract has evolved towards the constitutionalization of the contract law. This has become visible through the increased influence of constitutional human and fundamental rights in the private law.[2284] The substantive understanding of this freedom offsets constraints that may make contract parties de facto unequal.[2285] In some situations the contract parties - although formally equal - are factually not in a similar negotiation position when contracting. The differences may be caused by several different factors like lack of relevant information or one party having less financial resources.

In contract law the principle of freedom of contract is one of the main principles. The relevance of constitutionalization and social fairness has however also been increasingly identified. This has led to protection of the weaker party in order to apply contract law fairly.[2286] Interpretations on how the contracting freedom shall be applied varies between countries. In commercial transactions, where consumers are not contract parties, the freedom of contract is nevertheless wide. This gives possibility for the contract parties to agree the transaction terms quite freely.

The relevance of freedom of contract is discussed also in the case example *"Pekka IT Group"*.[2287] In all countries observed in the case example the conversion agreement leading to subordination of the shareholder loan is valid regardless of how the shareholder loan is classified in accounting or taxation. Irrespective whether the subordinated shareholder loan is considered to be equity or debt in accounting and/or taxation, the conditions can be prepared so that the subordination term remains valid and binding towards the parties. Consequently, if the ultimate goal of the parent company is to achieve subordination binding both the lender and the borrower, the accounting and taxation classifications do not have direct impact on that. In reality the management deciding on the recapitalisation details will nevertheless assess the rationality of the subordination taking into consideration all relevant points. This means among other things that if subordination of the shareholder loan led to

[2283] See above section *3.4.4 Freedom of contract*.
[2284] Micklitz, H.-W. ed. (2014), p. 1.
[2285] Colombi Ciacchi, A. (2012), p. 68.
[2286] Cherednychenko, O. (2007), p. 11.
[2287] See above section 6.3 Case example: how mezzanine can be concretely used?

losing right to deduct interest costs of the loan, the subordination might not be financially reasonable.

Principle of loyalty does not enjoy similar kind of status as freedom of contract in the countries in scope of this research. However, in Finland and Sweden the principle of loyalty and in Estonia and Germany its equivalence - the principle of good faith - are widely accepted in contractual relations.[2288] In the UK and USA there is not exactly the same legal terminology used as in European civil law countries but the concept of fairness is identified in these countries, too. In common law area the discussion on fairness has traditionally been more related to the fairness is process but lately increasingly also on the actual content of the contract i.e. on substantive fairness.[2289] The principle of loyalty and fairness can be understood to extend over the non-covered areas of the contract, take into consideration the surrounding environment and thus make contracting more flexible.[2290]

The principle of loyalty and good faith sets expectation that contract parties have to respect and honour each other´s contractual interests. This obligation covers different stages of contracting including negotiations, closing and execution. In continental European countries the principle of loyalty and good faith is a general principle of the law of obligations and in common law countries - although not necessarily in a form of general principle - good faith enjoys protection, too.[2291]

Pacta sunt servanda -principle means that contract parties shall honour their obligations and fulfill their contractual commitments.[2292] This contractual principle is widely recognized both in EU and USA. It is also identified by UNIDROIT Principles of International Commercial Contracts.[2293] The functionality of an organised society is subject to contracting freedom and binding agreements and even a prerequisite of efficient market economy. If agreements were not kept who would engage themselves in transactions generating costs and including thus also risk of final loss?

For parties of a mezzanine financing transaction principles of freedom of contract and pacta sunt servanda are central as these transactions are normally long term and the contract parties need to be able to rely on each other and the given promises and commitments. However, especially as these agreements are long term assumptions of a party at the moment of contracting may prove to be later incorrect due to various reasons. If the fulfilment of contract obligations is not considered any more fair and reasonable taking into consideration the circumstances as a whole, the execution could be restricted for example due to collision with the principles of loyalty and fair dealing.[2294] This kind of restriction would de facto mean modification of the pacta sunt servanda principle.

[2288] See above section *3.4.5 Principle of loyalty*.

[2289] Hook, M. (2016), p. 203.

[2290] Sund-Norrgård, P. et al. (2015), p. 204 writes that "*The principle of loyalty can be seen as the legal basis for legal protection based on legitimate expectations that arise from outside the contract. The principle of loyalty thereby fulfils the "empty space" around the contract and makes contracting more flexible. And also in the interpretation of a contract, relevance can be given to such expectations, which are based on the reality surrounding the contract. Through such an interpretation, which is connected to the principle of loyalty, it is possible to achieve more flexibility."*

[2291] Mäntysaari, P. (2010b), pp. 131-132, Kull, I. (2004), p. 37, Stone, R. and Devenney, J. (2017), p. 26 and Summers, R.S. (2000), p. 299-300. Additionally, to be noted that the UNIDROIT Principles of International Commercial Contracts contain elements of principle of loyalty, too. See for more details UNIDROIT (2016), p. 18.

[2292] See above section *3.4.6 Pacta sunt servanda*.

[2293] UNIDROIT (2016), p. 9.

[2294] Consequently, the principles of freedom of the contract and pacta sunt servanda are not absolute and they are limited by several rules out of which the principles of loyalty and fair dealing are only a part. See for example Mäntysaari, P. (2010b), pp. 75-186.

What is the relevance of principles of freedom of contract, loyalty and pacta sunt servanda in individual contract relations depends on the factual conditions of the transaction in question. The contract parties have to anyhow recognise and understand these concepts. This would be important especially if contract parties at some point disagreed how to interpret the wording of their agreement.

7.3.5 Differences of local market sizes

Efficient financial markets generate benefits to the economy and facilitate economic welfare. This increases also financial stability. For market to be effective the market participants need to be able to operate effectively including efficient management of their funding and risks. Those companies that are looking for external financing need to plan and budget their funding needs before turning to potential financiers. To find right financier is not always easy and it is normally more difficult the smaller the local finance market and the lower the number of potential financiers.

One additional major outcome of the research is that there are significant differences in mezzanine markets between the observed countries. This is due to variations in amounts of venture capital actors, venture capital investments, banks and bank loans. This influences among other things to the availability of the mezzanine financing in general.

The observed countries Finland, Sweden, Estonia, USA, UK and Germany can be put in order of size by using amount of

- venture capital actors
- venture capital investments
- banks and
- bank loans

as parameters. Based on that the ranking from smallest to biggest country is as follows: Estonia, Finland, Sweden, Germany, UK and USA.[2295]

Normally the bigger the market the greater the possibility for a company to get financing due to more actors - including investors and lenders - in the market. This concerns not only receiving venture capital financing and bank financing but also other external financing. It is fair to assume that company looking after new mezzanine financing would have bigger possibilities to get it in the USA than in Estonia.

7.3.6 Comparative conclusions on debt subordination

Financial liabilities can be subordinated contractually. This means that the debtor agrees with the creditor that certain liability has lower repayment ranking than the other liabilities. Due to this contractual condition it is agreed that the subordinated liability shall be repaid in the event of liquidation or bankruptcy only after all higher ranked obligations towards the

[2295] See for more details above section *6.1 Regulation and size of market* and below Appendix 5.

creditors have been fulfilled. According to this the senior debts are then repaid prior to lower-ranking subordinated debt.

A crucial difference has traditionally existed between the USA and Europe how subordination is achieved. Due to freedom of contract it has in practice been possible to agree on subordination in both continents but the enforceability of such agreements in the debtor´s bankruptcy has been uncertain in some situations. In the USA enforceable subordination is possible to achieve through contracts[2296] while in Europe the enforceability of contractual subordination has been at least in some situations unclear.[2297]

The legal uncertainty in Europe has led the financiers to favour in certain situations structural subordination, where debts are owed by separate companies in the same group like for example by the holding company and the operative subsidiary. When lender A has provided financing to the operating subsidiary company running the actual business and lender B has provided financing to the holding company, the receivable of lender B is in a structurally subordinated position in relation to the receivable of lender A. This is the case regardless whether the loan granted by lender B is by definition senior loan in relation to the borrower itself. For the lender B a significant downside in this kind of structure is that borrower´s repayment ability depends fully on the operative subsidiary´s capacity to distribute dividends. Another challenge is that in practice the receivable of lender B is in this set up always junior to all payment liabilities of the subsidiary including trade debts.

For example in acquisition financing in the USA it is more common that financing is granted to one entity and subordination is agreed in an intercreditor agreement by several financiers.[2298] In European acquisition financing transactions the subordination is achieved more often through structural subordination.[2299] This latter alternative means in practice that the financier of the holding company - being the junior financier due to structural subordination - relies on the cash-flow generated by the shares of the operating subsidiaries. This cash-flow is in practice dividend distribution. The financier of the operative subsidiary - being the senior financier due to structural subordination - can count on the cash flow generated from the actual operations of the acquisition target.

Although it is not uncommon in European acquisition transactions for the lenders to take the shares of the borrower as security, the lenders also target to take the borrower´s assets as part of security package. This is done to avoid structural subordination and to avoid third party creditors to get access to those assets. The legal limitations for getting the subsidiary shares as collateral may however set some restrictions for this. Due to the financial assistance rules[2300] it is important to assess in each transaction individually what kind of collateral package is possible to get. This assessment requires among other things legal expertise.

[2296] In the USA the treatment of subordination agreements in bankruptcy is governed by a specific statute since 1979. According to the United States Bankruptcy Code (11 U.S. Code, Chapter 5, § 510 (a)) "*A subordination agreement is enforceable in a case under this title to the same extent that such agreement is enforceable under applicable nonbankruptcy law.*"

[2297] For example in the UK only the Chancery Division of the High Court decision in Re Maxwell Communications plc (No. 2), [1994] 1 All ER 737 brought clarity to the enforceability of subordination in bankruptcy. About the case see also Finch, V. and Milman, D. (2017), p. 530. As another example about the unclear status of subordination agreements in bankruptcy in Europe see Vutt, A. (2008), p. 93 according to which the status of subordination agreements in Estonia "*…is indeterminate in bankruptcy proceedings…*"

[2298] Seretakis, A. (2013), p. 637. About intercreditor agreements in general see above section *3.3.3 Intercreditor agreements*.

[2299] Ibid. About the reasons why structural subordination is used see Lautjärvi, K. (2015), pp. 202-203.

[2300] Financial assistance refers to the assistance given by a company for the purchase of its own shares or the shares of its holding companies. For example, according to Chapter 13, Section 10:1 of the Finnish Limited Liability Companies Act (624/2006) the company is not allowed provide loans, assets or security for a third party having the purpose to acquire shares in the company or shares in its parent company.

When contractual or structural subordination is needed, provisions concerning ranking of loans, rights towards the collaterals and distribution of payments to different financiers are included in the inter-creditor agreement. Such an intercreditor agreement shall be signed by borrower, financiers and providers of security. The security arrangement shall be legally effective and enforceable in all relevant jurisdictions. This means also that the underlying asset shall be transferable.

7.3.7 Comparative conclusions on covenants

Covenants are important part of corporate finance. They are needed to respond to material negative developments in financial performance or collateral value especially in financing transactions where the collateral coverage is not comprehensive. The covenants are in practice borrower´s commitments towards a lender. By promising to do separately agreed items like to provide regular financial information to lenders, not to provide collateral in favour of third party or to keep cash flow above certain threshold are basic conditions in corporate finance. As well, the loan agreements contain often undertakings restricting such borrower´s acts that are not part of the commonly agreed business plan. Among other things the borrower is not normally permitted to merge, make significant acquisitions or change business strategy.

Covenants can be divided in different subclasses depending on their type. According to traditional division there are

- positive/affirmative covenants
- negative/restrictive covenants and
- financial covenants.[2301]

Positive/affirmative covenants relate often to obligation to carry out certain activities during the financing period. Such activities can include commitment to pay interest, principal and taxes on timely basis, have relevant business insurance, maintain accounting records in accordance with generally accepted accounting principles, provide relevant financial information to creditors in timely manner etc. Positive/affirmative covenants are in practice list of things that the borrower must do.

Negative/restrictive covenants limit and restrict borrower´s activities. These limitations and restrictions may apply to additional loan taking, security arrangements, capital expenditure, investments, dividend payments, sales of assets etc. Negative/restrictive covenants are in practice list of things that the borrower must not do during the financing period. To deviate from these limitations and restrictions is not possible without the lender´s consent.

Additionally, there are often financial covenants that a borrower must comply. Typical examples of financial covenants are

- Debt coverage cap: maximum level of net debt to EBITDA
- Interest coverage cap: maximum level of net interest costs to EBITDA

[2301] Nijs, L. (2014), p. 313.

- Cash flow coverage cap: maximum level of payable interest costs and amortisations to free cash flow

- Capex cap: annual limit on permitted capital expenditure that must not be exceeded.

The purpose of the financial covenants is to help to identify the negative development of the borrower as soon as possible and function thus as an early warning signal. To pay close attention to a borrower´s indebtedness and cash flow is important. It is important to highlight that equity linked financial covenants are not considered very relevant early warning signals because normally borrower´s underperformance leads to the breach of such covenants only after significant delay.

The trend in the Nordic and European corporate finance market has lately been that the deal structures have become more borrower-friendly including less comprehensive covenant packages.[2302] The U.S. deal patterns have gradually taken more space and increasingly substituted the traditional European transaction structures.[2303] Low interest rates have led the financiers to compete for yield even more and the market practices of the USA have gained more foothold in Europe through the globally operating operating financiers.[2304]

Part of adopting the U.S. market practice in corporate finance means adopting also covenant-lite structures. The covenant-lite loans have no maintenance financial covenants.[2305] Such loan packages include typically incurrence financial covenants which will become in force only when a separately agreed trigger event - like increase of leverage, sale of assets or merger - takes place.[2306] This kind of incurrence financial covenant known as a *"springing"* covenant can also be linked to revolving credit facility.[2307]

It is anticipated that the current convergence trend between the European and U.S. lending market will continue.[2308] This means also the European and U.S. loan products - which have been earlier identified as separate asset classes - are becoming more and more similar which will also be reflected by narrower pricing spreads between these two markets areas.[2309]

7.4 How mezzanine could be used in bank lending going forward in order to support functioning capital markets?

Mezzanine is not a financing form widely used by banks so far but mezzanine has potential to become more popular bank lending form. In this research a step has been taken in the direction of defining how mezzanine instruments could be used by banks. These hybrid instruments could be used especially in situations where customer does not have collateral to offer and bank would be prepared to grant financing even with traditional debt instruments.

[2302] ECB (2017), p. 2.
[2303] The overall trend of European corporate finance deal terms being influenced by the U.S. market practices has been identified by several legal practitioners. See for more details among other things Latham & Watkins (2018), Chambers & Partners (2018) and Ashurst (2018).
[2304] Latham & Watkins (2015).
[2305] Winick, D. and Young, A. (2015), p. 622.
[2306] Becker, B. and Ivashina, V. (2016), p. 1.
[2307] According to Latham & Watkins (2018) "*The covenant benefitting the revolving lenders typically is a "springing" covenant, i.e., tested when the revolver is drawn and such usage exceeds a certain percentage of the revolving credit commitments, often 25-35%, with the applicable levels set with significant EBITDA "cushion" or "headroom" of around 30% or more and no or very few step downs. Associated provisions customary in US covenant-lite structures are also now being adopted in Europe and in some cases are being made even less restrictive in Europe."*
[2308] Ashurst (2018).
[2309] Ibid.

However, mezzanine cannot be a tool which would allow banks to step to transactions or projects which would be riskier than those transactions or projects which are financed by banks today with traditional senior debt loan instruments. Mezzanine is rather a tool which would provide to banks additional alternatives to price more accurately the risks they would take anyhow. This tool would thus give additional possibilities for a bank to price the lending to reflect better the actual risk of the financing transactions.

The conclusions made on mezzanine as bank product are on theoretical level and practical applications of the conclusions drawn would deserve further research. Before giving concrete recommendations on future research objects it is good to remind for the inspiration what the current environment of the banking industry is like.

The overall landscape of the financial service industry has changed during the last years and will change rapidly also in the coming years. Disruptive technologies including among other things artificial intelligence and fintech solutions are among the factors influencing to that change.[2310] The possibility for the machines to replace human input in decision-making and customer recognition provides massive efficiency improvement potential. Also, companies outside the traditional financial service industry providing innovative technological solutions are increasing competition in a way not seen before. This also influences to the customer expectations related to products, distribution channels, online services etc. Customers today have different needs than customers of yesterday. In addition to that customers tomorrow have also different needs and expectations towards the banks than customers today. For the traditional banks this means they must be able to identify new threats and opportunities, understand the influence of the new trends and technologies for banks´ business and have strategies for the new environment.[2311] It means also that for the established players in the industry the new time also known as digital age is not necessarily a threat but also an opportunity to improve their business operations.[2312]

Another trend that can be identified in the banking sector is the increasing regulatory pressure. To structure a business model which be approved by relevant stakeholders - owners, investors, customers and supervisors - is challenging. The scanning and identification of the regulation, planning the process to act according to it and the actual implementation work is task requiring significant resources and tremendous managerial input. It is also a continuous process as regulatory pressure is not likely to decrease in the foreseen future.

Financial system performs the role of channelling funds from savers to borrowers. In indirect finance a financial intermediary has the role of channelling funds.[2313] This is the core business of banks and they play a critical role in the total network of financial system. When granting credits banks are acting as financial intermediates. The role of bank loans is significant in company finance. For example, in European Union bank financing is the major financing source for SMEs.[2314] There are however also other significant financing sources for the companies like capital markets. In the USA securities are even the major sources of financing for large companies.[2315]

[2310] Bean, R. (2017).
[2311] PwC (2016b)
[2312] Atherton, M. (2016). See also EBF (2016b), p. 1 according to which *"Banks can play a decisive role in the development of the European digital single market. On the one hand, banks are the main source of finance to the European economy that is undergoing a process of capital-intensive digitalisation. On the other hand, banks - guided by customer demand - are heavily investing in technology and partnering with technology start-ups to improve customer offerings and to transform their business models."*
[2313] Admati, A. and Hellwig, M. (2013), p. 50 and Krugman, P. (2015).
[2314] OECD (2015b), p. 32 and ECB (2016b), p. 9.
[2315] IMF (2014), p. 29.

The biggest banks provide broad selection of different services in Finland and in other countries observed in this thesis. Part of the service portfolio consists of different financing products. For corporate customers the offering of on-balance sheet lending products contains in practice secured or unsecured senior ranked lending instruments. Whether the actual financing will then take place depends on customer´s repayment ability i.e. is the forecasted cash flow sufficient to cover the required payments. When assessing the repayment ability company´s profitability, solvency and future forecasts are relevant elements.

Even though company´s cash flow must always be enough for repayment also collaterals have relevance. Collaterals are the alternative way out for loan repayment. They reduce the overall credit risk, may lower the capital requirement of the bank and therefore and thus also lower the pricing of the loan.[2316] In order the lender to have the second way out through collateral the pledge transaction must be legally enforceable and pledged assets must be liquid enough to ensure realisation if really needed.

The low interest level during the last years has brought major challenges to banks´ lending activities as the low overall interest rates have also decreased the interest margins. Specifically, in corporate financing this means extremely careful evaluation of each new transaction. It is not important only to assess that the credit risk involved is acceptable but also to evaluate that the pricing of the lending transaction is right. The low interest levels have lead the banks to look for more profitable business opportunities.[2317] Such opportunities may have been found among other things by focusing on services consuming less capital and lending activities which generate more profits. Example of the services consuming less capital are investment banking type advisory service (market analysis, valuation, legal advice, transaction structure advise etc.). Example of the lending activities generating more profits is financing of leveraged buyout (LBO) -type acquisition.[2318]

The regulatory pressure towards the banks has been immense in the recent years. Among the most central regulation is the Basel capital regulation which targets to ensure that banks hold amount of capital consistent with their risk exposure.[2319] These demands around capital adequacy and liquidity reserves including banks´ profitability pressures make it more challenging to finance corporate customers. This has led some banks to even partially withdraw from some areas of corporate lending activities.[2320] Such development leaves more room for stronger banks to operate in corporate lending. This kind of environment also creates new possibilities for innovative and out-of-box solutions in which mezzanine products could have a role that is bigger than earlier.

Up to now banks have only to limited extent provided mezzanine financing. The tailor-made mezzanine products provided by banks are meant for limited customer base and total financing volumes are also so far limited. The mezzanine/hybrid type of financing does not normally belong to low-risk bank´s product portfolio. There is however knowledge of these products among the professionals in the financial sector.

When providing financing banks operate traditionally only as lenders with senior ranked financing products. Banks have also created their operating models according to that. If starting more active use of mezzanine finance for growing and healthy corporate customers

---

[2316] In the bank´s capital calculation certain types of collaterals can be accepted as credit risk mitigation. See above footnote 2113.
[2317] Borio, C. and Gambacorta, L. (2017), p. 3.
[2318] In most leveraged buyout transactions significant amount of debt is used to complete the acquisitions. Due to higher financing risk compared to traditional corporate financing lenders demand higher interest margins. Additionally, the complexity of the leveraged buyout transactions requires advisory services and tailor-made financing packages generating also extra fees for the banks involved. See above also footnote 1831.
[2319] See more about Basel regulation below in section *5.4 Impact of Basel III.*
[2320] See Bridges, J. et al. (2015) and Drezner, D.W. (2014), p. 98.

their operating models should be adjusted. Customers receiving mezzanine financing - which is by its nature riskier than senior ranked lending assuming collateral - require more hands-on monitoring and control. If mezzanine lending by banks became more active banks should adjust operating models and organisations of their customer service units accordingly. Among other things more frequent meetings with customers, more active information sharing and more comprehensive covenant packages would be needed to properly manage the risks involved.

The mezzanine instruments are used already now in the risk management of the distressed corporate customers. Senior ranked loans are sometimes converted into subordinated loans to support the borrower´s balance sheet. As well a profit-sharing element can be used to give bank an option for upside. The logic here is that if at some point later the borrower´s financial situation improves the tailor-made upside clause will bring compensation for the bank for the risk taken.

One of the conclusions of this thesis is that mezzanine instruments could well be used as banking financing products in certain situations for healthy corporate customers. Banks product portfolio could well include both subordinated mezzanine loans and non-subordinated, senior mezzanine loans.

Subordinated financing offers similar kind of financing cushion against losses and against threat of liquidation as equity. Pricing of subordinated loan is higher than pricing of senior loan due to the lower repayment priority. The additional financing cushion between equity and senior financing justifies the higher price. If bank was in any case in a role of risk financier (i.e. customer has no collateral to offer), the subordinated financing would not increase bank´s risk. If all assets of the borrower company are already pledged or if bank is the only creditor the seniority does not have any influence on the actual risk position of the bank. In such situations it would make sense for the lender to be involved in restructuring bringing the benefit of getting the higher interest income of the subordinated loan.

To grant financing in the form of non-subordinated senior debt as could also be option for a bank. Regardless whether there is security available or not it would be in the lender´s interest to agree on interest clause including upside possibility. This upside could be agreed in several ways. It could be done by linking the interest payment obligation to customer´s profitability (profit-sharing loan) or value appreciation of specific assets (value-appreciation loan). It would be in lender´s interest to agree on interest rate clause including both the profit/value-linked component and fixed component. The component linked to profit/value change should thus be part of the total interest paid and should be paid on top of the fixed interest payment. This structure would ensure for the bank as the lender interest income also in case of borrower is facing a period of lower profitability not triggering the profit/value-linked interest payment obligation.

Banks lend often without fully secured loans. Bank´s return on money lent on traditional debt financing instrument is very often on the same level as on secured bank loan. The price differentiation is not always reflecting the actual financing risk. Lending without fully secured loans should be priced higher than lending with fully secured loans. The bank´s return should conform better with the risks involved. Mezzanine instruments could be one additional way to help banks to price their lending so that pricing would better reflect the financing risk involved.

Companies have - at least in theory - possibility to get both internal and external financing. For most companies the theoretical external financing sources are banks, venture capital firms, business angels and capital markets. As amount of business angels is limited and sourcing financing from capital markets is expensive, time consuming and costly the more realistic alternatives are often banks and venture capital funds.

When comparing venture capital and bank financing there are four significant differences: Firstly, bank does not seek ownership in the target companies unlike venture capital companies. Secondly bank acts only as a lender and does not seek to participate in the ownership or management of the borrower unlike venture capital company. Thirdly the rate of return requirement of the bank is substantially lower than that of the venture capital fund. Fourthly bank strives to maintain long lasting customer relations while venture capitalists supposed to exit normally within five years.

Additionally, banks provide today in practice only senior ranked financing for new customers. Subordinated bank financing is extremely rare and direct equity investments are not a bank financing option. However, venture capitalists do also provide subordinated financing and direct equity investments. Both financing forms - subordinated financing and equity input - offer the same protection against loss for the financial period and against threat of liquidation. If both financing sources - venture capital and bank financing - are available and the company does not want or need the management support provided by venture capitalist, loan from the bank is normally more attractive financing alternative.

If no shortage of equity is identified subordinated loan is not necessarily needed. In such a situation - subject to lack of security - profit-sharing loan and value-appreciation loan could be realistic alternatives. With these special interest clause loan types pricing could be agreed on higher level than pricing of traditional senior debt. If customer has no collateral to offer and if bank was in any case in a role of risk financier the use of unsecured loan with special interest payment clauses would not increase bank´s risk either.

Based on the above-mentioned mezzanine instruments could be used more as bank lending instruments and support aim to price financing risk more correctly. Mezzanine could be used as bank financing instrument especially in situations

- where there is lack of security and
- when bank in any case would be prepared to finance even with traditional debt instruments.

Banks shall be primarily senior loan lenders but mezzanine finance should be one tool in the toolbox of many bank financing instruments. Mezzanine should be seen thus supplementary financing form. This tailor-made financing form suits primarily for companies that are healthy, profitable companies with good growth prospects. The operative management must also have proven capabilities to perform. The cash flow must be predictable which makes companies in non-cyclical industries more favourable financing objects. The borrower companies must have strong market position and positive outlook.

Mezzanine is a financing form that could be used in situations for which the traditional lending does not fit in best possible way. As financing arrangements requiring tailor-made structuring mezzanine transactions are costlier than financing with standard terms. Documentation is more complex, extensive and requires also special legal and financial expertise. To be profitable for the lenders and thus also available for the borrowers the single mezzanine transactions need to be sizeable. Due to this the smallest SME companies are normally not the primary targets for a mezzanine lender.

7.5 Future research objects

To manage the regulatory pressures, technological development, increasing competition and changing customer needs banks need to reconsider their strategies and operating models. This

influences also on how bank manages its risks.[2321] All of this raises also interesting ideas on what could be future research topics in mezzanine financing provided by the banks in the heavily regulated digital age.

Taking into consideration what has been described above I recommend following future research objects related to the topic of mezzanine financing:

7.5.1 Mezzanine bank´s organisation and operating model

Banks have a role of channelling funds from savers to those wanting to spend i.e. to the borrowers. This role will remain even though new Basel regulation pushes banks to adjust their business models and dedicate increased share of their profits to the increase of the regulatory capital. Such financiers that are not subject to Basel regulation like hedge funds and private equity firms will benefit for the tighter capital requirements of banks.

Bank lending is traditionally done by granting senior debt and with assumption of getting security from the borrower to back up the repayment. The risk of senior term lending with security is lower and the operating model of the lending organisation is structured according to that. As additionally credits are spread on very wide customer base - in case of biggest banks the amount of corporate customer can be calculated in hundreds of thousands - loss risk related to an individual case is normally not very significant from the whole organisation´s perspective. Besides traditional banking organisation is structured for this kind of operating model. This means that active control activities over individual credit customers are normally not taking place on daily or even weekly basis. If usage of higher risk mezzanine lending products becomes everyday business for the traditional low risk bank it requires adjustment of operating model.

Besides, banks are facing increasing competition on multiple fronts. Other traditional banks are competing harder and non-banks including nonbanking financial technology companies called fintechs introduce new user-friendly and value-adding products. This change influences also to the business models of many corporate customers. All of this puts pressure on revenue streams of traditional banking and forces to look for new revenue streams.

Referring to what is mentioned above it could be researched what is a suitable organisational structure and general operating model in the bank supporting the efficient use of mezzanine financing products. Such a research could include business strategy, methods of reviewing the potential borrowers, identifying the investment targets, decision-making procedures, organising the monitoring routines, sufficient incentive systems for the customer responsible managers etc.

7.5.2 Mezzanine bank´s credit strategy

The banking industry has witnessed several macroeconomic and regulatory changes during the last years. Each bank involved in corporate lending must find its own balance between lending and non-lending activities. When granting credits, the organisation shall have among other things the necessary organisational competence to identify potential customers, to assess which ones are the right targets to be financed and to structure the suitable financing package. Prioritised customers shall have strong enough cash flow to repay the loan and the transactions shall generate revenues achieving business goals of the bank. Banks need to consider what is their prioritised lending customer base and which segments are acceptable

[2321] See Bahillo, J. A. et al. (2016).

and which are not from risk-to-return perspective. Taking into consideration that bank lenders tend to normally be more conservative than equity investors the bank´s plan to radically increase mezzanine lending requires also adjustment of its business strategy.

The role of technological development needs to be taken into consideration as well. It influences also credit granting. The digital transformation gives possibilities to improved credit processes and customer experiences. This includes potential for cost saving and income growth for the bank.

Referring to lending activities it could be researched what are the elements of concrete mezzanine credit strategy for a bank wanting to provide mezzanine financing. Such a research could include defining of target customers, product portfolio, portfolio size, risk/return - profile wanted, portfolio-management processes etc.

7.5.3 Mezzanine financing terms

In corporate lending the credit documentation can be very complicated. Although loan agreement comprises often also some standard provisions there is also regularly need to customise some part of the documents. The more there is need to take into consideration individual features of the lending relationship the more there is need to customise the terms. This may also bring additional challenges in the negotiations over the transaction in question. In theory all the loan terms can be negotiated but in real life the bargaining power of the contract parties may differ.

It is essential that both the lender and the borrower understand credit terms of mezzanine arrangement. Both parties need to understand what is the instrument type used, is financing subordinated or not, how is accounting done, what are the tax implications of the transaction, what is the maturity, what is the interest, what are the payment dates, what are the covenants, is the loan transferable to another lender etc.

Referring to the above-mentioned it could be researched what international comparison of financing terms of mezzanine transactions in separately chosen countries tells us. Such a research could include loan document types in general but also specific focus areas including maturity, pricing, leverage, covenants, collateral, loan documentation, applicable law, reporting etc.

7.5.4 Banking regulation influencing to mezzanine lending

Banks are challenged by continuously increasing regulation. Both national and international regulatory pressure is growing which requires firm steps from the banks to manage the supervisory demands besides running the normal banking business. As different rules are also applied in different jurisdictions - and the fragmentation of supervisory regulation between different countries is rather increasing than decreasing - complexity of compliance management becomes more and more evident. Due to the increase of capital allocation stemming from the Basel regulation the funding of financial institutions becomes also more expensive. According to Nijs the higher level capital requirements have led banks to retract from the senior debt which opens new market for equity and mezzanine capital.[2322]

[2322] Nijs, L. (2014), p. 353.

Banking has developed over the years and it is no doubt one of the most regulated industries globally. It is also self-evident that the new regulation reforms the financial sector further. The impact of regulation depends also on how rules are applied, monitored and controlled. It is also relevant how banks are supervised. As banking regulation and supervisory authorities are not the same in all countries, the regulation impact is not either the same in all countries.

Referring to the above-mentioned research focus could be in comparison of the banking regulation of separately chosen countries. It could be researched what is the influence of the regulation for usage of mezzanine financing as bank financing product. Attention could be given to banking legislation and supervisory regulation covering also capital and liquidity requirements.

7.5.5 Digitalisation influencing to mezzanine lending

Digitalization influences in banking in several ways. Exponential technology development transforms the whole banking industry radically. Among other things new products and service forms are created as nonbanking financial technology companies are more and more entering banking services. The fintech companies are providing already today loans, payment services and foreign exchange services and both competing and cooperating with traditional banks. The technological opportunities change the competition environment in a dramatic way and influence even to organizational structures and impact on the drivers of business growth. Increasing number of customers are demanding more and more banking services online or with a mobile device which has altered the traditional service models.

As customer demands are shifting along the technological development, banking sector needs to be awake and react accordingly. Banks have to organise their operations to provide competitive services online. The general trend in banking is to move away from physical interaction towards remote 24/7 services. Scaling down the physical branch network, major investments in IT-infrastructure and increased use of artificial intelligence are phenomena of these development. It is not too much to say that digitalisation is a gamechanger in the banking industry.[2323]

It could be researched how digitalization influences on usage of mezzanine financing as bank financing product.

7.5.6 Accounting regulation and practices

Accounting comprises bookkeeping, financial statements and relevant reporting based on bookkeeping and financial statements. Accounting regulations and practices vary from country to country and additionally the accounting implications are not straightforward. This brings sometimes complexity in the process of finding right rules to be applied. On top of that the profitability of products and business areas of the company can be influenced by the changing accounting regulation and practices.[2324]

[2323] Pentti Hakkarainen, Member of the Supervisory Board of the ECB mentioned in his speech at the Lisbon Research Centre on Regulation and Supervision of the Financial Sector Conference on June 6, 2018 that *"…To a large degree, this competition on the user-friendliness and trustworthiness of banks' digital offerings will determine which firms succeed and which fail in coming years…"* The speech is published on ECB website. See ECB (2018).

[2324] As an example see Maggi, F. et al. (2017) on how new IFRS 9 - which became effective in January 2018 - influences on banks´ business models.

It is important to ensure the quality and integrity of financial information is on high level. Although institutional financiers like banks, insurance companies and the state have less need for generally published information than external private investors all stakeholders value high-class and reliable data. Lack of high level and reliable accounting system would mean that the capital markets would be less efficient. In case of decreased efficiency, the capital cost would also be higher and lending would be more expensive. To motivate the corporations to provide high quality accounting the right incentives must be in place. Without transparent high-level information all the present and potential to-be owners and investors could not rely on news about the company performance. If financial information is transparent and correct possibility to attract new investors improves.

Globalization has influenced in several areas of human life and led to more harmonized practices also on the business world. The increased adoption of IFRS during the last years in different jurisdictions has meant application of more uniform accounting standards and simultaneously change of local standards and practices. These changes influence on several elements of accounting including comparability, transparency and overall quality. In different countries the changes have been executed in different ways and thus some local accounting structures and practices have remained.

Referring to the above-mentioned it could be researched what is the influence of the accounting regulation and practices for usage of mezzanine financing as bank financing product. Research could focus on comparison of the regulations (including local GAAP and IFRS rules) and practices of separately chosen countries. Additionally, it could be researched what are the *"ideal"* accounting principles for usage of mezzanine type financing.

7.5.7 Taxation

Taxation influences on the financing decisions of the company. The tax implications are not always straightforward but the tax advantage of debt gives the firm a motivation to strive for increased leverage. Changing tax rates could also have impact on decisions on the capital structure. Taxation policies can effectively encourage or discourage for investments if the fiscal regulations to be applied have cash flow implications. The lower the tax burden of the company the greater the cashflow to be generated. If companies must pay less tax their accounting cash flows and income statements will be strengthened. Tax treatment is relevant also for the providers of financing. For example, according to Weitnauer local tax rules are partially reason for Germany being in international comparison on lower level in venture capital fundraising and investments than the size of the country´s economy would suggest.[2325]

Mezzanine financing should be considered comparable to lending to generate deductible expense. In such a situation paying interest to mezzanine loan would not be dividend payment. Taxation rules however vary between jurisdictions and interpretations on what is debt and what is equity need to be judged on case by case basis.

Referring to the above-mentioned it could be researched what is the influence of the taxation for the usage of mezzanine financing. Based on that it could be further investigated how should taxation regulation be changed to increase the usage of mezzanine financing.

[2325] Weitnauer, W. et al. (2016), p. 577.

7.5.8 Company law regulation de lege ferenda

Mezzanine financing is one alternative form of financing for any company searching for capital to acquire another business or expand into another production or market area. This type of finance is totally different compared to senior ranked traditional loans. For the lender mezzanine finance is comparatively risky but has a higher risk adjusted return. Mezzanine providers are normally ready for long-term cooperation with those companies getting this tailor-made investment form. To allow as many companies as possible to get the mezzanine capital the regulatory environment should not unnecessarily limit the more increased usage of this kind of hybrid financing. On the contrary usage of mezzanine should rather be incentivised to support companies to grow and prosper.

Lautjärvi has proposed in his dissertation some regulatory improvements de lege ferenda for the Finnish Limited Liability Companies Act[2326]. According to Lautjärvi legislative reforms are needed among other things in the area of creditor´s protection regime in distribution and maintenance of company funds.[2327] This should be done by strengthening of the solvency test, abandoning the separation of restricted and unrestricted equity and redefining the distributable funds. Additionally, Lautjärvi proposes legislative improvements to the order of payments and to the availability of company financial information.[2328] He also concludes that

> *"Finally, the increasing symmetry of company, accounting and tax laws from the perspective of the factual nature and substance (rather than their purely legal form) of the corresponding financial instruments is considered important in the future."*[2329]

Lautjärvi´s views are grounded and they can be supported.[2330] Although his views regard only Finland the identified improvement needs could be applied at least to some extent also internationally. This would however require further research.

Referring to the above-mentioned it could be researched how regulation covering company laws should be amended to support the usage of mezzanine financing. As mezzanine is a commercial concept rather than a legal term company laws neither contain nor should contain this concept.[2331] Taking that into consideration at least following areas could be relevant when amending and improving the company laws to enhance usage of mezzanine:

- company law harmonisation with tax and accounting regulation including unified
    - equity/debt features
    - accounting treatment in profit and loss account and balance sheet and
    - forms of interest payment allowing deductibility of interest costs
- description of decision-making process of the company wanting to take a loan, repayment of which is dependent on the financial performance of the borrower
- description of obligatory/allowed repayment and interest payment criteria

[2326] Limited Liability Companies Act (624/2006).
[2327] Lautjärvi, K. (2015), pp. 336-340.
[2328] Lautjärvi, K. (2015), pp. 340-346.
[2329] Lautjärvi, K. (2015), p. 353.
[2330] See also Villa, S. (2010), p. 366 in which strengthening of the solvency test and redefining the distributable funds is proposed.
[2331] According to Mäntysaari, P. (2010c), p. 283 mezzanine financing *"is not a normative concept"*.

- minimum documentation criteria of taking a loan, repayment of which is dependent on the financial performance of the borrower.

If needed research scope could be limited by focusing on separately chosen countries.

Mezzanine finance is mostly described as debt ranking between senior loans and equity and featuring of attributes from both financing forms.[2332] Being hybrid form of lending it is positioned between senior debt and equity on a borrower´s balance sheet. It is quite often subordinated in priority of repayment to senior debt but on the other hand senior to equity. Especially when being subordinated the required return is higher than for senior loan financiers. This means higher interest rate and/or usage of equity warrants known also as *"equity kickers"*.[2333] The equity warrant element allows the mezzanine lender to participate in the upside of the equity value and provide compensation for the higher financier risk.

Due to mezzanine not having universally common definition its meaning may vary depending on the user. Due to this inclusion of the definition in the company law would be welcomed. Additionally, company law regulation should also include obligatory and allowed key features of a mezzanine debt and transaction involving this kind of instrument.

Company law harmonisation with tax and accounting regulation would also be welcomed. As mentioned above one of the key characteristics of any mezzanine financing is that it has features of both debt and equity. Mezzanine capital is therefore placed between senior debt and equity in a company´s capital structure. This means lower ranking in terms of priority of payment and security to senior debt but on the other hand higher priority ranking than equity. Mezzanine capital has thus *"dual nature"* and may be classified as equity from one perspective and as debt from another perspective. When knowing that from the view point of accounting and taxation the division between equity and debt is important the status of mezzanine in accounting and taxation is not always clear. In accounting equity would strengthen the equity ratio but in taxation only debt would create possibility for interest payment deductions. However not all mezzanine instruments fulfil both equity and debt criteria in this respect.[2334] The company law harmonisation with tax and accounting regulation covering unified equity and debt features would clarify the situation. This would in practice require more focus on the real nature and substance of the mezzanine finance transactions than on their legal form.[2335]

Description of decision-making process of the company wanting to take the mezzanine loan requires more comprehensive regulatory guidance as well. For example, what is the powers to act in this respect of general meeting, board and operative management could be clarified. Additionally, could be explained in the company law what are the obligatory or allowed repayment and interest payment criteria for different mezzanine financing forms and minimum documentation criteria of the mezzanine financing in general.

When using de lege ferenda approach the interest is in how laws and other regulation should be rather than how they are. Attention is given to the regulatory changes in supporting the increased use of mezzanine lending. There are several areas that could be changed taking into consideration that mezzanine type of hybrid financing is complex to structure and understand. When focusing on *"should be"* regulation in economical sense the perspective should include

[2332] Niskanen, J. and Niskanen, M. (2013), p. 30, Arnold, G. (2013), p. 437 and Nijs, L. (2014), pp. 5-6.
[2333] Mäntysaari, P. (2010c), p. 300, Nijs, L. (2014), pp. 25-26 and Weitnauer, W. et al. (2016), p. 156.
[2334] An example of a mezzanine instrument that can in some situations fulfil both equity and debt criteria is the capital loan defined in Chapter 12 of the Limited Liability Companies Act (624/2006). According to Chapter 5, Section 5c of the Finnish Accounting Act (1336/1997) such a capital loan that would be classified as equity in the IFRS financials can also be booked as equity in the financial statements not to be done according to IFRS.
[2335] Lautjärvi, K. (2015), pp. 346-347.

the one of the users of the regulation. In this case it would mean taking into consideration the perspective of the mezzanine lenders and the borrowers.[2336]

Figure 43: List of identified legislative improvement needs

Legislative improvements in the de lege ferenda company laws

- detailed definition of
  - subordinated financing forms
  - non-subordinated financing forms
- detailed definition of acceptable principal repayment clauses including
  - subordinated financing forms
  - non-subordinated financing forms
- detailed definition of acceptable interest payment clauses including
  - subordinated financing forms
  - non-subordinated financing forms
- detailed documentation requirements including
  - subordinated financing forms
  - non-subordinated financing forms
- detailed rules on decision-making including
  - powers to act of shareholders
  - powers to act of board of directors
  - powers to act of operative management
- symmetric definitions between company, accounting and tax laws to remove the discrepancies between the different regulatory areas including
  - deductibility of all interest payments for subordinated financing forms
  - deductibility of all interest payments for non-subordinated financing forms
- symmetric definitions between company and insolvency laws to remove the discrepancies between the different regulatory areas including
  - repayment ranking of different financing forms
  - repayment ranking of financing and other payment obligations
- harmonisation of regulation between EU countries and USA including also accounting and tax laws.

Taking into consideration what has been discussed in this research - and when brainstorming freely - one could hope several legislative improvements in the de lege ferenda company laws. These new elements should provide detailed enough definitions of subordinated financing forms and non-subordinated financing forms. These definitions should cover principal payment criteria, interest payment criteria and documentation criteria for both types of financing forms. Additionally, rules on decision-making should be explained for shareholder meeting, board of directors and operative management. As well increased symmetry between company, accounting and tax laws and between company and insolvency laws would be welcomed. The increased symmetry should be achieved also in the company regulations

[2336] See about the user of the legislation Mäntysaari, P. (2017), pp. 161-162.

between EU and USA. The identified legislative improvement needs are summarised in the table above (see Figure 43).

The identified improvement needs of company law are relevant both from the perspective of the lender and borrower. The more precise and harmonized international regulation should be in the interest of all mezzanine stakeholders. It would mean less need for interpretation, less other legal uncertainty and more possibilities for efficient transaction implementation.

KORT SAMMANFATTNING

Avhandlingens syfte är att ge svar på vilken den bolagsrättsliga bakgrunden är när det gäller användningen av mezzaninefinansiering, vilka de relevanta redovisnings- och skattereglerna är och hur denna finansieringsform används på marknaden i dag. Ytterligare undersöks hur stor mezzaninemarknaden är i de relevanta länderna. Avhandlingen fokuserar primärt på Finland och jämförelser har gjorts med Sverige, Estland, USA, Storbritannien och Tyskland. De viktigaste olikheterna mellan de legala strukturerna och marknaderna gällande finansieringsformen har analyserats. Det ultimata målet har varit att konkludera vilka som är de största skillnaderna inom bolagsrätten, redovisnings- och skattebestämmelserna samt i de lokala marknadsförhållandena. Särskilt har också granskats hur mezzanineinstrument kunde användas mera i bankernas kreditgivning för att stödja funktionerande kapitalmarknader.

Den juridiska analysen har fokuserat endast på bolagsrätten. Referenser till andra rättsområden har gjorts bara om det har varit nödvändigt för att bättre förstå den ifrågavarande bolagsrättsliga normen. Analysen av de gällande redovisningsreglerna har koncentrerat sig på de lokala GAAP och IFRS normerna. I analysen av de skatterättsliga normerna har man inriktat sig på thin capitalisation-regler och avdragsgiltigheten för räntekostnader ur gäldenärens perspektiv. Man har undersökt omfattningen av de lokala marknaderna genom att jämföra antalet venture capital-aktörer, volymerna av venture capital-investeringar, antalet banker och volymerna av bankfinansiering. Forskningsmaterialet består primärt av akademisk och professionell litteratur inom bolagsrätt och finansiering.

Resultaten tyder på att det finns betydande skillnader mellan de undersökta länderna när det gäller bolagsrätten, redovisningsreglerna och skattebestämmelserna. Det finns också betydande skillnader mellan mezzaninemarknaderna i de observerade länderna på grund av det varierande antalet finansiärer och deras varierande kapacitet att bevilja finansiering. Det här påverkar utbudet av finansiering på marknaden rent generellt.

Ytterligare kan man dra slutsatsen att mezzanine är en potentiell bankprodukt för företagsfinansiering. Mezzaninefinansiering kunde användas speciellt i sådana situationer där kunden inte har några säkerheter att pantsätta och banken skulle vara redo att finansiera kunden även i form av traditionella låneinstrument. Mezzanineinstrument skapar också tilläggsmöjligheter för banken att prissätta utlåningen så att prissättningen bättre reflekterar risken i arrangemangen. Mezzanine ska ändå inte vara ett verktyg som skulle göra det möjligt för banken att gå in i arrangemang eller projekt vilka är mera riskfyllda än de arrangemang eller projekt som idag finansieras med traditionella låneinstrument. Det är snarare ett verktyg med hjälp av vilket banker får ytterligare alternativ att mera exakt prissätta den risk som de är redo att ta i alla fall.

ABSTRACT

The purpose of the research is to give understanding what is the company law background concerning the use of mezzanine financing, how mezzanine instruments are handled from accounting and taxation perspective and how they are used in the market today. On top of that is reviewed the size of mezzanine market in relevant countries. The main focus is in Finland and comparison is done to Sweden, Estonia, USA, UK and Germany. The differences of legal frameworks and markets in relation to the discussed financing form are analysed. The research objective has been to conclude what are some of the main differences of company regulation, accounting and taxation rules and local market conditions related to the topic in question. Additionally, it is reviewed how mezzanine could be used in bank lending going forward in order to support functioning capital markets.

In the review of legal background, the focus has been on company law solely. Reference to other legislation is made only if it is necessary to understand better the specific company law regulation in question. The analysis of applicable accounting rules has concentrated on the local GAAP and IFRS regulation. In the review of taxation rules is focused on thin capitalisation rules and deductibility of interest from the borrower´s view. When reviewing the local market conditions, the attention has been given to the size of the market in terms of amount of venture capital actors, volumes of venture capital investments, number of banks and volumes of bank loans. The research is based on academic and professional literature in company law and finance.

The outcome of the research is that there are significant differences in the company law, accounting rules and taxation regulation between the observed countries. There are also significant differences in mezzanine markets between the observed countries due to variation of actors and their capacity to provide financing. This influences on the availability of the mezzanine financing in general.

Additionally, it can be concluded that mezzanine is a potential bank lending form. Mezzanine financing could be used especially in situations where customer does not have collateral to offer and bank would be prepared to grant financing even with traditional debt instruments. Mezzanine instruments give also additional possibilities for a bank to price the lending to reflect better the risk of the financing transactions. However, mezzanine cannot be a tool which would allow banks to step to transactions or projects which would be riskier than those transactions or projects which are financed by banks today with traditional senior debt loan instruments. It is rather a tool which would provide to banks additional alternatives to price more accurately the risks they would take anyhow.

REFERENCES

Literature

Aarnio, A. (1978), Mitä lainoppi on?, Kustannusosakeyhtiö Tammi, Helsinki.

ABA (2014), The Business of Banking - What Every Policy Maker Needs to Know, American Bankers Association, Washington, D.C.

Admati, A. and Hellwig, M. (2012), The Bankers' New Clothes, Princeton University Press, Princeton.

Agmon, T. and Sjögren, S. (2016), Venture Capital and the Incentive Process, Palcrave Mcmillan, Milan

Airaksinen, M. et al. (2010), Osakeyhtiölaki I. 2. uudistettu painos. Talentum Media Oy. Helsinki.

Airaksinen, M. et al. (2010b), Osakeyhtiölaki II. 2. uudistettu painos. Talentum Media Oy. Helsinki.

Alexander, S.K. et al. (2006), Transatlantic Financial Services Regulatory Dialoque, European Business Organization Law Review 7, pp. 647-673.

Allen, F. and Gale, D. (2000). Comparing Financial Systems, Cambridge, Massachusetts: MIT Press.

Allen F. and Santomero, A.M. (1998), The theory of financial intermediation, Journal of Banking & Finance 21 (1998), pp. 1461-1485.

Allmendinger, C. (2013), Company Law in the European Union and the United States: A Comparative Analysis of the Impact of the EU Freedoms of Establishment and Capital and the U.S. Interstate Commerce Clause, William & Mary Business Law Review, Volume 4, Issue 1, pp. 67-109.

Almi (2016), Årsredovisning och hållbarhetsredovisning (2015), available at http://np.netpublicator.com/netpublication/n27223279, accessed on August 9, 2016.

Almi (2016b), About Almi, available at http://www.almi.se/English/, accessed on August 10, 2016.

Almi (2016c), About Almi Invest, available at http://www.almi.se/Almi-Invest/About-Almi-Invest/, accessed on August 10, 2016.

Alva, C. (1990), Delaware and the market for corporate charters: history and agency, Delaware Journal of Corporate Law, Volume 15 pp. 885-920.

Alver, L. et al. (2014), Implemetation of IFRSs and IFRS for SMEs: the case of Estonia. Accounting and Management Information Systems, Vol. 13, No 2, pp. 236-258, 2014.

Alver, L. et al. (2013), Accounting Policy and Institutional Pressures: the Case of Estonia, GSTF Journal on Business Review (GBR) Vol.3 No.1, November 2013.

American Bar Association (2017), The American Bar Association, About the American Bar Association, available at http://www.americanbar.org/about_the_aba.html, accessed on May 17, 2017.

American Bar Association (2017b), Model Business Corporation Act (2016 Revision), available at http://www.americanbar.org/content/dam/aba/administrative/business_law/corplaws/2016_mbca.authcheckdam.pdf, accessed on May 17, 2017.

American Bar Association (2008), American Bar Association, Model Business Corporation Act: Official Text with Official Comment and Statutory Cross-references, Revised Through December 2007, American Bar Association.

An, X. et al. (2014), What is Subordination About? Credit Risk and Subordination Levels in Commercial Mortgage-backed Securities (CMBS), IRES Working Paper Series, IRES2014-002.

Andenas, M. and Wooldridge, F. (2009), European Comparative Company Law, Cambridge University Press. Cambridge.

Andersson, E. et al. (2009), Elinkeinoverolain kommentaari. 12. uudistettu painos, Talentum Media, Helsinki.

Andersson, S. et al. (2015), Aktiebolagslagen. En kommentar. Del I, Norstedts Juridik, Vanda.

Andersson, S. et al. (2015b), Aktiebolagslagen. En kommentar. Del II, Norstedts Juridik, Vanda.

Andersson, S. et al. (2015c), Aktiebolagslagen. En kommentar. Del III, Norstedts Juridik, Vanda.

Andersson, J. and Pehrson, L. (2008), Likhetsprincipen och generalklausulerna. Aktiebolagslagens minoritetsskydd, (red.), Carl Svernlöv, Stockholm Centre for Commercial Law, skriftserie nr 7, Västerås 2008.

Andersson, J. (2010), Kapitalskyddet i aktiebolag, Litteraturcompagniet, Stockholm.

Andoh, S.K. (2014), Essentials of Money, Banking and Financial Institutions: With Applications to the Developing World, Lexington Books. London.

Antoniou, A. et al. (2008), The Determinants of Capital Structure: Capital Market-oriented versus Bank-oriented Institutions, Journal of Financial and Quantitative Analysis, Vol. 43, March 2008, pp. 59-92.

Appelbaum, E. and Batt, R. (2016), Are Lower Private Equity Returns the New Normal? Center for Economic and Policy Research, June 2016.

Armour, J. (2006), Legal Capital: An Outdated Concept? European Business Organization Law Review, pp. 5-27.

Armour, J. (2005), Who Should Make Corporate Law? EC Legislation Versus Regulatory Competition, Institute for Law and Finance, Working paper series no. 41, 11/ 2005

Arnold, G. (2013), Corporate Financial Management, 5nd edition, Pearson, Harlow.

Arnold, G. (2010), Financial Times Handbook of Corporate Finance, 2nd edition, Prentice Hall, Harlow.

Arnull, A. and Chalmers, D. eds. (2015), The Oxford Handbook of European Union Law, Oxford University Press.

Arsht, S.S. (1976), A History of Delaware Corporation Law, Delaware Journal of Corporate Law, Volume 1, Number 1, pp. 1-22.

ASCG (2018), Articles of Association of the "ASCG - Accounting Standards Committee of Germany", July 2, 2018, available at https://www.drsc.de/app/uploads/2018/07/180702_Satzung_eng.pdf, accessed on November 17, 2018.

Ashraf, Q. et al. (2016), Banks, Market Organization, and Macroeconomic Performance: An Agent-Based Computational Analysis, available at https://ssrn.com/abstract=1849269, accessed on May 25, 2017.

Ashurst (2018), High yield bonds and leveraged loans: a convergence of terms, available at https://www.ashurst.com/en/news-and-insights/insights/high-yield-bonds-and-leveraged-loans-a-convergence-of-terms/, accessed on December 6, 2018.

Atherton, M. (2016), Traditional Banks Can Thrive in the Digital Age, March 14, 2016, an article available at https://internationalbanker.com/technology/traditional-banks-can-thrive-digital-age/, accessed on April 27, 2017.

Atiyah, P.S. (2003), The Rise and Fall of Freedom of Contract, Clarendon Press, Oxford.

Atiyah, P.S. and Smith, S.A. (2006), Atiyah's Introduction to the Law of Contract, Oxford University Press, New York.

Aughey, A. and Oakland, J. (2013), Irish Civilization: An Introduction, Routhledge. New York.

Bainbridge, S.M. (2015), Corporate Law, Third Edition, Foundation Press, New York.

Bachmann, G. et al. (2014), Regulating the Closed Corporation, De Gruyter, Göttingen.

Baglioni, A. (2016), The European Banking Union: A Critical Assessment, Palgrave Macmillan, London.

Bahillo, J. A. et al. (2016), The value in digitally transforming credit risk management, July, 2016, available at http://www.mckinsey.com/business-functions/risk/our-insights/the-value-in-digitally-transforming-credit-risk-management, accessed on April 27, 2017.

Baker, H-K. et al. (2011), Survey Research in Corporate Finance: Bridging the Gap Between Theory and Practice, Oxford University Press, New York.

Baker, H.K. et al. eds. (2015), Private Equity: Opportunities and Risks, Oxford University Press, New York.

Ball, R. (2006), International Financial Reporting Standards (IFRS): pros and cons for investors, Accounting and Business Research 36 (3), pp. 5-27.

Bank of America (2017), Corporate and Investment Banking, available at http://www.bofaml.com/en-us/content/global-corporate-investment-banking.html, accessed on May 18, 2017.

Bank, S.A. (2014), Historical Perspective on the Corporate Interest Deduction, 18 Chapman Law Review 29 (2014); UCLA School of Law, Law-Econ Research Paper No. 14-04, available at http://ssrn.com/abstract=2413968, accessed on May 18, 2017.

Banks, E. (1993), The Credit Risk of Financial Instruments, McMillan Press, London.

Barclay, M. J. and Smith, C. W. (1995), The priority structure of corporate liabilities, The Journal of Finance 50(3), pp. 899-917.

Barkan, S.M. et al. (2015), Fundamentals of Legal Research, Foundation Press, St. Paul, USA.

Bartl, H. et al. (2013), GmbH-Recht, C.F. Müller GmbH, Heidelberg.

Baudenbacher, C. ed. (2015), The Handbook of EEA Law, Springer.

Baums, T. (2011), Agio und sonstige Zuzahlungen im Aktienrecht, Institute for Law and Finance, Working paper series No. 123, 4/2011.

Bauweraerts, J. and Vandernoot, J. (2013), Allowance for corporate equity and tax aggressiveness: Do family firms differ from non-family firms?, Journal of Management Research, 5(3), pp. 1-16.

BBA (2016), BBA response to the European Commission's call for evidence initiative: EU regulatory framework for financial services, January 2016.

BCBS (2017), Basel Committee on Banking Supervision - overview, available at http://www.bis.org/publ/bcbsc111.htm, accessed on May 18, 2017.

BDO (2012), IFRS in practice, Accounting for convertible notes, BDO IFR Advisory Limited.

Bean, R. (2017), Is the Financial Industry Ripe for Disruption, Feb 24, 2017, an article available at https://www.forbes.com/sites/ciocentral/2017/02/24/is-the-financial-services-industry-ripe-for-disruption/#e8b822678af2, accessed on April 27, 2017.

Beatson, J. et al. (2016), Anson´s Law of Contract, Oxford University Press, Oxford.

Bebchuk, L.A. (1992), Federalism and the Corporation: The Desirable Limits on State Competition in Corporate Law. Harvard Law Review 105: 1435-1510.

Bech-Bruun and Lexidale (2013), Study on the Application of the Cross-Border Mergers Directive, September 2013, available at http://ec.europa.eu/justice/civil/files/131007_study-cross-border-merger-directive_en.pdf, accessed on August 14, 2017.

Becker, B. and Ivashina, V. (2016), Covenant-Light Contracts and Creditor Coordination, Sveriges Riksbank Research paper series 149.

Becker, R. and Helmann, T. (2003), The genesis of venture capital - lessons from the German experience, CESifo working paper no. 833.

Behr, B. and Schmidt, R.H. (2015), The German Banking System: Characteristics and Challenges, White Paper No. 32, SAFE, Frankfurt am Main, available at http://safe-frankfurt.de/fileadmin/user_upload/editor_common/Policy_Center/Behr_Schmidt_German_Banking_System.pdf, accessed on August 5, 2016.

Beinbridge, S.M. (2012), Mergers and Acquisitions, Foundation Press, New York.

Bellini, N. et al eds (2012), Regional Development Agencies: The Next Generation?: Networking, knowledge and regional policies, Routledge, New York.

Bender, M. (2011), Spatial Proximity in Venture Capital Financing: A Theoretical and Empirical Analysis of Germany, Gabler Verlag, Wiesbaden.

Bergström, C. and Samuelsson, P. (2015), Aktiebolagets grundproblem, Stockholm, Norstedts Juridik.

Berkery, D. (2008), Raising Venture Capital for the Serious Entrepreneur, McGraw-Hill.

Berk, J. and DeMarzo, P. (2017), Corporate Finance, 4th edition, Global Edition, Pearson.

Berle, A. A. and Means, G.C. (1932), The Modern Corporation and Private Property. Macmillan, New York.

Berrospide, J. M. and Edge, R. M. (2010), The Effects of Bank Capital on Lending: What Do We Know, and What Does It Mean?, Finance and Economics Discussion Series, Divisions of Research & Statistics and Monetary Affairs, Federal Reserve Board, Washington, D.C.

BFN (2016), Bokföringsnämnden, Bokföringsnämndens vägledning, Årsredovisning och Koncernredovisning K3, Vägledning till BFNAR 2012:1, Uppdaterad 2016-11-29.

Bhattacharya, S. (1979), Imperfect Information, Dividend Policy and the 'Bird in the Hand' Fallacy, The Bell Journal of Economics, Vol. 10, No.1, Spring, pp. 259-270.

Bicker, E.T. (2006), Creditor Protection in the Corporate Group. Working paper. University of Freiburg.

Birds, J. et al. eds. (2010), Annotated Companies Legislation, Oxford University Press, Oxford.

BIS (2017), Basel III: Finalising post-crisis reforms, available at https://www.bis.org/bcbs/publ/d424.htm, accessed on January 2, 2018.

BIS (2016), Basel III: international regulatory framework for banks, available at http://www.bis.org/bcbs/basel3.htm?m=3%7C14%7C572, accessed on October 3, 2016.

BIS (2015), Guidelines - Corporate governance principles for banks, July 2015, available at http://www.bis.org/bcbs/publ/d328.pdf, accessed on October 6, 2016.

BIS (2013), Basel III phase-in arrangements, available at http://www.bis.org/bcbs/basel3/basel3_phase_in_arrangements.pdf, accessed on September 28, 2016.

BIS (2006), International Convergence of Capital Measurement and Capital Standards, A Revised Framework Comprehensive Version, available at http://www.bis.org/publ/bcbs128.pdf, accessed on May 18, 2017.

BIS (1998), International Convergence of Capital Measurement and Capital Standards (July 1988, Updated to April 1998), available at http://www.bis.org/publ/bcbsc111.pdf, accessed on May 18, 2017.

Bjuvberg, J. (2014), Skattemässig hantering av "tvingande" konvertibler - en rättsfallskommentar, Svensk skattetidning 2 (2014), pp. 153-168.

Bjuvberg, J. (2010), Företagsekonomi för jurister - redovisning, räkenskapsanalys och kalkylering, Studentlitteratur, Lund.

Black, L.S. Jr (2007), Why Corporations choose Delaware, Delaware Department of State, Division of Corporations.

Black, B. and Kraakman, R. (1996), A Self-Forcing Model of Corporate Law, Harvard Law Review 109, pp. 1911-1981.

Blair, M.M. and Stout, L.A. (1999), A Team Production Theory of Corporate Law, Virginia Law Review 85, pp. 247-328.

Blouin, J. et al. (2014), Thin Capitalisation Rules and the Multinational Firm Capital Structure, IMF Working Paper, WP/14/12.

Boccuzzi, G. (2016), The European Banking Union: Supervision and Resolution, Palgrave Macmillan, Hampshire.

Bodie, Z. and Merton R. C. (2000), Finance, Upper Saddle River, New Jersey, Prentice Hall.

BoF (2016), Bank of Finland forecast, The Finnish economy is returning to growth, Bank of Finland Bulletin 3/2016, pp. 6-27.

BoF (2015), Bank of Finland forecast, Finland´s economic situation remains difficult, Bank of Finland Bulletin 5/2015, pp. 6-23.

Booth, R.A. and Hamilton R.W. (2014), Corporations, Sixth edition, West Publishing.

Booth, R.A. (2005), Capital Requirements in United States Corporate Law, available at http://digitalcommons.law.villanova.edu/cgi/viewcontent.cgi?article=1105&context=wps, accessed on June 20, 2017.

Borio, C. and Gambacorta, L. (2017), Monetary policy and bank lending in a low interest rate environment: diminishing effectiveness? BIS Working Papers No 612, Monetary and Economic Department , Bank for International Settlements.

Bradley, C. A. (2015), International Law in the U.S. Legal System, Oxford University Press, New York.

Bradley, M. and Roberts, M.R. (2015), The Structure and Pricing of Corporate Debt Covenants, available at http://finance.wharton.upenn.edu/~mrrobert/resources/Publications/DebtCovenantsQJF2015.pdf, accessed on June 20, 2017.

Brand, O. (2007), Conceptual Comparisons: Towards a Coherent Methodology of Comparative Legal Studies, Brooklyn Journal of International Law, Volume 32, Issue 2, pp. 405-466.

Bratton, W.W. (2006), Bond Covenants and Creditor Protection: Economics and Law, Theory and Practice, Substance and Process, available at http://scholarship.law.georgetown.edu/cgi/viewcontent.cgi?article=1575&context=facpub, accessed on June 20, 2017.

Brav, O. (2009), Access to capital, capital structure, and the funding of the firm, Journal of Finance 64, pp. 263-308.

Brealey, R. A. et al. (2014), Principles of Corporate Finance, Global Edition, McGraw-Hill.

Breuer, T. (2017), What conclusions can be drawn from the EBA 2016 Market Risk Benchmarking Exercise? European Union, available at http://www.europarl.europa.eu/RegData/etudes/IDAN/2017/602103/IPOL_IDAN(2017)602103_EN.pdf, accessed on January 2, 2018.

Brezski, E. et al. (2006), Mezzanine-Kapital für den Mittelstand - Finanzierungsinstrumente, Prozesses, Rating, Bilanzierung, Recht. Stuttgart.

Bridges, J. et al. (2015), The Impact of Capital Requirements on Bank Lending, Bank of England, Working Paper no. 486.

Brinlee, J.B., Bell, J.R. and Bullock, C.A. (2004), Educating entrepreneurs on angel venture capital financing options, Journal of Business and Entrepreneurship, Vol. 16, No. 2, October 2004, pp. 141-152.

British Business Bank (2016), Annual Report and Accounts 2016, available at https://annualreport2016.british-business-bank.co.uk/uploads/documents/BBB-Annual-Report-2016_tagged.pdf, accessed on June 21, 2017.

British Business Bank (2016b), Corporate information and subsidiary companies, available at http://british-business-bank.co.uk/corporate-information/, accessed on June 21, 2017.

British Business Bank (2016c), What we do, available at http://british-business-bank.co.uk/what-the-british-business-bank-does/, accessed on June 21, 2017.

British Business Bank (2016d), The business finance guide, available at https://thebusinessfinanceguide.co.uk/wp-content/uploads/2016/06/thebusinessfinanceguide2016.pdf, accessed on June 21, 2017.

Brokamp, J. et al. (2011), Mezzanine-Finanzierungen, Vahlen, München.

Brown, P. (2012), Debt-Equity Conundrum, Cahiers de Droit droit fiscal international vol. 97b, International Fiscal Association, Amersfoort 2012, General Report, pp. 19-43.

Brownsword, R. (2006), Contract law. Themes for the twenty-first century, 2nd edition. Oxford University Press, Oxford.

Brunner, A. et al. (2004), Germany's Three-Pillar Banking System: Cross-Country Perspectives in Europe, IMF Occassional Paper No.233.

Buettner, T. et al. (2012), The Impact of Thin-Capitalization Rules on the Capital Structure of Multinational Firms, available at http://www.finanzwissenschaft.wiso.uni-erlangen.de/uploads/thincap_final.pdf, accessed on June 21, 2017.

Bürgers, T. and Körber, T. (2017), Aktiengesetz, 4. Auflage, C.F. Müller, München.

Burns, T. (2007), Structured Finance and Football Clubs: an Interim Assessment of the Use of Securitisation, The Entertainment and Sports Law Journal, 2007, 4.3., available at http://www.entsportslawjournal.com/articles/10.16997/eslj.80/, accessed on June 21, 2017.

Bußalb, J.P. (2015), Subordinated loans and loans with profit participation: BaFin urges caution in connection with capital raising, available at https://www.bafin.de/SharedDocs/Veroeffentlichungen/EN/Fachartikel/2015/fa_bj_1503_nachrangdarlehen_en.html, accessed on June 21, 2017.

BVCA (2016), Why join the BVCA?, available at http://www.bvca.co.uk/Membership/WhyJointheBVCA.aspx, accessed on June 21, 2017.

BVCA (2016b), BVCA Private Equity and Venture Capital Report on Investment Activity 2015, Autumn 2016, British Private Equity & Venture Capital Association, available at https://www.bvca.co.uk/Portals/0/library/documents/BVCA%20RIA%202015.pdf?ver=2016-09-01-124840-343, accessed on June 21, 2017.

BVCA (2012), A Guide to Private Equity, available at http://www.bvca.co.uk/Portals/0/library/Files/Website%20files/2012_0001_guide_to_private_equity.pdf, accessed on June 21, 2017.

BVK (2017), Private Equity in Deutschland, available at http://www.bvkap.de/markt/interaktive-charts#Private_Equity_in_Deutschland, accessed on June 21, 2017.

BVK (2017b), BVK: Overall market remains solid, venture capital continues its upswing, available at http://www.bvkap.de/en/presse/pressemitteilungen/2017-02-27/bvk-overall-market-remains-solid-venture-capital-continues, accessed on June 21, 2017.

BVK (2017c), Who we are, available at http://www.bvkap.de/en/bvk/who-we-are, accessed on June 21, 2017.

Båvestam, U. (2001), Aktiebolagsstyrelsens möjligheter att delegera sina uppgifter med ansvarsreducerande verkan. Jurisdisk Tidskrift, Nr 2 2001/02, pp. 252-277.

Bärsch, S.-E. (2012), Taxation of Hybrid Financial Instruments and the Remuneration Derived Therefrom in an International and Cross-border Context: Issues and Options for Reform, Springer.

Bärsch, S.-E. and Spengel, C. (2013), Hybrid Mismatch Arrangements: OECD Recommendations and German Practice, Bulletin for International Taxation, Volume 67, No 10.

Cabinet Office (2011), The Cabinet Manual, 1st edition, London.

Cahn, A. and Donald, D.C. (2010), Comparative Company Law, Cambridge University Press, New York.

Camfferman, K. and Zeff, S.A. (2007), Financial reporting and global capital markets. A history of the International Accounting Standards Committee, 1973-2000, Oxford University Press, Oxford.

Campbell, D. ed. (2009), The Comparative Law Yearbook of International Business, Volume 31, 2009, Kluwer Law International, The Netherlands.

Cary, W. (1974), Federalism and Corporate Law: Reflections upon Delaware, The Yale Law Journal, Volume 83, Number 4, March 1974, pp. 663-705.

Cetindamar, D. ed. (2003), The Growth of Venture Capital: A Cross-cultural Comparison, Praeger, Westport.

Chambers & Partners (2018), Banking & Finance 2019, available at https://practiceguides.chambers.com/practice-guides/banking-finance-2019, accessed on December 6, 2018.

Chatterjee, R. (2014), Practical Methods of Financial Engineering and Risk Management: Tools for Modern Financial Professionals, Springer, New York.

Cherednychenko, O. (2007), A Comparative Analysis of the Constitutionalisation of Contract Law, with Emphasis on Risky Financial Transactions Fundamental Rights, Contract Law and the Protection of the Weaker Party. Sellier. München.

Cheffins, B.R. (2003), Mergers and Corporate Ownership Structure: The United States and Germany at the turn of the 20th Century, American Journal of Comparative Law, 2003, 51.3, pp. 473-503.

Cheffins, B.R. (2001), Law as Bedrock: The Foundations of an Economy Dominated by Widely Held Public Companies, available at https://www.researchgate.net/profile/Brian_Cheffins/publication/228213022_Law_as_Bedrock_The_Foundations_of_an_Economy_Dominated_by_Widely_Held_Public_Companies/links/02e7e5305c2937833a000000.pdf, accessed on June 27, 2017.

Chen, R. and Hanson, J. (2004), The Illusion of Law: The Legitimating Schemas of Modern Policy and Corporate Law. Michigan Law Review, Vol 103:1, October 2004.

Chew, D.H. ed. (2001), The New Corporate Finance: Where Theory Meets Practice, McGraw-Hill, New York.

Chofaras, D.N. (2004), Economic Capital Allocation with Basel II: Cost, Benefit and Implementation Procedures, Elservier Butterworth-Heinemann, Oxford.

Choudhry, M. (2011), Structured Credit Products: Credit Derivatives and Synthetic Securitisation. John Wiley & Sons.

Citigroup (2017), Investment Banking, available at http://icg.citi.com/icg/corporateandinvestmentbanking/invest_banking.html, accessed on May 18, 2017.

CJEU (2017), Court of Justice of the European Union, General Presentation, available at http://curia.europa.eu/jcms/jcms/Jo2_6999/, accessed on May 17, 2017.

CJEU (2017b), Court of Justice of the European Union, Presentation, available at http://curia.europa.eu/jcms/jcms/Jo2_7024/, accessed on May 17, 2017.

Clarke, M.A. et al. (2017), Commercial Law: Text, Cases, and Materials, Oxford University Press, Oxford.

Coffee, J.C. (2006), Gatekeepers: The Professions and Corporate Governance, Oxford University Press, Oxford.

Coffee, J.C. (1999), The Future as History: The Prospects for Global Convergence in Corporate Governance and Its Implications. Columbia Law School Center for Law and Economic Studies Working Paper No. 144.

Collins, H. (2013), The Vanishing Freedom to Choose a Contractual Partner, Law and Contemporary Problems, Vol 76, No. 2, pp 71-88.

Collins, H. (2004), The Freedom to Circulate Documents: Regulating Contracts in Europe, European Law Journal, 10 (6), pp. 783-803.

Crawford, L. et al. (2014), Control over accounting standards within the European Union: the political controversy surrounding the adoption of IFRS 8. Critical Perspectives on Accounting, Volume 25, Issues 4-5, July 2014, pp. 304-318.

Colombi Ciacchi, A. (2012), Party autonomy as a fundamental right in the European Union, Acta Universitatis George Bacovia, Juridica Bacau 1, 2012, pp. 68-79.

Coopey, R. and Clarke, D. (1995), 3i: Fifty Years Investing in Industry, Oxford University Press, Oxford.

Cooter, R. and Ulen, T. (2016), Law and Economics, 6th edition, Berkeley Law Books. Book 2, available at http://scholarship.law.berkeley.edu/cgi/viewcontent.cgi?article=1001&context=books, accessed on May 3, 2017.

Cornelli, F. and Yosha, O. (2003), Stage financing and the role of convertible debt, Review of Economics Studies, 2003, 70, pp. 1-32.

Corporate Laws Committee (2017), Model Business Corporation Act (2016 Revision), The Business Lawyer, Vol. 72, Spring 2017, pp. 1-10.

Coyle, B. (2000), Venture Capital & Buyouts, Fitzroy Dearborn Publishers, Chicago.

Cracogna, D. et al. eds (2013), International Handbook of Cooperative Law, Springer, Heidelberg

Craig, P. and de Burca, G. (2015), EU Law: Text, Cases and Materials. Sixth edition. Oxford University Press. Oxford.

Cranston, R. (2002), Principles of Banking Law. Oxford University Press. Oxford.

Cross, F.B. and Prentice, R.A. (2007), Law and Corporate Finance, MPG Books, Bodmin, Cornwall.

Culp, S. (2013), Final Volcker Rule Leaves Banks Facing Compliance Hurdles, Dec 17, 2013, an article available at http://www.forbes.com/sites/steveculp/2013/12/17/final-volcker-rule-leaves-banks-facing-compliance-hurdles/#7e0d26a24662, accessed on October 5, 2016.

Cumming, D. ed. (2012), The Oxford Handbook of Venture Capital, OUP, New York.

Cumming, D. ed. (2012b), The Oxford Handbook of Private Equity, OUP, New York.

Cumming, D. ed. (2010), Venture Capital: Investment Strategies, Structures, and Policies, John Wiley & Sons, Inc., Hoboken, New Jersey,

Cumming, D. and Johan, S. (2014), Venture Capital and Private Equity Contracting: An International Perspective, Elsevier.

Darbellay, A. (2013), Regulating Credit Agencies, Edward Elgar Publishing, Cheltenham, UK.

Da Rin, M. et al. (2011): A survey of venture capital research, Working Paper 17523, National Bureau of Economic Research.

David, R. (1978), Major legal systems in the world today: an introduction to the comparative study of law, Simon and Schuster, New York.

Davies, P. and Worthington, S. (2012), Gower and Davies: Principles of Modern Company Law, 9th edition. Sweet & Maxwell. London.

Davis, D. et al. eds. (2015), An Inquiry into the Existence of Global Values: Through the Lens of Comparative Constitutional Law, Hart Publishing, Oxford and Portland, Oregon.

DeAngelo, H. et al. (2011), Capital structure dynamics and transitory debt, Journal of Financial Economics, 2011, Vol. 99, Issue 2, pp. 235-261.

DEG (2016), DEG: About us, available at https://www.deginvest.de/International-financing/DEG/Über-uns/, accessed on June 30, 2017.

DEG (2016b), What we do, available at https://www.deginvest.de/International-financing/DEG/Über-uns/Was-wir-tun/, accessed on June 30, 2017.

DEG (2016c), DEG: Financing opportunities - shaping development, available at https://www.deginvest.de/DEG-Documents-in-English/Download-Center/DEG_Brochure_EN_2013.pdf, accessed on June 30, 2017.

DEG (2016d), Our solutions for corporates, available at https://www.deginvest.de/International-financing/DEG/Unsere-Lösungen/Unternehmen/Unsere-Lösungspakete-für-Unternehmen/, accessed on June 30, 2017.

Deloitte (2017), Issuers' accounting for debt and equity capital transactions: Key differences between U.S. GAAP and IFRSs, available at https://www.iasplus.com/en-us/standards/ifrs-usgaap/debt-eqcaptr, accessed on September 20, 2017.

Deloitte (2017b), IAS 7 — Statement of Cash Flows, available at https://www.iasplus.com/en/standards/ias/ias7, accessed on September 11, 2017.

Deloitte (2017c), IAS 32 — Financial Instruments: Presentation, available at https://www.iasplus.com/en/standards/ias/ias32 , accessed on September 28, 2017.

De Luca, N. (2017), European Company Law, Cambridge University Press, Cambridge.

Department for Exiting the European Union (2017), Legislating for the United Kingdom's withdrawal from the European Union, March 2017, available at https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/604516/Great_repeal_bill_white_paper_accessible.pdf, accessed on May 11, 2015.

Destatis (2017), Umsatzsteuerstatistik (Voranmeldungen), available at https://www.destatis.de/DE/ZahlenFakten/GesellschaftStaat/OeffentlicheFinanzenSteuern/Steuern/Umsatzsteuer/Tabellen/Voranmeldungen_Rechtsformen.html, accessed on April 1, 2017.

Detzer, D. et al. (2013), The German Financial System, Studies in Financial Systems No 3, Financialisation, Economy, Society & Sustainable Development (FESSUD) Project, 2013.

De Vries, S. et al. eds. (2015), The EU Charter of Fundamental Rights as a Binding Instrument: Five Years Old and Growing, Hart Publishing, Oxford.

DGCL (2017), Title 8, Corporations, available at http://delcode.delaware.gov/title8/title8.pdf, accessed on May 17, 2017.

Dotevall, R. (2015), Aktiebolagsrätt: fördjupning och komparativ belysning, 1. uppl., Norstedts juridik, Stockholm.

Dotevall, R. (2008), Bolagsledningens skadeståndsansvar, upplaga 2, Norstedts juridik, Stockholm.

Drezner, D.W. (2014), The System Worked: How the World Stopped Another Great Depression, Oxford University Press, New York.

Drury, R. (2005), A European Look at the American Experience of the Delaware Syndrome", 5 JCLS 1, pp. 1-35.

Dörr, O. and Schmalenbach, K. eds. (2018), Vienna Convention on the Law of Treaties: A Commentary, Springer.

Easterbrook, F.H. and Fischel, D.R. (1991), The Economic Structure of Corporate Law, Harvard University Press, Cambridge, Massachusetts.

Eberle, E.J. (2009), The Method and Role of Comparative Law, 8 Washington University Global Studies Law Review, Volume 8, Number 3, 2009, pp. 451-486, available at http://openscholarship.wustl.edu/cgi/viewcontent.cgi?article=1088&context=law_globalstudies, accessed on May 4, 2017.

EBF (2016), EBF Response to the European Commission consultation: "Call for evidence: EU regulatory framework for financial services", European Banking Federation, 31 January 2016 - OT, available at http://www.ebf-fbe.eu/wp-content/uploads/2016/02/EBF_019203-EBF-Response-call-for-evidence-.pdf, accessed on October 6, 2016.

EBF (2016b), Innovate. Collaborate. Deploy.- The EBF vision for banking in the Digital Single Market, available at http://www.ebf-fbe.eu/wp-content/uploads/2016/11/EBF-vision-for-banking-in-the-Digital-Single-Market-October-2016.pdf, accessed on April 27, 2016.

Ebge, W.F. (1997), Company Law and the European Union: Centralized Versus Decentralized Lawmaking, The International Lawyer, pp. 961-986.

ECB (2018), The digitalisation of banking - supervisory implications, Speech by Pentti Hakkarainen, Member of the Supervisory Board of the ECB, at the Lisbon Research Centre on Regulation and Supervision of the Financial Sector Conference, Lisbon, 6 June 2018, available at https://www.bankingsupervision.europa.eu/press/speeches/date/2018/html/ssm.sp180606.en.html, accessed on January 3, 2019.

ECB (2017), Guidance on leveraged transactions, available at https://www.bankingsupervision.europa.eu/ecb/pub/pdf/ssm.leveraged_transactions_guidance_201705.en.pdf, accessed on August 24, 2017.

ECB (2017b), Press release: ECB publishes guidance to banks on leveraged transactions, available at https://www.bankingsupervision.europa.eu/press/pr/date/2017/html/ssm.pr170516.en.html, accessed on August 24, 2017.

ECB (2016), What is the SREP?, available at https://www.bankingsupervision.europa.eu/about/ssmexplained/html/srep.en.html, accessed on October 4, 2016

ECB (2016b), The euro area bank lending survey, available at https://www.ecb.europa.eu/pub/pdf/scpops/ecbop179.en.pdf, accessed on October 12, 2017.

ECB (2015), European Central Bank, Banking supervision, Legal Framework for Banking Supervision, Volume III, November 2015

Edwards, C. (2009), Freedom of Contract and Fundamental Fairness for Individual Parties: The Tug of War Continues, UMKC Law Rev, Vol. 77:3, pp. 647-654.

Edwards, V. (1999), EC Company Law, Oxford University Press, Oxford.

Eidenmüller, H. (2011), Why Withdrawal Rights?, European Review of Contract Law, Volume 7, 1/2011, pp. 1-24, available at https://epub.ub.uni-muenchen.de/25816/1/Eidenmueller_25816.pdf, accessed on December 19, 2018.

Eisenberg, M. A. (2018), Foundational Principles of Contract Law, Oxford University Press, New York

Epstein, R.A. (1997), Contracts Small and Contract Large: Contract Law Through the Lens of Laissez-Faire, Coase-Sandor Institute for Law & Economics, Working Paper No. 49, 1997.

Essers, P. et al. (2009), The Influence of IAS/IFRS on the CCCTB, Tax Accounting, Disclosure and Corporate Law Accounting Concepts, Kluwer International Law.

EstVCA (2017), available at http://www.estvca.ee/members, accessed on June 30, 2017.

EstVCA (2015), Estonian Private Equity & Venture Capital Industry Review 2014, http://www.estvca.ee/data-and-publications, accessed on May 26, 2016.

Etzkowitz, H. (2002), MIT and the Rise of Entrepreneurial Science, Routledge, London.

EVCA (2015), Central and Eastern Europe Statistics 2014, An EVCA Special Paper edited by the EVCA Central and Eastern Europe Task Force, August 2015.

EVCA (2010), Private Equity Fund Structures in Europe, An EVCA Tax & Legal Committee Special Paper - June 2010.

EY (2016), Banking Capital Markets Regulatory Updates, Market Abuse Directive (MAD) - What you need to know, EYGM Limited.

EY (2015), Financial reporting developments, A comprehensive guide, Issuer's accounting for debt and equity financings, October 2015, Ernst & Young LLP.

EY (2015b), Global Regulatory Network Executive Briefing, 21 January 2015, EYGM Limited.

EY (2014), 2014 Risk management survey of major financial institutions, Shifting focus: Risk culture at the forefront of banking, 2014 EYGM Limited.

Fabozzi, F.J. (2015), Capital Markets: Institutions, Instruments, and Risk Management, MIT.

Fagerstedt, J. and Kukkonen, M. (2015), Pääomalaina tuloverotuksessa: vierasta pääomaa vaiko omaa? Verotus 2/2015, pp. 185-195.

Fama, E.F. and French, K.R. (2005), Financing Decisions: Who Issues Stock, Journal of Financial Economics, Vol. 76, Issue 3, pp. 549-582.

Fama, E.F. and French, K.R. (2002), Testing Trade-Off and Pecking Order Predictions about Dividends and Debt, Review of Financial Studies 15, pp. 1-33.

Farrar, J., and A. Mawani, A. (2008), Debt-Equity Limitations in Thin Capitalization Rules: Canadian Evidence. CAAA 2008 Annual Conference Paper.

Fazio, S. (2007), The Harmonization of Internation Commercial Law, Kluwer Law International, The Netherlands.

Federal Reserve (2016), Large Commercial Banks as of September 30, 2016, available at https://www.federalreserve.gov/releases/lbr/current/default.htm, accessed on May 18, 2017.

Federal Reserve (2013), Interagency Guidance on Leveraged Lending, March 21, 2013, available at https://www.federalreserve.gov/supervisionreg/srletters/sr1303a1.pdf, accessed on August 24, 2017.

Feldman, D. (2009), English Public Law, Oxford University Press, Oxford.

Ferran, E. (1999), Company Law and Corporate Finance, Oxford University Press, Oxford.

Ferran, E. and Ho, L.C. (2014), Principles of Corporate Finance Law, Oxford University Press, Oxford.

FFI (2016), The Federation of Finnish Financial Services (FFI), http://www.finanssiala.fi/en/ financial-services/banks/Pages/default.aspx, accessed on July 8, 2016

FFI (2016b), The Federation of Finnish Financial Services (FFI), Banking group employees and offices 31 Dec 2015 and 31 Dec 2014, http://www.finanssiala.fi/en/statistics/FK-Tilasto-Banking-group-employees-and-offices-2015.pdf, accessed on July 8, 2016.

FFI (2016c), The Federation of Finnish Financial Services (FFI), Finnish Banking in 2015, Financial overview of Finnish banks, available at http://www.finanssiala.fi/en/material/Finnish Banking_2015.pdf, accessed on August 1, 2016.

Finanssiala (2016), ”Basel IV” heikentäisi pankkien kykyä luotottaa talouden kasvua, available at http://www.finanssiala.fi/uutismajakka/Sivut/Basel_IV.aspx, accessed on November 1, 2017.

Finantsinspektsioon (2017), Estonian financial services market as at 31 December 2016.

Finch, V. (2002), Corporate Insolvency Law. Perspectives and Principles. Cambridge University Press, Cambridge.

Finnish Corporate Governance Code (2015), Securities Market Association.

Finnvera (2016), Finnvera Investor Presentation, Finland's Export Credit and SME Financing Agency, June 2016, available on https://www.finnvera.fi/eng/Finnvera/Investors/ Introduction, accessed on August 8, 2016.

Finnvera (2016b), Statement on the Corporate Governancen and Steering System 2016, available on http://annualreport2016.finnvera.fi/media/hallinto_ja_ohjausjarjestelma_2016_en.pdf, accessed on July 3, 2017.

Finnvera (2016c), Products, available on https://www.finnvera.fi/eng/Products/Loans/Growth-Loan, accessed on August 8, 2016.

Finnvera (2016d), The Growth Loan for faster growth and internationalisation, available on https://www.finnvera.fi/eng/Finnvera/Newsroom/News/The-Growth-Loan-for-faster-growth-and- internationalisation, accessed on August 8, 2016.

Fischer, H. and Lohbeck, A. (2012), Debt-Equity Conundrum, Cahiers de Droit droit fiscal international vol. 97b, International Fiscal Association, Amersfoort 2012, Germany, pp. 307-327.

Flannery, M.J. and Rangan, K.P. (2006), Partial Adjustment toward Target Capital Structures, Journal of Financial Economics, Volume 79, Issue 3, March 2006, pp. 469-506.

Fleischer, H. (2015), A Guide to German Company Law for International Lawyers - Distinctive Features, Particularities, Idiosyncracies, Max Planck Private Law Reasearch Paper No. 15/8.

Fohlin, C. (2006), Venture Capital Revolutions: Germany and the United States in the Post-War Era.

Foster, N.G. and Sule, S. (2010), German Legal System and Laws, Oxford University Press, Oxford.

FRA (2015), European Union Agency for Fundamental Rights Luxembourg, Publications Office of the European Union. Luxembourg.

Fraser, S. et al. (2015), What do we know about entrepreneurial finance and its relationship with growth?, International Small Business Journal 2015, Vol. 33(1), pp. 70-88.

Franzke, S. et al. (2003), Initial Public Offerings and Venture Capital in Germany, No. 2003/26, Center for Financial Studies an der Johann Wolfgang Goethe-Universität.

Frodermann, J. and Jannott, D. (2017), Handbuch des Aktienrechts, C.F. Müller GmbH, Heidelberg.

Fuller, G. (2006), Corporate Borrowing: Law and Practice, Jordan Publishing, Bristol.

FVCA (2017), available at http://www.fvca.fi/en/fvca, accessed on July 6, 2017.

FVCA (2017b), available at http://www.fvca.fi/files/1323/Buyout_Suomessa_2016_alustavat.pdf, accessed on July 6, 2017.

FVCA (2017c), available at http://www.fvca.fi/files/1291/VC_Suomessa_2016_alustavat.pdf, accessed on July 6, 2017.

FVCA (2016), available at
http://www.fvca.fi/files/1159/VC_PE_Industry_in_Finland_2015.pdf, accessed on July 6, 2017.

Företagsskattekomitten (2014), SOU 2014:40, Neutral bolagsskatt: för ökad effektivitet och stabilitet: slutbetänkande. Stockholm.

Gabor, B. (2013), Regulatory Competition in the Internal Market: Comparing Models for Corporate

Law, Securities Law and Competition Law, Edward Elgar Publishing Limited, Cheltenham.

Garantia (2016), Garantia Insurance Company, available at http://www.garantia.fi/en/about- us/company-profile, accessed on August 8, 2016.

Garantia (2016b), Garantia Insurance Company Ltd, Report By The Board Of Directors And Financial Statements 2015, available at http://www.garantia.fi/images/garantia_vk-2016/FinancialReport2015.pdf, accessed on August 8, 2016.

Garantia (2016c), Garantia Insurance Company, available at http://www.garantia.fi/en/our-services/loan-guaranties, accessed on August 8, 2016.

Garrett, R. (1950), History, purpose and summary of the Model Business Corporation Act, The Business Lawyer, Vol. 6, No. 1 (November 1950), pp. 1-7.

Geens, K. and Hopt, K.J. eds (2003), The European Company Law Action Plan Revisited: Reassessment of the 2003 priorities of European Commision, Leuven University Press.

Gevurtz, F. (2010), Gevurtz's Corporation Law, West Academic, Saint Paul, Minnesota, USA.

Ghosh, A. (2012), Managing Risks in Commercial and Retail Banking, John Wiley & Sons, Singapore.

Gilani, S.R.S. (2011), The 'Doctrine of Ultra Vires' and its Subsequent Development in the Frame Work of Company Law, SSRN Electronic Journal, October 2011.

Goddard, D. (1998), Corporate Personality - Limited Recourse and its Limits, pp. 11-64, in Grantham, R. and Rickett, C. eds, Corporate Personality in the 20th Century, Hart Publishing, Oxford.

Gompers, P.A. (1994), The Rise and Fall of Venture Capital, Business and economic history, Volume 23, no. 2, pp. 1-26.

Gompers, P.A. and Lerner, J. (2004), The Venture Capital Cycle. MIT Press, Cambridge, MA.

Goode, R. (2011), Principles of Corporate Insolvency Law, 4nd ed. Sweet & Maxwell, London

Gordon, M. J. and Chamberlin, T. (1994), Neoclassical Theory on Capital Structure" in Finance, Investment and macroeconomics edited by M.J Gordon (1994), chapter 4, pp. 47-58.

GovUK (2017), Corporation Tax rates and reliefs, available at
https://www.gov.uk/corporation-tax-rates/allowances-and-reliefs , accessed on May 18, 2017.

Gray, K. et al. (2016), Practical impediments to convergence of US GAAP and IFRS, European Scientific Journal, ESJ 11.10, 2016, pp. 181-191.

Green, C.J. et al. (2002), Corporate Financial Structures in India, Economic Research Paper No. 02/4 Institute for Development Policy and Management, University of Manchester.

Green, M.B. ed. (1991), Venture Capital: International Comparions, Routledge, London.

Green, R.C. (1984), Investment incentives, debt, and warrants, Journal of Financial Economics, Vol 13, Issue 1, pp. 115-136.

Gregoriou, G. N. et al. eds (2007), Venture Capital in Europe, Elsevier, Oxford.

Griffin, J.M. and Dragon Y.T. (2012), "Did subjectivity play a role in CDO credit ratings?" The Journal of Finance 67(4), pp. 1293-1328.

Grundmann, S. (2011), The Future of Contract Law, European Review of Contract Law 7 (2011), Heft 4, pp. 490-527.

Grundmann, S. (2007), European Company Law, Intersentia, Antwerpen-Oxford.

Gullifer, L. and Payne, J. (2015), Corporate Finance Law: Principles and Policy. Bloomsbury Publishing.

Haaramo, V. (2012), Kansainvälinen tilinpäätöskäytäntö IFRS-raportointi, Sanoma Pro Oy, Helsinki.

Hanks, J.J. (2011), Legal Capital And The Model Business Corporation Act: An Essay For Bayless Manning, Law And Contemporary Problems, Vol. 74:211, Winter 2011, pp. 211-230.

Hannigan, B. (2015), Company Law, 4th edition.Oxford University Press, Oxford.

Hansmann, H. and Kraakman, R. (2001), The End of History for Corporate Law, Georgetown Law Journal 89, pp. 439-468.

Harris, P. (2013), Corporate Tax Law: Structure, Policy and Practice, Cambridge University Press, Cambridge.

Harris, R.S. et al. (2015), How Do Private Equity Investments Perform Compared to Public Equity?, Darden Business School Working Paper No. 2597259.

Hartley, T.C. (2014), The Foundations of European Union Law, Eight Edition, Oxford University Press, Oxford.

Hawk, B. E. ed. (2015), International Antitrust Law and Policy: Fordham Competition Law Institute. Huntington.

Hellmann, T. et al. (2008), Building relationships early: Banks in venture capital, Review of Financial Studies 21.2 (2008), pp. 513-541.

Helminen, M. (2010), The International Tax Law Concept of Dividend, Kluwer Law International.

Helsingin Sanomat (2016), OP:n välirahoituksella vähän asiakkaita, July 31, 2016, p. B12.

Hemmelgran, T. and Nicodeme, G. (2010). The 2008 Financial Crisis and Taxation Policy, Office for Official Publications of the European Communities, Luxembourg.

Henry, C. P. (2016), The Volcker Rule and the Presumption Against Extraterritoriality: Utterly Incompatible, William & Mary Business Law Review, Volume 7, pp. 825- 854.

Hilling, A. and Vilhelmsson A. (2015), Equal taxation as a basis for classifying financial instruments as debt or equity-a Swedish case study, eJournal of Tax Research, Volume 13, Number 3, December 2015 (2015), pp. 677-715.

HM Revenue & Customs (2017), CFM95000: Interest restriction: Contents, available at https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/605134/corporate_Interest_Restriction_Draft_Guidancefinal.pdf , accessed on May 18, 2017.

HM Revenue & Customs (2016), Transfer pricing: the main thin capitalisation legislation: Overview, available at http://www.hmrc.gov.uk/manuals/intmanual/intm413010.htm, accessed on May 17, 2017.

HM Revenue & Customs (2016b), CFM38010 - Loan relationships: tax avoidance: overview: unallowable purpose and non-arm's length transactions, available at http://www.hmrc.gov.uk/MANUALS/cfmmanual/cfm38010.htm, accessed on May 17, 2017.

HM Revenue & Customs (2016c), INTM511015, Thin capitalisation: practical guidance: introduction: what is thin capitalisation?, available at https://www.gov.uk/hmrc-internal-manuals/international-manual/intm511015, accessed on May 17, 2017.

HM Revenue & Customs (2016d), Policy paper Taxing multinationals: how international transfer pricing rules work, Updated 1 March 2016, available at https://www.gov.uk/government/publications/taxing-multinationals-transfer-pricing-rules/taxing-multinationals-how-international-transfer-pricing-rules-work, accessed on May 17, 2017.

HM Treasury (2016), Closed consultation, Tax deductibility of corporate interest expense: Consultation, Updated 6 January 2016, available at https://www.gov.uk/government/consultations/tax-deductibility-of-corporate-interest-expense/tax-deductibility-of-corporate-interest-expense-consultation, accessed on May 17, 2017.

Holmström, B. and Tirole, J. (2011), Inside and outside liquidity. MIT press.

Holmström, B. and Tirole, J. (1989), The theory of the firm. Handbook of industrial organization 1, pp. 61-133.

Honkamäki, T. and Pennanen, M. (2010), Yritysjärjestelyjen käsikirja - kirjanpito, verotus ja yhtiöoikeus, WSOYpro, Juva.

Hook, M. (2016), The Choice of Law Contract, Hart Publishing, Portland, Oregon

Hopt, K.J. (2015), Corporate Governance in Europe A Critical Review of the European Commission's Initiatives on Corporate Law and Corporate Governance, ECGI Working Paper Series in Law, Law Working Paper N° 296/2015 August 2015.

Hopt, K.J. and Wymeersch, E. eds (2003), Capital Markets and Company Law. OUP.

Hopwood, A.G. (1994), Some reflections on the harmonization of accounting within the EU. The European Accounting Review 1994;3, pp. 241-253.

Hou, D. and Skeie, D. (2014), LIBOR: Origins, Economics, Crisis, Scandal, and Reform. Federal Reserve Bank of New York Staff Reports. Staff Report No. 667, March 2014.

Hsu, D. H. and Kenney, M. (2005), Organizing Venture Capital: The Rise and Demise of American Research & Development Corporation, 1946-1973, Industrial and Corporate Change, 14 (4) 2005, pp. 579-616.

Huber, W. D. (2016), Can A Not-For-Profit Membership Corporation Be Created As A "Shell" Corporation, Liberty University Law Review, Volume, Issue 1, Article 2.

Huizinga, H. et al. (2008), Capital structure and international debt shifting. Journal of Financial Economics, 88(1), pp. 80-108.

Husa, J. (2016), The Future of Legal Families, available at http://www.oxfordhandbooks.com/view/10.1093/oxfordhb/9780199935352.001.0001/oxfordhb-9780199935352-e-26, accessed on April 30, 2018.

Husa, J. (2015), A New Introduction to Comparative Law, Hart Publishing, Oxford and Portland, Oregon.

Husa, J. (2013), Oikeusvertailu, Lakimiesliiton Kustannus, Viro 2013.

Husa, J. (2013b), Functional Method in Comparative Law - Much Ado About Nothing?, EPLJ 2013; Vol. 2 No. 1, available at https://ssrn.com/abstract=2708717, accessed on May 20, 2018.

Husa, J. (2010), The Constitution of Finland: A Contextual Analysis, Hart Publishing, Oxford and Portland, Oregon.

Husa, J. (2004), Classification of Legal Families Today - Is it Time for Memorial Hymn?, Revue internationale de droit comparé 56.1, pp. 11-38.

Hyun, J.S. and Rhee, B.K. (2011), Bank Capital Regulation and Credit Supply, Journal of Banking & Finance, Vol. 35(2), pp. 323-330.

Iannotta, G. (2010), Investment Banking: A Guide to Underwriting and Advisory Services, Springer, Heidelberg.

IAS Standards as of January 1, 2017.

IFC (2011), Corporate and SME workouts: A Manual of Best Practisies, International Finance Corporation, June 2011, Washington, DC, USA.

IFRS (2017), Global Standards for the world economy, available at http://www.ifrs.org/Pages/default.aspx, accessed on May 17, 2017.

IFRS Foundation (2017), IFRS Application around the world, Jurisdictional profile: United States of America.

IFRS Foundation (2016), IFRS Application around the world, Jurisdictional profile: Finland.

IFRS Foundation (2016b), IFRS Application around the world, Jurisdictional profile: Sweden.

IFRS Foundation (2016c), IFRS Application around the world, Jurisdictional profile: Estonia.

IFRS Foundation (2016d), IFRS Application around the world, Jurisdictional profile: United Kingdom.

IFRS Foundation (2016e), IFRS Application around the world, Jurisdictional profile: Germany.

IFRS Standards as of January 1, 2017.

IMF (2016), Germany Financial Sector Assessment Program, International Monetary Fund Country Report No. 16/189, June 2016.

IMF (2014), Global Financial Stability Report, Risk Taking: Liquidity, and Shadow Banking - Curbing Excess while Promoting Growth, International Monetary Fund, October 2014

Immonen, R. (2011), Yritysjärjestelyt, Talentum Media. Helsinki.

Immonen, R. (2002), Yritysmuodot ja liiketoiminta, Talentum, Helsinki.

Immonen, R. et al. (2011), Osakeyhtiön pääoman hallinta (Osakeyhtiö-, kirjanpito- ja verolainsäädännön rajapinta muodostettaessa ja järjesteltäessä yhtiön pääomaa sekä jaettaessa yhtiön varoja), Talentum Media Oy, Helsinki.

Immonen, R. and Villa, S. (2017), Pääomalainan ja kehitysmenojen käsittely taseessa, available at https://www.suomentilintarkastajat.fi/nakoaloja/artikkelit-tilinpaatos/paaomalainan-ja-kehitysmenojen-kasittely-taseessa, accessed on September 19, 2017.

Immonen, R. and Villa S. (2015), Osakeyhtiön varojen käyttö, Talentum Media, Liettua.

Invest Europe (2017), What is Private Equity?, available at https://www.investeurope.eu/about-private-equity/private-equity-explained/, accessed on July 4, 2017.

Invest Europe (2015), Professional Standards Handbook, November 2015, available at http://www.investeurope.eu/media/431779/Invest-Europe-Professional-Standards-Handbook-2015.pdf , accessed on July 4, 2017.

IBP (2009), United Kingdom Company Law and Regulations Handbook, Volume 1, International Business Publications.

IPG (2016), IPG Receives $15MM in Mezzanine Debt Financing from Silicon Valley Bank, available at http://www.ipg.com/ipg-receives-15mm-in-mezzanine-debt-financing-from-silicon-valley-bank/, accessed on May 17, 2017.

Isaksson, A. (2006), Studies on the venture capital process, Umeå School of Business, Print & Media, Umeå University.

Isanbaert, M. (2010), EC Law and the Sovereignty of the Member States in Direct Taxation, IBFD Publications, Amsterdam.

James, M. (2009), The UK Tax System: an introduction, Second edition, Spiramus Press Ltd, London.

Jansen, N. and Zimmermann, R. eds (2018), Commentaries on European Contract Laws, Oxford University Press, Oxford.

Jennings, R.W. (1958), The Role of the States in Corporate Regulation and Investor Protection, 23 Law and Contemporary Problems 23(2), 193-230.

Jensen, M.C. (1986), Agency costs of free cash flow, corporate finance and takeovers, American Economic Review 76, pp. 323-329.

Jensen, M.C. and Meckling, W.H. (1976), Theory of the firm: managerial behavior, agency costs and ownership structure, Journal of Financial Economics 3, pp. 305–360.

Jermakowicz, E.K. and Gornik-Tomaszewski, S. (2006), Implementing IFRS from the perspective of EU publicly traded companies, Journal of International Accounting, Auditing and Taxation 15, pp. 170-196.

Johansson, S. (2011), Svensk associationsrätt i huvuddrag, Nordstedts Juridik AB, Stockholm.

Jokinen, J. (2012), Osakeyhtiölain uudistunut selvitystilasääntely ja pääoman vähenemistä koskeva sääntely, Edilex, available at https://www.edilex.fi/artikkelit/8477.pdf, accessed on January 3, 2016.

Jokinen, J. (2008), Osakeyhtiön johdon huolellisuusvelvollisuus ja osakeyhtiölain maksukykyisyystestin taloudelliset osatekijät, Defensor Legis, pp. 239-254.

JPMorgan Chase (2017), Investment Banking, available at https://www.jpmorgan.com/global/about/investment-banking, accessed on May 17, 2017.

Jung-Senssfelder, K. (2005), Equity Financing and Covenants in Venture Capital, An Augmented Contracting Approach to Optimal German Contract Design, Deutscher Universitäts-Verlag, Wiesbaden.

Jyränki, A. (1996), “Im fremden Spiegel” - Tankar om jämförande rättsforskning, pp. 9-16, in Suksi, M. ed.(1996): Jämförande juridik: Vad, varför, hur?, Meddelanden från Ekonomisk-statsvetenskapliga fakulteten vid Åbo Akademi Rättsvetenskapliga institutionen, Ser. A:468.

Kaarenoja, A. and Suontausta, S. (2007), Maksukyvyttömyys ja osakeyhtiön varojenjako, Defensor Legis N:o 2/2007, pp. 239-256.

Kaczorowska, A. (2013), European Union Law, Routledge. Oxon

Kahan, M. and Kamar, E. (2002), The myth of state competition in corporate law, Stanford Law Review, Vol. 55, pp. 679-749.

Kaplan, S. N. and Strömberg, P. (2003), Financial contracting theory meets the real world: an empirical analysis of venture capital contracts, Review of Economic Studies (2003) 70, pp. 281-315.

Karaömerlioglu, D.C. and Jacobsson, S. (2000), The Swedish venture capital industry: an infant, adolescent or grown-up?, Venture Capital: an international journal of entrepreneurial finance 2 (1), pp. 61-88.

Karhu, J. (2008), Lojaliteettiperiaate sopimusoikeudessa - oikeudellista peruskartoitusta in Vihervuori, P. et al. eds (2008), Juhlajulkaisu Leena Kartio 1938 - 30/8 - 2008, Suomalaisen lakimiesyhdistyksen julkaisuja, C-sarja N:o 39, Suomalainen lakimiesyhdistys, Helsinki, pp. 101-116.

Kashyap, A.K. and Stein, J.C. (2004), Cyclical implications of the Basel II capital standards, Economic Perspectives, Federal Reserve Bank Of Chicago, 1Q/2004, pp. 18-31.

Kershaw, D. (2012), Company Law in Context: Text and Materials, Second edition, Oxford University Press, Oxford.

Kersting, C. (2002), Corporate Choice of Law: A Comparison of the United States and European Systems and a Proposal for a European Directive, 28 BROOK. J. INT'L L. 1, 37.

KfW (2017), Development Finance, available at https://www.kfw.de/KfW-Group/About-KfW/Auftrag/Entwicklungsfinanzierung/, accessed on July 17, 2017.

Kiefel, S. (2015), Good Faith in Contractual Performance, A background paper for the Judicial Colloquium, Hong Kong, September 2015.

Kiff, J. et al. (2002), Instruments of Credit Risk Transfer: Effects on Financial Contracting and Financial Stability.

Kimel, D. (2003), From Promise to Contract: Towards a Liberal Theory of Contract, Hart Publishing, Portland.

Kirilenko, A. A. (2001), Valuation and control in venture finance, The Journal of Finance, Vol. 56, No. 2, pp. 565-587.

Knight, J.F. (2016), Of Conflicts and Corporations: Analyzing Corporate Forms for Future Litigation Finance Firms, Journal of Corporation Law, Iowa, Summer 2016, pp. 993-1007.

Knuutinen, R. (2015), Vieraan pääoman vero-oikeudellinen uudelleenluokitteleminen etuyhteystilanteissa, Defensor Legis, N:o 1/2015, Suomen Asianajajaliitto, Helsinki, pp. 107-124.

Knuutinen, R. (2009), Muoto ja sisältö vero-oikeudessa - erityistarkastelussa rahoitus- ja sijoitusinstrumentit, Suomalaien Lakimiesyhdistys, Sastamala 2009.

Knüpfer, S. and Puttonen, V. (2014), Moderni rahoitus. 7. painos, Talentum Media Oy.

Kollegiet för svensk bolagsstyrning (2016), Svensk kod för bolagsstyrning, Trosa Tryckeri.

Koller, T. et al. (2010), Valuation - Measuring And Managing The Value Of Companies, John Wiley & Sons, Hoboken, New Jersey.

Kommers, D.P. and Miller, R.A. (2012), The Constitutional Jurisprudence of the Federal Republic of Germany: Third Edition, Duke University Press.

Konkurrensverket (2016), Storbankskoncernernas olika verksamheter - en översiktlig beskrivning av olika delmarknader, Rapport 2016:2.

Koster, H. (2015), EU Legal Entities: New Options?, European Company Law, Volume 12, no. 1, 2015, pp. 5-6.

KPMG (2016), Evolving Banking Regulation - Part Five: Culture and Conduct, Publication number: 133129-G, February 2016.

KPMG (2015), Evolving Banking Regulation - Part One: From Design to Implementation, Publication number: 132195-G, March 2015.

KPMG (2015b), Global Transfer Pricing Review, Germany, Publication number: 132762-G, October 2015.

Kraakman, R. et al. (2017), The Anatomy of Corporate Law, A comparative and Functional Approach, Oxford University Press, Oxford.

Kraus, A. and Litzenberger, R.H. (1973), A State-Preference Model of Optimal Financial Leverage, Journal of Finance, September 1973, pp. 911-922.

Kraus, H. (2005), Executive Stock Options and Stock Appreciation Rights, Law Journal Press, New York.

KredEx (2016), Annual Report 2015, available at https://issuu.com/sihtasutus_kredex/docs/annual_report_2015_b2f9b85ca2f5ee?e=24879711/35805486, accessed on August 10, 2016.

Kredex (2016b), Capital loan, available at http://www.kredex.ee/en/enterprise/laen-ja-kaendus/allutatud-laen/, accessed on August 10, 2016.

KredEx (2016c), General terms of capital loan, available at http://www.kredex.ee/enterprise/laen-ja-kaendus/allutatud-laen/allutatud-laenu-uldtingimused/, accessed on August 10, 2016.

Kreipl, M. et al. (2014), Information Quality under IFRS, IFRS for SME and German-GAAP—Survey on Preferences of Non-Publicly Traded Mid-Sized Corporations. Open Journal of Business and Management, 2014, 2, pp. 138-150, available at http://file.scirp.org/pdf/OJBM_2014043016401271.pdf, accessed on July 4, 2017.

Krugman, P. (2015), The rage of the bankers, The New York Times, 21 Sept. 2015.

Kull, I. (2004), European and Estonian Law of Obligations - Transposition of Law or Mutual Influence?, Juridica International IX/2004.

Kumar, R. (2014), Strategies of Banks and Other Financial Institutions: Theories and Cases, Elsevier.

Kõomägi, M. and Sander, P. (2006), Deal structuring of private equity investments in Estonia, Vadyba Management 2 (11), pp. 65-72.

Kõomägi, M. and Sander, P. (2006), Venture Capital Investments and Financing in Estonia: A Case Study Approach, University of Tartu, Faculty of Economics and Business Administration, Working Paper Series, No. 44, 2006.

Kyläkallio, J. et al. (2008), Osakeyhtiö, Edita Publishing, Helsinki.

Laeven, L. et al. (2014), Bank Size and Systemic Risk, International Monetary Fund, Research Department, IMF Staff Discussion Note, July 2014.

Laffranque, J. (2005), The Judicial System of Estonia and European Union Law, International Journal of Legal Information, Vol. 33, Issue 2, Article 7.

Lando, O. (2005), Der Aktionsplan der EG-Kommission zum europäischen Vertragsrecht, Recht der Internationalen Wirtschaft, 1/2005, pp. 1-6.

Lando, O. et al. eds (2003), Principles of European Contract Law, Parts III, Kluwer, Hague.

Lando, O. and Beale, H. eds (2000), Principles of European Contract Law, Parts I and II, Kluwer, Hague.

Landstöm, H. and Mason C. eds (2012), Handbook of Research on Venture Capital: Volume 2, A Globalising Industry, Edward Elgar Publishing Limited, Cheltenham.

Langohr, H. and Langohr, P. (2008), The Rating Agencies and Their Credit Ratings: What They Are, How They Work and Why They are Relevant, John Wiley & Sons Ltd, West Sussex, UK.

La Porta, R. et al. (1998), Law and Finance, Journal of Political Economy, Volume 106, Issue 6, 1998), pp. 1113-1155.

Latham & Watkins (2018), The Growth of European Covenant Lite, Latham & Watkins LLP, available at https://www.lw.com/thoughtLeadership/lw-the-growth-of-european-covenant-lite-2018, accessed on December 6, 2018.

Latham & Watkins (2015), Covenant-lite Terms Continue to Develop in Europe, available at https://www.lw.com/thoughtLeadership/covenant-lite-terms-in-europe, accessed on December 6, 2018.

Laukkanen, M. ed. (2007), Kasvuyritys, Talentum Oy, Helsinki

Lauriala, J. (2008), Rahoitusstrategia - modernin rahoitusoikeuden luomat mahdollisuudet, WSOY, Juva

Lauriala, J. (2004), Pääomasijoittaminen, Edita Publishing Oy, Helsinki.

Lautjärvi, K. (2015), Välipääomarahoitusinstrumentit, Talentum Media Oy, Tallinna.

Lautjärvi, K. (2011), Välipääomarahoitus suomalaisen osakeyhtiön rahoituksen vaihtoehtona, Lakimies 2011/7-8, pp. 1341-1362.

Lautjärvi, K. (2009), Suomalaisen osakeyhtiön välipääomarahoitus, Defensor Legis 1/2009, pp. 75-80.

Leanerts, K. et al. (2014), EU Procedural Law, Oxford University Press, Oxford.

Leary, M.T. (2009), Bank loan supply, lender choice, and corporate capital structure, The Journal of Finance, Volume 64, Issue 3, June 2009, pp. 1143-1185.

Leary, M.T. and Roberts, M.R. (2010), The pecking order, debt capacity, and information asymmetry, Journal of Financial Economics 95, 2010, pp. 332-355.

Lehtimäki, M. J. (2007), Debt Subordination in Corporate Liquidation, available at http://www.thetrust.fi/wordpress/wp-content/uploads/2015/03/Debt-Subordination-1.pdf, accessed on May 10, 2017.

Leleux, B. and B. Surlemont (2003), Public versus private venture capital: seeding or crowding out? A Pan-European analysis, Journal of Business Venturing 18, 2003, pp. 81-104.

Leppiniemi, J. (2009), Rahoitus, WSOY, Vantaa

Leppiniemi, J. and Puttonen, V. (2002), Yrityksen rahoitus, WSOY, Porvoo

Lerner, J. and Hardymon, F. (2002), Venture Capital and Private Equity: A Casebook, Volume Two, New York 2002.

Lerner, J. and Tåg, J. (2013), Institutions and venture capital, Industrial and Corporate Change, Volume 22, Number 1, pp. 153-182.

Le Sueur, A. et al. (2013), Public Law: Text, Cases, and Materials, Second edition, Oxford University Press, Oxford.

Lindskog, S. (1993), Aktuella spörsmål - Mer om efterställningsvillkor, Svensk Juristtidning 1993, pp. 358-361.

Lindskog, S. (1992), Om efterställningsvillkor, Svensk Juristtidning 1992, pp. 609-646.

Linnanvirta, R. and Viitala, T. (2012), Debt-Equity Conundrum, Cahiers de Droit droit fiscal international vol. 97b, International Fiscal Association, Amersfoort 2012. Finska bransch-rapporten, pp. 271-282.

LMA (2017), The LMA Mission, available at http://www.lma.eu.com/about-us , accessed on May 16, 2017.

Loader, D. (2007), Fundamentals of Fund Administration: A Guide, Elsevier.

Lohse, T. and Riedel, N. (2013), Do Transfer Pricing Laws Limit International Income Shifting? Evidence from European Multinationals, CESifo Working Paper, No. 4404.

Lovio, R. (1993), Evolution of Firm Communities in New Industries, The Case of the Finnish Electronics Industry, Helsingin Kauppakorkeakoulu, 1993.

LSTA (2017), LSTA mission & overview, available at http://www.lsta.org/about/mission-and-overview, accessed on May 16, 2016.

Luukkonen, T. (2006), Venture capital industry in Finland - country report for the venture fun Project, ETLA, Elinkeinoelämän Tutkimuslaitos, The Research Institute of the Finnish Economy, Helsinki,

MacKenzie, R. et al. (2010), The Manual on International Courts and Tribunals, Oxford University Press, Oxford.

Maggi, F. et al. (2017), IFRS 9: A silent revolution in banks' business models, April 2017, available at https://www.mckinsey.com/business-functions/risk/our-insights/ifrs-9-a-silent-revolution-in-banks-business-models, accessed on October 29, 2017.

Magnus, U. and Mankowski, P. (2012), Brussels IIbis Regulation, European Law Publisher.

Maisch, M. et al. (2015), Banks Bemoan "Tsunami" of Regulation, Handelsblatt 2015-09-03, available at https://global.handelsblatt.com/edition/255/ressort/finance/article/banks-bemoan-tsunami-of-regulations, accessed on October 7, 2016.

Maisto, G. ed. (2012), Taxation of Intercompany Dividends Under Tax Treaties and EU Law, IBFD Publications, Amsterdam.

Malke, C. (2010), Taxation of European Companies at the Time of Establishment and Restructuring. Gabler Verlag.

Mallon, C. and Waisman, S.Y. eds (2011), The Law and Practice of Restructuring in the UK and US, Oxford University Press, New York.

Manne, H G. (1967), Our Two Corporation Systems: Law and Economics, Virginia Law Review, Volume 53, Number 2, pp. 259-284.

Manso, G. et al. (2010), Performance-sensitive debt, Review of Financial Studies, v 23 n 5 2010, pp. 1819-1854.

Marshall, C. and Rossman, G. B. (2016), Designing qualitative research, Sage Publications, Thousand Oaks, California, USA

Maskow, D. (1992), Hardship and Force Majeure, 40 American Journal of Comparative Law pp. 657-669.

Mathur, A. (2016), An American Problem: High Taxes, Low Revenues, Jan 19, 2016, an article available at http://www.forbes.com/sites/aparnamathur/2016/01/19/thank-high-taxes-for-revenue-losses/#903053d2f6e8, accessed on March 27, 2017.

Mayer, C. (2002), Financing the New Economy: financial institutions and corporate governance, Information Economics and policy, 14 (2002), pp. 311-326.

Mayson, S.W. et al. (2014), Mayson, French and Ryan on Company Law, Oxford University Press, Oxford.

McCormick, R. (2006), Legal risk in the Financial Markets, Oxford University Press, Oxford.

McKinsey (2012), First-Mover matters: Building credit monitoring for competitive advantage, McKinsey Working Papers on Risk, Number 37, October 2012, McKinsey & Company.

McLaughlin, S. (2015), Unlocking Company Law, 3rd edition, Routledge, Abington.

McNeil, A.J. et al. (2015), Quantitative Risk Management: Concepts, Techniques and Tools, Princeton University Press, Princeton, New Jersey.

Mello, A. and Quintin, E. (2015), A Back-up Quarterback View of Mezzanine Finance, 2015 Meeting Papers. No. 370. Society for Economic Dynamics, 2015.

Mellor, T. ed. (2014), The International comparative Legal Guide to: Lending & Secured Finance 2014, 2nd edition, Global Legal Group Ltd, London.

Merimaa, M. and Mändla, S. (2011), Commercial and Economic Law in Estonia, Kluwer Law International, The Netherlands.

Merriam-Webster (2018), Dictionary, pacta sunt servanda, available at https://www.merriam-webster.com/legal/pacta%20sunt%20servanda, accessed on December 19, 2018.

Merton, R. C. (1974), On the pricing of corporate debt: The risk structure of interest rates, The Journal of Finance, Volume 29, Issue 2, May 1974, pp. 449-470.

Metrick, A. and Yasuda, A. (2011), Venture capital and other private equity: a survey, European Financial Management, 17 (4), pp. 619-654.

Michaels, R. (2006), The Functional Method of Comparative Law, pp. 339-382, in Reimann, M. and Zimmermann, R. eds, The Oxford Handbook of Comparative Law, Oxford University Press, Oxford.

Micklitz, H.-W. (2015), On the Intellectual History of Freedom of Contract and Regulation, The Penn State Journal of Law & International Affairs, Volume 4, Issue 1.

Micklitz, H.-W. ed. (2014), Constitutionalization of European Private Law, Oxford University Press, Oxford.

Miller, S. M. et al. (2016), Small-Business Financing after the Financial Crisis: Lessons from the Literature, Mercatus Working Paper, Mercatus Center at George Mason University, Arlington, VA, August 2016, available at https://www.mercatus.org/sites/default/files/Mercatus-Miller-Small-Business-Financing-v1.pdf, accessed on October 7, 2016.

Miller, M. H. (1977), Debt and Taxes, Journal of Finance, Vol. 32, May 1977, pp. 261-275.

Miller, M. H. and Modigliani, F. (1961), Dividend Policy, Growth and the Valuation of Shares, The Journal of Business, Vol. 34, October 1961, pp. 411-433.

Milne, A. and Parboteeah, P. (2016), The Business Models and Economics of Peer-to-Peer Lending, No. 17 / May 2016, available https://www.ceps.eu/system/files/ECRI%20RR17%20P2P%20Lending.pdf, accessed on December 7, 2016.

Minister of Finance (2006), Regulation No 53 “Methods for determining the value of transactions concluded between associated persons”, Passed 10.11.2006, Annex 53, Estonia.

Modigliani, F. and Miller, M. H. (1963), Corporate Income Taxes and the Cost of Capital: A Correction, American Economic Review, Vol. 53, June 1963, pp. 433-443.

Modigliani, F. and Miller, M. H. (1958), The Cost of Capital, Corporate Finance and the Theory of Investment, American Economic Review, Vol. 48, June 1958, pp. 261-297.

Mokal, R.J. (2001), Cambridge Law Journal, 60(3), November 2001, pp. 581-621.

Moloney, N. (2014), EU Securities and Financial Markets Regulation, Oxford University Press, Oxford.

Moloney, N. et al. eds (2015), The Oxford Handbook of Financial Regulation, Oxford University Press, Oxford.

Morris, G.G. (2015), Model Business Corporation Act as Adopted in Louisiana, Louisiana Law Review, Volume 75, Number 4.

Munukka J. (2010), Lojalitetsplikten som rättsprincip, Svensk Juristtidning, pp. 837-848.

Munukka J. (2005), Harmonisation of Contract Law: In Search of a Solution to the Good Faith Problem”, Scandinavian Studies in Law, pp. 229-250.

Murphy, D. (2008), Understanding Risk: The Theory and Practice of Financial Risk Management, CRC Press, Boca Raton.

Muukkonen, P. J. (1975), Yhteistyösopimukset ja lojaliteettivelvollisuus in Hoppu, E. et al. eds (1975), Juhlajulkaisu Urho Kaleva Kekkonen, 1900-3/9-1975, Suomalainen Lakimiesyhdistys, Helsinki, pp. 356-364.

Muukkonen, P.J. (1993), Sopimusoikeuden yleinen lojaliteettiperiaate, Lakimies 7/1993, pp. 1030-1048.

Møen, J. et al. (2011), International debt shifting: do multinationals shift internal or external debt?, CESifo Working Paper No. 3519.

Müller-Känel, O. (2009), Mezzanine Finance-Neue Perspektiven in der Unternehmens-finanzierung, 3. Auflage, Haupt Verlag AG, Bern.

Myers, S. C. (2001), Capital structure, Journal of Economic Perspectives 15, pp. 81-102.

Myers, S. C. (2000), Outside equity, Journal of Finance 55, pp. 1005-1037.

Myers, S.C. (1984), Presidential address: The capital structure puzzle, Journal of Finance 39, pp. 575-592.

Myers, S.C., (1977), Determinants of corporate borrowing, Journal of Financial Economics 5, pp. 147-175.

Myers, S.C. and Majluf, N.S. (1984), Corporate financing and investment decisions when firms have information that investors do not have, Journal of Financial Economics, pp. 187-221.

Myers, S C. and Nicholas M. (1984), Corporate financing and investment when firms have information that investors do not have, Journal of Financial Economics 13, pp. 187-221.

Myllymäki, J. (2013), Hybrid Loans in the Finnish Securities Market, Helsinki Law Review 2013/2, pp. 103-142.

Mähönen, J. (2009), Osakeyhtiön taloudellinen raportointi ja tilintarkastus, Edita, Helsinki.

Mähönen, J. (2005), Kansainväliset tilinpäätösstandardit ja yhtiöoikeus, Edita, Helsinki.

Mähönen, J. (2000a), Lojaliteettivelvollisuus ja tiedonantovelvollisuus in Saarnilehto, A. ed. (2000), Varallisuusoikeuden kantavat periaatteet, WSOY, Helsinki, pp. 129-143.

Mähönen, J. (2000b), 'Good Faith and Fair Dealing' ja lojaliteettivelvollisuus in Aine, A. and Kumpula, A. eds (2000), Juhlajulkaisu Tuula Ämmälä 2.11.2000, Turun yliopiston oikeustieteellisen tiedekunnan julkaisuja, Turku, pp. 203-231.

Mähönen, J. and Villa, S. (2015) Osakeyhtiö I: Yleiset opit, WSOY, Porvoo

Mähönen, J. and Villa, S. (2012) Osakeyhtiö II: Pääomarakenne ja rahoitus, Sanoma Pro Oy, Porvoo.

Mähönen, J. and Villa, S. (2010) Osakeyhtiö III: Corporate governance, WSOY, Porvoo.

Mähönen, J. and Villa, S. (2009) Osakeyhtiö IV: Osakeyhtiö ja verotus, WSOY, Porvoo.

Mäntysaari, P. (2017), User-friendly Legal Science, Springer, Cham.

Mäntysaari, P. (2016), Osakeyhtiöoikeuden teoriasta, available at https://www.edilex.fi/artikkelit/16286.pdf, accessed on May 8, 2017.

Mäntysaari, P. (2015), Oikeudenaloista tieteenaloihin, Lakimies 2/2016, pp. 297-304.

Mäntysaari, P. (2014), Kauppaoikeuden teoriasta, Lakimies 3/2014, pp. 347-367.

Mäntysaari, P. (2012), Organising the Firm: Theories of Commercial Law, Corporate Governance and Commercial Law, Springer, Heidelberg.

Mäntysaari, P. (2010), The Law of Corporate Finance: General Principles and EU Law, Volume I: Cash Flow, Risk, Agency, Information, Springer, Heidelberg.

Mäntysaari, P. (2010b), The Law of Corporate Finance: General Principles and EU Law, Volume II: Contracts in General, Springer, Heidelberg.

Mäntysaari, P. (2010c), The Law of Corporate Finance: General Principles and EU Law, Volume III: Funding, Exit, Takeovers, Springer, Heidelberg.

Nagel, J. (2011), Auswirkungen der Bankenregulierung auf die deutsche Wirtschaft und das deutsche Bankensystem, Rede auf der Agrarfinanztagung 2011 in Berlin am 2. März 2011, available at https://www.bundesbank.de/Redaktion/DE/Downloads/Presse/Reden/2011/2011_03_02_nagel_auswirkungen_bankenregulierung_wirtschaft_und_bankensystem.pdf?__blob=publicationFile, accessed on July 5, 2017.

Narits, R. (1996), Interpretation of Law in the Estonian Legal System, Juridica International Law Review, University of Tartu, pp. 11-16.

Nasdaq (2017), NASDAQ Stock Market Rules, available at http://nasdaq.cchwallstreet.com/, accessed on March 27, 2017.

Nasdaq Helsinki (2017), Nasdaq Helsinki Ltd, Rules of the Exchange 1 Jan 2017, available at http://business.nasdaq.com/media/Nasdaq-Helsinki-Rules-of-the-exchange-EN_tcm5044-30771.pdf, accessed on March 9, 2017.

Nergelius, J. (2011), Constitutional Law in Sweden, Kluwer Law International.

Nenova, T. (2003), The value of corporate voting rights and control: a cross-country analysis, Journal of Financial Economics 68, 2003, pp. 325-351.

Nicholas, T. (2015), The Origins of High-Tech Venture Investing in America, Working Paper 16-047.

Nijs, L. (2014), Mezzanine financing: tools, applications and total performance, John Wiley & Sons Ltd, West Sussex, UK.

Niskanen, J. and Niskanen, M. (2013), Yritysrahoitus, Edita Publishing Oy, Kuopio.

Niskanen, J. and Niskanen, M. (2004), Covenants and small business lending: the Finnish case, Small Business Economics, Vol. 23, 2004, pp. 137-149.

Nobes, C. and Parker, R. (2012), Comparative international accounting, 12th edition, Pearson, Harlow.

Norrgård, M. (2006), Avtalsingrepp - Om otillbörliga ingripanden i kommersiella affärsförhållanden, Swedish School of Economics and Business Administration, Research Reports 61, Helsinki.

Norton, E. and Tenenbaum, B. (1993), Specialisation Versus Diversification As a Venture Capital Investment Strategy, Journal of Business Venturing, 8, pp. 431-442.

NVCA (2016), National Venture Capital Association Yearbook 2016, Thomson Reuters.

NVCA (2016b), NVCA Membership Directory, available at http://nvca.org/resources/membership-directory/, accessed on July 5, 2017.

NYSE (2017), Listed Company Manual, available at http://wallstreet.cch.com/LCM/, accessed on March 27, 2017.

Næss-Schmidt, S. et al. (2017), Swedish Private Equity Market, A footprint analysis, Copenhagen Economics, available at http://resources.mynewsdesk.com/image/upload/fxwrbsy4n31zc720ji36.pdf, accessed on July 6, 2017.

OCC (2013), Interagency Guidance on Leveraged Lending, March 21, 2013, Office of the Comptroller of the Currency, Board of Governors of the Federal Reserve System, and Federal Deposit Insurance Corporation.

OECD (2017), Limiting Base Erosion Involving Interest Deductions and Other Financial Payments, Action 4 - 2016 Update: Inclusive Framework on BEPS, OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing, Paris.

OECD (2017b), Table II.1. Corporate income tax rate, available at http://stats.oecd.org//Index.aspx?QueryId=58204, accessed on July 5, 2017.

OECD (2016), Entrepreneurship at a Glance 2016, OECD Publishing, Paris.

OECD (2016b), National Accounts of OECD Countries, Financial Balance Sheets 2015, OECD Publishing, available at http://www.keepeek.com/Digital-Asset-Management/oecd/economics/national-accounts-of-oecd-countries-financial-balance-sheets-2015_na_fbs-2015-en#page3, accessed on October 13, 2016.

OECD (2015), Executive Summaries 2015 Final Reports, OECD/G20 Base Erosion and Profit Shifting Project.

OECD (2015b), New Approaches to SME and Entrepreneurship Financing: Broadening the Range of Instruments, available at https://www.oecd.org/cfe/smes/New-Approaches-SME-full-report.pdf, accessed on July 5, 2017.

OECD (2014), Public Discussion Draft, BEPS Action 4: Interest Deductions and other Financial Payments, 18 December 2014 - 6 February 2015.

OECD (2014b), Financing SMEs and Entrepreneurs 2014, An OECD Scoreboard: An OECD Scoreboard, OECD Publishing, Paris.

OECD (2013), Organisation for Economic Co-operation and Development, Centre for Entrepreneurship, SMEs and Local Development, Alternative Financing Instruments for SMEs and Entrepreneurs: the Case of Mezzanine Finance, Final Report 08-Feb-2013.

OECD (2012), Thin Capitalisation Legislation, A Background Paper for Country Administrations (Pilot version for comments), Initial draft - August 2012

OECD (2011), Glossary of Statistical Terms: Non-Financial Corporations, available at http://stats.oecd.org/glossary/detail.asp?ID=1805, accessed on May 18, 2017.

OECD (2010), Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations, August 18, 2010.

OECD (2003), OECD Territorial Reviews: Helsinki, Finland 2003.

Ojanen, T. (2006), EU-oikeuden perusteita. Edita. Helsinki 2006.

Olsson, S. (2014), Avdragsrätt för ränta på konvertibler, Skattenytt 5 (2014), pp. 286-288.

OP Group (2017), Pankkilainaa täydentävä riskirahoitusmalli pk-yrityksille, available at https://www.op.fi/op/yritysasiakkaat/rahoitus/investoinnit/%20riskirahoitusmalli?id=60208&srcpl=8, accessed on May 18, 2017.

Ovtchinnikov, A.V. (2010), Capital structure decisions: Evidence from deregulated industries, Journal of Financial Economics 95, pp. 249-274.

Ozkan, A. (2001), Determinants of Capital Structure and Adjustment to Long Run Target: Evidence from UK Company Panel Data. Journal of Business Finance and Accounting 28, pp. 175-198.

Ozmel, U. et al. (2013), Strategic alliances, venture capital, and exit decisions in early stage high-tech firms, Journal of Financial Economics 107.3, 2013, pp. 655-670.

Palmer, V.V. (2012), Mixed Jurisdictions Worldwide: The Third Legal Family, Cambridge University Press, Cambridge.

Papadopoulos, T. (2012), The Magnitude of EU Fundamental Freedoms: Application of the Freedom of Establishment to the Cross-Border Mergers Directive'. European Business Law Review. Kluwer, pp 517-546.

Parsons, D.F. and Slights III, J.R. (2008), The History of Delaware´s Business Courts, Business Law Today, Volume 17, Number 4, March/April 2008, available at https://apps.americanbar.org/buslaw/blt/2008-03-04/slights.shtml, accessed on May 17, 2017.

Parsons, C. and Titman, S. (2008), Empirical capital structure: A review, Foundations and Trends in Finance, pp. 1-93.

Partington, M. (2015), Introduction to the English Legal system, Oxford University Press, Oxford.

Payne, J. (2014), The Use of Schemes of Arrangement to Effect Takeovers: A Comparative Analysis, Oxford Legal Studies Research Paper No. 51/2014.

Payne, J. (2008), Legal Capital in the UK following the Companies Act 2006, University of Oxford Faculty of Law Legal Studies Research Paper Series Working Paper No 13/2008.

Peczenik, A. (2005), Scientia Juris: Legal Doctrine as Knowledge of Law and as a Source of Law, Springer, Dordrecht.

Piketty, T. (2014), Capital in the Twenty-First Century, Belknap Press.

Pineschi, L. ed. (2015), General Principles of Law - The Role of the Judiciary, Springer, Heidelberg.

Piris, J.-C. (2010), The Lisbon Treaty: A Legal and Political Analysis, Cambridge University Press, New York.

Pistor, K. et al. (2002), Evolution of Corporate Law: A Cross-Country Comparison, University of Pennsylvania Journal of International Law, Volume 23, Issue 4, pp. 791-871.

Pistor, K. et al. (2000), Law and finance in transition economies, Working paper No.48, European Bank for Reconstruction and Development.

PKF (2017), Wiley IFRS 2017: Interpretation and Application of IFRS Standards, John Wiley & Sons.

Plagge, A. (2006), Venture capital in Germany, Public Policy for Venture Capital: A Comparison of the United States and Germany, pp. 37-58.

Porter, M. (1998), Competitive Strategy: Techniques for Analyzing Industries and Competitors, The Free Press, New York.

Porter, M. (1998b), The Competitive Advantage of Nations, The Free Press, New York.

Posner, R.A. (2014), Economic Analysis of Law, Ninth edition, Wolters Kluwer Law & Business, New York.

PRA (2016), Bank of England, Prudential Regulation Authority, Annual Report and Accounts 2016.

Pratt, S.P. and Grabowski, R.J. (2010), Cost of Capital: Applications and Examples, John Wiley & Sons, Hoboken, NJ.

Putkuri, H. and Savolainen, E, (2016), Low interest rates place a strain on the banks, Bank of Finland Bulletin, 2/2016, pp. 32-36.

PwC (2017), Financing transactions, July 2017, available at https://www.pwc.com/us/en/cfodirect/assets/pdf/accounting-guides/pwc-guide-financing-transactions-debt-equity.pdf, accessed on June 20, 2018.

PwC (2017b), IFRS and US GAAP: similarities and differences, June 2017, available at https://www.pwc.com/us/en/cfodirect/assets/pdf/accounting-guides/pwc-ifrs-us-gaap-similarities-and-differences-2017.pdf, accessed on June 20, 2018

PwC (2016), United Kingdom, Corporate - Deductions, Last Reviewed - 01 December 2016, available at http://taxsummaries.pwc.com/uk/taxsummaries/wwts.nsf/ID/United-Kingdom-Corporate-Deductions, accessed on May 18, 2017.

PwC (2016b), Q&A - What is FinTech?, April 2016, available at https://www.pwc.com/us/en/financial-services/publications/viewpoints/assets/pwc-fsi-what-is-fintech.pdf , accessed on April 27, 2017.

PwC (2015), Germany, Corporate - Deductions, Last Reviewed - 18 November 2015, available at http://taxsummaries.pwc.com/uk/taxsummaries/wwts.nsf/ID/Germany-Corporate-Deductions, accessed on April 22, 2016.

PwC (2014), Doing business in the United States, A guide to the key tax issues, 2014.

PwC (2008), BVCA Private Equity and Venture Capital Report on Investment Activity 2007.

Pylkkönen, P. (2015), Bank´s share in corporate finance has increased in Finland, Bank of Finland Bulletin, 2/2015, pp. 27-32.

Pönkä, V. (2012), Yhdenvertaisuus osakeyhtiössä, Sanoma Pro, Helsinki.

Radebaugh, L.H. et al. (2006), International accounting and multinational enterprises. 6th edition, John Wiley & Sons, New York.

Raiser, T. and Veil, R. (2010), Recht der Kapitalgesellschaften. Verlag Franz Vahlen.

Rajan, R. G. and Zingales, L. (1995), What Do We Know About Capital Structure Choice, Some Evidence from International Data, Journal of Finance, Vol. 50, No. 5, pp. 1421-60.

Ramirez, J. (2017), Handbook of Basel III Capital - Enhancing Bank Capital in practice, John Wiley & Sons Ltd.

Ramsinghani, M. (2014), Business of Venture Capital, Wiley.

Regeringskansliet (2013), The Constitution of Sweden. Ministry of Justice, Elanders.

Reich, N. (2014), General Principles of EU Civil Law, Intersentia, Cambridge.

Republic of Estonia (2016), http://www.vm.ee/en/estonian-economy-overview, accessed on August 3, 2016.

RFR 2 (2017), Rådet för finansiell rapporteringen, RFR 2, Redovisning för juridiska personer, available at http://www.radetforfinansiellrapportering.se/UserFiles/Archive/29/2Rekomendationer/RFR2_arsupdatering_2017_2.pdf, accessed on July 5, 2017.

Richelle, I. et al. eds (2013), Allocating Taxing Powers within the European Union, Springer.

Ring, D. (2012), Debt-Equity Conundrum, Cahiers de Droit droit fiscal international vol. 97b, International Fiscal Association, Amersfoort 2012. United States of America, pp. 771-791.

Rocco, J. (2004), Der GmbH-Gesellschafter: GmbH-Gründung Rechte und Pflichten Haftungsrisiken Ausscheiden und Abfindung, Springer-Verlag, Heidelberg.

Rodhe, K. (1986), Lärobok i obligationsrätt, Nordstedts Förlag, Lund

Rodhe, K. and Skog, R. (2014) Aktiebolagsrätt, 24. Uppl, Norstedts Juridik, Stockholm.

Roland, G. ed. (2008), Privatization: Successes and Failures, Columbia University Press, New York.

Romano, V.C. (2015), Empirical Comparative Law, Doctoral dissertation, Libera Universita Internazionale Degli Studie Sociali, available at http://eprints.luiss.it/1425/1/20150528-romano-tesi.pdf, accessed on May 4, 2017.

Romano, R. (1985), Law as a Product: Some Pieces of the Incorporation Puzzle, Journal of Law, Economics and Organization, Volume 1, Issue 2, pp. 225-283.

Rosas, A. et al. eds (2012), The Court of Justice and the Construction of Europe: Analyses and Perspectives of Sixty Years of Case-Law, Springer.

Ross, S. et al. (2013), Fundamentals of Corporate Finance, McGraw-Hill, New York.

Rothgang, H. and Scheider, S. eds (2015), State Transformations in OECD Countries: Dimensions, Driving Forces, and Trajectories, Palcrave MacMillan, New York.

Ruostetsaari, I. (2015), Elite Recruitment and Coherence of the Inner Core of Power in Finland, Lexington Books.

Rutberg, A. and Skog, R. (2000), Aktiebolags förvärv av egna aktier- bolags- och skatterättsliga regler, SvSkT, nr. 1, 2000, pp. 5-28.

Saare, K. et al. (2015), Ühinguõigus I, Juura.

Saare, K. (2004), Eraõigusliku juriidilise isiku õigussubjektsuse piiritlemine, Tartu Ülikool.

Sabaliauskas, L. (2015), Seeding a venture wolf: Baltics, A Regional Case Study, Venture Findings, 2015-2, History Issue, pp. 124-130.

Sahlman, W. A. (1990), The structure and governance of venture capital organizations, Journal of Financial Economics 27, 2, pp. 473-521.

Sander, P. (2003), Capital structure choice in Estonian companies: a survey. Management of Organizations: Systematic Research, Issue 27, 2003, pp. 123-135.

Sander, P. and Kõomägi, M (2007), The allocation of control rights in financing private companies: views of Estonian private equity and venture capitalists, Trames, 2007, 11, 2, pp. 189-205.

Sandström, T. (2015), Svensk aktiebolagsrätt, 5. uppl., Hansaprint, Vantaa, 2015.

Santander UK (2016), available at https://www.santandercb.co.uk/breakthrough/breakthrough-finance, accessed on August 5, 2016.

Sasso, L. (2012), Capital Structure and Corporate Governance: The Role of Hybrid Financial Instruments, Doctoral dissertation, The London School of Economics and Political Science.

SBA (2017), Swedish Bankers´ Association, Banks in Sweden.

Schade, V. (2014), Successful Management of Mergers & Acquisitions, Anchor Academic Publishing, Hamburg.

Schneider, S. et al. (2017), Basel "IV": What's next for banks? Implications of intermediate results of new regulatory rules for European banks, Global Risk Practice April 2017, McKinsey&Company.

Schneider, S. R. (2015), Is Debt vs. Equity Different in a Partnership?, TAXES The Tax Magazine, March 2015, pp. 111-132.

Schultén, G. af (2004), Osakeyhtiölain kommentaari I, luvut 9-17. Talentum.

Schultén, G. af (2003), Osakeyhtiölain kommentaari I, luvut 1-8. Talentum.

Sealy, L. and Worthington, S. (2013), Cases and Materials in Company Law, Oxford University Press, UK.

SEC (2017), Remarks before the 2015 Baruch College Financial Reporting Conference, Speech by James Schnurr, Chief Accountant, available at https://www.sec.gov/news/speech/schnurr-remarks-before-the-2015-baruch-college-financial-reporti.html, accessed on May 17, 2017.

SEC (2013), U.S. Securities and Exchange Commission, The Laws that Govern the Securities Industry, available at https://www.sec.gov/about/laws.shtml#sox2002, accessed on May 17, 2017.

Seligman, J., (1976), A History of Delaware Corporation Law, Delaware Journal of Corporate Law, Volume 1, Number 2.

Seligman, E.R.A. (1914), The income tax: a study of the history, theory and practice of income taxation at home and abroad, 2nd edition, The McMillan Company, New York.

Seminogovas, B. (2015), Taxation of Hybrid Instruments, Procedia - Social and Behavioral Sciences 213 (2015), pp. 299 - 303, available online at http://ac.els-cdn.com/S1877042815058966/1-s2.0-S1877042815058966-main.pdf?_tid=763a5a24-4066-11e7-8ac5-00000aab0f26&acdnat=1495619627_2eea235ebf5b5b9779215b7ab96445dc, accessed on May 24, 2017.

Seppä, M. (2000), Strategy logic of the venture capitalist:understanding venture capitalism - the businesses within - by exploring linkages between ownership and strategy of venture capital companies, over time, in America and Europe, University of Jyväskylä.

Seretakis, A. (2013), A Comparative Examination of Private Equity in the United States and Europe: Accounting for the Past and Predicting the Future of European Private Equity, Fordham Journal of Corporate & Financial Law, Volume 18, Number 3, 2013, pp. 613-667.

Sharpe, W. et al. (1999), Investments, Prentice Hall, Upper Saddle River, New Jersey.

Shaw, J. (2000), Law of the European Union, Palgrave Macmillan, Hampshire.

Sheikh, S. (2008), A Guide to Companies Act 2006, Routledge-Cavendish, Abingdon.

Siedler, N.-L. (2014), Here we go again - Mezzanine financing makes a comeback, Corporate law & finance, Business Law Magazine, No. 2, September 25, 2014, pp. 18-20.

Silbernagel, C. and Vaitkunas, D. (2016), Mezzanine Finance White Paper, 2nd edition, Bond Capital.

Siltala, R. (2001), Johdatus oikeusteoriaan, Helsingin yliopiston oikeustieetellisen tiede-kunnan julkaisut, Helsinki.

Sismangil, H.E. (2014), Creditor Protection in Private Equity-Backed Leveraged Buyout and Recapitalisation Practices, Berliner Wissenschafts-Verlag, Berlin.

Sjåfjell, B. (2009), Towards a Sustainable European Company Law: A Normative Analysis of the Objectives of EU Law, with the Takeover Directive as a Test Case, Kluwer Law International, The Netherlands.

Sjöman, E. (2008), Hembud, förköp och samtycke: en kommentar till 4 kap. 7-36 §§ aktiebolagslagen, 2. uppl., Norstedts juridik, Stockholm.

Skatteverket (2017), Aktieägartillskott, available at https://www4.skatteverket.se/rattsligvagledning/edition/2017.7/331685.html#ref-cite-ra-2002-ref-107-1, accessed on September 19, 2017.

Skatteverket (2012), Hybridsituationer inom bolagssektorn, Gränsöverskridande och särskilt i samband med finansiering, Rapport, Datum 2012-04-23, Dnr 131-183077-12/1211.

Slapper, G. and Kelly, D. (2015), The English Legal System: 2015-2016, Sixteenth edition, Routledge,

Smith, A. (1902), The Wealth of Nations, P.F. Collier & Son, New York.

Staehr, K. (2014), Corporate Income Taxation in Estonia. s It Time to Abandon Dividend Taxation? TUT Economic Research Series 1 (2014).

Standard & Poor´s (2016), RatingsDirect, S&P Global Ratings Definitions, August 18, 2016, available at http://img.en25.com/Web/StandardPoorsRatings/RatingsDirect_Commentary_1695715_Sep-13-2016_15_16.pdf, accessed on May 16, 2017.

Statista (2017), available at http://www.statista.com/statistics/300792/uk-banking-sector-leading-banks-by-total-assets/, accessed on August 4, 2016.

Stefanova, M. (2015), Private Equity Accounting, Investor Reporting, and Beyond: Advanced Guide for Private Equity Managers, Institutional Investors, Investment Professionals, and Students, FT Press, New Jersey.

Stein, P. (2016), Die Aktiengesellschaft - Gründung, Organisation, Finanzverfassung, Springer Gabler, Wiesbaden.

Stenbeck, E. et al. (1970), Aktiebolagslagen jämte dithörande författningar med förklaringar, 6 uppl., Norstedt & Söners, Stockholm.

Stice, J.D. and Stice, E.K. (2014), Intermediate Accounting, South-Western.

Stone, R. and Devenney, J. (2017), The Modern Law of Contract, Routledge, New York.

Storme, M.E. (2003), Good Faith and Contents of Contracts in European Private Law, Electronic Journal of Comparative Law, vol. 7.1, March 2003.

Strouhal, J. ed. (2011), Harmonization of SME's Financial Reporting in Emerging CEE Countries, WSEAS Press.

Sund-Norrgård, P. (2011), Lojalitet i licensavtal, Publications of IPR University Center, Juridiska föreningens publikationsserie nr 56, Helsinki

Sund-Norrgård, P. et al. (2015), The Principle of Loyalty and Flexibility in Contracts in Nystén-Haarala, S. et al. eds (2015), Flexibility in Contracting, A Special Issue of the Lapland Law Review 2015, Issue 2.

Sum, K. (2016), Post-Crisis Banking Regulation in the European Union: Opportunities and Threats, Palgrave MacMillan.

Summers, R.S. et al. (2000), The Conceptualization of Good Faith in American Contract Law in Zimmermann, R. and Whittaker, S. eds (2000), Good Faith in European Contract Law, University Press, Cambridge, pp. 118-141.

Summers, R.S. (1968), "Good Faith" in General Contract Law and the Sales Provisions of the Uniform Commercial Code, Virginia Law Review, Volume 54, March 1968, Number 2.

Suokas, J. (2016), Finnveran uudet rahoitusinstrumentit, TEM Toimialojen rahoitusseminaari 11.5.2016, available at http://www.temtoimialapalvelu.fi/files/2629/Jukka_Suokas_Finnvera.pdf, accessed on August 8, 2016.

Suomen Pankki (2015), Yritysrahoituskysely 2015, Suomen Pankin selvitykset ja raportit.

Sørensen, M. (2007), How Smart Is Smart Money? A Two-Sided Matching Model of Venture Capital, Journal of Finance, 62 (6), pp. 2725-2762.

SVB (2017), Private Equity & Venture Capital, available at http://www.svb.com/venture-private-equity-banking/, accessed on May 18, 2017.

SVCA (2017), Medlemskap i SVCA, available at http://www.svca.se/medlemmar/, accessed on July 6, 2017.

SVCA (2015), SVCA:s årsrapport 2014, http://www.svca.se/wp-content/uploads/2015/11/Årsrapport-2014.pdf, accessed on June 21, 2016

Swedish Trade & Invest Council (2015), Running a Business, Corporate Taxes in Sweden, Operating Guide, August 2015.

Svensson, B. and Danelius, J. (2012), Aktiebolagslagen. Kommentar och lagtext, Norstedts Juridik AB, Stockholm.

Svernlöv, C. (2014), Aktiebolagslagen: en översikt, Norstedts Juridik, Stockholm.

Svernlöv, C. (2012), Styrelse- och VD-ansvar i aktiebolaget: en introduktion, 2. uppl., Norstedts juridik, Stockholm.

Taxell, L.-E. (1972), Avtal och rättskydd, Åbo Akademi, Åbo.

Tay, K. (2016), Corporate and Business Lending: Setting the Standards, Partridge Publishing, Singapore.

Tepora, J. (2013), Rahoitusmuodot ja vakuudet, Lakimiesliiton Kustannus, Helsinki.

TheBanks.eu (2017), Banks in Estonia, available at https://thebanks.eu/articles/banks-in-Estonia, accessed on July 6, 2017.

Tjio, H. (2014), The Unchanging “Debenture”, The Cambridge Law Journal 73.03 (2014), pp. 503-506.

Tikka, M. et al. (2014), Rahoitusinstrumentit - yrityksen kirjanpito, tilinpäätös ja verotus, Helsinki, Sanoma Pro Oy.

Tirole, J. (2006), The Theory of Corporate Finance. Princeton University Press.

Tivéus, U. (2014), Tvingande konvertibel - eget eller främmande kapital, Skattenytt, pp. 274-285.

Tivéus, U. (2010), Skatt på kapital, Norstedts Juridik, Stockholm.

Tolstov, L. (2015), Tort liability of the director to company's creditors. Doctoral dissertation.

Trading Economics (2017), available at http://www.tradingeconomics.com/estonia/gdp, accessed on July 6, 2017.

Tridimas, T. (2007), The General Principles of EU Law, 2nd edition, Oxford University Press, Oxford.

Tridimas, T. et al. eds (2010), Yearbook of European Law 2009, Oxford University Press, Oxford.

UK Department of Trade and Industry (2005), Company Law Reform, White Paper. London, March 2005.

UNIDROIT (2018), International Institute for the Unification of Private Law, available at unidroit.org, accessed on December 28, 2018.

UNIDROIT (2016), UNIDROIT Principles of International Commercial Contracts 2016, International Institute for the Unification of Private Law (UNIDROIT), Rome.

U.S. Securities and Exchange Commission (2013), Annual Report on Nationally Recognized Statistical Rating Organizations.

Wahlroos, B. (2015), Talouden kymmenen tuhoisinta ajatusta. Kustannusosakeyhtiö Otava, Keuruu.

Wahlroos, B. (2012), Markkinat ja demokratia. Loppu enemmistön tyrannialle. Kustannusosekeyhtiö Otava, Keuruu.

Vahtera, V. (2011), Osakeomistuksen riski ja sääntely, Lakimiesliton Kustannus, Helsinki.

Walther, B. (2014), The Peril And Promise Of Preferred Stock, Delaware Journal Of Corporate Law, Vol. 39, 2014, pp. 161-209.

Van Gerven, D. ed. (2014), Capital Directive in Europe: The Rules on Incorporation and Capital of Limited Liability Companies, Cambridge University Press, Cambridge.

Varul, P. et al. (2005), Äriühingu juhtorganid. Äriühingu juhtorganite liikmete õigused, kohustused ja vastutus, Äripäeva Kirjastus 2005.

Varul, P. (2000), Legal Policy Decisions and Choices in the Creation of New Private Law in Estonia, Juridica International Law Review, University of Tartu, pp. 104-118

Watson, D. and Head, A. (2010), Corporate finance: priciples and practice, Pearson Education Limited, Harlow, UK.

Weatherill, S. (2012), Cases & Materials on EU law, 10th edition, Oxford University Press, UK.

Webley, L. and Samuels, H. (2015), Complete Public Law: Text, Cases, and Materials, Oxford University Press, Oxford.

Wehinger, G. (2014), SMEs and the credit crunch: Current financing difficulties, policy measures and a review of literature, OECD Journal: Financial Market Trends, Volume 2013/2, available at http://www.oecd.org/finance/financial-markets/SMEs-Credit-Crunch-Financing-Difficulties.pdf, accessed on July 6, 2017.

Weiss, F. and Kaupa, C. (2014), European Union Internal Market Law, Cambridge University Press.

Weitnauer, W. et al. (2016), Handbuch Venture Capital - von der Innovation zum Börsengang, C.H.Beck, München.

Welch, E.P. et al. (2016), Folk on the Delaware General Corporation Law, Fundamentals, Wolters Kluwer Law & Business, New York.

Wells Fargo (2017), Investment Banking & Capital Markets, available at https://www.wellsfargo.com/com/securities/investment-banking/, accessed on May 17, 2017.

Vermeylen, J. and Velde, I.V. eds (2012), European Cross-Border Mergers and Reorganisations, Oxford University Press.

Vernimmen, P. et al. (2017), Corporate Finance: Theory and Practice, John Wiley & Sons, UK.

Werner, R.A. (2015), A lost century in economics: Three theories of banking and the conclusive evidence, International Review of Financial Analysis 46 (2016), pp. 361-379.

Verohallinto (2014), Korkovähennysoikeuden rajoitukset elinkeinotoiminnassa, Ohje 7.4.2014.

Verohallinto (1997), Osakeyhtiölain uudet rahoitusvälineet verotuksessa,Tiedote 5/1997, 4.9.1997.

Verspay, H.-P. (2014), GmbH-Handbuch für den Mittelstand, Springer-Verlag, Heidelberg.

White House (2016), Wall Street Reform: The Dodd-Frank Act, available at https://obamawhitehouse.archives.gov/economy/middle-class/dodd-frank-wall-street-reform, accessed on November 6, 2017.

Vile, J.R. (2015), A Companion to the United States Constitution and Its Amendments, 6th Edition, Praeger, Santa Barbara, CA.

Villa, S. (2012), Velkojan saatavan muuttaminen SVOP-rahastosijoitukseksi in Iire, T. ed. (2012), Varallisuus, vakuudet ja velkojat. Juhlajulkaisu Jarmo Tuomisto 1952-9/6-2012, pp. 471-486, Turun yliopiston oikeustieteellisen tiedekunnan julkaisuja, A. Juhlajulkaisut N:o 24, Turun yliopisto, Porvoo 2012.

Villa, S. (2010), Mihin sidottua pääomaa enää tarvitaan?, pp. 333-371, in Tepora, J. et al. eds, Business Law Forum 2010, Lakimiesliiton Kustannus, Helsinki.

Villa, S. (2003), Velkojan asema osakeyhtiössä, Saarijärvi.

Villa, S. (2001): Välipääomarahoitus, Lakimiesliiton Kustannus, Jyväskylä 2001

Villa, S. (1997), Pääomalaina. Velvoite ja yhtiöoikeudellinen tutkimus osakeyhtiön oman pääoman ehtoisista lainoista Suomessa. Kauppakaari Oy Lakimiesliiton kustannus, Jyväskylä.

Winick, D. and Young, A. (2015), Across the pond and back again: US and European leveraged finance terms, available at https://www.cliffordchance.com/content/dam/cliffordchance/PDFDocuments/Across%20the%20pond%20and%20back%20again-%20US%20and%20European%20leveraged%20finance%20terms.pdf, accessed on December 6, 2018.

Winter Jr., R.K. (1977), State Law, Shareholder Protection and the Theory of the Corporation, The Journal of Legal Studies, Vol. 6, No. 2, June 1977), pp. 251-292.

Winton, A. and Yerramilli, V. (2008), Entrepreneurial finance: Banks versus venture capital, Journal of Financial Economics 88 (2008), pp. 51-79.

Wittendorff, J. (2010), Transfer Pricing and the Arm's Length Principle in International Tax Law, Kluwer Law International.

Von Thadden, E.-L. et al. (2010), The design of corporate debt structure and bankruptcy, Review of Financial Studies, Volume 23, Issue 7, July 2010, pp. 2648-2679.

Wood, P. R. (2011), The Bankruptcy Ladder of Priorities and the Inequalities of Life, Hofstra Law Review, Vol. 40:93, pp. 93-101.

Wood, P. R. (2008), Law and Practice of International Finance, Thomson Reuters Limited, London.

Wood, P. R. (2007), Principles of international insolvency, Volume 1, Sweet & Maxwell, London

Wood, P. R. (2007b), Project Finance, Securitisations, Subordinated Debt, Sweet & Maxwell, London.

Wood, P. R. (2007c), International Loans, Bonds, Guarantees, Legal Opinions, Sweet & Maxwell, London.

Woodward, S. E. (1985), Limited Liability in the Theory of the Firm, Zeitschrift fur die gesamte Staatswissenschaft (ZgS)/Journal of Institutional and Theoretical Economics, Bd. 141, H. 4., Dezember 1985, pp. 601-611.

Vossestein, G.J. (2010), Modernization of European Company Law and Corporate Governance: Some Considerations on Its Legal Limits, Kluwer Law International, The Netherlands.

Wupperfeld, U. (1997), Der Beteiligungskapitalmarkt in Deutschland, Technologie-unternehmen im Innovationsprozeß. Physica-Verlag HD,1997. pp. 153-178.

Vutt, A. (2011), Legal capital rules as a measure for creditor and shareholder protection. Doctoral dissertation.

Vutt, M. (2010), Systematics of Shareholder Remedies - Origins and Developments, Juridica International XVII/2010, pp 188-196.

Vutt, A. (2008), Subordination of Shareholder Loans in Estonian Law, Juridica International, 2008, No. 2, pp. 86-93.

Vutt, A. (2005), Aktsiakapitali õiguslik reguleerimine: olevik ja tulevik, Juridica 2005, nr 9, pp. 606-620.

Välimäki, O. (2014), Kovenantit, Lakimiesliiton Kustannus, Vantaa.

Värv, A. (2008), Ühinguõigus, Sisekaitseakadeemia, Tallinn.

Ycharts (2017), available at https://ycharts.com/indicators/us_number_of_commercial_banks, accessed on July 6, 2017.

Zartner, D. (2014), Courts, Codes, and Custom: Legal Tradition and State Policy toward International Human Rights and Environmental Law, Oxford University Press.

Zweigert, K. and Kötz, H. (1998), An Introduction to Comparative Law, Oxford University Press, Oxford.

Äimä, K. (2009), Sisäiset korot lähiyhtiöiden kansainvälisessä verotuksessa, WSOYPro Oy, Juva.

Legal material

Directives - EU

Directive (EU) 2017/1132, Directive of the European Parliament and of the Council of 14 June 2017 relating to certain aspects of company law.

Directive 2014/65/EU of the European Parliament and of the Council of 15 May 2014 on markets in financial instruments and amending Directive 2002/92/EC and Directive 2011/61/EU Text with EEA relevance.

Directive 2014/57/EU of the European Parliament and of the Council of 16 April 2014 on criminal sanctions for market abuse (market abuse directive).

Directive 2013/50/EU, Directive of the European Parliament and of the Council of 22 October 2013 amending Directive 2004/109/EC of the European Parliament and of the Council on the harmonisation of transparency requirements in relation to information about issuers whose securities are admitted to trading on a regulated market, Directive 2003/71/EC of the European Parliament and of the Council on the prospectus to be published when securities are offered to the public or admitted to trading and Commission Directive 2007/14/EC laying down detailed rules for the implementation of certain provisions of Directive 2004/109/EC.

Directive 2013/36/EU, Directive of the European Parliament and of the Council of 26 June 2013 on access to the activity of credit institutions and the prudential supervision of credit institutions and investment firms, amending Directive 2002/87/EC and repealing Directives 2006/48/EC and 2006/49/EC Text with EEA relevance.

Directive 2012/30/EU, Directive of the European Parliament and of the Council of 25 October 2012 on coordination of safeguards which, for the protection of the interests of members and others, are required by Member States of companies within the meaning of the second paragraph of Article 54 of the Treaty on the Functioning of the European Union, in respect of the formation of public limited liability companies and the maintenance and alteration of their capital, with a view to making such safeguards equivalent.

Directive 2012/17/EU, Directive of the European Parliament and of the Council of 13 June 2012 amending Council Directive 89/666/EEC and Directives 2005/56/EC and 2009/101/EC of the European Parliament and of the Council as regards the interconnection of central, commercial and companies registers.

Directive 2011/35/EU, Directive of the European Parliament and of the Council of 5 April 2011 concerning mergers of public limited liability companies.

Directive 2009/102/EC, Directive of the European Parliament and of the Council of 16 September 2009 in the area of company law on single-member private limited liability companies.

Directive 2009/101/EC, Directive of the European Parliament and of the Council of 16 September 2009 on coordination of safeguards which, for the protection of the interests of members and third parties, are required by Member States of companies within the meaning of the second paragraph of Article 48 of the Treaty, with a view to making such safeguards equivalent.

Directive 2005/56/EC, Directive of the European Parliament and of the Council of 26 October 2005 on cross-border mergers of limited liability companies.

Directive 2004/109/EC, Directive of the European Parliament and of the Council of 15 December 2004 on the harmonisation of transparency requirements in relation to information about issuers whose securities are admitted to trading on a regulated market and amending Directive 2001/34/EC.

Directive 2004/39/EC of the European Parliament and of the Council of 21 April 2004 on markets in financial instruments amending Council Directives 85/611/EEC and 93/6/EEC and Directive 2000/12/EC of the European Parliament and of the Council and repealing Council Directive 93/22/EEC.

Directive 2003/72/EC, Council Directive of 22 July 2003 supplementing the Statute for a European Cooperative Society with regard to the involvement of employees.

Directive 2001/86/EC, Council Directive of 8 October 2001 supplementing the Statute for a European company with regard to the involvement of employees.

Directive 2001/23/EC, Council Directive of 12 March 2001 on the approximation of the laws of the Member States relating to the safeguarding of employees' rights in the event of transfers of undertakings, businesses or parts of undertakings or businesses.

Directive 95/46/EC, Directive of the European Parliament and of the Council of 24 October 1995 on the protection of individuals with regard to the processing of personal data and on the free movement of such data.

Directive 89/666/EEC, Eleventh Council Directive 89/666/EEC of 21 December 1989 concerning disclosure requirements in respect of branches opened in a Member State by certain types of company governed by the law of another State.

Directive 82/891/EEC , Sixth Council Directive 82/891/EEC of 17 December 1982 based on Article 54 (3) (g) of the Treaty, concerning the division of public limited liability companies.

Directive 68/151/EEC, First Council Directive 68/151/EEC of 9 March 1968 on co-ordination of safeguards which, for the protection of the interests of members and others, are required by Member States of companies within the meaning of the second paragraph of Article 58 of the Treaty, with a view to making such safeguards equivalent throughout the Community.

Council regulations - EU

Council Regulation (EC) No 1435/2003, Council Regulation of 22 July 2003 on the Statute for a European Cooperative Society (SCE).

Council Regulation (EC) No 2157/2001, Council Regulation of 8 October 2001 on the Statute for a European company (SE).

Council Regulation (EEC) No 2137/85, Council Regulation of 25 July 1985 on the European Economic Interest Grouping (EEIG).

Regulations of the European Parliament and of the Council - EU

Regulation (EU) No 600/2014 of the European Parliament and of the Council of 15 May 2014 on markets in financial instruments and amending Regulation (EU) No 648/2012 Text with EEA relevance.

Regulation (EU) No 596/2014 of the European Parliament and of the Council of 16 April 2014 on market abuse (market abuse regulation) and repealing Directive 2003/6/EC of the European Parliament and of the Council and Commission Directives 2003/124/EC, 2003/125/EC and 2004/72/EC Text with EEA relevance.

Regulation (EU) No 575/2013 of the European Parliament and of the Council of 26 June 2013 on prudential requirements for credit institutions and investment firms and amending Regulation (EU) No 648/2012 Text with EEA relevance.

Regulation (EC) No 1606/2002 of the European Parliament and of the Council of 19 July 2002 on the application of international accounting standards.

Treaties and agreements - EU

Treaty on European Union (2016), Official Journal of the European Union, 202, June 2016.

Treaty on the Functioning of the European Union (2016), Official Journal of the European Union, 202, June 2016.

Treaty of Lisbon (2007), Amending the Treaty on European Union and the Treaty establishing the European Community, Official Journal of the European Union, C 306, December 2007.

Treaty of Nice (2001), amending the Treaty on European Union, the Treaties establishing the European Communities and certain related acts, Official Journal of the European Communities, C 80, March 2001.

Agreement on the European Economic Area (1994).

Case law - EU

ECJ, 22 October 2013, Case C-95/12 (Federal Republic of Germany).

ECJ, 8 November 2012, Case C-244/11 (Hellenic Republic)

ECJ, 12 July 2012, Case C-378/10 (VALE Epitesi kft).

ECJ, 10 November 2011, Case C-212/09 (Portuguese Republic), I-10889

ECJ, 11 November 2010, Case C-543/08 (Portuguese Republic), I-11241

ECJ, 8 July 2010, Case C-171/08 (Portuguese Republic), I-06817

ECJ, 26 March 2009, Case C-326/07 (Italian Republic), I-02291

ECJ, 16 December 2008, Case C-210/06 (Cartesio), ECR 2008, I-9641

ECJ, 17 July 2008, Case C-207/07(Kingdom of Spain), I-00111

ECJ, 14 February 2008, Case C-274/06 (Kingdom of Spain), I-00026

ECJ, 6 December 2007, Cases C-463/04 and C-464/04 (Comune di Milano), I-10419

ECJ, 23 October 2007, Case C-112/05 (Federal Republic of Germany), I-08995

ECJ, 28 September 2006, Cases C-282/04 and C-283/04 (Kingdom of the Netherlands), I-09141

ECJ, 13 December 2005, Case C-411/03 (SEVIC), ECR 2005, I-10805

ECJ, 2 June 2005, Case C-174/04 (Italian Republic), I-04933

ECJ, 30 September 2003, Case C-167/01 (Inspire Art), ECR 2003, I-10155

ECJ, 13 May 2003, Case C-98/01 (United Kingdom of Great Britain and Northern Ireland), I-04641

ECJ, 13 May 2003, Case C-463/00 (Kingdom of Spain), I-04581

ECJ, 12 December 2002, Case C-324/00 (Lankhorst-Hohorst), ECR 2002, I-11779

ECJ, 5 November 2002, Case C-208/00 (Überseering), ECR 2002, I-9919

ECJ, 4 June 2002, Case C-367/98 (Portuguese Republic), I-04731

ECJ, 4 June 2002, Case C-483/99 (French Republic), I-04781

ECJ, 4 June 2002, Case C-503/99 (Kingdom of Belgium), I-04809

ECJ, 23 May 2000, Case C-58/99 (Italian Republic), I-03811

ECJ, 9 March 1999, Case C-212/97 (Centros), ECR 1999, I-1459.

Other - EU

Charter of Fundamental Rights of the European Union, Official Journal of the European Union, C 202, June 2016.

Commission of the European Communities (2005), Commission staff working document, Special rights in privatised companies in the enlarged Union - a decade full of developments, Brussels, 22.7.2005.

EC (2016), Commission Staff Working Document, Impact assessment accompanying the document Commission Delegated Regulation Supplementing Regulation (EU) No 600/2014 of the European Parliament and of the Council with regard to definitions, transparency, portfolio compression and supervisory measures on product intervention and positions, Brussels, 18.5.2016 SWD(2016) 157 final.

EC (2015), European Commission - Press release: How revised bank capital requirements have affected lending: Commission consults, available at http://europa.eu/rapid/press-release_IP-15-5347_en.htm?locale=EN, accessed on October 6, 2016.

EC (2013), European Parliament's endorsement of the political agreement on Market Abuse Regulation, 10 September 2013, available at http://europa.eu/rapid/press-release_MEMO-13-774_en.htm, accessed on October 6, 2016.

EU (2015), Experiences with cash-flow taxation and prospects, Final Report 12 May 2015.

EUR-Lex (2017), White Paper, available at http://eur-lex.europa.eu/summary/glossary/white_paper.html, accessed on May 16, 2017.

EUR-Lex (2017b), Green Paper, available at http://eur-lex.europa.eu/summary/glossary/green_paper.html, accessed on May 16, 2017.

EUR-Lex (2016), European Cooperative Society, available at http://eur-lex.europa.eu/legal-content/EN/TXT/?uri=uriserv%3Al26018, accessed on May 17, 2017.

EUR-Lex (2016b), European Economic Interest Grouping, available at http://eur-lex.europa.eu/legal-content/EN/TXT/?uri=URISERV%3Al26015, accessed on May 17, 2017.

EUR-Lex (2014), Public limited liability companies (PLCs) - protecting shareholders and creditors, available at http://eur-lex.europa.eu/legal-content/EN/TXT/?qid=1447753285558&uri=URISERV:l26004, accessed on May 17, 2017.

EUR-Lex (2014b), Statute for a European Company, available at http://eur-lex.europa.eu/legal-content/EN/TXT/?uri=URISERV:l26016, accessed on May 17, 2017.

EUR-Lex (2012), Companies: protecting the interests of members and third parties, available at http://eur-lex.europa.eu/legal-content/FI/TXT/?uri=URISERV:mi0076, accessed on May 17, 2017.

EUR-Lex (2011), Council Regulation (EC) No 2157/2001 of 8 October 2001 on the Statute for a European company (SE), available at http://eur-lex.europa.eu/legal-content/EN/TXT/?uri=celex:32001R2157, accessed on May 17, 2017.

EUR-Lex (2010), Sources of European Union law, available at http://eur-lex.europa.eu/legal-content/EN/ALL/?uri=URISERV:l14534, accessed on May 16, 2017.

EUR-Lex (2010b), The non-written sources of European law: supplementary law, available at http://eur-lex.europa.eu/legal-content/EN/TXT/?uri=URISERV:l14533, accessed on May 16, 2017.

EUR-Lex (2003), Council Regulation (EC) No 1435/2003 of 22 July 2003 on the Statute for a European Cooperative Society (SCE), available at http://eur-lex.europa.eu/legal-content/EN/TXT/?uri=celex:32003R1435, accessed on May 17, 2017.

EUR-Lex (1985), Council Regulation (EEC) No 2137/85 of 25 July 1985 on the European Economic Interest Grouping (EEIG), available at http://eur-lex.europa.eu/legal-content/EN/TXT/?uri=celex:31985R2137, accessed on May 17, 2017.

European Commission (2017), Company law and corporate governance, available at http://ec.europa.eu/justice/civil/company-law/index_en.htm accessed on May 16, 2017.

European Commission (2016), Commission staff working document, Country Report Estonia 2016, Brussels, 26.2.2016.

European Commission (2015), Consultation document, Review of the European venture capital funds (EuVECA) and European Social Entrepreneurship Funds (EuSEF) regulations. Available at http://ec.europa.eu/finance/consultations/2015/venture-capital-funds/docs/consultation-document_en.pdf, accessed on August 9, 2017.

European Commission (2014), Proposal for a Directive of the European Parliament and of the Council on single member private limited liability companies, April 2014, COM/2014/0212 final.

European Commission (2012), Communication from the Commission to the European Parliament, the Council, the European Economic and Social Committee and the Committee of the Regions, Action Plan: European company law and corporate governance - a modern legal framework for more engaged shareholders and sustainable companies, COM/2012/0740 final.

European Commission (2007), Roundtable between bankers and SMEs, Mezzanine Finance, Final Report, Enterprise publications.

European e-justice (2017), Interconnection of EU Business Registers, available at https://e-justice.europa.eu/content_business_registers_at_european_level-105-en.do, accessed on August 9, 2017.

European Parliament (2017), Sources and scope of European Union law, available at http://www.europarl.europa.eu/atyourservice/en/displayFtu.html?ftuId=FTU_1.2.1.html, accessed on May 16 2017.

European Securities and Markets Authority (2013), CRAs' Market share calculation according to Article 8d of the CRA Regulation, 16 December 2013, ESMA/2013/1933.December

Finland

Supreme Administrative Court decision, KHO 2014:119

Act on the Book-Entry System (348/2017)

Act on Credit Institutions (610/2014)

Act on Cooperative Banks and Other Credit Institutions in the Form of a Cooperative (423/2013)

Act on Trading in Financial Instruments (748/2012)

Securities Markets Act (746/2012)

Limited Liability Companies Act (624/2006)

Bankruptcy Act (120/2004)

Savings Bank Act (1502/2001)

Act on Commercial Banks and Other Credit Institutions in the Form of a Limited Company (1501/2001)

Constitution of Finland (731/1999)

Act on the State-Owned Specialised Financing Company (443/1998)

Credit Institution Act (1340/1997)

Accounting Decree (1339/1997)

Accounting Act (1336/1997)

Law of Amending of Limited Liability Companies Act (145/1997)

Act on Assessment Procedure (1558/1995)

Restructuring of Enterprises Act (47/1993)

Finnish Act on Recovery (758/1991)

General Partnership and Limited Partnership Act (389/1988)

Procuration Act (130/1979)

Commercial Register Act (129/1979)

Trade Name Act (128/1979)

Act on Mortgage Societies (936/1978)

Limited Liability Companies Act (734/1978)

Companies Income Tax Act (360/1968)

Advocates Act (496/1958)

Contracts Act (228/1929)

Freedom of Enterprise Act (122/1919)

Government Bill for the Law amending the Accounting Act (HE 89/2015)

Government Bill for the Act on Credit Institutions (HE 39/2014)

Government Bill for the Law amending the Companies Income Tax Act (HE 146/2012)

Government Bill for the Limited Liability Companies Act (HE 109/2005)

Sweden

Supreme Administrative Court decisions

- HFD 2014, ref. 10
- RÅ 1997, ref. 65
- RÅ 1987, ref. 145

Supreme Court decisions

- NJA 2014, p. 877
- NJA 1988, p. 620

Securities Market Act (SFS 2007:528)

Companies Act (SFS 2005:551)

Banking and Financing Business Act (SFS 2004:297)

Income Tax Law (SFS 1999:1229)

Accounting Act (SFS 1999:1078)

Financial Instruments Accounts Act (SFS 1998:1479)

Members´ Banks Act (SFS 1995:1570)

Annual Accounts Act (SFS 1995:1554)

Fundamental Law on Freedom of Expression (SFS 1991:1469)

Private Sector Employees Board Representation Act (SFS 1987:1245)

Savings Bank Act (SFS 1987:619)

Instrument of Government (SFS 1974:152)

Freedom of the Press Act (SFS 1949:105)

Act of Succession (SFS 1810:0926)

Commercial Code (SFS 1736:01232)

Government Proposal for the Companies Act (Prop. 2004/05:85)

Estonia

Securities Register Maintenance Act (RT I, 26.06.2017)

Accounting Act (RT I 2002, 102, 600)

Law of Obligations Act (RT I 2001, 81, 487)

Income Tax Act (RT I 1999, 101, 903)

Credit Institutions Act (RT I 1999, 23, 349)

Commercial Code (RT I 1995, 26, 355)

Constitution of Estonia (RT 1992, 26, 349)

USA

U.S. Supreme Court cases

- Santa Clara County v. Southern Pacific R.R., 118 U.S. 394 (1886).
- Louis K. Liggett Co. v. Lee, 288 U.S. 517 (1933)

Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010

Sarbanes-Oxley Act of 2002

Employee Retirement Income Security Act of 1974

Securities and Exchange Act of 1934

Securities Act of 1933

Constitution of the United States of America

Delaware General Corporation Law (Title 8, Chapter 1 of the Delaware Code)

11 U.S. Code - United States Bankruptcy Code of 1978

26 U.S. Code - Internal Revenue Code of 1986

UK

Chancery Division of the High Court decision, Re Maxwell Communications plc (No. 2), [1994] 1 All ER 737

Court of Appeal decision, James Spencer & Co Ltd v Tame Valley Padding Co. Ltd (April 8, 1998, unreported)

Financial Services Act 2012

Taxation (International and Other Provisions) Act 2010

Banking Act 2009

Companies Act 2006

Stock Transfer Act 1982

Act of Union 1801

Germany

Basic Law for the Federal Republic of Germany of May 23, 1949

Limited Liability Companies Act of April 20, 1892

Stock Corporation Act of September 6, 1965

German Civil Code of August 18, 1896

German Commercial Code of May 10, 1897

Foreign Transactions Tax Act of September 8, 1972

General Tax Code of March 16, 1976

Banking Act of July 10, 1961

APPENDIX 1

Some of the most significant Court of Justice (ECJ) judgments regarding free movement of companies

Case Centros[2337]

Two Danish residents, Mr. and Mrs. Bryde, wanted to set up an incorporated business in Denmark. In the early 1990's the capital requirements included in the private companies act of Denmark were increased. According to the changed regulation a private company would require about 27,000 euros (200,000 Danish crowns) fully paid-up before the company could be registered. Mr. and Mrs. Bryde established Centros Ltd under UK company law for the trade only in Denmark. This establishment required only about 20 euros (100 GBP).[2338] Without starting any business activity in the UK the incorporators applied for registration at the Danish registry office. The incorporators explained that they had established the entity under UK company law to avoid the minimum capitalization requirement of Danish limited liability companies.

The above described arrangement was considered illegal by the Danish commercial registry. The arrangement was considered to be an illegal circumvention of the minimum capitalization rules of the country and the registry refused to register the company's branch office in Denmark. The ECJ considered the company Centros to be legal under UK law and therefore entitled to have a branch in another member state. It did not qualify as a public policy exemption that the UK capital requirements differed from the Danish ones. The government of Denmark additionally stated that requirement for the UK company to follow the Danish private companies act should be seen as an internal Danish matter. The argument for that was that as there was an uncontested intent to avoid Danish regulation the Danish law was required to protect creditors and the taxman.

On March 9, 1999 the ECJ rejected the Danish government view. The ECJ ruled that when a company exercises its freedom of establishment under the Articles 52 and 58 of the Treaty establishing the European Community[2339], the member states are prohibited from

---

[2337] ECJ, 9 March 1999, Case C-212/97 (Centros), ECR 1999, I-1459.

[2338] UK company law does not contain a minimum capital requirement for private limited companies. In practice 100 GBP is enough for a formation of a private limited company. For public limited liability companies there is a minimum capital requirement of 50.000 GBP.

[2339] Articles 52 and 58 of the Treaty establishing the European Community valid during the Centros case are nowadays replaced by Articles 49 and 54 of the Treaty on the Functioning of the European Union but are in terms of content the same. About Articles 49 and 54 of the Treaty on the Functioning of the European Union see for more details footnote 2374 below. Articles 52 and 58 of the codified version of the Treaty establishing the European Community (OJ C 224, 31.8.1992) were as follows:

Article 52

"*Within the framework of the provisions set out below, restrictions on the freedom of establishment of nationals of a Member State in the territory of another Member State shall be abolished by progressive stages in the course of the transitional period. Such progressive abolition shall also apply to restrictions on the setting up of agencies, branches or subsidiaries by nationals of any Member State established in the territory of any Member State.*

Freedom of establishment shall include the right to take up and pursue activities as self-employed persons and to set up and manage undertakings, in particular companies or firms within the meaning of the second paragraph of Article 58, under the conditions laid down for its own nationals by the law of the country where such establishment is effected, subject to the provisions of the Chapter relating to capital."

Article 58

"*Companies or firms formed in accordance with the law of a Member State and having their registered office, central administration or principal place of business within the Community shall, for the purposes of this Chapter, be treated in the same way as natural persons who are nationals of Member States.*

discriminating against this company. Discrimination is not allowed although the company was established according to the law of another member state in which the company has its registered office but does not carry on any business. A state is not either authorized to limit freedom of establishment on the ground of protecting creditors or preventing fraud if other ways of countering fraud or protecting creditors are available. Additionally, ECJ points to the availability to member states of the option of adopting European Community harmonizing legislation in this area of company law. Moreover, the court considered the conditions governing abuses of EC law restrictive.[2340]

All in all, in this case the ECJ view on freedom of establishment can be considered to be fairly liberal.[2341]

Case Überseering[2342]

A limited liability company Überseering BV, organized under the Dutch law, acquired a piece of land in Germany, which it used for business purposes. In 1992, Überseering BV hired a German corporation, Nordic Construction Company Baumanagement GmbH to renovate a garage and motel on a piece of land it owned in Düsseldorf, Germany. After the completion of the renovation work Überseering BV claimed that the work was defective. Later the Dutch company filed an action for contract damages before a German court in 1996. Although all the directors of the Dutch limited liability company were resident in Germany the German first level court and courts of appeal concluded that Überseering did not have legal capacity in Germany. As the company was incorporated under Netherlands law the fact that its administrative center was is Germany was not relevant when considering the legal capacity. The issue here was whether a company´s legal capacity shall be determined to be in the place where its actual center of administration is (administration principle) or in place of incorporation (incorporation principle). According to the administration principle - also called as real-seat principle - the location of company headquarters is decisive in judging which law shall be applied.[2343] According to the incorporation principle the applicable law is the law of the incorporation place meaning the registration place.[2344]

In its ruling on November 5, 2002 the ECJ concluded that a member state must recognize the legal capacity of an established company which transfers its place of administration to another member state. The legal background for this is the freedom of establishment guaranteed in Articles 43 and 48 of the Treaty establishing the European Community.[2345] The legal capacity

---

Companies or firms` means companies or firms constituted under civil or commercial law, including cooperative societies, and other legal persons governed by public or private law, save for those which are non-profitmaking."

[2340] The judgment of ECJ is as follows: "*It is contrary to Articles 52 and 58 of the EC Treaty for a Member State to refuse to register a branch of a company formed in accordance with the law of another Member State in which it has its registered office but in which it conducts no business where the branch is intended to enable the company in question to carry on its entire business in the State in which that branch is to be created, while avoiding the need to form a company there, thus evading application of the rules governing the formation of companies which, in that State, are more restrictive as regards the paying up of a minimum share capital. That interpretation does not, however, prevent the authorities of the Member State concerned from adopting any appropriate measure for preventing or penalising fraud, either in relation to the company itself, if need be in cooperation with the Member State in which it was formed, or in relation to its members, where it has been established that they are in fact attempting, by means of the formation of a company, to evade their obligations towards private or public creditors established in the territory of the Member State concerned*."

[2341] Kaczorowska, A. (2013), p. 701.

[2342] ECJ, 5 November 2002, Case C-208/00 (Überseering), ECR 2002, I-9919.

[2343] Rothe, N. (2004), p. 1110 and Ebke W.F. (2002), pp. 1015-1016.

[2344] Rothe, N. (2004), p. 1110 and Kersting, C. (2002), p. 37.

[2345] Articles 43 and 48 of the Treaty establishing the European Community valid during the Überseering case are nowadays replaced by Articles 49 and 54 of the Treaty on the Functioning of the European Union but are in terms of content the same. About Articles 49 and 54 of the Treaty on the Functioning of the European Union see

allows a company to be a party to legal proceedings and thus stand to sue or be sued in courts.[2346]

Based on the above described preliminary ECJ ruling the Federal Court of Justice in Germany reversed the judgment of the lower level German court. The court case was referred back for a ruling consistent with the ECJ's interpretation.[2347]

Case Lankhorst-Hohorst[2348]

Lankhorst-Hohorst GmbH was a loss-making German company which had a small amount of equity capital in comparison to its debt capital. This meant that the company was thinly capitalised.[2349] Bank financing or other third-party financing would not have been available on arm's-length terms and therefore the German company borrowed money from its Dutch grandparent, Lankhorst Taselaar BV. The loan granted by the parent company was intended to a substitute the equity capital and to be used to repay a bank loan. As country tax rules typically allow a deduction for interest paid from the profit before tax measure or payable the leverage has impact on the taxes to be paid. The higher the level of debt and thus amount of

---

for more details footnote 2374 below. Articles 43 and 48 of the consolidated version of the Treaty establishing the European Community (OJ C 325, 24.12.2002) were as follows:
Article 43

"*Within the framework of the provisions set out below, restrictions on the freedom of establishment of nationals of a Member State in the territory of another Member State shall be prohibited. Such prohibition shall also apply to restrictions on the setting-up of agencies, branches or subsidiaries by nationals of any Member State established in the territory of any Member State.*

Freedom of establishment shall include the right to take up and pursue activities as self-employed persons and to set up and manage undertakings, in particular companies or firms within the meaning of the second paragraph of Article 48, under the conditions laid down for its own nationals by the law of the country where such establishment is effected, subject to the provisions of the chapter relating to capital."

Article 48

"*Companies or firms formed in accordance with the law of a Member State and having their registered office, central administration or principal place of business within the Community shall, for the purposes of this Chapter, be treated in the same way as natural persons who are nationals of Member States.*

Companies or firms means companies or firms constituted under civil or commercial law, including cooperative societies, and other legal persons governed by public or private law, save for those which are non-profitmaking."

[2346] The judgment of ECJ is as follows:

"*1. Where a company formed in accordance with the law of a Member State (`A') in which it has its registered office is deemed, under the law of another Member State (`B'), to have moved its actual centre of administration to Member State B, Articles 43 EC and 48 EC preclude Member State B from denying the company legal capacity and, consequently, the capacity to bring legal proceedings before its national courts for the purpose of enforcing rights under a contract with a company established in Member State B.*

2. Where a company formed in accordance with the law of a Member State (`A') in which it has its registered office exercises its freedom of establishment in another Member State (`B'), Articles 43 EC and 48 EC require Member State B to recognise the legal capacity and, consequently, the capacity to be a party to legal proceedings which the company enjoys under the law of its State of incorporation (`A')."

[2347] Rothe, N. (2004), p. 1110.

[2348] ECJ, 12 December 2002, Case C-324/00 (Lankhorst-Hohorst), ECR 2002, I-11779.

[2349] Thin capitalisation means the situation where a company is financed with a high debt level compared to equity. As tax rules normally allow a deduction for interest paid at the tax measure of profit the way a company balance sheet is structured has often a significant impact on the amount of profit to be reported for taxation. The higher the level of debt in a company and thus the amount of interest it pays, the lower taxable profit will be. Debt is due to this reason often a more tax efficient method of finance compared to equity. See also Farrar, J.H and Mawani, A. (2008), p. 3 according to which "*A business is said to be thinly capitalized if it is financed with a high proportion of debt relative to equity. The rules that limit the amount of interest deductions in those situations are known as thin capitalization rules"*.

interest to be paid, the lower the taxable income will be. For this reason debt is often a more tax efficient method of finance compared to equity.

The German tax authorities did not allow deduction for interests based on the German tax regulation. The German thin capitalisation rules were applied as the level of debt exceeded a fixed ratio of debt to equity of 3:1, and equivalent finance was not available on arm's length terms. However, if the loan been granted from a German parent company instead of a Dutch company there would have been no disallowance.

The UK, Germany and Denmark made submissions to the ECJ in the Lankhorst-Hohorst case because they had also designed thin capitalisation rules to denying an interest deduction in the subsidiary and thus treating payments of interest as taxable dividends. The rules were made to avoid the shifting of taxable profits from the country of the borrower to the country of the lender by excessive interest deductions.[2350] There was also an argument by the German and UK governments that the thin-capitalisation rules applied are in line with the Article 9 of OECD Model.[2351]

In Lankhorst-Hohorst case decision on December 12, 2002 ECJ decided to set aside German tax law rules on *"thin capitalisation"* limiting the deductibility as the rules were incompatible with the freedom of establishment guaranteed in Articles 43 of the Treaty establishing the European Community.[2352] The reason for having this conclusion was that the German tax rules make a difference between groups where the mother company was founded in Germany and other groups where the mother was founded abroad. However, it shall be noted that ECJ does not insist that interest should always be deductible in case a company is thinly capitalised. But the point is that if a member state provides an exception for a loan between local companies, then the member states must treat foreign mother companies equally well as their own. According to the ECJ different treatment between national and non-national parties had to be precluded by the EC law.[2353] One additional conclusion out of the judgment is that OECD Model is not a relevant argument in respect to European tax law.[2354]

Case Inspire Art[2355]

A Dutchman established the limited liability company Inspire Art Ltd under the laws of United Kingdom. The director was resident in the Netherlands. The company established a Dutch branch office in Amsterdam without having business in UK. The company requested the registration of the Dutch branch at the commercial registry Dutch Chamber in Commerce in the Netherlands. However, the registry took the view that specific Dutch rules for foreign entities registered in the Netherlands had to be applied to the company. It meant that Inspire Art Ltd would have been required among other things to use a company name indicating its foreign origin. Additionally, Inspire Arts would have been obliged to comply with the minimum capitalisation rules for Dutch limited liability companies. The subscribed capital and the paid-up share capital had to be at least the minimum 18,000 euros at the time of the

[2350] Arnull, A. and Chalmers, D. eds. (2015), p. 824.
[2351] Article 9 of the OECD (Organization for Economic Cooperation and Development) Model Tax Convention on Income and Capital valid during the Lankhorst-Hohorst case authorised the reintegration of transactions not considered to be arm´s length into company´s taxable income. See more about the transfer pricing and *"arm´s length principle"* in OECD (2010).
[2352] Article 43 of the Treaty establishing the European Community valid during the Lankhorst-Hohorst case is nowadays replaced by Article 49 of the Treaty of European Union but is in terms of content the same. See for more details footnote 2374 below.
[2353] The judgment of ECJ is as follows: "*Article 43 EC is to be interpreted as precluding a measure such as that contained in Paragraph 8a(1), Head 2, of the Körperschaftsteuergesetz (Law on corporation tax).*"
[2354] Richelle, I. et al. eds. (2013), p. 76.
[2355] ECJ, 30 September 2003, Case C-167/01 (Inspire Art), ECR 2003, I-10155.

requested registration. Until the payment of the share capital the directors were personally liable of the obligations of the company.

The ECJ continued in its decision on September 30, 2003 its tendency of deciding in favour of freedom of establishment according to EU law. ECJ concluded that it is contrary to Articles 43 and 48 of the Treaty establishing the European Community[2356] for national legislation to impose on companies formed in accordance with the law of another member state requirement to register as *"formally foreign company"*[2357].

The above-mentioned means that ECJ required that rules submitting "formally foreign companies" to the company law of the host state were inadmissible. ECJ thus laid down that a foreign company must be respected as a legal entity having the right to be a party to legal proceedings and also as a foreign company that is subject to the company law of its country of incorporation. Any adjustments to the company law of the host state are therefore non-compatible with European law.[2358]

This means that establishing a company in another country to avoid national requirements is considered legal by the ECJ. As referred to by ECJ already in Centros case the countries are only permitted to prevent individuals from fraudulently or otherwise improperly taking advantage of EU law.[2359] Such broad-sweeping measures that depend exclusively on the fact that a company is incorporated in another member state are not allowed.[2360] Basically, this means that ECJ has continued to open the door to regulatory competition in the EU corporate law. [2361]

[2356] Articles 43 and 48 of the Treaty establishing the European Community valid during the Inspire Art case are nowadays replaced by Articles 49 and 54 of the Treaty on the Functioning of the European Union but are in terms of content the same. See for more details footnote 2374 below.

[2357] Dutch law applied to *"formally foreign companies"* having their activity limited primarily to the Netherlands specific provisions concerning disclosure, a capital requirement of 18,000 euros at the minimum and personal liability for managers in case of violations.

[2358] The judgment of ECJ is as follows:

"*1. It is contrary to Article 2 of the Eleventh Council Directive 89/666/EEC of 21 December 1989 concerning disclosure requirements in respect of branches opened in a Member State by certain types of company governed by the law of another State for national legislation such as the Wet op de Formeel Buitenlandse Vennootschappen (Law on Formally Foreign Companies) of 17 December 1997 to impose on the branch of a company formed in accordance with the laws of another Member State disclosure obligations not provided for by that directive.*

2. It is contrary to Articles 43 EC and 48 EC for national legislation such as the Wet op de Formeel Buitenlandse Vennootsc happen to impose on the exercise of freedom of secondary establishment in that State by a company formed in accordance with the law of another Member State certain conditions provided for in domestic company law in respect of company formation relating to minimum capital and directors' liability. The reasons for which the company was formed in that other Member State, and the fact that it carries on its activities exclusively or almost exclusively in the Member State of establishment, do not deprive it of the right to invoke the freedom of establishment guaranteed by the EC Treaty, save where the existence of an abuse is established on a case-by-case basis."

[2359] Weiss, F. and Kaupa, C. (2014), p. 227.

[2360] Armour, J. (2005), p. 14 refers to ECJ judgment in case C-55/94, Gebhard v. Colsiglio dell'Ordine degli Avvocati e Procuratori di Milano [1995] ECR I-4165, according to which restrictions of EU Treaty freedoms are not possible "*unless they satisfy the four-stage criteria set out in Gebhard: that is, they are (i) applied in a non-discriminatory manner; (ii) are justified by imperative requirements of the public interest; (iii) secure the attainment of their objective; and (iv) are not disproportionate in their effect."*

[2361] See Kersting, C. (2002), Drury, R. (2005) and Armour, J. (2005).

Case SEVIC[2362]

The case SEVIC from 2005 concerned a cross-border merger between a German and a Luxembourgian company.

SEVIC Systems AG (later SEVIC) is a company founded in Neuwied in Germany and was involved in a merger process. SEVIC had prepared an application for registration in the national commercial register of the merger between itself and Luxembourg company Security Vision Concept SA. A Luxembourg company was dissolved without liquidation process and all of its assets were transferred to SEVIC. Amtsgericht Neuwied had however rejected a merger registration on the ground that the German law on company transformations provides only for mergers between companies established in Germany and cross-border mergers were not recognized.

SEVIC Systems started legal process and due to that the competent court turned to the ECJ. The local court asked whether the refusal to register the merger - as the German law did not provide for cross-border mergers - was contrary to Articles 43 and 48 of the Treaty establishing the European Community. The ECJ held on its judgment on December 13, 2005 that the refusal of a national commercial court to register the cross-border merger in question is contrary to Articles 43 and 48 Treaty establishing the European Community constituting a violation of the freedom of establishment.[2363] Taking into consideration the German rules according to which the registration of a merger between two German companies was possible, a prohibition of a merger between a German and a Luxembourg company was contrary to the rights granted under the freedom of establishment.[2364] In EU the cross-border mergers promote the possibility to access to other EU countries and therefore facilitate exercising the right of establishment.

Case SEVIC was an important case as it extended the rights under the freedom of establishment to mergers and even beyond concerning also cross-border takeovers, cross-border divisions and seat transfers. After the Cross-Border Merger Directive became in force[2365] the ECJ decision was superseded. Thus, the importance of the SEVIC decision has decreased.[2366]

Case Cartesio[2367]

In case Cartesio was discussed whether a partnership can transfer its registered seat to other country without the change of the applicable law.

Cartesio Oktató és Szolgáltató bt (later Cartesio) was a limited partnership formed in accordance with Hungarian law and registered in Hungary. The company sent an application

---

[2362] ECJ, 13 December 2005, Case C-411/03 (SEVIC), ECR 2005, I-10805.
[2363] Articles 43 and 48 of the Treaty establishing the European Community valid during the SEVIC case are nowadays replaced by Articles 49 and 54 of the Treaty of European Union but are in terms of content the same. See for more details footnote 2374 below.
[2364] The judgment of ECJ is as follows: "*Articles 43 EC and 48 EC preclude registration in the national commercial register of the merger by dissolution without liquidation of one company and transfer of the whole of its assets to another company from being refused in general in a Member State where one of the two companies is established in another Member State, whereas such registration is possible, on compliance with certain conditions, where the two companies participating in the merger are both established in the territory of the first Member State*."
[2365] Directive 2005/56/EC of the European Parliament and of the Council of 26 October 2005 on cross-border mergers of limited liability companies became effective on 15 December 2005 and was to be included in the national laws of all member states until December 2007. See above for more details section *3.4.1.2.5 Cross-border mergers of limited liability companies.*
[2366] Isanbaert, M. (2010), p. 307 and Sjåfjell, B. (2009), p. 156, footnote 148.
[2367] ECJ, 16 December 2008, Case C-210/06 (Cartesio), ECR 2008, I-9641.

to the commercial court with the purpose to amend its registration in the local commercial register. Cartesio wanted to register an address in Italy as its new operational head office. The company only wanted to transfer its de facto head office to Italy, while simultaneously continuing to operate under Hungarian company law. The court however declined the application. The reason for the rejection was that according to the Hungarian law a change of company's registered seat to another country required liquidation procedure before re-incorporation in another country. Therefore, it was not possible for Cartesio to keep its legal status after the seat transfer as a company governed by Hungarian law. The company would have to first dissolve itself in Hungary and after that re-establish itself under Italian law.

After Cartesio made an appeal against the decision of the commercial court, the Court of Appeal referred several questions to the ECJ for a preliminary ruling. The Hungarian court asked whether Articles 43 and 48 of the Treaty establishing the European Community[2368] are to be interpreted as precluding national legislation. In such a situation transfer of operational headquarters to another EU country would prevent a company to retain its status as a company governed by the law of incorporation country.

The ECJ ruled on December 16, 2008 that Articles 43 and 48 of the Treaty establishing the European Community do not preclude national legislation that prevents a company from moving its seat to another member state while remaining under governance of the law of the incorporation country.[2369] Thus a member state has the power not to permit a company governed by its law to retain that status if the company intends to move its seat to the territory of another member state.

By Cartesio ruling the ECJ reaffirmed the doctrine of its earlier case law which allows member states to restrict the transfer of the central administration of a company abroad.[2370] The legal

---

[2368] Articles 43 and 48 of the Treaty establishing the European Community valid during the Cartesio case are nowadays replaced by Articles 49 and 54 of the Treaty of European Union but are in terms of content the same. See for more details footnote 2374 below.

[2369] The judgment of ECJ is as follows:

"*1. A court such as the referring court, hearing an appeal against a decision of a lower court, responsible for maintaining the commercial register, rejecting an application for amendment of information entered in that register, must be classified as a court or tribunal which is entitled to make a reference for a preliminary ruling under Article 234 EC, regardless of the fact that neither the decision of the lower court nor the consideration of the appeal by the referring court takes place in the context of inter partes proceedings.*

2. A court such as the referring court, whose decisions in disputes such as that in the main proceedings may be appealed on points of law, cannot be classified as a court or tribunal against whose decisions there is no judicial remedy under national law, within the meaning of the third paragraph of Article 234 EC.

3. Where rules of national law apply which relate to the right of appeal against a decision making a reference for a preliminary ruling, and under those rules the main proceedings remain pending before the referring court in their entirety, the order for reference alone being the subject of a limited appeal, the second paragraph of Article 234 EC is to be interpreted as meaning that the jurisdiction conferred on any national court or tribunal by that provision of the Treaty to make a reference to the Court for a preliminary ruling cannot be called into question by the application of those rules, where they permit the appellate court to vary the order for reference, to set aside the reference and to order the referring court to resume the domestic law proceedings.

4. As Community law now stands, Articles 43 EC and 48 EC are to be interpreted as not precluding legislation of a Member State under which a company incorporated under the law of that Member State may not transfer its seat to another Member State whilst retaining its status as a company governed by the law of the Member State of incorporation."

[2370] See ECJ, 27 September 2008, Case 81/87 The Queen v HM Treasury and Commissioners of Inland Revenue, ex parte Daily Mail and General Trust plc, ECR 5483. This so-called *"case Daily Mail"* was a tax-law case where Daily Mail plc (later Daily Mail) wanted to transfer its de facto headquarter (tax residence) to the Netherlands due to more favourable tax regime. The company wanted however to stay all the time subject to UK company law. The UK Treasury Department declined permission for the transfer of seat. Daily Mail referred therefore the question to the ECJ, whether Articles 43 and 48 of the EC Treaty preclude a member state from

situation of the member state is decisive in concluding whether a company has right of primary establishment by relocating its seat.[2371]

Golden share cases

Due to big waves of privatization in EU in starting from 1990´s the issue of golden shares has repeatedly been the subject of discussion. Golden shares refer here to temporary or permanent special powers granted to the state or statutory constraints in the private companies.[2372] They are used to retain control over ownership and central decisions of privatized companies. Reasons for this are many. Strategic privatized companies are important employers and tax-payers and may have also otherwise large influence on a State's economy. Privatized companies may also have substantial effect on public policy and security in the communication and energy industry. As the European governments are more than ever selling state-owned companies being responsible of services of general interest the seller would like to keep control on certain items. Even as the governments reduce their ownership shares in these companies they are however willing to avoid the new owners to take over power to make all significant decisions.

The ECJ has discussed several times the issue of the compatibility of the golden shares provisions of many European countries with the EU law.[2373] The focus has been specifically on the relation between the national systems providing possibility to intervene in the share structure and management of the company vs. the principles on the freedom of establishment and the freedom of capital.[2374] The concept of restriction has been interpreted broadly and any

---

obstructing the transfer of the de facto headquarter from a member state. According to the ECJ this issue falls outside the scope of the Treaty provisions on freedom of establishment.

[2371] Baudenbacher, C. ed. (2015), p. 459.

[2372] Roland, G. ed. (2008), p. 67 according to which the special powers typically include *"(1) the right to appoint members in corporate board; (2) the right to express consent or to veto the acquisition of relevant interests in the privatized companies; (3) other rights such as consent on the transfer of subsidiaries, dissolution of the company, and ordinary management."* Statutory constraints include *"(1) ownership caps; (2) voting caps, and (3) provisions of national control."*

[2373] Golden shares have been in focus in following cases: ECJ, 23 May 2000, Case C-58/99 (Italian Republic), I-03811; ECJ, 4 June 2002, Case C-367/98 (Portuguese Republic) I-04731; ECJ, 4 June 2002, Case C-483/99 (French Republic), I-04781; ECJ, 4 June 2002, Case C-503/99 (Kingdom of Belgium), I-04809; ECJ, 13 May 2003, Case C-98/01 (United Kingdom of Great Britain and Northern Ireland), I-04641; ECJ, 13 May 2003, Case C-463/00 (Kingdom of Spain), I-04581; ECJ, 2 June 2005, Case C-174/04 (Italian Republic), I-04933; ECJ, 28 September 2006, Cases C-282/04 and C-283/04 (Kingdom of the Netherlands), I-09141; ECJ, 23 October 2007, Case C-112/05 (Federal Republic of Germany), I-08995; ECJ, 6 December 2007, Cases C-463/04 and C-464/04 (Comune di Milano), I-10419; ECJ, 14 February 2008, Case C-274/06 (Kingdom of Spain), I-00026; ECJ, 17 July 2008, Case C-207/07. (Kingdom of Spain), I-00111; ECJ, 26 March 2009, Case C-326/07 (Italian Republic), I-02291; ECJ, 8 July 2010, Case C-171/08 (Portuguese Republic), I-06817; ECJ, 11 November 2010, Case C-543/08 (Portuguese Republic), I-11241; ECJ, 10 November 2011, Case C-212/09 (Portuguese Republic), I-10889; ECJ, 8 November 2012, Case C-244/11 (Hellenic Republic); ECJ, 22 October 2013, Case C-95/12 (Federal Republic of Germany).

[2374] Today the legal basis for the freedom of establishment is Article 49 including reference to Article 54 and for the freedom of capital is the Article 63 of the Treaty on the Functioning of the European Union:

Article 49

"Within the framework of the provisions set out below, restrictions on the freedom of establishment of nationals of a Member State in the territory of another Member State shall be prohibited. Such prohibition shall also apply to restrictions on the setting-up of agencies, branches or subsidiaries by nationals of any Member State established in the territory of any Member State.

Freedom of establishment shall include the right to take up and pursue activities as self-employed persons and to set up and manage undertakings, in particular companies or firms within the meaning of the second paragraph of Article 54, under the conditions laid down for its own nationals by the law of the country where such establishment is effected, subject to the provisions of the Chapter relating to capital."

Article 54

exceptions to the principle of free movement has been interpreted narrowly.[2375] The ECJ has concluded in most of the cases that the specific golden shares provisions

- were in breach of the EU treaty provisions on the on the freedom of establishment and the freedom of capital[2376]
- could not be accepted on the basis of the exceptions of public health, public order or public interest in general[2377] and
- contradict the proportionality principle.[2378]

This means in practice that golden shares are highly restricted but can be permitted under strict conditions. Such an arrangement can be compatible with EU regulation if justified based on the overriding reasons of general interest, not going beyond what is necessary to attain its objective and effective to achieve its objective pursued.[2379]

Case VALE[2380]

The case VALE regarded a cross-border conversion of a company founded according to the Italian law, VALE Construzioni Srl (later VALE Italy), into a company established under Hungarian law, VALE Építési kft (later VALE Hungary).

Vale Italy was incorporated and added to the commercial register in Rome, Italy in 2000. The company applied to be deleted from that register on February 2006 as it wished to transfer its business and seat to Hungary. The plan was not to continue the business in Italy. The company was taken out from the Italian commercial register with a register note that the company had transferred to Hungary.

After the company had been removed from the Italian register, VALE Hungary was founded by the director of VALE Italy together with another natural person. The Hungarian company requested a Hungarian commercial court to register the company in the Hungarian commercial register together with an entry stating that VALE Italy was the predecessor in law of VALE Hungary. The application was however rejected by the commercial court because a company which was incorporated and registered in Italy was not able to transfer its seat to Hungary. This meant also that the company could not be registered in the Hungarian commercial register as the predecessor in law of a Hungarian company. However, it is possible under Italian law for a company to convert into a company established under foreign law.

"Companies or firms formed in accordance with the law of a Member State and having their registered office, central administration or principal place of business within the Union shall, for the purposes of this Chapter, be treated in the same way as natural persons who are nationals of Member States.

"Companies or firms" means companies or firms constituted under civil or commercial law, including cooperative societies, and other legal persons governed by public or private law, save for those which are non-profit-making."

Article 63

"1. Within the framework of the provisions set out in this Chapter, all restrictions on the movement of capital between Member States and between Member States and third countries shall be prohibited.

2. Within the framework of the provisions set out in this Chapter, all restrictions on payments between Member States and between Member States and third countries shall be prohibited".

[2375] Hawk, B. E. ed. (2015), p. 83 and Rothgang, H. and Scheider, S. eds (2015), pp. 119-120.

[2376] See ECJ, 13 May 2003, Case C-98/01 (United Kingdom of Great Britain and Northern Ireland), I-04641, paragraph 43.

[2377] See ECJ, 4 June 2002, Case C-483/99 (French Republic), I-04781.

[2378] Hawk, B. E. ed. (2015), p. 93.

[2379] Commission of the European Communities (2005), p 12.

[2380] ECJ, 12 July 2012, Case C-378/10 (VALE Epitesi kft).

Under Hungarian law nevertheless only companies incorporated under the law of Hungary could convert.

The Supreme Court of Hungary adjudicated on the application to register and asked the ECJ whether Hungarian legislation is compatible with the principle of the freedom of establishment. In this situation the Hungarian court aimed to determine whether a member state may refuse to register the predecessor of that company which originates in another member state.

The ECJ gave its judgment on July 12, 2012. According to the decision the lack of a uniform definition of companies in EU law means that the existence of companies is only based on the national legislation governing their incorporation and functioning.[2381] In cross-border company conversions the hosting member state may determine the applicable national law to company operations. This gives possibility to apply national provisions on the incorporation and functioning. The national regulation cannot however avoid the important principle of the freedom of establishment.[2382] The ECJ concluded that the Hungarian legislation treats companies in a different way depending on whether the conversion has domestic or cross-border nature. This again leads to unjustified restrictions when exercising that freedom.

The ECJ judgment means in practice that when national law allows national companies to convert - but does not allow companies of other member states to do so - the provisions of the freedom of establishment are not complied with. This means that a host state is not allowed to refuse the conversion of foreign companies to national companies if it allows the change of legal form for the national companies.[2383]

[2381] The judgment of ECJ is as follows:

"1. Articles 49 TFEU and 54 TFEU must be interpreted as precluding national legislation which enables companies established under national law to convert, but does not allow, in a general manner, companies governed by the law of another Member State to convert to companies governed by national law by incorporating such a company.

2. Articles 49 TFEU and 54 TFEU must be interpreted, in the context of cross-border company conversions, as meaning that the host Member State is entitled to determine the national law applicable to such operations and thus to apply the provisions of its national law on the conversion of national companies governing the incorporation and functioning of companies, such as the requirements relating to the drawing-up of lists of assets and liabilities and property inventories. However, the principles of equivalence and effectiveness, respectively, preclude the host Member State from

- refusing, in relation to cross-border conversions, to record the company which has applied to convert as the 'predecessor in law', if such a record is made of the predecessor company in the commercial register for domestic conversions, and

- refusing to take due account, when examining a company's application for registration, of documents obtained from the authorities of the Member State of origin."

[2382] About freedom of establishment see footnote 2374 above.

[2383] Bachmann, G. et al. (2014), p. 209.

APPENDIX 2

Company laws

Finland

In Finland the mezzanine instruments are regulated mainly by the company law. The Finnish Limited Liability Companies Act[2384] contains special provisions on a specific loan type called capital loan which has features of both debt and equity.[2385] On top of that it includes regulations on how option loans and convertible loans can be issued.[2386]

One of the key elements of the Finnish capital loan is that interest and principal can be paid back only within the limits of the unrestricted equity of the company. This loan is subordinated to all the other loans of the company and its interest and principal can only be paid, if the restricting conditions stated in the law and described below are fulfilled.

- Interest payment is possible only if the amount of the company's unrestricted shareholders' equity and of all its subordinated loans exceeds at the moment of payment the amount of loss to be confirmed for the latest financial period or complying with the balance sheet included in a newer financial statement. If it is not possible to pay the interest due on a capital loan, the interest payment shall be deferred to be happen later based on the first such financial statements that make payment possible.

- The loan shall only be amortised or paid back subject to that the amount of the company's unrestricted shareholders' equity and of all its subordinated loans exceeds at the moment of payment the amount of loss to be confirmed for the latest financial period or complying with the balance sheet included in a newer financial statement.

- The principal and interest are subordinated to other debts in the company´s liquidation and bankruptcy.

- The company or a subsidiary shall not provide security for the principal and interest payments.

- A capital loan contract shall be done in written form.

- A capital loan shall be recorded in the borrower´s balance sheet as a separate item.

Already the previous Companies Act from year 1997[2387] included rules of subordinated capital loan.[2388] Before that there was no specific company law regulation on subordinated financing in Finland. However, in practice subordinated loans were used based on freedom of contract by creditors specially in restructuring of companies facing repayment difficulties.[2389]

The Finnish company law gives also possibility for the companies to issue option right entitling to new shares or treasury shares against payment. The option rights may be issued also to a creditor of the company meaning in practice that the debt is converted to an option loan.

[2384] Limited Liability Companies Act (624/2006), Government Bill for the Limited Liability Companies Act (HE 109/2005).
[2385] Chapter 12, Section 1 of the Limited Liability Companies Act (624/2006).
[2386] Chapter 10, Section 1:1-2 of the Limited Liability Companies Act (624/2006).
[2387] The capital loan regulation was introduced as an amendment of the previous Limited Liability Companies Act (734/1978) in 1997.
[2388] Villa, S. (1997), p. 181.
[2389] Villa, S. (1997), p. 182.

According to the company law this requires a *"weighty financial reason"* for the company to do so.[2390] In case of option right the holder may have the right to choose if to subscribe for shares.

It is possible to issue the rights mentioned above also to the company´s creditor on condition that the creditor´s receivable is to be set off against the subscription price of the share. This means that the debt is converted to a so-called convertible loan. According to the agreed terms the creditor as the holder of the conversion right may convert its receivable into share capital. The issuer can decide what is the conversion price and conversion ratio.

In Finland it is the General Meeting of the company that shall decide on the issue of option loans and convertible loans.[2391] Some decision require qualified majority meaning that at least 2/3 of the votes cast and the shares represented at the meeting shall create the decision. The issue of option rights and other special rights entitling to shares is subject to such a qualified majority unless it is otherwise provided in the law or the articles of association.[2392]

As a summary can be stated that the Finnish company law specifically identifies capital loan, option loan and convertible loan.

Sweden

The Swedish Companies Act[2393] applies both to the private and public limited liability companies. It does not directly identify any subordinated loan types but recognises some other financing forms falling under mezzanine category.

The act regulates the principal-linked participating debentures and dividend-linked participating debentures as potential instruments for the Swedish companies to raise debt - although the law itself does not use these names for these instruments.[2394] Dividend-linked participating debentures refer to specific type of profit-sharing loans (*"vinstandelslån"*) and principal-linked participating debentures refer to specific type of value-appreciation loan (*"kapitalandelslån"*). A resolution must be adopted by the general meeting if the company shall raise a loan where the interest or the amount of repayment is dependent on dividends, changes in the price of the company's shares, company's results or company's financial position.[2395]

The Swedish company regulation allows limited liability company also to issue option right entitling to new shares against payment.[2396] When issued to a creditor of the company the debt becomes basically an option loan. The company can also to issue convertible loans.[2397]

Although the Swedish Companies Act does not include regulation on subordinated loans, there is a market practice on how shareholders or other stakeholders can provide additional subordinated capital to companies in a form of shareholder´s contribution (aktieägartillskot).[2398] This kind of additional shareholder´s contribution can be either unconditional (ovillkorat aktieägartillskott) or conditional (villkorat aktieägartillskott). The unconditional debt capital is repaid only in a company´s liquidation and the conditional debt

[2390] Airaksinen, M. et al. (2010), p. 671 and Lautjärvi, K. (2015), pp. 237-238.
[2391] Chapter 9, Section 2:1 of the Limited Liability Companies Act (624/2006)
[2392] Chapter 5, Section 27:1-2 of the Limited Liability Companies Act (624/2006).
[2393] Companies Act (SFS 2005:551), Government Proposal for the Companies Act (Prop. 2004/05:85).
[2394] Skatteverket, pp. 80-82.
[2395] Chapter 11, Section 11:1 of the Companies Act (SFS 2005:551).
[2396] Chapter 14 of the Companies Act (SFS 2005:551).
[2397] Chapter 15 of the Companies Act (SFS 2005:551).
[2398] Andersson, J. (2010), p. 261.

capital only after all other company debts are repaid. The concept of additional shareholder contributions based on freedom of contract is known also in the Swedish court practice.[2399]

As a summary can be stated that the Swedish company law specifically identifies profit-sharing loan, value-appreciation loan, option loan and convertible loan.

Estonia

The Commercial Code in Estonia[2400] includes rules on convertible loans and subscription rights.

Both in case of private and public limited liability companies the shareholders may decide on the conditional increase of the share capital in a form of convertible bond.[2401] The shareholders and in case of public limited company the management board may also decide on a conditional increase of the share capital in the form of subscription rights i.e. option rights as described in the law.[2402]

As a summary can be stated that the Estonian company law specifically identifies convertible loans and options.

USA

According to the Model Business Corporation Act (MBCA)[2403] an issuance of securities convertible into or rights exercisable for shares requires approval of the shareholders.[2404]

According to the Delaware General Corporation Law (DGCL)[2405] the certificate of incorporation may contain provisions granting to the stockholders of the corporation the pre-emptive right to subscribe to stock or to any securities convertible into such stock.[2406] Stockholder shall have pre-emptive right to subscribe to an additional issue of stock or to any security convertible into such stock only if such right is expressly granted in the certificate of incorporation.[2407]

According to the DGCL corporation may also create and issue rights or options entitling the holders to buy from the corporation any shares of its capital stock.[2408]

As a summary can be stated that MBCA and DGCL specifically identify option and convertible loan.

[2399] See Swedish Supreme Court decision NJA 1988, p. 620.
[2400] Commercial Code (RT I 1995, 26, 355).
[2401] Chapter 19, Section 167^2:1 and Chapter 24, Section 241:1 of the Commercial Code (RT I 1995, 26, 355).
[2402] Chapter 21, Section 195^1:2 of the Commercial Code (RT I 1995, 26, 355) and Chapter 29, Sections 351-351^2 of the Commercial Code (RT I 1995, 26, 355).
[2403] The Model Business Corporation Act (MBCA) is a model set of law created by the Committee on Corporate Laws of the Section of Business Law of the American Bar Association.
[2404] Chapter 6, Subchapter B, Section 6.21.(f) of the Model Business Corporation Act.
[2405] Title 8, Chapter 1 of the Delaware Code.
[2406] Subchapter I, Section 102(b) of the Delaware General Corporation Law.
[2407] Ibid.
[2408] Subchapter V, Section 157(a) of the Delaware General Corporation Law.

UK

According to the UK Companies Act[2409] the directors have power to grant rights to subscribe for shares or to convert any security into shares.[2410] This is possible in a private company with only one share class unless the directors are prohibited from doing so. In other situations, this is possible if the directors receive authority to do so by the company's articles or company´s resolution.

As a summary can be stated that UK company law specifically identifies option and convertible loan.

Germany

In Germany the private limited liability companies cannot issue convertible loans and options due to the Limited Liability Companies Act (Gesellschaftsrecht)[2411] not including the concept of conditional capital.[2412] This means that only public limited liability companies can issue convertible loans and options/option loans.

According to the German Stock Corporation Act (Aktiengesetz)[2413] the meeting of shareholders may decide on a share capital increase that shall be executed only to the extent that conversion rights or stock warrants are exercised.[2414] Such a resolution on a conditional capital increase may be approved among other things for the purpose of granting conversion rights or stock warrants to holders of convertible bonds or warrant bonds.[2415]

Convertible or warrant bonds providing holders with a conversion right or share warrant and dividend bonds connecting the holders´ rights to dividends paid to shareholders may only be issued based on a shareholders' meeting resolution.[2416]

As a summary can be stated that the German company law for public limited liability companies specifically identifies option and convertible loan. It shall be additionally noted that the concept of subordinated loan is not mentioned in the German company laws. A subordinated loan is considered legally a normal loan under the German Civil Code (Bürgerliches Gesetzbuch).[2417]

Conclusion on differences in company laws

The company laws in Finland, Sweden, Estonia, USA[2418], UK and Germany all identify either directly or indirectly option loan and convertible loan. Indirect identification means here that the instrument in question is not specifically mentioned in the law but the text refers to usage of such instruments. A good example is the Finnish company law which gives possibility for

[2409] Companies Act 2006.
[2410] Part 17, Chapter 1, Sections 550 and 551(1) of the Companies Act 2006.
[2411] Limited Liability Companies Act of April 20, 1892.
[2412] Mäntysaari, P. (2010c), p.301.
[2413] Stock Corporation Act (Aktiengesetz) of September 6, 1965.
[2414] Book 1, Part 6, Section 192(1) of the Stock Corporation Act.
[2415] Book 1, Part 6, Section 192(2) of the Stock Corporation Act.
[2416] Book 1, Part 6, Section 221(1) of the Stock Corporation Act.
[2417] Mäntysaari, P. (2010c), p. 295. The basic regulation in this respect is Chapter 1, Section 488 of the German Civil Code of August 18, 1896.
[2418] The company law in the USA refers here to Model Business Corporation Act (MBCA) and Delaware General Corporation Law (DGCL).

the companies to issue option rights and other special rights entitling to shares.[2419] According to the law text such rights may be granted also to a creditor on the condition that the creditor´s receivable is to be set off against the subscription price of the share.[2420] This means that the debt is actually converted to a convertible loan although this instrument type is not specifically mentioned in the law.[2421]

In case of Germany the option loan and convertible loan is identified in the company law for public limited liability companies but not in the company law of private limited companies.[2422]

The Finnish company law contains also special provisions on a specific loan type called capital loan.[2423] It has typical mezzanine features of both debt and equity and is also subordinated to all the other loans of the company. The repayment is subject to balance sheet related requirements. Interest and principal of a capital loan can be paid back only within the limits of the unrestricted equity of the company. The borrower of the capital loan may not provide security for the payment of the principal and interest.

The Swedish company law includes specific rules related to dividend-linked participating debentures and principal-linked participating debentures. In these loans the interest or the amount to repaid is dependent on dividends, price changes of the shares or borrowers financial position.[2424] The dividend-linked participating debenture loan is called in the Swedish tax law *"vinstandelslån"*[2425] and principal-linked participating debentures refers to a value-appreciation loan *"kapitalandelslån"*[2426].

[2419] Chapter 10, Section 1:1 of the Limited Liability Companies Act (624/2006).
[2420] Chapter 10, Section 1:2 of the Limited Liability Companies Act (624/2006).
[2421] Government Bill for the Limited Liability Companies Act (HE 109/2005), p. 113.
[2422] In Germany the private limited liability companies can not issue convertible loans and options as the German Limited Liability Companies Act (Gesellschaftsrecht) does not contain the concept of conditional capital.
[2423] Chapter 12, Section 1 of the Limited Liability Companies Act (624/2006).
[2424] Chapter 11, Section 11:1 of the Companies Act (SFS 2005:551).
[2425] Chapter 24, Sections 5-10 of the Income Tax Law (SFS 1999:1229).
[2426] In the Government Bill for the Swedish Companies Act (Regeringens proposition 2004/05:85, Ny aktiebolagslag) both terms *"vinstandelslån"* and *"kapitalandelslån"* were used but not in the final Swedish Companies Act. See Government Bill for the Swedish Companies Act (Regeringens proposition 2004/05:85, Ny aktiebolagslag), pp. 367-369.

APPENDIX 3

Accounting

Finland

The Finnish Accounting Act[2427] requires that company having issued securities to be traded in the regulated market in European Economic Area must prepare its consolidated accounts according to the IFRS rules.[2428] Even if there is no obligation to prepare consolidated accounts the financial statement of the company must be prepared anyhow in conformity with the IFRS.[2429]

In general mezzanine instruments like capital loan and debentures are normally classified as liabilities in IFRS financials.[2430] According to the IFRS rules however a compound instrument that contains both liability and equity components must be classified as financial assets, financial liabilities or equity instruments separately.[2431] A convertible bond is an example of such a compound financing instrument.

Sweden

The annual reports of a limited company must be prepared in accordance with the so-called K-regulations issued by the Swedish Accounting Standards Board (BFN).[2432] In practice IAS rules are followed for the classification of the mezzanine instruments

Those companies that do not apply IFRS-standards follow the K-regulation of BFN. According to K3-rules financial instruments shall be classified either to debt or equity based on the instrument´s economical characteristic.[2433]

Estonia

According to the Estonian Accounting Act companies may choose whether to compile their annual financial statements according to Estonian Accounting Standards (Estonian GAAP) or IFRS.[2434] The classification of financial instruments is in practice always done according to IAS as the Estonian GAAP is in compliance with the instrument classification rules of IAS.[2435]

[2427] Finnish Accounting Act (1336/1997).
[2428] Chapter 7a, Section 2:1 of the Finnish Accounting Act (1336/1997).
[2429] Chapter 7a, Section 2:2 of the Finnish Accounting Act (1336/1997).
[2430] IAS 32.11.
[2431] IAS 32.15 and IAS 32.28. See also about the different components Haaramo, V. (2012), pp. 129-130.
[2432] The purpose of the K-regulation is to simplify the financial reporting for smaller companies. There are four sets of accounting regulations from which a company will choose one to follow depending on the size of a company. The basis is the Annual Accounts Act and each of the four regulation sets target to meet the company's complexity level. The K-regulation categories are as follows:

- K1 (BFNAR 2006:1): Sole traders establishing simplified financial statements.
- K2 (BFNAR 2008:1): Annual reporting in small companies.
- K3 (BFNAR 2012:1): Annual reporting and consolidated financial statement.
- K4 is for companies who must or choose to follow IFRS.

[2433] BFN (2016), pp. 201-202.
[2434] Chapter 3, Section 17:1 of the Accounting Act (RT I 2002, 102, 600).
[2435] Strouhal, J. ed. (2011), p. 86.

USA

The SEC permits foreign private issuers to use IFRS but not domestic issuers.[2436] When IFRS is not used US GAAP is applied.[2437] In case of mezzanine instruments there are some differences between the two standards. For example, in case of convertible debt the conversion option must be always separated from the debt part under IFRS.[2438] Under U.S. GAAP the separation is precluded according to the main rule.[2439]

UK

All listed companies in the UK must prepare their consolidated financial statements using IFRS as adopted in the EU. The unlisted UK companies are permitted to choose whether to prepare their account according to IFRS or in accordance with UK GAAP. UK GAAP and IFRS have in certain areas different approaches but regarding liabilities and equity the standards are broadly consistent with each other.[2440]

Germany

The German companies listed in an EU securities market shall follow IFRS. For non-listed companies there is an option to prepare the consolidated financials according to the German Commercial Code (Handelsgesetzbuch, HGB)[2441] or IFRS. Regarding the individual financial statements, the companies must prepare financial statements in accordance to the German Commercial Code.[2442]

According to the German GAAP basing on the German Commercial Code (HGB) the mezzanine instruments shall be split into debt and/or equity subject to specific criteria [2443] which differ from IFRS.

Conclusion on differences in accounting

Regulation (EC) No 1606/2002 of the European Parliament and of the Council of 19 July 2002 on the application of international accounting standards defines when listed companies in EU are required to follow IFRS standards when preparing their financial statements.[2444] The regulation means that in EU countries Finland, Sweden, Estonia, UK and Germany companies having issued securities to be traded in the regulated market in European Economic Area have to prepare their consolidated accounts according to the IFRS rules. Even in cases where local GAAP is applied instead of IFRS rules the classification of financial instruments is in practice mostly done according to IAS/IFRS in Finland, Sweden, Estonia and UK.[2445] However the

[2436] IFRS Foundation (2017), p. 2.
[2437] Ibid.
[2438] IAS 32:28-29.
[2439] PwC (2017b), p. 10-2.
[2440] KPMG (2015b), pp. 180-191.
[2441] German Commercial Code (Handelsgesetzbuch) May 10, 1897.
[2442] IFRS Foundation (2016e), p. 5.
[2443] Brokamp, J. et al. (2011), p. 124.
[2444] According to the Article 4 main rule IFRS shall be applied to the consolidated financial statements of EU companies whose securities are traded on a regulated EU market. According to the Article 5 EU countries can decide to extend the use of IFRS to annual financial statements and non-listed companies, too.
[2445] For example in Estonia the local GAAP is in compliance with the instrument classification rules of IAS.

German GAAP basing on the German Commercial Code[2446] requires splitting of the mezzanine instruments into debt and/or equity subject to criteria differing from IFRS.[2447]

In case the specific Finnish mezzanine instrument capital loan would be classified as equity in the IFRS financials then that capital loan can also be booked as equity in the non-IFRS financials.[2448] In other situations mezzanine instruments shall booked as debt.

In the USA the SEC permits foreign private issuers to use IFRS. When IFRS is not used US GAAP is applied. In case of mezzanine instruments there are some differences between the two standards. According to the main rule the US GAAP precludes in case of convertible debt the separation of the conversion option from the debt part[2449] - unlike IFRS.

[2446] German Commercial Code (Handelsgesetzbuch) May 10, 1897.
[2447] Brokamp, J. et al. (2011), p. 124.
[2448] Chapter 5, Section 5c of the Finnish Accounting Act (1336/1997).
[2449] PwC (2017b), p. 10-2.

APPENDIX 4

Tax rules

Finland

In Finland based on the general rule of the Companies Income Tax Act the starting point is that business related interest expenses are deductible for the payer of the interest.[2450] Also interest that is dependent on the profit of the company is deductible.[2451]

There are no actual thin capitalisation rules to be followed but there are some restrictions on interest deductions. These limitations of deductibility will apply to interest paid between related parties.[2452]

Sweden

In Sweden interest expenses are generally deductible for the borrower company.[2453] There are no separate thin capitalization restrictions for tax purposes. Interest costs relating to intra-group loans are however not deductible with some exemptions.[2454]

Regarding mezzanine instruments relevant from the interest deduction point of view is whether the instrument shall be classified as debt or equity from the taxation perspective. In case of debt interest expenses are deductible. A company owner who has subscribed the profit-sharing loan by using the shareholder´s pre-emption priority is not entitled to deduct the profit-sharing part of the interest costs.[2455]

Estonia

In Estonia corporates are subject to income tax only in respect of all distributed profits.[2456] This means that the retained earnings are not taxed until profit distributions are made and interest cost deduction is not applied.

There are no thin capitalization rules in Estonia. There is however some regulation on transfer pricing. In case the value of a transaction carried out between related parties differs from the value of similar transactions between non-related parties, the resulting difference is subject of income tax.[2457]

USA

Interest expenses of debt are generally deductible for the corporations in the USA.[2458] Regarding mezzanine financing the deductibility of interest is possible if the financing form can be considered to be debt.

[2450] Division I, Chapter 2, Section 7 of the Companies Income Tax Act (360/1968).
[2451] Division II, Chapter 2, Section 18:1, point 2 of the Companies Income Tax Act (360/1968).
[2452] Division II, Chapter 2, Section 18a of the Companies Income Tax Act (360/1968).
[2453] Chapter 16, Section 1 of the Income Tax Law (SFS 1999:1229).
[2454] Chapter 24, Section 10d of the Income Tax Law (SFS 1999:1229).
[2455] Chapter 24, Section 6:1 of the Income Tax Law (SFS 1999:1229).
[2456] Chapter 10, Sections 49-51 of the Income Tax Act (RT I 1999, 101, 903).
[2457] Chapter 14, Sections 7-8 and Chapter 50, Sections 4-8 of the Income Tax Act (RT I 1999, 101, 903) and Minister of Finance (2006).
[2458] 26 U.S. Code § 163. The law includes also several exceptions of the main rule.

Thin capitalization rules may also be applied to prevent companies from borrowing in excess with a view to reduce their tax liability.[2459]

UK

In the UK the debt interest is generally deductible. In case of mezzanine financing this means that the interest is deductible if the financing form can be considered to be debt. The tax treatment of financing instruments in the UK follows generally the accounting treatment of the instruments.[2460]

There are no actual thin capitalisation rules to be followed but limitations of deductibility will sometimes apply to interest paid between related parties.[2461]

Germany

In Germany the debt interest is generally deductible with some restrictions. The taxation of financing instruments in Germany follows generally the accounting principles of the instruments i.e. the classification of instruments as debt or equity is decisive for the tax treatment.[2462]

According to the transfer pricing rule the related party transactions must comply with the arm's length principles.[2463]

Conclusion on differences in taxation rules

In Finland, Sweden, USA, UK and Germany the main rule is that business related interest expenses are deductible for the payer of the interest. In case of mezzanine instruments the deductibility of interest is possible if the financing form can be considered to be debt. Also, interest that is dependent on the profit of the company can be deductible. However, in Sweden a profit-sharing loan from a shareholder who has subscribed the loan by using the shareholder´s pre-emption priority does not create interest deduction right for the profit-sharing part of the interest.[2464]

There are no separate thin capitalization rules in Finland, Sweden, Estonia and UK. However, limitations of deductibility are applied to interest paid between related parties both in Finland, Sweden and UK. In the USA thin capitalization rules exist and they may be applied to prevent companies from borrowing excessively with a purpose to reduce their tax liability.

In Germany there are also some restrictions of interest deductibility. The major one of which is the interest deduction ceiling (Zinsschranke). According to this rule the net interest expense deduction is possible up to 30% of borrower´s EBITDA.[2465] .

In Estonia corporates are subject to income tax only in respect of all distributed profits. This means that the retained earnings are not taxed until profit distributions are made and interest cost deduction is not applied.

[2459] 26 U.S. Code § 163 (j) and § 385.
[2460] James, M. (2009), p. 17.
[2461] HM Revenue & Customs (2016d).
[2462] Bärsch, S.-E. (2012), p. 148.
[2463] Section 1 of the Foreign Transactions Tax Act (Aussensteuergesetz).
[2464] Chapter 24, Section 6:1 of the Income Tax Law (SFS 1999:1229). See also Tivéus, U. (2010), p. 93.
[2465] There are several more detailed rules complementing the Zinsschranken-regulation. See for more details above section *3.6.3.4.2 Germany.*

APPENDIX 5

Size of market

General

When reviewing the size of the local market the focus is given on

- amount of venture capital actors
- amount of venture capital investments
- amount of banks
- total amount of loans of the non-financial corporations[2466].

The researcher considers these factors to give sufficient picture what is the relative market potential of the country in question and what kind of competition exist for a potential mezzanine provider.[2467]

As a source for non-financial corporate sector debt amount is used the data provided by the OECD[2468] to get better comparable data.

Finland

The Finnish Venture Capital Association (FVCA) has 61 full members and 43 associate members.[2469] The Finnish venture capital firms invested in total MEUR 452 in 265 growth companies in 2016 globally.[2470] The foreign venture capital companies invested in total MEUR 271 in 19 Finnish target companies in 2016.[2471] All in all MEUR 653 was invested in 234 Finnish target companies. In international comparison Finland is very active in the venture capital financing.[2472]

In the Finnish banking market operate more than 200 banks.[2473] The amount of total loans of the non-financial corporate sector is 136 billion EUR.[2474]

Sweden

The Swedish Venture Capital Association has 155 members (79 ordinary and 76 associate members). [2475] The Swedish venture capital firms invested in total 13.7 billion SEK in

[2466] Here the term *"non-financial corporation"* is used according to OECD glossary of statistical terms. According to OECD (2011) *"non-financial corporations are corporations whose principal activity is the production of markets good or non-financial services".*
[2467] This approach excludes business angels. Due to business angel activity being mostly unorganised in terms of non-existing umbrella associations there is no reliable statistical data of its volumes. On the other hand, it is in volumes only a fraction of total financing to corporates and would thus not change the conclusions drawn here of the overall market conditions.
[2468] OECD (2016b).
[2469] FVCA (2017).
[2470] FVCA (2017b), 3.
[2471] FVCA (2017b), p. 22 and FVCA (2017c), p. 25.
[2472] See Figure 8 above in section *4.1.2 Venture capital in Finland.*
[2473] FFI (2016).
[2474] OECD (2016b), p. 93.
[2475] SVCA (2017).

companies in 2014.[2476] In international comparison the Swedish venture capital investments are on high level in terms of a percentage of GDP.[2477]

In the Swedish banking market operate more than 100 banks.[2478] The amount of total loans of the non-financial corporate sector in the country is 3638 billion SEK.[2479]

Estonia

The Estonian Venture Capital Association (EstVCA) has 38 members (14 ordinary and 24 associate members).[2480] The private equity investments in Estonia totalled to MEUR 40 and they were channelled in total to 8 companies in 2014 which makes the country clearly smaller venture capital country than its two closest Nordic neighbours Finland and Sweden.[2481]

Estonian banking market comprises 15 banks.[2482] The amount of total loans of the non-financial corporate sector in the country is around 14 billion EUR.[2483]

USA

According to the National Venture Capital Association statistics there are around 800 venture capital companies operating in the USA.[2484] The amount of total investments was 59,1 billion USD in 2015.[2485] Those funds were channelled in total to 3709 companies.[2486] These figures make the nation by far bigger venture capital market than any other country.

In the USA there are more than 5.000 commercial banks.[2487] The amount of total loans of the non-financial corporate sector in the country is around 6855 billion USD.[2488]

UK

British Private Equity and Venture Capital Association BVCA has over 600-member firms[2489] and there are over 250 active UK private equity firms operating in this sector.[2490] The UK venture capital firms invested in total 16.9 billion GBP in companies during year 2016.[2491]

In the UK there are more than 300 banks.[2492] The amount of total loans of the non-financial corporate sector in the country is around 965 billion GBP.[2493]

[2476] SVCA (2015), p. 7.
[2477] See Figure 8 above in section *4.1.2 Venture capital in Finland*.
[2478] SBA (2017), p. 5.
[2479] OECD (2016b), p. 284.
[2480] EstVCA (2017).
[2481] EVCA (2015), p. 13-14.
[2482] TheBanks.eu (2017).
[2483] OECD (2016b), p. 83.
[2484] NVCA (2016), p. 9.
[2485] NVCA (2016), p. 26-27.
[2486] Ibid.
[2487] Ycharts (2017).
[2488] OECD (2016b), p. 317.
[2489] BVCA (2016).
[2490] BVCA (2012), p. 7.
[2491] BVCA (2016b), p. 4.
[2492] PRA (2016), p. 15.
[2493] OECD (2016b), p. 309.

Germany

The German Private Equity and Venture Capital Association e.V. (BVK) has around 300 members and almost 200 of them are private equity firms.[2494] The German private equity companies invested in total 5.7 billion EUR in 1011 companies during 2016.[2495]

The German banking sector is very heterogeneous consisting of over 1700 banks.[2496] The amount of total loans of the non-financial corporate sector in the country is around 1172 billion EUR.[2497]

Conclusion on differences in size of market

Based on

- amount of venture capital actors
- amount of venture capital investments
- amount of banks
- amount of bank loans

Finland, Sweden, Estonia, USA, UK and Germany can be put in ranking order from smallest to the largest as follows:

Estonia is the clearly smallest market and Finland is in the second smallest market. Next in ranking order is Sweden. Germany and UK are approximately in the same size category. The clearly biggest market is USA.

Normally the bigger the market the greater the possibility for a company to get financing due to more potential investors and lenders. This is the case both in relation to getting venture capital financing and bank financing in general but also mezzanine financing specifically.

[2494] BVK (2017c).
[2495] BVK (2017b).
[2496] IMF (2016), p. 54.
[2497] OECD (2016b), p. 113.

APPENDIX 6

Transaction example - subordinated debt

General

The observations are done from the borrower company´s perspective and focus is on consolidated financial statements. The borrower in these examples is public limited liability company or local equivalents being traded in the regulated market[2498]. It is also assumed here that the financing transactions are done on arm´s length[2499] and no other than instrument specific interest deduction rules apply.[2500]

Finland

In Finland Company Oyj[2501] can take a subordinated loan in the form of capital loan[2502]. The terms of subordinated loans shall be based on an agreement between the parties and fulfil the minimum requirements set forth in the law. Capital loans shall be shown on the borrower´s balance sheet as a separate item.[2503] As an EU member state Finland is subject to the IAS Regulation adopted by the EU.[2504] This means applying IFRS for consolidated financials. According to IAS 32 § the substance of a financial instrument governs the classification rather than the legal form of an instrument. Capital loan is normally classified as liabilities in IFRS financials (see Figure 44 below).[2505] However the credit terms in some cases may require that a capital loan would be classified as equity in the IFRS financials (see Figure 45 below).[2506]

As a general rule, interest expenses are fully deductible in Finland.[2507] The interest expense of the capital loan is also deductible.

[2498] Companies traded on a regulated market refers here to stock exchange listed companies.
[2499] *"Arm´s length principle"* means here transaction according to the market price. See more about the transfer pricing and *"arm´s length principle"* OECD (2010).
[2500] This means that thin capitalisation rules or local general interest deduction caps are not applied.
[2501] There are two forms of limited liability companies (LLCs) in Finland: the private limited liability company (abbreviation in Finnish: Oy) and the public limited liability company (abbreviation in Finnish: Oyj).
[2502] Chapter 12, Section 1 of the Limited Liability Companies Act (624/2006). The Limited Liability Companies Act in Finland contains also special provisions on a specific loan type called capital loan which has features of both debt and equity. Interest and principal of a capital loan can be paid back only within the limits of the unrestricted equity of the company. This loan type is also subordinated to all of the other loans of the company. See for more details above in section *3.4.2.2.4 Capital structure*.
[2503] Chapter 12, Section 2 of the Limited Liability Companies Act (624/2006).
[2504] The IAS Regulation in EU requires application of IFRS Standards for the consolidated financial statements of European companies who have their securities traded in a regulated securities market.
[2505] Myllymäki, J. (2013), p. 117 and Government Bill for the Limited Liability Companies Act (HE 109/2005), p. 120.
[2506] Chapter 5, Section 5c of the Finnish Accounting Act (1336/1997). In case of mezzanine financing there may sometimes be a problem to differentiate between liabilities and equity due to mezzanine instrument having equity characteristics in substance but debt characteristics from the legal point of view. If mezzanine instrument does not meet the definitions of financial asset or financial liability as defined according to IFRS rules, then the mezzanine instrument is equity in the IFRS classification. See also above section *3.5.1 IFRS and mezzanine*.
[2507] Division I, Chapter 2, Section 7 of the Companies Income Tax Act (360/1968).

Figure 44: Simplified split of equity and liabilities in the balance sheet of Finnish capital loan borrower

Equity
• Share capital
• Retained earnings
Liabilities
• Long term debt
• Capital loan
• Other liabilities

Figure 45: Alternative simplified split of equity and liabilities in the balance sheet of Finnish capital loan borrower in case capital loan qualifies as equity according to IFRS

Equity
• Share capital
• Retained earnings
• Capital loan
Liabilities
• Long term debt
• Other liabilities

Sweden

In Sweden Company Abp[2508] can take a subordinated loan. Contractual subordination of debt may be achieved by an agreement. As an EU member state Sweden is subject to the IAS Regulation adopted by the EU.[2509] Subordinated loan type is normally classified as liabilities in IFRS financials (see Figure 46 below). However, in some situations the subordinated loan can also be classified as equity depending on the exact credit terms (see Figure 47 below).[2510]

Relevant from the interest deduction point of view is whether the instrument shall be classified as debt or equity from the taxation perspective.[2511] It shall be noted that the taxation classification does not necessarily follow the accounting classification. In case of tailor-made credit instruments like subordinated loans the possibility to deduct interest expenses shall be

[2508] In Sweden a public limited company is legally denoted as *"AB (publ)"*.
[2509] The IAS Regulation in EU requires application of IFRS Standards for the consolidated financial statements of European companies whose securities are traded in a regulated securities market.
[2510] In case of mezzanine financing there may sometimes be a problem to differentiate between liabilities and equity due to mezzanine instrument having equity characteristics in substance but debt characteristics from the legal point of view. If mezzanine instrument does not meet the definitions of financial asset or financial liability as defined according to IFRS rules, then the mezzanine instrument is equity in the IFRS classification. See also above section *3.5.1 IFRS and mezzanine.*
[2511] In Sweden the applicable taxation is based on two step process. First shall be assessed whether the instrument is debt or equity and is the payment to the investor interest or dividend. At the second stage shall be assessed whether the compensation paid is deductible or not. See for more details Skatteverket (2012), pp. 82-84.

concluded on case by case basis.[2512] If the instrument can be classified as debt from taxation perspective the payment to the investor is interest and interest is deductible expense.

Figure 46: Simplified split of equity and liabilities in the balance sheet of Swedish subordinated loan borrower

Equity
• Share capital
• Retained earnings
Liabilities
• Long term debt
• Subordinated loan
• Other liabilities

Figure 47: Alternative simplified split of equity and liabilities in the balance sheet of Swedish subordinated loan borrower in case loan qualifies as equity according to IFRS

Equity
• Share capital
• Retained earnings
• Subordinated loan
Liabilities
• Long term debt
• Other liabilities

Estonia

In Estonia Company AS[2513] can take a subordinated loan. Unlike in Finland and like in Sweden there are no specific subordinated loan types identified in the Estonian company legislation but lender and borrower can agree on loan subordination within the general freedom of contract.[2514] Being an EU member state Estonia is subject to the IAS Regulation adopted by the EU.[2515] As the substance rather than the legal form of a financial instrument governs the classification of the instrument, subordinated loan type is normally classified as liability in IFRS financials (see Figure 48 below). However, in some situations the subordinated loan can also be classified as equity depending on the exact credit terms (see Figure 49 below).[2516]

[2512] The Swedish Tax Board and the Supreme Administrative Court have also had different views related to the classification of financial instruments as debt or equity. See Hilling, A. and Vilhelmsson, A. (2015), p. 700 and also Bjuvberg, J. (2014), Olsson, S. (2014) and Tivéus, U. (2014).
[2513] In Estonia a public limited company shall use the appendage *"aktsiaselts"* (public limited company) or alternatively the relevant abbreviation *"AS"*.
[2514] About freedom of contract in general see above section *3.4.4 Freedom of contract*.
[2515] The IAS Regulation in EU requires application of IFRS Standards for the consolidated financial statements of European companies whose securities trade in a regulated securities market.
[2516] In case of mezzanine financing there may sometimes be a problem to differentiate between liabilities and equity due to mezzanine instrument having equity characteristics in substance but debt characteristics from the legal point of view. If mezzanine instrument does not meet the definitions of financial asset or financial liability as defined according to IFRS rules, then the mezzanine instrument is equity in the IFRS classification. See also above section *3.5.1 IFRS and mezzanine.*

Figure 48: Simplified split of equity and liabilities in the balance sheet of Estonian subordinated loan borrower

Equity
• Share capital
• Retained earnings
Liabilities
• Long term debt
• Subordinated loan
• Other liabilities

Figure 49: Alternative simplified split of equity and liabilities in the balance sheet of Estonian subordinated loan borrower in case loan qualifies as equity according to IFRS

Equity
• Share capital
• Retained earnings
• Subordinated loan
Liabilities
• Long term debt
• Other liabilities

In Estonia interest cost deduction is not applied and thus interest expense is not deductible.[2517]

USA

In the USA Company Inc.[2518] can take a subordinated loan. Unlike in Finland and like in Sweden and Estonia there are no specific subordinated loan types identified in the US company legislation. Lender and borrower can however agree on loan subordination within the general freedom of contract.[2519] The SEC does not permit its domestic issuers to use IFRS in preparing their financial statements but obliges them to use US GAAP.[2520] Subordinated

[2517] The Estonian corporates are subject to income tax only in respect of all distributed profits including dividends distributed, gifts and donations and payments unrelated to business. The consequence of this is that retained earnings are not taxed until profit distributions are made. This means that interest cost deduction is not applied. See more about the Estonian corporate taxation system in Staehr, K. (2014).

[2518] According to the Chapter 4, Section 4.01. (a) of the Model Business Corporation Act a corporate name *"must contain the word "corporation," "incorporated," "company," or "limited," or the abbreviation "corp.," "inc.," "co.," or "ltd.," or words or abbreviations of like import in another language; …"*

According to Subchapter I, Section 101(a) (1) of the Delaware General Corporation Law *"The name of the corporation …shall contain 1 of the words "association," "company," "corporation," "club," "foundation," "fund," "incorporated," "institute," "society," "union," "syndicate," or "limited," (or abbreviations thereof, with or without punctuation), or words (or abbreviations thereof, with or without punctuation) of like import of foreign countries or jurisdictions (provided they are written in roman characters or letters)…"*

[2519] About freedom of contract in general see above section *3.4.4 Freedom of contract*.

[2520] IFRS Foundation (2017), p. 2.

loan type is normally classified as liability according to US GAAP (see Figure 50 below).[2521] The lower repayment ranking priority alone does not take away the liability classification.

Figure 50: Simplified split of equity and liabilities in the balance sheet of US subordinated loan borrower

Equity
• Share capital
• Retained earnings
Liabilities
• Long term debt
• Subordinated loan
• Other liabilities

All interest expenses in relation to debt are generally deductible for the corporations in the USA.[2522]

UK

In the UK Company Plc[2523] can take a subordinated loan. Unlike in Finland there are no specific subordinated loan type identified in the UK company legislation but lender and borrower can agree on loan subordination within the general freedom of contract.[2524] As an EU member state UK is subject to the IAS Regulation adopted by the EU.[2525] This loan type is normally classified as liabilities in IFRS financials (see Figure 51 below). However, in some situations the subordinated loan can also be classified as equity depending on the exact credit terms (see Figure 52 below).[2526]

The tax treatment of financing instruments in the UK follows generally the accounting treatment of the instruments.[2527] This means that that interest payments of subordinated loan is generally deductible.

[2521] Stice, J.D. and Stice, E.K. (2014), p. 12-52 in which is referred to FASB Accounting Standards Codification (ASC) paragraph 470-10-599-2.
[2522] 26 U.S. Code § 163. The law includes also several exceptions of the main rule.
[2523] The name of a limited company that is a public company must end with *"public limited company"* or *"p.l.c."* In practice Registrar of Companies - the public authority in UK responsible for managing a companies register - allows also forms without punctuation and *"Plc"* and *"PLC"* are also commonly used abbreviations. See IBP (2009), p. 41.
[2524] About freedom of contracting in general see above section *3.4.4 Freedom of contract.*
[2525] The IAS Regulation in EU requires application of IFRS Standards for the consolidated financial statements of European companies whose securities trade in a regulated securities market.
[2526] In case of mezzanine financing there may sometimes be a problem to differentiate between liabilities and equity due to mezzanine instrument having equity characteristics in substance but debt characteristics from the legal point of view. If mezzanine instrument does not meet the definitions of financial asset or financial liability as defined according to IFRS rules, then the mezzanine instrument is equity in the IFRS classification. See also above section *3.5.1 IFRS and mezzanine.*
[2527] James, M. (2009), p. 17.

Figure 51: Simplified split of equity and liabilities in the balance sheet of UK subordinated loan borrower

Equity
• Share capital
• Retained earnings
Liabilities
• Long term debt
• Subordinated loan
• Other liabilities

Figure 52: Alternative simplified split of equity and liabilities in the balance sheet of UK subordinated loan borrower in case loan qualifies as equity according to IFRS

Equity
• Share capital
• Retained earnings
• Subordinated loan
Liabilities
• Long term debt
• Other liabilities

Germany

In Germany Company AG[2528] can take a subordinated loan. Unlike in Finland there are no specific subordinated loan type identified in the German company legislation but lender and borrower can agree on loan subordination within the general freedom of contract.[2529] As an EU member state Germany is subject to the IAS Regulation adopted by the EU.[2530] This loan type is normally classified as liabilities in IFRS financials (see Figure 53 below). However, in some situations the subordinated loan can also be classified as equity depending on the exact credit terms (see Figure 54 below).[2531]

The tax treatment of financing instruments in Germany follows generally the accounting treatment of the instruments.[2532] This means that that interest payments of subordinated loan

[2528] According to Book 1, Part 1, Section 4 of the Stock Corporation Act (Aktiengesetz) of 6 September, 1965 the business name of the company shall contain the designation *"Aktiengesellschaft"* or a generally understood abbreviation of this designation.
[2529] About freedom of contracting in general see above section *3.4.4 Freedom of contract.*
[2530] The IAS Regulation in EU requires application of IFRS Standards for the consolidated financial statements of European companies whose securities trade in a regulated securities market.
[2531] In case of mezzanine financing there may sometimes be a problem to differentiate between liabilities and equity due to mezzanine instrument having equity characteristics in substance but debt characteristics from the legal point of view. If mezzanine instrument does not meet the definitions of financial asset or financial liability as defined according to IFRS rules, then the mezzanine instrument is equity in the IFRS classification. See also above section *3.5.1 IFRS and mezzanine.*
[2532] Bärsch, S.-E. (2012), p. 142.

is generally deductible. The subordination alone does not take away the liability classification.[2533]

Figure 53: Simplified split of equity and liabilities in the balance sheet of German subordinated loan borrower

Equity
• Share capital
• Retained earnings
Liabilities
• Long term debt
• Subordinated loan
• Other liabilities

Figure 54: Alternative simplified split of equity and liabilities in the balance sheet of German subordinated loan borrower in case loan qualifies as equity according to IFRS

Equity
• Share capital
• Retained earnings
• Subordinated loan
Liabilities
• Long term debt
• Other liabilities

[2533] Weitnauer, W. et al. (2016), p. 174.

APPENDIX 7

Transaction example - senior ranked convertible debt.

The observations are done from the borrower company´s perspective and focus is on consolidated financial statements. The borrower in these examples is public limited liability company or local equivalents being traded in the regulated market[2534]. It is also assumed here that the financing transactions are done on arm´s length[2535] and no other than instrument specific interest deduction rules apply.[2536]

Finland

In Finland Company Oyj[2537] can take a senior ranked convertible loan.[2538] How such a loan is treated in accounting depends on the terms of the instrument. As an EU member state Finland is subject to the IAS Regulation adopted by the EU.[2539] This means applying IFRS for consolidated financials. Different components of mezzanine instrument must be classified as financial assets, financial liabilities or equity instruments separately.[2540] Senior ranked convertible loan is normally classified as liability in IFRS financials (see Figure 55 below).[2541] However the credit terms in some cases may require that a senior ranked convertible loan would be classified partially as equity in the IFRS financials (see Figure 56 below).[2542]

Figure 55: Simplified split of equity and liabilities in the balance sheet of Finnish senior ranked convertible loan borrower

Equity
• Share capital
• Retained earnings
Liabilities
• Long term debt
• Convertible loan
• Other liabilities

[2534] Companies traded on a regulated market refers here to stock exchange listed companies.
[2535] *"Arm´s length principle"* means here transaction according to the market price. See more about the transfer pricing and *"arm´s length principle"* OECD (2010).
[2536] This means that thin capitalisation rules or local general interest deduction caps are not applied.
[2537] There are two forms of limited liability companies (LLCs) in Finland: the private limited liability company (abbreviation in Finnish: Oy) and the public limited liability company (abbreviation in Finnish: Oyj).
[2538] Chapter 10 of the Limited Liability Companies Act (624/2006).
[2539] The IAS Regulation in EU requires application of IFRS Standards for the consolidated financial statements of European companies whose securities trade in a regulated securities market.
[2540] IAS 32.15 and IAS 32.28. See also about the different components Haaramo, V. (2012), pp. 129-130.
[2541] Myllymäki, J. (2013), p. 117 and Government Bill for the Limited Liability Companies Act (HE 109/2005), p. 120.
[2542] Chapter 5, Section 5c of the Finnish Accounting Act (1336/1997) and BDO (2012). In case of mezzanine financing there may sometimes be a problem to differentiate between liabilities and equity due to mezzanine instrument having equity characteristics in substance but debt characteristics from the legal point of view. If mezzanine instrument does not meet the definitions of financial asset or financial liability as defined according to IFRS rules, then the mezzanine instrument is equity in the IFRS classification. See also above section *3.5.1 IFRS and mezzanine*.

Figure 56: Alternative simplified split of equity and liabilities in the balance sheet of Finnish senior ranked convertible loan borrower in case loan qualifies partially as equity according to IFRS

Equity
• Share capital
• Retained earnings
• Convertible loan (equity component)
Liabilities
• Long term debt
• Convertible loan
• Other liabilities

The interest expense of the senior ranked convertible loan is deductible.[2543] The lender´s right to convert the instrument into equity does not influence to borrower´s right to deduct the interest expenses.

Sweden

In Sweden Company Abp[2544] can take a senior ranked convertible loan.[2545] As an EU member state Finland is subject to the IAS Regulation adopted by the EU.[2546] This means applying IFRS for consolidated financials. Different components of mezzanine instrument must be classified as financial assets, financial liabilities or equity instruments separately.[2547] Senior ranked convertible loan is normally classified as liability in IFRS financials (see Figure 57 below). However, the credit terms in some cases may require that a senior ranked convertible loan would be classified partially as equity in the IFRS financials (see Figure 58 below).[2548]

Figure 57: Simplified split of equity and liabilities in the balance sheet of Swedish senior ranked convertible loan borrower

Equity
• Share capital
• Retained earnings
Liabilities
• Long term debt
• Convertible loan
• Other liabilities

[2543] Verohallinto (2014), Section 2.4. According to the Finnish tax authorities´ guidance interest expenses of convertible debt are generally considered to be deductible until to the moment of converting the debt to the shares.
[2544] In Sweden a public limited company is legally denoted as *"AB (publ)"*.
[2545] Chapter 15 of the Companies Act (SFS 2005:551).
[2546] The IAS Regulation in EU requires application of IFRS Standards for the consolidated financial statements of European companies whose securities trade in a regulated securities market.
[2547] IAS 32.15 and IAS 32.28.
[2548] BDO (2012). In case of mezzanine financing there may sometimes be a problem to differentiate between liabilities and equity due to mezzanine instrument having equity characteristics in substance but debt characteristics from the legal point of view. If mezzanine instrument does not meet the definitions of financial asset or financial liability as defined according to IFRS rules, then the mezzanine instrument is equity in the IFRS classification. See also above section *3.5.1 IFRS and mezzanine.*

Figure 58: Alternative simplified split of equity and liabilities in the balance sheet of Swedish senior ranked convertible loan borrower in case loan qualifies partially as equity according to IFRS

Equity
• Share capital
• Retained earnings
• Convertible loan (equity component)
Liabilities
• Long term debt
• Convertible loan
• Other liabilities

Relevant from the interest deduction point of view is whether the instrument shall be classified as debt or equity from the taxation perspective.[2549] It shall be noted that the taxation classification does not necessarily follow the accounting classification. In case of tailormade credit instruments like convertible loans the possibility to deduct interest expenses shall be concluded on case by case basis.[2550] If the instrument can be classified as debt from taxation perspective the payment to the investor is interest and interest is deductible expense.

Estonia

In Estonia Company AS[2551] can take a senior ranked convertible loan.[2552] As an EU member state Finland is subject to the IAS Regulation adopted by the EU.[2553] This means applying IFRS for consolidated financials. Different components of mezzanine instrument must be classified as financial assets, financial liabilities or equity instruments separately.[2554] Senior ranked convertible loan is normally classified as liability in IFRS financials (see Figure 59 below). However, the credit terms in some cases may require that a senior ranked convertible loan would be classified partially as equity in the IFRS financials (see Figure 60 below).[2555]

[2549] In Sweden the applicable taxation is based on two step process. First shall be assessed whether the instrument is debt or equity and is the payment to the investor interest or dividend. At the second stage shall be assessed whether the compensation paid is deductible or not. See for more details Skatteverket (2012), pp. 82-84.

[2550] The Swedish Tax Board and the Supreme Administrative Court have also had different views related to the classification of financial instruments as debt or equity. See Hilling, A. and Vilhelmsson, A. (2015), p. 700 and also Bjuvberg, J. (2014), Olsson, S. (2014) and Tivéus, U. (2014).

[2551] In Estonia a public limited company shall use the appendage *"aktsiaselts"* (public limited company) or alternatively the relevant abbreviation *"AS"*.

[2552] Chapter 19, Section 167[2]:1 and Chapter 24, Section 241:1 of the Commercial Code (RT I 1995, 26, 355).

[2553] The IAS Regulation in EU requires application of IFRS Standards for the consolidated financial statements of European companies whose securities trade in a regulated securities market.

[2554] IAS 32.15 and IAS 32.28.

[2555] BDO (2012). In case of mezzanine financing there may sometimes be a problem to differentiate between liabilities and equity due to mezzanine instrument having equity characteristics in substance but debt characteristics from the legal point of view. If mezzanine instrument does not meet the definitions of financial asset or financial liability as defined according to IFRS rules, then the mezzanine instrument is equity in the IFRS classification. See also above section *3.5.1 IFRS and mezzanine*.

In Estonia interest cost deduction is not applied and thus interest expense is not deductible.[2556]

Figure 59: Simplified split of equity and liabilities in the balance sheet of Estonian senior ranked convertible loan borrower

Equity
• Share capital
• Retained earnings
Liabilities
• Long term debt
• Convertible loan
• Other liabilities

Figure 60: Alternative simplified split of equity and liabilities in the balance sheet of Estonian senior ranked convertible loan borrower in case loan qualifies partially as equity according to IFRS

Equity
• Share capital
• Retained earnings
• Convertible loan (equity component)
Liabilities
• Long term debt
• Convertible loan
• Other liabilities

USA

In the USA Company Inc.[2557] can take a senior ranked convertible loan.[2558] The SEC does not permit its domestic issuers to use IFRS in preparing their financial statements but obliges them to use US GAAP.[2559] In case of mezzanine instruments there are some differences

[2556] The Estonian corporates are subject to income tax only in respect of all distributed profits including dividends distributed, gifts and donations and payments unrelated to business. The consequence of this is that retained earnings are not taxed until profit distributions are made. This means that interest cost deduction is not applied. See more about the Estonian corporate taxation system in Staehr, K. (2014).

[2557] According to the Chapter 4, Section 4.01. (a) of the Model Business Corporation Act a corporate name *"must contain the word "corporation," "incorporated," "company," or "limited," or the abbreviation "corp.," "inc.," "co.," or "ltd.," or words or abbreviations of like import in another language; …"*

According to Subchapter I, Section 101(a) (1) of the Delaware General Corporation Law *"The name of the corporation …shall contain 1 of the words "association," "company," "corporation," "club," "foundation," "fund," "incorporated," "institute," "society," "union," "syndicate," or "limited," (or abbreviations thereof, with or without punctuation), or words (or abbreviations thereof, with or without punctuation) of like import of foreign countries or jurisdictions (provided they are written in roman characters or letters)…"*

[2558] Chapter 6, Subchapter B, Section 6.21.(f) of the Model Business Corporation Act and Subchapter I, Section 102(b) of the Delaware General Corporation Law.

[2559] IFRS Foundation (2017), p. 2.

between the two standards.[2560] Under U.S. GAAP the separation of conversion option from the debt part is precluded unless certain specific conditions are fulfilled.[2561] To determine the proper accounting of the equity conversion option, a detailed analysis of the terms and conditions on case by case has to be done.[2562] According to the US GAAP mezzanine like hybrid financial instruments are generally accounted for as a financial liability (see Figure 61 below) or equity instrument (see Figure 62) in their entirety.[2563]

All interest expenses in relation to debt are generally deductible for the corporations in the USA.[2564] However in case of convertible debt when the issuer of the debt has an option to convert the debt into stock then the tax deduction for interest on the debt will be disallowed.[2565] If the holder of this debt has an option to convert the debt into stock then the interest deduction will be permitted subject to that there is *"substantial certainty"* that the option would not be exercised.[2566]

Figure 61: Simplified split of equity and liabilities in the balance sheet of US senior ranked convertible loan borrower

Equity
• Share capital
• Retained earnings
Liabilities
• Long term debt
• Convertible loan
• Other liabilities

Figure 62: Alternative simplified split of equity and liabilities in the balance sheet of US senior ranked convertible loan borrower in case loan qualifies partially as equity according to IFRS

Equity
• Share capital
• Retained earnings
• Convertible loan
Liabilities
• Long term debt
• Convertible loan

[2560] See PwC (2017b), p. 10-2 according to which *"Unlike IFRS, financial instruments may potentially be equity-classified under US GAAP if the issuer's obligation to deliver cash or another financial asset at settlement is conditional. As such, US GAAP will permit more financial instruments to be equity-classified as compared to IFRS."*
[2561] PwC (2017b), p. 10-2.
[2562] This is important as loan terms may vary a lot. According to PwC (2017), pp. 164-202 it is possible to agree that loan is converted to (i) shares only, (ii) shares and cash or (iii) even only in cash. Different conversion options may lead to different accounting treatment.
[2563] PwC (2017b), p. 10-2. See also above section *3.5.3.3 USA.*
[2564] 26 U.S. Code § 163. The law includes also several exceptions of the main rule.
[2565] 26 U.S. Code § 163 (l).
[2566] See also private letter ruling 201517003 issued by IRS on April 24, 2015 according to which the interest of convertible debt is tax deductible because it was not *"substantially certain"* that the holder would exercise the option to convert the debt into stock.

UK

In the UK Company Plc[2567] can take a senior ranked convertible loan.[2568] As an EU member state Sweden is subject to the IAS Regulation adopted by the EU.[2569] This means applying IFRS for consolidated financials. Different components of mezzanine instrument must be classified as financial assets, financial liabilities or equity instruments separately.[2570] Senior ranked convertible loan is normally classified as liability in IFRS financials (see Figure 63 below). However, the credit terms in some cases may require that a senior ranked convertible loan would be classified partially as equity in the IFRS financials (see Figure 64 below).[2571]

Figure 63: Simplified split of equity and liabilities in the balance sheet of UK senior ranked convertible loan borrower

Equity
• Share capital
• Retained earnings
Liabilities
• Long term debt
• Convertible loan
• Other liabilities

Figure 64: Alternative simplified split of equity and liabilities in the balance sheet of UK senior ranked convertible loan borrower in case loan qualifies partially as equity according to IFRS

Equity
• Share capital
• Retained earnings
• Convertible loan (equity component)
Liabilities
• Long term debt
• Convertible loan
• Other liabilities

[2567] The name of a limited company that is a public company must end with *"public limited company"* or *"p.l.c."* In practice Registrar of Companies - the public authority in UK responsible for managing a companies register - allows also forms without punctuation and *"Plc"* and *"PLC"* are also commonly used abbreviations. See IBP (2009), p. 41.

[2568] Part 17, Chapter 1, Sections 550 and 551(1) of the Companies Act 2006.

[2569] The IAS Regulation in EU requires application of IFRS Standards for the consolidated financial statements of European companies whose securities trade in a regulated securities market.

[2570] IAS 32.15 and IAS 32.28.

[2571] BDO (2012). In case of mezzanine financing there may sometimes be a problem to differentiate between liabilities and equity due to mezzanine instrument having equity characteristics in substance but debt characteristics from the legal point of view. If mezzanine instrument does not meet the definitions of financial asset or financial liability as defined according to IFRS rules, then the mezzanine instrument is equity in the IFRS classification. See also above section *3.5.1 IFRS and mezzanine*.

The tax treatment of financing instruments in the UK follows generally the accounting treatment of the instruments.[2572] This means that debt interest is deductible and equity interest is not deductible as dividend distribution. In case of convertible loan this means that interest payments of convertible loan are generally tax deductible.[2573]

Germany

In Germany Company AG[2574] can take a senior ranked convertible loan.[2575] As an EU member state Germany is subject to the IAS Regulation adopted by the EU.[2576] This means applying IFRS for consolidated financials. Different components of mezzanine instrument must be classified as financial assets, financial liabilities or equity instruments separately.[2577] Senior ranked convertible loan is normally classified as liability in IFRS financials (see Figure 65 below). However, the credit terms in some cases may require that a senior ranked convertible loan would be classified partially as equity in the IFRS financials (see Figure 66 below).[2578]

In Germany the debt interest is generally deductible with some restrictions. The taxation of financing instruments in Germany follows generally the accounting principles of the instruments i.e. the classification of instruments as debt or equity is decisive for the tax treatment.[2579] According to this the interest payments of convertible loan are tax deductible taking however in the consideration the local restrictions concerning the deductions.[2580]

Figure 65: Simplified split of equity and liabilities in the balance sheet of German senior ranked convertible loan borrower

Equity
• Share capital
• Retained earnings
Liabilities
• Long term debt
• Convertible loan
• Other liabilities

[2572] James, M. (2009), p. 17.
[2573] Harris, P. (2013), p. 207.
[2574] According to Book 1, Part 1, Section 4 of the Stock Corporation Act (Aktiengesetz) of 6 September, 1965 the business name of the company shall contain the designation *"Aktiengesellschaft"* or a generally understood abbreviation of this designation.
[2575] Book 1, Part 6, Section 192 of the Stock Corporation Act.
[2576] The IAS Regulation in EU requires application of IFRS Standards for the consolidated financial statements of European companies whose securities trade in a regulated securities market.
[2577] IAS 32.15 and IAS 32.28.
[2578] BDO (2012). In case of mezzanine financing there may sometimes be a problem to differentiate between liabilities and equity due to mezzanine instrument having equity characteristics in substance but debt characteristics from the legal point of view. If mezzanine instrument does not meet the definitions of financial asset or financial liability as defined according to IFRS rules, then the mezzanine instrument is equity in the IFRS classification. See also above section *3.5.1 IFRS and mezzanine*.
[2579] Bärsch, S.-E. (2012), p. 148.
[2580] Weitnauer, W. et al. (2016), p. 183. See also above section *3.6.3.4.2 Germany.*

Figure 66: Alternative simplified split of equity and liabilities in the balance sheet of German senior ranked convertible loan borrower in case loan qualifies partially as equity according to IFRS

Equity
• Share capital
• Retained earnings
• Convertible loan (equity component)
Liabilities
• Long term debt
• Convertible loan
• Other liabilities

Mika Reunanen

Mezzanine Financing

A Comparison between the Finnish and International Financial Market Regulation

The purpose of the research is to give understanding what is the company law background concerning the use of mezzanine financing, how mezzanine instruments are handled from accounting and taxation perspective and how they are used in the market today. On top of that is reviewed the size of mezzanine market in relevant countries. The main focus is in Finland and comparison is done to Sweden, Estonia, USA, UK and Germany. The differences of legal frameworks and markets in relation to the discussed financing form are analysed. The research objective has been to conclude what are some of the main differences of company regulation, accounting and taxation rules and local market conditions related to the topic in question. Additionally, is reviewed how mezzanine could be used in bank lending going forward in order to support functioning capital markets.

In the review of legal background, the focus has been on company law solely. Reference to other legislation is made only if it is necessary to understand better the specific company law regulation in question. The analysis of applicable accounting rules has concentrated on the local GAAP and IFRS regulation. In the review of taxation rules is focused on thin capitalisation rules and deductibility of interest from the borrower´s view. When reviewing the local market conditions, the attention has been given to the size of the market in terms of amount of venture capital actors, volumes of venture capital investments, number of banks and volumes of bank loans. The research is based on academic and professional literature in company law and finance.

The outcome of the research is that there are significant differences in the company law, accounting rules and taxation regulation between the observed countries. There are also significant differences in mezzanine markets between the observed countries due to variation of actors and their capacity to provide financing. This influences on the availability of the mezzanine financing in general.

Additionally, it can be concluded that mezzanine is a potential bank lending form. Mezzanine financing could be used especially in situations where customer does not have collateral to offer and bank would be prepared to grant financing even with traditional debt instruments. Mezzanine instruments give also additional possibilities for a bank to price the lending to reflect better the risk of the financing transactions. However, mezzanine cannot be a tool which would allow banks to step to transactions or projects which would be riskier than those transactions or projects which are financed by banks today with traditional senior debt loan instruments. It is rather a tool which would provide to banks additional alternatives to price more accurately the risks they would take anyhow.

HANKEN SCHOOL OF ECONOMICS

HELSINKI
ARKADIANKATU 22, P.O. BOX 479,
00101 HELSINKI, FINLAND
PHONE: +358 (0)29 431 331

VAASA
KIRJASTONKATU 16, P.O. BOX 287,
65101 VAASA, FINLAND
PHONE: +358 (0)6 3533 700

BIBLIOTEKET@HANKEN.FI
HANKEN.FI/DHANKEN

ISBN 978-952-232-381-1 (PRINTED)
ISBN 978-952-232-382-8 (PDF)
ISSN-L 0424-7256
ISSN 0424-7256 (PRINTED)
ISSN 2242-699X (PDF)

HANSAPRINT OY, TURENKI