

Sweden

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MARKET AND INCENTIVES

1. Please describe briefly the private equity market in your jurisdiction and the opportunities for investment available to:
 - Institutional investors such as pension funds, insurance companies and banks.
 - Private individuals.

The Swedish private equity environment is well developed and comprises all types of investment opportunities from large buyout funds to seed financing. Currently, the total amount of capital committed to private equity funds on the Swedish market is about SEK220 billion (about US\$29.5 billion). From this, about 50% has not yet been invested. About 60% of the invested capital has been used for buyouts and 40% for various forms of early stage financing.

The Swedish buyout market is dominated by a number of large to medium sized Swedish buyout firms. In recent years, several international buyout firms have established a Swedish presence.

The Swedish early stage market used to comprise a large number of funds. However, over the last few years, the market has been consolidated. A significant amount of the capital committed to early stage investments comes from state-owned funds.

According to a survey performed by the Swedish Private Equity and Venture Capital Association (SVCA) (*see box, Private Equity/Venture Capital Associations*), in the first quarter of 2004, the highest number of investments were made in the pharmaceutical technologies, IT software and telecom industries. The highest sums of capital were invested in the construction, financial and other service industries.

Institutional investors may invest in buyout and early stage funds. However, there are regulatory and other restrictions limiting certain institutional investors' ability and willingness to commit capital. Negative experiences over the last few years have also made some Swedish institutional investors wary of investing in early stage funds. Nevertheless, investments of this nature are increasing.

2. Please summarise the level of activity in recent years in relation to:
 - Fundraising by private equity funds.
 - Private equity investment in established, early stage and start-up businesses.
 - Private equity financed transactions (for example, management buyouts (MBOs), management buy-ins (MBIs) and "public to private" transactions).
 - Exits from private equity funds.

Fundraising by Swedish private equity funds has been very active in recent years and competition for available capital has increased as a result of, among other things, an increased number of private equity firms operating on the Swedish market. While many Swedish institutional investors historically have been able and willing to invest in private equity funds, most of the capital now committed by Swedish investors is provided by a small number of institutions.

A significant number of the investors in recent funds raised by larger buyout firms are foreign. According to the SVCA, there is a shortage of capital available for early stage investments. As a result, tax incentives have been proposed to encourage this type of investment. It has also been proposed that the public funds for such capital, set up a few years ago as a temporary source of early stage capital, should be extended to bridge the availability of financing until private capital is available.

There was a high level of private equity investment and transaction activity on the Swedish market between 1999 and 2001. During 2002 and 2003, investment activity shifted from initial investments to follow-on investments, particularly in early stage investments. During 2004, activities have begun to pick up again. According to the SVCA survey (*see Question 1*), 91% of respondents (who represented about 83% of the total capital committed to the Swedish private equity market) believed that the business cycle will improve and none expected negative development.

In the last few years, exits through initial public offerings (IPOs) have been rare, probably due to the unfavourable capital market situation. Instead, Sweden has seen, among other things, a number of secondary buyouts as well as partial exits through recapitalisations.

3. What tax incentive schemes exist to encourage investment in unquoted companies? At whom are the schemes directed? What conditions must be met?

No specific incentive schemes exist to encourage investments in private equity funds.

Natural persons who hold shares in unquoted Swedish limited companies (*aktiebolag*) (LCs) are, to a limited extent, exempt from paying tax on dividends. In current practice, this exemption has limited relevance to investments in private equity funds.

In the corporate sector, capital gains made from the divestment of unquoted shares in a limited company held as capital investments are tax exempt. The same applies to divestments of quoted shares provided the shares are business related and have been held as business related for at least one year. Shares are regarded as business related if they meet both of the following criteria:

- They are held as capital investments (and not stock items).
- They represent at least 10% of the voting capital.

However, this exemption is not available if the divested shares are held through a Swedish limited partnership (*kommanditbolag*) (LP) or a foreign LP of a similar nature. Since private equity funds are commonly structured as LPs (*see Question 4*), the exemption is normally not relevant for such entities – a fact that, to a certain extent, has impaired the attractiveness of using Swedish LPs as a private equity vehicle.

FUND FORMATION

4. What legal structure (domestic or other) is most commonly used as a vehicle for private equity funds in your jurisdiction?

Swedish or foreign LPs are the most commonly used legal structure for private equity funds in Sweden. Where all the investors in a fund are resident in Sweden, a Swedish LP is normally used as the investment vehicle. If some of the investors are resident abroad, a foreign LP is normally used so as to avoid the risk of being treated for fiscal purposes as having a permanent establishment in Sweden (*see Question 5*). The tax exemption (*see Question 3*) for capital gains made by an LC from the divestment of unquoted shares in an LC has increased the attractiveness of LCs as a vehicle for private equity investments. The SVCA is also supporting the introduction of a specific legal structure adjusted for use as a vehicle for private equity funds.

5. Is this structure tax exempt or fiscally transparent (that is, tax is levied on the individual investors rather than the fund itself):

- So far as domestic investors are concerned?
 - So far as foreign investors are concerned?
-

Swedish LPs are fiscally transparent for domestic investors. The same applies if Swedish investors are partners in a foreign LP, provided it is regarded as fiscally transparent in the country where it is resident.

Swedish LPs are generally deemed to be fiscally transparent for foreign investors. However, it should be noted that foreign investors may be subject to taxation in Sweden on their share of the partnership income since they may be treated as having a permanent establishment in Sweden due to their participation in the Swedish LP.

6. What, if any, structures commonly used for private equity funds in other jurisdictions are regarded in your jurisdiction as not being tax transparent (in so far as they invest in companies in your jurisdiction)? What parallel domestic structures are typically used in these circumstances?

Foreign investors in a foreign LP that is tax transparent (or a foreign private equity fund that is not transparent for tax purposes) who realise capital gains from the divestment of shares in a Swedish portfolio company will not be subject to taxation in Sweden provided neither the investors nor the fund have a permanent establishment in Sweden (*see Question 5*).

Foreign investors who hold shares in a Swedish portfolio company through a tax transparent foreign LP and who receive dividend payments from the portfolio company are subject to withholding tax at 30%. This may be reduced in accordance with an applicable tax treaty between Sweden and the country in which each foreign investor is resident.

7. Is it possible for private equity funds to be quoted on a stock exchange? If so, what requirements apply?

No specific requirements are set up for the listing of a private equity fund. A fund applying for a listing will need to show, among other things, that it and its securities are suitable for listing, for example, on the basis of:

- Profitability.
- Shareholder structure.
- Corporate governance procedures.

In practice, an LP cannot be listed on a Swedish stock exchange. The managing or advising entity of a private equity fund could be listed, provided it fulfils the above requirements. The few quoted private equity funds in existence in Sweden are all structured as LCs.

8. Are a private equity fund's promoter, principals and manager required to be licensed?

If the private equity fund is structured as an LP, no licensing requirements exist under Swedish securities law for the fund, its managers or promoters.

The promoter of shares in a private equity fund structured as a Swedish LC would, in some cases, need a licence under the Swedish Investment Business Act 1991. However, a licence is not required:

- For a Swedish LC seeking to procure investments in its own shares.
- For a Swedish LC's principals and managers.

9. Are private equity funds regulated as investment companies and, if so, what are the consequences? Are there any exemptions?

There are no formal requirements on how a private equity fund operating in Sweden should be structured. However, certain investment companies on the Swedish market do invest in unquoted shares and can be said to operate on the private equity market. Investment companies are tax exempt with respect to capital gains on divestment of shares and other equity related securities. To qualify as an investment company for tax purposes, the private equity fund must be, among other things, an LC with a large number of shareholders who are natural persons. The investment company must also have a diversified investment portfolio, which offers its shareholders appropriate risk allocation.

10. What devices are commonly used by private equity funds to incentivise fund managers?

Incentives for managers of Swedish private equity funds differ little from those used in other jurisdictions. Fund managers are commonly granted a right to invest in shares or equity related instruments issued by the entity managing the private equity fund.

11. Please describe any restrictions on how a private equity fund may be marketed or advertised (for example under private placement or prospectus rules)?

There are no restrictions in Sweden on how private equity funds structured as LPs may be marketed or advertised. The marketing of a private equity fund structured as a Swedish LC may be subject to prospectus requirements, for example, if:

- The minimum investment permitted is below SEK300,000 (about US\$40,190).

- The investment offer is made to an open-ended group of investors.

12. Are there any restrictions (for example, nationality, age, number) on investors in private equity funds?

There are no statutory restrictions on investors in Swedish LCs or LPs.

13. Are there any statutory or other limits on maximum or minimum investment periods, amounts or transfers of investments in private equity funds?

There are no statutory restrictions on maximum or minimum investment periods, or amounts or transfers of investments in private equity funds. These issues are typically regulated through an agreement between the partners in the private equity fund.

EQUITY SUBSCRIPTION

14. What are the most common investment objectives of private equity funds?

The investment objective of a private equity fund depends on whether the private equity fund is involved in buyouts or early stage investments. Some of the largest buyout funds on the Swedish market have, during the last few years, raised funds with a pan-European scope. Medium sized and smaller buyout as well as early stage funds normally have a Nordic or Swedish focus.

15. What forms of equity interest are commonly taken by a private equity fund in a portfolio company? What are the relative advantages and disadvantages of each? Are there any restrictions on the issue or transfer of shares by law?

In buyouts, private equity funds normally invest in shares or convertible loan notes in portfolio companies. It is not unusual to find that investors in private equity funds are unwilling to accept unrelated business income (such as interest) which is paid out prior to the divestment of the portfolio company in question. If shareholder loans are granted, ideally they should not be subordinated other than to acquisition and working capital financing.

In early stage investments, private equity funds often take shares which contractually entitle the fund to preference in the event of liquidation and which give investors preference to a certain level of return in the event of an exit. In addition, it has become increasingly common for private equity funds in early stage investments to be granted warrants allowing the fund to subscribe for additional shares in the portfolio company at a later stage and at a predetermined price.

There are no restrictions on the issue of shares by law except that

shares in a Swedish LC may not be issued at a price below nominal value.

The Companies Act 1975 contains provisions protecting the shareholders of a Swedish LC against dilution through new issues of shares to third parties. Exceptions to these restrictions are made, among other things, for:

- Shares issued to management as part of an incentive programme.
- Shares issued in connection with add-on acquisitions by the portfolio company.

Protection against dilution can also be waived by a shareholder vote. There are no formal restrictions under Swedish law against transfers of shares in a Swedish LC. It is very common that pre-emption restrictions are included in the company's articles of association or by agreement.

16. How is the relationship between the investor and the fund governed? What protections do investors typically seek?

The relationship between the investor and the fund is typically governed by an LP agreement or a shareholders' agreement, and the articles of association. These agreements generally do not differ significantly from those used in other jurisdictions with a similarly developed private equity industry. LP agreements and shareholders' agreements usually contain, among other things, catch-up provisions, clawback provisions and keyman clauses.

BUYOUTS

17. Is it common for buyouts to take place by auction? If so, which legislation and rules apply?

Buyouts through auction are common on the Swedish market. Auction processes are not subject to any particular rules under Swedish law. Acquisition of shares through an auction is, as with any other acquisition of shares, subject to the Sale of Goods Act 1990. However, rights and obligations under this Act are normally contractually amended.

18. Are buyouts of listed companies common (public to private transactions)? If so, which legislation and rules apply?

Public to private transactions occur in Sweden but are not as common as buyouts of private companies. Offers for publicly traded shares are subject to many regulatory provisions mainly governing the conduct of the offeror. The main rules that apply are:

- The Financial Instruments Trading Act 1991.
- The Companies Act 1975.

- The Rules Concerning Public Offers for the Acquisition of Shares 2003 (the Takeover Rules) issued by the Swedish Industry and Commerce Stock Exchange Committee.

The Takeover Rules are, to a large extent, based on the UK City Code on Takeovers and Mergers and include, among other things:

- Prospectus provisions.
- A mandatory bid level of 30%.
- A general obligation to treat all shareholders equally.
- Restrictions on a bidder's ability to make the bid conditional on the availability of financing.
- Restrictions on a quoted company's right to provide non-public information to potential bidders.

The Companies Act prescribes a squeeze-out level of 90%. It is not clear to what extent a Swedish LC can give warranties in conjunction with a subscription for its own shares.

19. What forms of contractual buyer protection are commonly requested by private equity funds from sellers and/or management?

The Swedish market does not differ significantly in this regard from the rest of the world. Private equity funds normally seek warranties or indemnities from the sellers for, among other things:

- Title to shares.
- Authority to sign.
- The accuracy of any financial information.
- Title to intellectual property.
- Lack of litigation or threats of litigation.

In addition, managers of a portfolio company who are invited to invest in that company along with the private equity fund are often asked to verify to the best of their knowledge that the business case presented by them or the private equity fund is correct and attainable.

20. What non-contractual duties (for example, of confidentiality, employment) do the portfolio company managers owe and to whom (for example, when approaching possible investors in relation to an MBO)?

Portfolio company managers owe a duty of loyalty towards their employer. Under the Companies Act, the managing director is subject to specific liability provisions with respect to the shareholders of the employer. For example, the managing

director may not be involved in the handling of any agreements between the company and himself or any entity which the managing director may represent, or between the company and a third party if he holds a significant personal interest in the matter which may conflict with the company's. Therefore, managers are well advised to seek their employer's consent before approaching possible investors or at least inform their employers of any such contacts, particularly when they are interested in investing in part of the business operated by their employer. Shareholders in a quoted company in Sweden must normally approve agreements between the company and its management team which relate to the acquisition of a subsidiary of the company (or part of its business) (*Certain Directed Issues in Stock Market Companies etc. Act 1987* and the *rules of the Stockholm Stock Exchange*).

Portfolio company managers are also normally subject to confidentiality undertakings in their employment agreements which, along with the general duty of loyalty, prohibits them from disclosing non-public information to possible investors. In disclosing non-public information, managers of a quoted LC may commit a criminal offence under the Insider Penal Act 2000 if the information is used by the receiver to buy shares on the market. Similarly, it would be a criminal offence under the Insider Penal Act if an investor receiving insider information from management of a quoted company acquires shares in the company in question on the securities market.

21. What terms of employment are typically imposed on management in an MBO?

Swedish employment law will only uphold non-compete and non-solicitation undertakings in employment agreements if:

- They are very limited in time; and
- The employer continues to remunerate the employee during the term of restrictions.

It is common for the management team invited to invest alongside the private equity fund to make additional non-compete and non-solicitation undertakings in the shareholders' agreement entered into between them and the private equity fund investing in the portfolio company. The shareholders' agreement usually also contains some form of good leaver/bad leaver provision stating the consequences of the termination of a management investor's employment. The effects of such provisions from a tax perspective are, however, not entirely clear.

22. What measures are commonly used to give a private equity fund a level of management control over the activities of the portfolio company (for example, representation at board level)? Are such protections more likely to be given in the shareholders' agreement or company bye-laws?

Private equity funds normally require majority board representation. Such rights are usually given in the shareholders' agreement relating to the portfolio company but are also sometimes included in the company's articles of association. Certain types of investors may

have specific requirements relating to governance such as a need to contractually secure the right to continuous information relating to, and access to the management of, the portfolio company.

23. What percentage of the finance will typically be provided by debt and what form does that debt financing normally take (for example, term loans, working capital facilities, bonds)?

Debt will normally be provided for about a half to two-thirds of the amount needed to acquire a portfolio company, although exact amounts will vary in each case. It is relatively common for some financing to be mezzanine financing. If this is the case, an equity kicker is often requested by the mezzanine lender. Other types of financing, such as high yield bonds, are unusual on the Swedish market. Acquisition financing is generally provided in the form of term loans supplemented by a revolving working capital facility.

Although not common, there is a growing trend on the Swedish market for sellers to arrange an acquisition finance package which is made available to potential buyers in connection with auctions.

24. What forms of protection do debt providers typically use to protect their investments, in particular through what types of:

- Security?
 - Contractual and structural mechanisms such as subordination?
-

Sweden has relatively strict financial assistance rules (see *Question 25*). This creates difficulties when providing collateral for acquisition financing.

Debt providers normally require a pledge of shares in the acquired company as collateral for the acquisition financing. In addition, cross-guarantees and cross-collateralisation are sought, mainly as a result of international influences, even though it is uncertain whether or not they are enforceable under Swedish law. Impediments created by financial assistance restrictions can be avoided, or at least reduced, by pushing the working capital financing down into the acquired group, achieving access to the subsidiaries' assets for collateralisation.

Contractual subordination is normally required where there are several providers of finance. In addition, structural subordination is often sought, sometimes requiring the purchaser to set up several acquisition vehicles.

25. Are there rules preventing a company from giving financial assistance for the purpose of assisting a purchase of shares in the company? If so, how does this impact on the ability of a target company in a buyout to give security to lenders? Are there exemptions and, if so, which are most commonly used in the context of private equity transactions?

The Companies Act prevents the purchaser of a Swedish LC from using the assets of the company and its subsidiaries as collateral for the acquisition financing. There are no formal whitewash procedures in Sweden. However, various practical methods of providing collateral for acquisition financing in private equity transactions have been established (see *Question 24*).

The current Swedish Companies Act prohibits a seller of shares in a subsidiary from granting the purchaser a loan to acquire the shares. Provisions entitling the seller to an additional purchase price is sometimes deemed to correspond to a loan. The prohibition against seller loans is expected to be abolished by amendments to the Companies Act.

26. What is the order of priority on insolvent liquidation? Are debt providers given priority over equity holders by law or is priority purely a matter of contract and company constitution?

Swedish law gives debt providers priority over equity holders in the event of an insolvent liquidation.

27. Is it possible for a debt holder to achieve equity appreciation through conversion features such as rights, warrants or options?

Swedish LCs may issue convertible loans.

PORTFOLIO COMPANY MANAGEMENT

28. What management incentives are most commonly used (for example, shares, options, ratchets) to encourage portfolio company management to produce healthy income returns and facilitate a successful exit from a private equity transaction?

Currently, management incentive programmes often include a combination of shares and equity related instruments such as warrants, convertibles or call-options. Stock options are most commonly used by quoted companies in Sweden and can be made subject to almost any conditions. Stringent restrictions (such as good leaver/bad leaver provisions) on the transferability of shares and equity related securities (other than stock options) may have adverse tax consequences and should therefore be drafted carefully.

29. Are any tax reliefs or incentives available to portfolio company managers investing in their company?

It is usual for managers of a portfolio company to acquire shares,

convertible bonds or warrants in the portfolio company (see *Question 28*). Capital gains on divestment of such securities are normally taxed as capital income (and not as salary). The current tax rate for capital income is 30%. The tax rates for salary is progressive and starts at about 31%, going up to about 57% for salary exceeding SEK440,000 (about US\$58,495). Additionally, the employer is liable to pay social security contributions amounting to about 33% of the manager's salary.

The reasons for portfolio company managers acquiring shares or derivative instruments issued by the company are usually commercial. However, the difference between the taxation of salary and the taxation of capital income will be an influencing factor.

There are no specific tax reliefs or other tax incentives available for the management of a portfolio company.

EXIT

30. What forms of exit are typically used to realise a private equity fund's investment in a successful company (for example, trade sale, auction, initial public offering, secondary buyout)? What are the relative advantages and disadvantages of each?

Due to a weak capital market in the last few years, trade sales have been a more common method of exit than IPOs. Sweden has also seen an increasing number of secondary buyouts and partial exits through recapitalisation. In the early stage investment market, combinations of portfolio companies held by different private equity funds have become increasingly common.

The choice of exit is primarily based on:

- The expected return on investment.
- The expected speed of the exit process.
- Requirements for warranties and escrows.
- Available exit opportunities.

31. What forms of exit are typically used to end the private equity fund's investment in an unsuccessful company? What are the relative advantages and disadvantages of each?

Private equity funds normally seek to avoid insolvent liquidations, for example, by selling an unsuccessful portfolio company to its founders. Where this method is used, the purchase price paid at the time of the transfer is normally very low but the private equity fund entity retains a right to a higher purchase price if the portfolio company is divested by the founder within a certain period of the transfer.

PRIVATE EQUITY/VENTURE CAPITAL ASSOCIATIONS

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Status. The SVCA is a non-governmental organisation

Membership. The SVCA has about 330 members, of which 110 are active corporate members with over SEK220 billion (about US\$29.5 billion) in funds under management and about 1,400 investments in unlisted companies. Included in this category are pension and other funds which invest in private equity funds. The SVCA has over 90 associated corporate members who are active as service providers for the private equity industry and for growth companies. Remaining members are individuals who have an interest in private equity such as private investors and advisers.

Principal activities. The SVCA is an independent, non-profit association supporting the interests of companies and persons who are active in the Swedish private equity and venture capital industry. The SVCA's objectives are to:

- Promote an efficient private equity and venture capital market.
- Inform and educate about the industry.
- Promote entrepreneurship.

The SVCA offers no service or advisory functions for entrepreneurs, but does provide information on venture capital and the SVCA's members through its directory and website (*see above*), as well as in newspaper articles. Entrepreneurs who are seeking capital to establish or develop businesses may make direct contact with the investing members of the SVCA, through the Active Corporate Members group, or contact associated members for assistance in procuring capital and other services. The SVCA is a member of the European Private Equity & Venture Capital Association (EVCA).

Published guidelines. Members of the SVCA adhere to the ethical guidelines and valuation principles of the SVCA and the EVCA's.

Information sources. www.vencap.se

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