

Mergers and acquisitions – the legal regime in the former Soviet Union

A Guest Article by Nigel Kotani
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Grey areas of law

Despite considerable progress both socially and economically in the former Soviet Union (FSU), the legal regime still lags behind market practice there. Accordingly, various grey areas of law have arisen where practice does not entirely match the letter of the law. This is inevitable in a legal system that was not originally designed to deal with businesses that were privately owned.

A consequence of this is that due diligence investigations into target companies in the FSU invariably throw up technical legal problems in relation to the target. Many of these issues relate to privatisations of shares in the early 1990s, so the issues often go to the very fundamentals of legal title to assets or shares. These legal issues will have varying degrees of significance, and local expertise is needed to help quantify the risks. Local lawyers are often reluctant to do this, preferring to advise in terms of black and white, so guidance and prompting from UK counsel is often required.

Ways to acquire a business

There are essentially three ways to acquire a business in the FSU:

- acquire an offshore holding company
- acquire a local company direct
- acquire assets.

Out of more than fifty corporate transactions in the FSU on which the author has advised, no more than three or four have involved direct acquisitions of local companies – and those usually in the banking sector, where central banks tend to insist on direct ownership. Only one has ever been a pure asset sale – driven by a particularly strong concern of the buyer not to inherit any possible tax liabilities.

Accordingly, in the great majority of cases, acquisitions of businesses in the FSU are effected through the acquisition of an offshore holding company.

Acquiring assets

Problems concerning asset purchases in the FSU stem from the enormous number of licences, consents and approvals required when transferring a business as a going concern. The sole asset sale in the FSU in which the author was involved required the transfer of no fewer than 37 consents, with complicated outsourcing arrangements put in place between buyer and seller to

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cover the period between completion and the final transfer of the last licence. In contrast, asset sales in the UK rarely require anything more than landlord consent and the consent of the counterparty to one or two particularly significant contracts.

Acquiring a local company direct

There are a number of legal problems that arise when making a direct acquisition of a local company in the FSU.

Co-ordinating change

One of the main problems is to co-ordinate the simultaneous change of ownership and of control of the target company. Sellers are unwilling to give up either until they receive the purchase funds, and buyers are unwilling to pay the purchase funds until they receive both.

Unfortunately, the regimes for changing directors and the general manager of FSU companies are unrelated to the regimes for changing ownership of shares. Furthermore, the regime for changing ownership of shares in a joint stock company is different from the regime for changing ownership of participatory interests in a limited liability company. This makes co-ordination of the change of ownership and the change of control extremely difficult.

Applying both local and overseas law

Another problem with acquiring local companies direct is that this will generally mean using share purchase agreements that are governed by local law, particularly with joint stock companies where the share purchase agreement has to be shown to the company's independent registrar.

Local legal systems, which are based on codes rather than common law, simply cannot accommodate classic common law representations and warranties. They are also not ideal for complex pricing structures, such as those involving earn-outs or prices based on completion accounts.

Accordingly, if substantial representations and warranties are needed, or the purchase price does not involve a one-off fixed payment, the purchaser invariably has to effect the transaction pursuant to an agreement governed by an overseas law. This usually means having two sets of agreements, with an overarching agreement (complete with representations and warranties) governed by overseas law, and the local ones that are used to register the transfer of the shares being governed by local law.

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Acquiring an offshore holding company

Because of the difficulties described above, the great majority of acquisitions of businesses in the FSU are effected through the acquisition of an offshore holding company incorporated in a tax-friendly jurisdiction. A double taxation treaty between Cyprus and a number of FSU countries (not to mention its geographical proximity) makes Cyprus a common choice, but the Netherlands and the British Virgin Islands are also used.

An acquisition of this nature will require a restructuring of the local business in advance, whereby the local owners will transfer ownership of the target business to an offshore holding company and will in return be issued shares in the offshore holding company. It is those shares that the buyer will purchase.

Subject to the two provisos below, the acquisition of shares in the holding company will proceed in substantially the same way as would the acquisition of shares in an English company, with no problem co-ordinating the change of ownership and management of the holding company. It will also be possible for the share purchase agreement to be governed by English law, particularly if the holding company is in Cyprus or the British Virgin Islands.

Proviso 1: Disputes go to arbitration

The first proviso to bear in mind is that, if warranties are to be enforceable against the local sellers, disputes arising under the share purchase agreement will have to be governed by arbitration. This is because overseas court judgements are generally unenforceable in FSU countries and because, as detailed above, the local courts simply do not have experience dealing with warranty claims. Arbitration awards are generally enforceable in FSU countries, although enforcement difficulties still exist.

The majority of buyers will therefore try to negotiate some sort of mechanism to facilitate the making of warranty claims, such as retaining a portion of the purchase price for a limited period, or depositing a portion of the purchase price in an escrow account for a limited period.

Proviso 2: Anti-monopoly approval required

The second proviso is that the great majority of transactions in the FSU require the approval of the anti-monopoly authorities of the relevant country. This usually requires between six weeks and three months to obtain. Moreover, because applications become a matter of public record, applications are generally not made until after a conditional share purchase agreement has been

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signed. This invariably means that there will be a significant delay between signing the share purchase agreement and closing it.

A buyer will want to protect itself by imposing restrictions on the actions that the seller can take in respect of the target group during that period. The buyer will also want to negotiate rights for itself, including the right to pull out of the transaction, if anything untoward occurs in relation to the target group during that period (such as the target group being hit by a significant third party legal claim).

Provisions of this nature are often the most heavily negotiated in any conditional sale agreements.

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If you would like more information on any of the points covered in this Guest Article, please contact **TCii** on **020 7099 2621**.