

Legal due diligence, a crucial part of the M&A process, is a relatively new tool in Russia. Nevertheless, it has become a compulsory stage in most major M&A transactions involving Russian companies. Generally, extensive legal due diligence in Russia takes place in complex deals involving sophisticated parties, wherein the underlying deal documents are governed by foreign law (typically, English or US). Because Russian law does not regulate legal due diligence, the process usually adheres to unwritten rules adopted from Western business and legal practice.

Most potential purchasers are unwilling to buy a company without a thorough investigation. Well-structured due diligence provides the opportunity for the purchaser to examine the target's documents and investigate its operations and financial condition. This step helps to achieve the following goals:

i) identifying and evaluating operational strengths/weaknesses and business/legal risks may affect the valuation of the target (or even preclude the transaction altogether);

(ii) gathering information about the target's structure and related corporate issues facilitates more accurate drafting of transaction documents; and

(iii) the resulting information allows the purchaser to better prepare for integrating the target into its own operations.

For the seller, due diligence gives the following advantages:

(i) provides support for negotiating an increase in the offer price if company financials and other materials bear out such an increase;

(ii) decreases the purchaser's demands for broad warranties and indemnities with respect to some aspects of the business; and

(iii) allows the parties to discuss potential problems during negotiations in a calm, rational manner rather than litigating them later.

When preparing for and performing due diligence, purchasers and their legal advisers must assess the specific desires of the purchaser — for example, are they most concerned about the financial position of the target company, its tax liabilities, potential environmental liabilities, compensation schemes, or other issues (or all of the above), and how deeply should the due diligence delve in order to assuage the purchaser's concerns? What types of findings would impact the offer price or desirability of the deal, and what warranties and indemnities will be necessary to require of the seller?

The seller and its legal counsel, while previewing documents to be provided during due diligence, should clearly identify areas of particular concern — for example, does the company have sloppy accounting records, are shareholders' and directors' resolutions missing, does the company owe back-taxes or has it used 'grey' tax schemes, have important permits expired, or are some executives being paid 'off the books' or in a manner that does not appear on the balance sheets? All such matters should be addressed before due diligence begins, if possible. This provides an opportunity for the seller to clean up its records and to document operations and activities that were not being properly documented in the past.

Due diligence may be accomplished in one or several rounds. The latter approach is used typically in transactions with several potential buyers conducting due diligence simultaneously, but it can also be used in highly complex transactions involving single buyers or deals involving large target companies.

During the first round, which usu-

RUSSIAN DUES

Due diligence in Russia currently has unwritten rules and no regulation. **Kimberly Reed** and **Ilya Viktorov** explain how the process is managed in Moscow



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DUE DILIGENCE IS A CRITICAL PART OF ANY M&A TRANSACTION, AND IT IS VITAL THAT MANAGERS AND LEGAL COUNSEL UNDERSTAND THE DUE DILIGENCE PROCESS

ally begins after the signing of a letter of intent, a confidentiality agreement and data room rules (discussed below), general corporate information is provided to the bidder(s), such as the target's constituent documents, board/shareholder resolutions, important permits, and annual financial statements.

In a multi-bidder situation, the second round is tailored for a smaller group of bidders (normally one or two), who receive more detailed information such as balance sheets and other financial records, employment agreements of executives, real estate title documents, and documents regarding environmental and regulatory issues.

A third round of due diligence, which occurs only when the parties are close to making a deal, might include highly confidential business information such as detailed business plans and strategy documents, site visits, and interviews with management of the target company. In many cases, the second and third rounds are combined.

Management interviews

Interviews with management are an effective way for the target to share business information with a potential buyer. Such interviews allow managers or employees with particular expertise about operations of the target to explain matters that might be confusing or misleading if the purchaser only reviews documents. In addition, interviews benefit the seller by allowing it to explain apparent inconsistencies or weaknesses in documentation or negative financial results of the target.

Generally, interviews are scheduled with top executives and department heads of the target, as well as other key employees with knowledge that is important to the potential buyer in deciding whether to proceed with the purchase. It is advisable for a potential buyer to provide a list of questions to the interviewee several days before the interview so that the interviewee may prepare (e.g. by refreshing his knowledge about a past transaction or collecting documents that might assist him in providing answers).

The seller's legal counsel (whether in-house or external) should attend these interviews to ensure that the requirements of the confidentiality agreement are followed and that the interview does not exceed an appropriate scope.

The party producing documents (i.e. the seller in an acquisition or both parties in a merger) should require the other party to agree to carefully drafted data room rules prior to the beginning of due diligence. Data room rules should provide for confidentiality of the documents and information being provided (which also could be contained in a separate confidentiality agreement); limits on the receiving party's additional document requests after the initial due diligence requests; whether the reviewing party will be allowed to make/request copies of the documents; the maximum number of persons who can attend the data room at a time; dates and opening hours for the data room; and rules regarding the use of laptops, PDAs and mobile phones (particularly those with photographic capability) in the data room.

Clear data room rules and strict adherence by all parties creates a more predictable and efficient process and helps to prevent information leakage and disruptions in the target company's activities.

It is highly recommended that the seller and/or target company appoint a data room coordinator from the target company who is knowledgeable about company operations and where (or from who) to find additional documents and information as requested during the course of the due diligence. The coordinator should work closely with the seller's external legal counsel to manage the

data room, response to requests for additional documents and clarifications and ensure adherence to the data room rules.

Confidential information

Another important aspect of legal due diligence is protecting commercially sensitive information that, notwithstanding a confidentiality agreement, is inappropriate to produce. For example, particularly when the purchaser competes with the seller or target in the US, the European Union, or other western markets, competition/antitrust laws in those countries prohibit sensitive sales, cost, marketing, strategic or forecasting data from being reviewed by or even made known to individuals working for the potential buyer in decision-making capacities.

Since most purchasers will insist on examining such documents if they are critical to valuation, the financial or regulatory position of the target, or other important matters, it is not realistic to withhold these documents altogether.

In these situations, it is possible to arrange for them to be viewed only by the purchaser's lawyers, who then may provide a limited summary of such documents to the purchaser after such summaries are approved by counsel for the seller. If the purchaser's lawyers find information that would raise significant issues for the purchaser and thus needs to be communicated in more detail, then the respective parties' lawyers should negotiate the best way to communicate this information to the purchaser (while taking into account both confidentiality and competition law concerns). It is recommended that provision for such lawyer review of highly-sensitive documents be made in the data room rules.

In many cases, certain documents of the target, especially commercial agreements, may themselves contain provisions that impose a non-disclosure obligation on the target or require the prior consent of the counterparty for disclosure. Even if an agreement containing such a provision is not commercially sensitive from the target's standpoint, the non-disclosure obligation must be observed. In some cases, rather than seeking the consent of the counterparty, it may be possible to submit the documents to lawyer-only review.

Confidentiality issues also arise in connection with disclosure of employees' personal data. According to legislation in Russia (and many other countries), certain personal data must be kept confidential unless such information is public, is disclosed in impersonalised form (without names or identifying information), or is cleared for disclosure by the relevant employee.

Due diligence is a critical part of any M&A transaction, and it is vital that managers and legal counsel understand the process and adopt measures that result in an efficient and confidential process.

A smoothly functioning due diligence process can lay the groundwork for trust between the parties, mutually beneficial negotiations and, ultimately, a better deal for all parties involved. ■

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