



“How to do Legal Due Diligence in Russia”

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Moscow

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- 16 years in consulting
- Performed 14 Due Diligence projects only last year
- Sections provided: “Legal Due Diligence”

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Legal Due Diligence

- **Due Diligence of a target company is an essential precursor to any acquisition project as it provides a buyer with a precious knowledge of the issues and risks likely to be involved in or affecting the operation of the target business**
- **DD gives the prospective buyer information to enable it to renegotiate the initial transaction terms and the purchase price or to avoid investing considerable sums into a risk exposed businesses should the results of the due diligence exercise not be satisfactory**

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Legal Due Diligence

Case Study



Case Study - Background

■ Background

- Existing Foreign Manufacturer (FM) of consumer goods (CG)
- Russian distribution contract with Russian individual for last 2 years, contract renewed recently for 2 years
- Russian locations currently 10, compared to original plan for 5; business very profitable
- FM controls the retail sales price of the CGs, and the quantity of inventory

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Case Study - Background

- Background (con't)
 - Russian partner controls the store leases and locations, which are valuable
 - Russian partner has hired 100 employees successfully
 - Russian is assumed to be using black import (customs) schemes
 - FM wants to expand the business to 100 stores, but does not want to share the profits of additional stores with Russian partner

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Case Study – Proposed JV Structure

- Structures for Joint Venture (JV)
 - Russian Legal Entity (RLE) partially owned by the Russian Partner

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Legal Due Diligence

- Advantages and disadvantages of deal structure
- Current and contingent obligations of target
- Past, present and future legal issues related to target's business
- Input for an appraisal

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Case Study – Proposed JV Structure

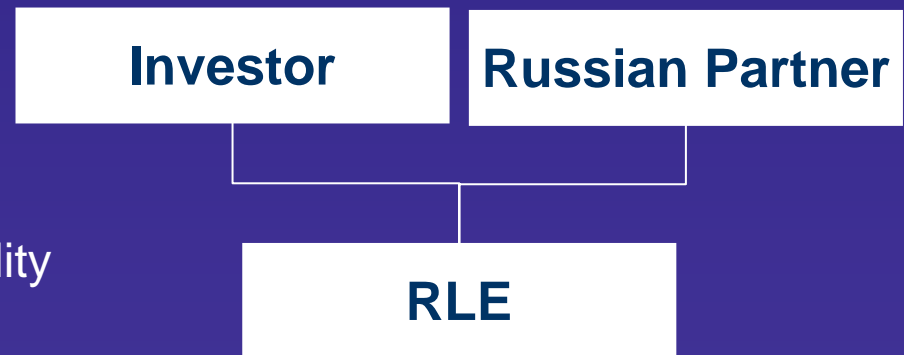
RLE partially owned by the Russian Partner

– Advantages:

- ❖ Maintain control over all Russian operations
- ❖ Legal control – subject to Russian law

– Disadvantages:

- ❖ Loss of legal flexibility
- ❖ Difficult to exclude Russian partner later



Case Study – Alternative JV Structure

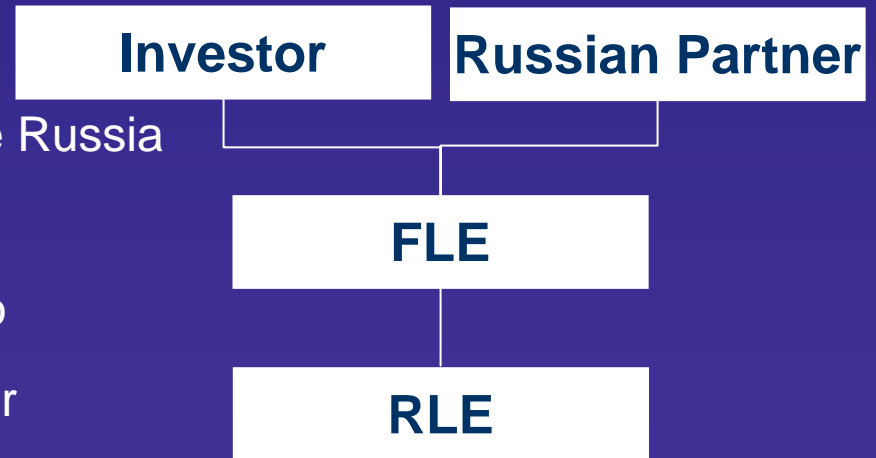
- **Modification:**
FLE partially owned by the Russian Partner

- **Advantages:**

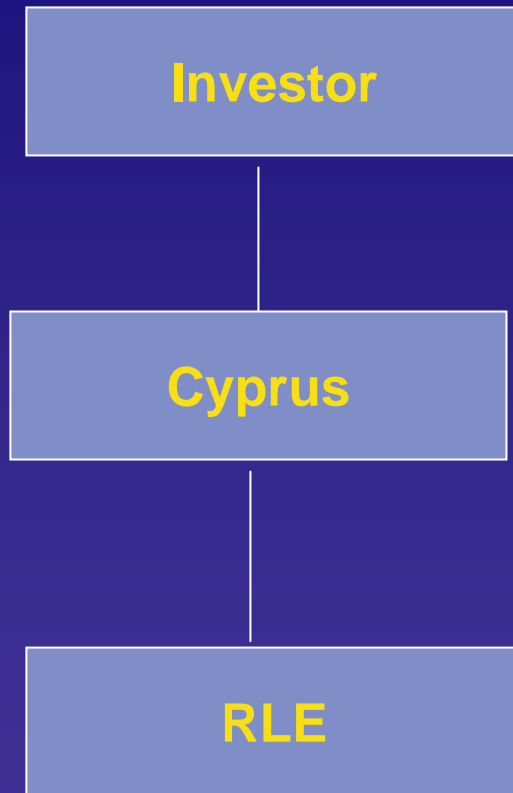
- ❖ Maintain control over all Russian operations
- ❖ Legal control – subject to foreign law
- ❖ Legal flexibility
- ❖ Exit strategy outside Russia

- **Disadvantages:**

- ❖ Difficult but easier to exclude Russian partner later



Typical Holding Structure for RLE



- Favorable Russia – Cyprus Double Tax Treaty
- Favorable tax climate in Cyprus
- Identity of Cyprus owner generally not disclosed
- Transfer of Cyprus shares does not require re-registration or anti-monopoly approval (?)
- Shareholders Agreement subject to English law



Acquisition of Units (Shares) of a Legal Entity

Not only assets and liabilities, but also risks related to previous operations are transferred.

Legal Due Diligence should focus on:

- Estimation of contractual obligations
- Verification of compliance of foundation documents
- Review of title to the company's assets
- Payment of the charter capital
- Compliance with tax and antimonopoly law
- Examination of employment contracts
- Possible claims
- Current Litigations

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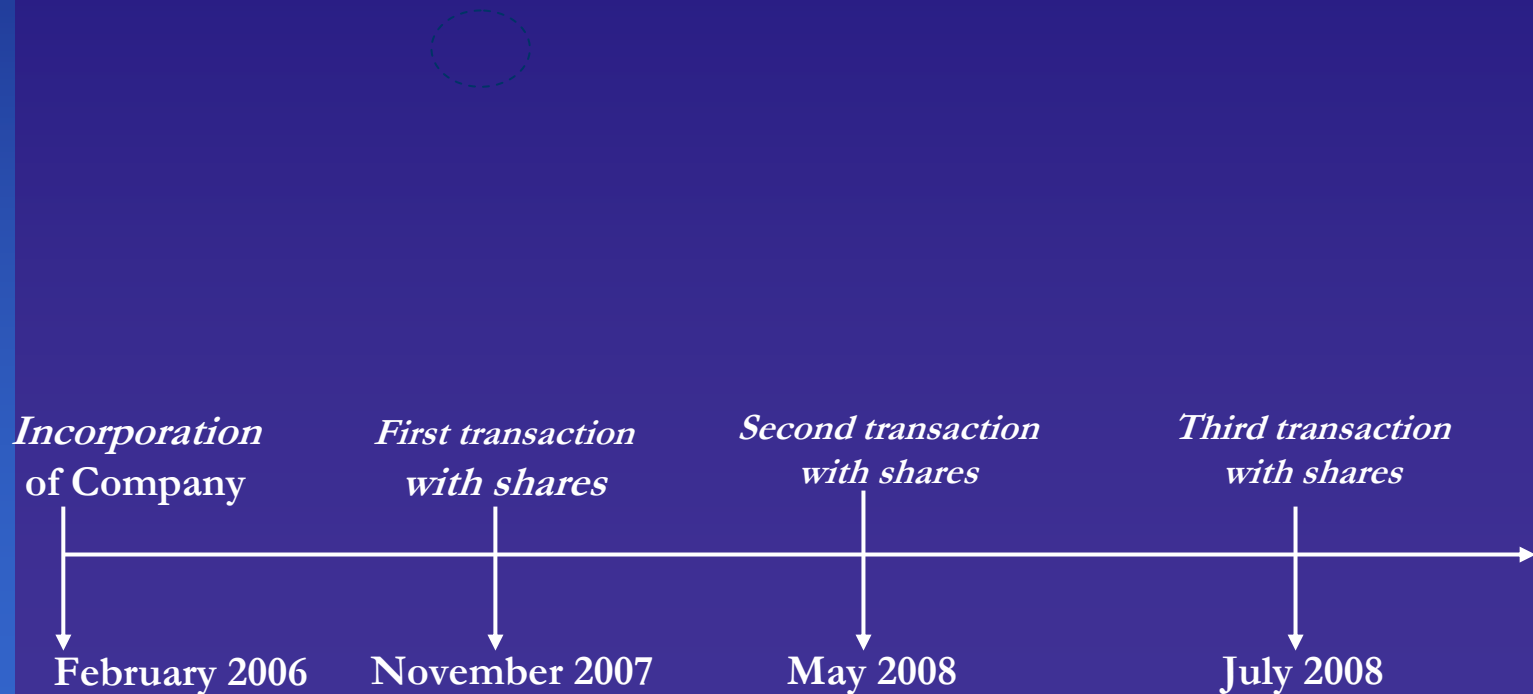
Legal Due Diligence - Scope

- **Corporate**
- **Regulatory, Authorizations, Permits and Licenses**
- **Main civil and commercial agreements**
- **Intellectual Property**
- **Environmental**
- **Assets**
- **Real Property**
- **Litigation**
- **Contingencies and Commitments**
- **Labour and employment matters**

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History of transactions with equity interest of Target



Due Diligence Impact

■ Quote from Due Diligence Report on Legal Risks of Target:

- Throughout the corporate history of Target the shareholding structure has been changed several times, there are no documents evidencing that equity interest was duly paid. Unpaid equity interest is deemed to be under a statutory lien...
- All lease agreements concluded for a period less than one year
- Target has no assets

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Case Study – Alternative JV Structures

- Alternative Structures for Joint Venture (JV)
 - Russian or Foreign Legal Entity (RLE/FLE) partially owned by the Russian Partner
 - Modified Distribution Agreement (MDA)
 - FM owned Separate Distribution Network (SDN) (parallel to Russian partner's)

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Case Study – Negotiating Positions

Negotiation Positions

- Russian Partner's Position
 - ❖ Control over existing Leases and Locations
 - ❖ Control over People
 - ❖ Russian partner essential to growth
- FM's Position
 - ❖ Control over inventory and prices
 - ❖ Cancellation of Distribution Contract in 2 years

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Case Study – Negotiating Positions

Negotiation Process

- Russian Partner's Potential Reactions to Proposals
 - ❖ RLE – Agreement if sufficient ownership and control
 - ❖ MDA – Agreement if terms favorable
 - ❖ SDN – Actions to frustrate FM; take benefit of store locations to another consumer goods manufacturer

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Case Study – Negotiating Positions

Negotiation Process

- FM's Potential Reactions to Proposals
 - ❖ RLE – Agreement if sufficient ownership and control
 - ❖ MDA – Undesirable if terms favorable to Russian partner
 - ❖ SDN – Difficult to prevent actions by Russian partner and to keep existing value of distribution network.

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Case Study

- Final result?

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Legal Due Diligence

- Questions?



Legal Due Diligence

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Legal Due Diligence

- Attachements



Methods of Business Acquisition

- Acquisition of units (shares) of a legal entity which directly or indirectly controls the target business
- Acquisition of the target's assets (real estate, fixed assets)

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Acquisition of Property

The Buyer receives assets and liabilities free from contingent and unassumed liabilities.

- **Transfer of different kinds of intellectual property**
 - technical documentation
 - trademarks, know-how
 - licenses
- **Check of legitimacy of the Seller's possession**
 - estimation of the title history of the property
 - legitimacy of deals and order of their execution

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Acquisition of Assets or Shares (1)

Aspect	Acquisition of assets	Acquisition of shares
Licenses	Remain at the Seller's disposal	Remain at the Target's disposal
Historic tax risks	The Seller bears unless the deal is not fictitious	The Target bears
Stability of tax position	Depends on the future activity of the Buyer	Depends on the future activity of the Target
Tax obligations	Tax consequences arising from the asset sale are taken into consideration	The following is taken into consideration: <ul style="list-style-type: none"> ■ tax consequences arising from the sale of shares ■ historic tax risks ■ the Target forecast
Seller	<ul style="list-style-type: none"> ■ Russian companies ■ Foreign companies ■ Individuals (rarely) 	<ul style="list-style-type: none"> ■ Russian companies ■ Foreign companies ■ Individuals

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Acquisition of Assets or Shares (2)

Aspect	Acquisition of assets	Acquisition of shares
Tax base	Is subject to alteration	Cannot be changed
VAT	Is calculated on the basis of the total sale value	Is not collected
Profits tax	The difference between the sale price and the tax base is subject to taxation	The difference between the sale price and the tax base is subject to taxation
Previous period losses	Recorded by the Seller	Recorded by the Target
Property tax	Is subject to alteration	Can not be changed
Tax assets and obligations	Tax consequences arising from the asset sale	<ul style="list-style-type: none"> ■ Tax consequences arising from the share sale ■ Historic tax risks ■ The Target forecast

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Acquisition of Assets or Shares (3)

Aspect	Acquisition of assets	Acquisition of shares
Taxation at source (for foreign companies)	Withheld from income received as a result of immovable property sale	Withheld from income received as a result of share (unit) sale, if the immovable property represents more than 50% of the Target's assets
Double taxation of foreign seller's income	Exemption from taxation is subject to double-tax treaties	Exemption from taxation is subject to double-tax treaties
Acquisition of a foreign company	<ul style="list-style-type: none"> ■ More complete legislation ■ More precise and detailed regulation ■ Other rules on asset and obligation "inheritance" 	<ul style="list-style-type: none"> ■ More complete legislation ■ More precise and detailed regulation ■ Other rules on asset and obligation "inheritance"

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