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Due diligence for M&A purposes in Azerbaijan

Due diligence is a very important action that should be taken by a buyer before entering into a merger and acquisition (M&A) transaction. In the M&A transaction, the legal due diligence enables the buyer to get clear information about legal aspects of the target's business such as corporate structure, contracts, assets, IP rights, litigation, labor matters. In other words, by conducting a due diligence, the buyer obtains a complete picture of the business being acquired. Such due diligence protects the buyer from potential legal risks that may arise from the M&A transaction.

As a rule, due diligence process commences by signing a letter of intent (LoI) by the parties to the potential transaction.

The due diligence process consists of several steps:

- ▶ formation of team members responsible for the process;
- ▶ preparation of a checklist;
- ▶ collection of information/documents via data room;
- ▶ review and analysis of the uploaded documents;
- ▶ preparation of a due diligence report.

Normally the due diligence report does not provide comprehensive advice on any specific legal issues. Instead, it highlights those issues which appear to legal counsel from the documents/information provided, the responses and the data rooms to be material or significant in relation to the proposed transaction taken as a whole with regard to the level of materiality referred to in the scope of work for the legal counsel. Meaning that detailed descriptions or summaries of each document are not included unless expressly stated in the scope of work for the legal counsel. In general, a due diligence report covers the matters below:

1. Corporate law

Under this section of the report, mainly the below matters are clarified *prima facie*

- ▶ verification that the target's legal structure is in accordance with the structure chart provided by the target by way of review of the target's shareholders' registers and a review of recent extract from the state register (

prima facie)

- ▶ ;
- ▶ identification and list of the statutory directors and officers (if and to the extent applicable) of the target by way of a review of a recent extract from the relevant state register;
- ▶ a review of company charter/regulations, all management board resolutions/minutes in the past years and all resolutions/minutes of shareholders' meetings in the past years;
- ▶ a review of the constitutional documents relating to the target to ascertain whether the shares in the capital of the target have been pledged.

In particular, it is necessary to check whether the target has followed corporate rules when entering into transactions with

related parties. It should be noted that Article 49-1 of the Azerbaijani Civil Code regulates rules of contracting between related parties. If the contract price concluded between related parties equals to or exceeds 5% of the assets of a company, the contract shall be approved by the simplified majority votes of shareholders' general meeting and independent auditor's opinion.

The contract with a related person must be approved by the general meeting of the shareholders, board of directors or executive board, in case the contract price does not reach 5% of the company's assets. Failure to follow these formalities of related party transactions may lead to invalidation of the contract in future.

Under this section, it is also worth checking whether any transaction undertaken by the target constitutes a "transaction of special importance". As per Article 87.10 of the Civil Code a transaction of special importance means a deal with value in excess of 50% of a company's net assets. Such a transaction shall be approved by the general meeting of shareholders.

2. Material contracts

One of the most important components of a due diligence report is the review of all material contracts of the target. Definition of a material contract (including materiality threshold) is usually determined by the client depending on the size of the transaction. Under this section, material contracts are reviewed whether they are in compliance with Azerbaijani laws. In particular, review of the material contracts aims at identifying terms and conditions relating to change of control, duration, termination, minimum volume commitments, exclusivity (including after termination and non-compete), assignment, sub-contracting and pricing (including rebating and subsidies) matters.

Below categories of contracts are reviewed under this section of the report:

- ▶ guarantee, loan, suretyship, pledge, mortgage agreements;
- ▶ customer and supplier contracts;
- ▶ lease agreements (including finance and operating leases);
- ▶ indemnification agreements;
- ▶ distribution, insurance, agency, and advertising agreements;
- ▶ out staffing contracts;
- ▶ license agreements;
- ▶ franchise agreements;
- ▶ non-competition agreements.

3. Real Estate

The purpose of this section is to identify and list real estate owned/used by the target (if any) to ascertain title and identify encumbrances. Under this section, lease agreements to which the target is a party (if any) shall be reviewed for the purpose of identifying key provisions and items such as parties, current term plus any extension options for the lessee, rent plus any rent adjustment mechanisms, contractual use (restrictions), sub-lease (possibilities), assignability or substitution, guarantees and reporting on the existence of flexibility provisions in the lease agreements, without further analysis (as that will depend on the business plans of eventual new owners).

In particular, contracts on immovable properties shall be checked whether they have been concluded as per formalities required by legislation. Under the Azerbaijani Civil Code (art. 144), agreements on transfer of immovable property (including lease agreements) shall be certified by a notary public. This rule also applies to certain types of movable properties, of which state registration is mandatory. In practice, some companies disregard this requirement. Failure to comply with this requirement may

lead to disputes on validity of the agreements in future. The legislation also requires that transfer of immovable assets and certain types of movable assets (e.g., vehicles, aircraft, excavators, bulldozers, cranes etc.) need to be registered with relevant state authorities.

4. Litigation

The litigation section aims at identifying and listing all actual or threatened litigation or arbitration proceedings in which the target is or may become involved. This may exclude cases on routine recoveries of accounts receivable at the request of the client.

A materiality threshold may also be determined by the client on the litigation part of the report. Aim of this section is to provide the following details (to the extent available): parties, brief description of the conflict (e.g. rental/lease dispute, product liability, intellectual property dispute, employee grievance, etc), basis of the conflict (e.g. non-fulfilment or wrongful act), amount or other issues at stake, management's prediction of the outcome, provisions on the balance sheet, whether the matter is covered by insurance and details of any recourse against third parties other than insurers.

Normally the target company uploads court judgments to the data room for their review and analysis by the legal counsel. The legal counsel can also research into the e-court system to see if there are any pending/completed court cases with respect to the target. It should be noted that judgments of local courts are publicly available in the e-court database. The legal counsel can research into the database by including the Tax ID of a company. However, please note that not all court judgments are available in the database. In addition, most of the judgments are anonymized (i.e., names of plaintiff/defendant are removed from the judgments). Therefore, the legal counsel may not be able to identify court judgments of certain courts related to the target by using the e-court database.

The e-court database also provides a brief information about pending/completed court cases. The brief information mainly includes names of plaintiff/defendant, subject of claim and status of the case hearing. The legal counsel can research into the database by including the Tax ID of the Company to get brief information (if any) on court cases related to the target.

5. Employment law

Issues that are identified during an employment due diligence can have a crucial impact on the business transaction as during M&A the buyer also acquires the human capital of the target company. Human capital is considered an intangible asset of the company. Besides that, the employment issues and disputes can be extremely costly. As such, prior to M&A, the employment lawyer should assess the potential administrative and criminal risks that might lay on the target company. It is, therefore, essential for the buyer to review all employment-related files and documents.

Before acquisition, the purchaser must ascertain whether there have been any claims against the seller and whether such claim has been resolved. If it is unresolved, how can it affect the acquisition? This is one of the topics that is discussed during due diligence. Some companies, of course, may choose different priorities or additional areas of focus. The essential considerations upon conducting the employment due diligence include:

(a) Compliance of the Employment Agreements with the requirements of the Labor Code

Employment agreements, amendments to the employment agreements and other related documents must be reviewed during due diligence. The employment lawyers must check whether the content of the employment agreements complies with the requirements of Article 43.2 of the Labor Code. Article 43.2 of the Labor Code provides the list of the information that must be included in the employment agreement. Lack of any information as stipulated in Article 43.2 may lead to invalidation issues. Additionally, it is necessary to check whether the information stated in the employment agreement matches with the information that appears in the e-gov.az portal. Sometimes, it is observed in practice that the companies make amendments to

the employment agreements; however, they do not register such changes in the e-gov.az portal. Such inactions might cause a headache to the new owner as the changes to the employment agreements get into legal force after their appropriate registration in the e-gov.az portal. To prevent adverse outcomes, the acquirer must pay detailed attention to such issues.

(b) Classification of the employee as an independent contractor

The rule regulating the misclassification issues found its reflection quite recently in the Law on the Amendments to the Labor Code of the Republic of Azerbaijan effective from 8th of May 2021. In order to conduct a misclassification audit, the buyer has to obtain the target company's employees and independent contractors list along with the subsequent agreements. Afterward, it is necessary to assess whether the independent contractors fall under the requirements of Art. 7.2-3 of the Labor Code. In the event it is detected that an employee is misclassified as an independent contractor, the penalties must be evaluated.

(c) Vacation Pay

Paid leave-offs must also be examined during merger and acquisition. Following the requirements of the Labor Code, during termination of the employment agreement with the employee, the last payment including the compensation for the unused time must be made to him/her. Failure to pay the compensation for the unused vacation or failure in the calculation of the vacation payment can lead to administrative penalties. Therefore, it is important to be aware of whether the statutory payments are made or duly made to the employees or not.

(d) Employee's compensation and benefit plans

Any comprehensive due diligence should include a detailed review of the target company's compensation and incentive/ bonus plans. Especially, the buyer should pay attention to whether the seller fulfilled their obligations under the plans. Last but not least, the new owner should be attentive to whether such plans include any obligation on the payments of leave offs.

(e) Labor Safety

The buyer must ensure that all existing policies of the target company concerning occupational health and safety comply with the local legislative requirements and the requirements related to occupational health and safety are met. Otherwise, administrative and criminal sanctions can be applied to the new owner.

(f) Immigration Considerations

Change in ownership can affect foreign employees. Employees might need new work permits and/or temporary residence permits. Therefore, it is principal for the acquirer to evaluate the number of foreign employees, their holding positions, and the type of documents under which they remain in the country. If, after the corporate transaction, foreign employees carry out the labor activity under the old immigration documents, the administrative sanctions might be imposed for non-renewal/cancellation reasons.

(g) Legal Consideration of the employee's dismissal/transfer

A key issue to be considered under any M&A transaction is the status of the employees and adherence to the procedural requirements.

Under the local law, should the owner of the enterprise change, the employment agreement signed by and between the former owner and the employees must be kept in effect by the new owner. An exception to the general rule applies. Pursuant to the Labor Code, the new business acquirer may terminate employment agreements with the employees under Articles 70, 73, and 75. In the light of Art. 63.2 of the Labor Code, a new owner, can also terminate the employment agreements with the employees

holding managerial positions such as deputy directors, chief accountant, and other division managers. The local law also allows modifying the terms and conditions of the agreements with the above-mentioned employees under Article 56 of the Labor Code.

Although the termination might seem straightforward concerning the employees who meet the prescribed criteria, it can be more complicated with regard to the protected employees. The Labor Code provides the list of the employees with whom the employment agreement cannot be terminated except for the reason of the expiration of the term of the contract or upon liquidation of the enterprise, which is not applied to M&A transaction. Therefore, it is advisable from the acquirer company's viewpoint to request and analyze personal files of the questioned employees to decide whether to keep or dismiss them; if the decision on dismissal was reached, what is the applicable ground to cease the employment relationship.

Another issue that might require attention in the course of M&A deal: whether and how to transfer the employees of the affected business to the new owner. In some jurisdictions, transfer of the employees is allowed by the law, whereas the concept of the "transfer of the employees" under the local legislation does not exist in Azerbaijan.

(h) Labor disputes

Existing claims that have been raised against the target company by the seller company's employees must be reviewed. This can include not only the active litigation but also the cases where the employees sent the complaint letters to the Ministry of Labor and Social Protection of the Population of the Republic of Azerbaijan, to the State Employment Agency and etc. The new business acquirer must be aware of any current, pending, or future litigation concerning unlawful dismissal and other issues.

Depending on the nature and scope of the target's business, additional sections can be included into the due diligence report such as regulatory, antitrust matters, etc. The due diligence report also contains an "executive summary" section, which provides an overview of the major findings from the due diligence conducted on the target. Under this section, major issues with risk levels are listed and briefly described. The legal counsel should also provide recommendations on how to address those issues.

The new business acquirer should not underestimate the necessity of conducting a legal due diligence. The due diligence plays a substantive role in deciding on acquisition or merging with another business. The results of the due diligence can affect the purchase price and terms.

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