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# Due diligence in mergers and acquisitions in Russia (Moscow)

Due diligence is a comprehensive audit of an asset in order to identify and assess existing and possible future risks that may arise from transactions / operations with this asset.

**Such audit is usually carried out by independent consultants:**

- ▶ in mergers and acquisitions transactions;
- ▶ upon acquisition of shares or an interest in the company – target of the transaction;
- ▶ when issuing credit or borrowed funds;
- ▶ when creating joint ventures;
- ▶ in transactions for the acquisition of real estate;
- ▶ when attracting large investments (in particular, when entering an IPO);
- ▶ when buying and selling an existing business.

**What is the scope of legal due diligence?**

Depending on the subject matter of the transaction and the objectives of the legal due diligence initiator, the scope and methods thereof may vary.

For example, in the case a credit is granted or funds are borrowed, the initiator of due diligence is most often a bank or other lender, in order to make sure of the proper status and stable financial position of the borrower. The scope of the audit, as a rule, is limited to such issues as the proper establishment and payment of the authorized capital of the borrower, the existence of risks of compulsory liquidation (as a result of material violations of the law) and challenging the transaction by third parties, net assets, the need for approval of the transaction by the management bodies of the borrower and / or by third parties (often referred to as "corporate matters" for convenience).

In the event of a sale of a business, the seller – its management and / or owner (s) of shares in the company may initiate due diligence for the purpose of justifying the assessment of the value of business and determining what terms of the transaction, i.e. price, the procedure for its payment and liability are fair and is any leverage to negotiate them with the buyer. The seller can also use the results of due diligence to improve the condition of the assets and minimize / eliminate risks, which ultimately leads to an increase in the value of the asset and improves the bargaining position in relationships with other potential buyers.

In M&A transactions, due diligence is usually initiated by an investor – buyer.

The scope of legal due diligence in transactions for the sale and purchase of a business as a going concern where 100% (or a controlling stake) of shares / interests in the target company is purchased, covers a wider range of issues.

**In addition to the corporate matters, the following are analyzed:**

- ▶ the seller's rights to shares / participation interests, whether or not such rights are encumbered (including pledges and seizures); in particular, were there any violations sustained of the legislation in force at the time when the seller acquired

shares / participation interests, including the need to obtain prior consent to the transaction from other shareholders / participants or the target company itself;

- ▶ the need to obtain the prior consent of the Federal Antitrust Service of the Russian Federation or the government commission on strategic investments for the transaction, based on the value of assets and proceeds from the sale of goods, works and services of the target company, the buyer and their groups of persons, as well as the types of activities that the target company conducts;
- ▶ the availability and validity of licenses / permits / membership in self-regulatory organizations, etc., necessary for the target company to conduct its activities; inspections by authorized bodies and detected violations of the licenses/other authorizations' terms and conditions;
- ▶ material contracts, including those providing for financial obligations (credit, loan agreements, etc.), in particular, their provisions in connection with the change of the company – target's ownership;
- ▶ rights to immovable and substantial movable (fixed production assets) property, encumbrances of such rights (including pledges and seizures) and risks of claims of third parties (for example, a shareholder – a former owner of immovable property granted this property as a contribution to the authorized capital of the target company when it had signs of bankruptcy; in the event of initiation of a bankruptcy management procedure against the former owner, the liquidator can challenge the capital contribution as an invalid transaction and then sue the target company to recover the property from its illegal possession);
- ▶ judicial and enforcement proceedings, signs of bankruptcy;
- ▶ compliance by the target company with industry specific legislation – depending on the scope of its activity (on environmental protection, industrial safety, on the subsoil, etc.), risks of administrative liability;
- ▶ intellectual property rights (patents, know-how, trademarks, service marks, commercial designations, etc.) of the target company and the observance of the intellectual rights of third parties by the target company;
- ▶ compliance by the target company with labor legislation, employment contracts with top management, labor disputes.

**Based on the risks identified in the course of legal due diligence and the recommendations of external consultants to eliminate / minimize the consequences of such risks, the buyer gets broader negotiating opportunities:**

- ▶ to influence the price of an asset and the terms of its payment (for example, to provide in the contract for the retention of a part of the price within certain term after the closing of transaction and its payment subject to certain conditions subsequent);
- ▶ to stipulate the seller's representations in connection with its corporate status and rights to the asset;
- ▶ to provide for indemnities – the seller's obligations to reimburse the buyer for losses that may arise after the closing of the transaction in connection with claims by third parties or state authorities against the buyer and / or the target company.

#### **How does the due diligence initiator obtain information and documents?**

When due diligence is conducted by the buyer, the information and documents are provided directly to the buyer's team which conducts the due diligence – as a rule, to external consultants, based on the checklist they prepare which is handed in to the seller and the target company.

Documents and information are most often provided electronically in a virtual information room; or, in the case of exclusive confidentiality, by granting to the due diligence team access to originals or copies of such documents, without the right or with the right of limited copying.

The due diligence team also receives information about the target company and the seller from publicly available sources, including open registers: the Unified State Register of Legal Entities, the Unified State Register of Real Estate, the Unified Federal Register of Bankruptcy Information, Open Registers of Rospatent, etc.

Due diligence, as a rule, is limited by strict time frames – from several working days to several weeks, depending on the scope of the audit.

If the verification team is not provided with any of the requested documents and information due to their absence, this may, to one degree or another, influence the conclusions and recommendations regarding the identified risks.

### How are the results of due diligence presented?

Based on the results of legal due diligence, a report is prepared, which usually includes the following sections:

**1) Introduction**, which describes: the transaction planned to be concluded; target company and areas of its economic activity; scope of due diligence and sources of information; limitations on the liability of external consultant that conducted due diligence; the right of the recipient of the report to disclose it to third parties (or prohibition to carry out such disclosure), the main contact persons of the external consultant if questions arise in connection with the content of the report; the date on which the due diligence report is issued, as well as the applicable assumptions (that all information provided as part of due diligence contains correct data, that the submitted copies of documents correspond to the originals, signatures and seals on documents are genuine, etc.).

**2) Brief conclusions on the results of due diligence (executive summary):** this section contains a description of the most significant risks identified during due diligence, taking into account the provisions of applicable legislation and law enforcement practice, the estimated level of such risks (low – medium – significant) and recommendations for their elimination / minimization of consequences. For example, a due diligence may reveal several violations by the target company of industry legislation with an unexpired statute of limitations for prosecution, each of which may involve a significant administrative fine or suspension of activities; in this case, the report indicates the maximum amount of administrative fines and other penalties that may be incurred by the target company.

**3) The main part of the report**, the structure of which is based on the due diligence scope, i.e. corporate matters, litigation, material contracts of the target company, containing a more detailed description of the identified risks, especially when it comes to the history of the acquisition by seller of its shares, history of acquiring rights to immovable and material movable property by the target company, terms and conditions of material agreements and labor contracts with top management, etc.

#### 4) Schedules to the report include:

- ▶ a list of documents that were analyzed by the due diligence team;
- ▶ a list with a brief description of the most important decisions of the management bodies of the target company (on the appointment of the sole executive body, the election of members of the board of directors and the management board, decisions on the approval of major transactions, transactions in which there is an interest, on increasing the authorized capital and admitting new participants, etc.);
- ▶ a list with a brief description of the terms and conditions of material contracts (i.e. price of the contract, its validity period,

governing law and jurisdiction, the possibility of unilateral termination of contracts);

- ▶ a list of real estate assets (usually in the form of a table containing the following data: the name of the real estate object; location; cadastral number; area; details of state registration of rights; encumbrances with the rights of third parties (mortgages, etc.)); rights to the land plot on which the corresponding immovable property is located, etc.;
- ▶ a list of intellectual property rights, including the rights to software (drawn up in the form of a table containing: name and type of asset; right holder; encumbrances with third party rights; validity period of the right);
- ▶ a list of judicial proceedings involving the target company.

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