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Legal Due Diligence in Ukraine

Legal due diligence is defined as the process of investigation carried out usually by a law firm on behalf of a potential investor or a party contemplating a business transaction (such as a corporate acquisition or merger, financial loan, or purchase of securities) for the purpose of providing information with which to evaluate the advantages and risks involved.

Legal due diligence is a crucial prerequisite to any transaction. Despite being quite a demanding process, due diligence can be proceeded with more efficiently if all parties involved understand the reasons for such procedure and the manner in which it is usually conducted.

Benefits of due diligence

The benefits of due diligence include a better understanding of the state of affairs of the target company or business, the identification of risks of the contemplated transaction, and a proper valuation of the target company or business. Performance of due diligence can reveal any hidden risks and remedy them prior to conclusion of the transaction or, in the event of severe legal risks being identified, to postpone or abandon the deal.

Timeframe and other procedural aspects of due diligence

The timeframe of due diligence may vary from several days in minor deals to several months in complex cross-border M&A transactions. Also, it significantly helps when a virtual room is created and all required documents are uploaded and can be accessed from any location rather than an on-site check of hard copies. Nevertheless, an opportunity to visit a head office or manufacturing facilities of the target company should not be neglected and be used to the fullest extent possible, especially at the commencement of the due diligence process.

In order to carefully identify all possible risks, an examination of the documents provided may not be sufficient. In our practice, it is considered necessary to conduct interviews with the owners and key management staff as well as, in certain cases, to contact state authorities and banks and counterparties, if permitted. Another key factor is to conclude a confidentiality and non-disclosure agreement between the seller and the potential investor, which results in the former being more likely to disclose to the latter valuable commercial and corporate information for the purposes of due diligence.

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18. August 2016

With regards to the due diligence of Ukrainian companies, it is worth noting some of the most typical issues which can arise following examination of the documents of the target company. Also, a scrupulous approach for any interested party would be to conduct a preliminary investigation of the target company's state of affairs by way of a proper check upon access to open registers in Ukraine, which could confirm, inter alia, the existence and corporate management of the target company, any encumbrances over its assets, any past and current court disputes, the presence of tax debt owed to state authorities, inclusion in the 'black list' of traders by the Ministry of Economic Development and Trade of Ukraine, financial standing and other related information (applicable to joint stock companies only), commencement of insolvency proceedings, etc.

Corporate issues

Corporate issues can vary from minor risks - such as inadequate formalisation of the minutes of general meetings or lack of provisions or their conflict with certain mandatory provisions required by Ukrainian law in the charter of the target company (especially in relation to some obligatory thresholds of corporate governance, including convocation of a quorum for the general meeting of shareholders, decision-making procedures, etc.), which could easily be remedied by re-convocation of such general meetings or amendment(s) to the charter - to more serious risks.

The latter could include failure to properly formalise title to shares by previous shareholders of the target company. Even some minor defects or non-compliance in the acquisition or passing of title may lead to the invalidation of the respective sale and purchase agreement(s) as well as invalidation of all subsequent title transfers leading to a chain of bilateral restitutions and recognition of plaintiff's title to shares at a claim of an interested party. For example, in limited liability companies, the proper transfer of title to shares should be accompanied, inter alia, by an application to withdraw from the composition of participants, spousal consent and pre-emption rights waiver of other participants regarding the sale.

One should also take into consideration the restrictions in the Civil Code of Ukraine pursuant to which (i) a company may not be the sole shareholder of more than one Ukrainian limited liability company; and (ii) a limited liability company or a joint stock company with only one shareholder may not be the sole shareholder of another limited liability company or a joint stock company. Theoretically, there is a risk that non-compliance with these may lead to a judicial invalidation (at the claim of an interested party) of the acquisition(s) of shares in the non-compliant company or companies.

Land and real estate

Pursuant to Ukrainian law, land lease agreements must contain several mandatory terms. The absence of only one of the essential terms of lease of land could serve as a basis for declaring the land lease agreement null and void. There is an established court practice invalidating lease agreements lacking essential terms or having defective essential terms as provided by the applicable legislation. However, we are also aware of

judgments regarding the claims based on the argument of absence of essential lease term(s) which found lease agreements valid.

We note that until February 2015 the agreement on lease of land had to contain eleven mandatory terms and five additions. Following respective amendments, only three mandatory terms remained. However, despite these changes in legislation, the Model Land Lease Agreement approved by the Cabinet of Ministers of Ukraine still contains the old extended list of essential terms. Therefore, until the Model Land Lease Agreement is amended in line with current legislation, we recommend specifying all essential terms, as provided in the Model Land Lease Agreement, as failure to include them might result in the invalidation of the agreement.

Loans

It is often neglected by the parties to an M&A transaction that many loan agreements contain a change of control provision which constitutes an adverse event entitling the bank (or other lender) to accelerate repayment of the loan in case of any changes in the shareholding structure of the target company, its affiliated companies and/or its sureties/property sureties. At the same time, the target company is often obliged to notify the bank (or other lender) regarding changes in its shareholding structure following occurrence of such changes. Failure to comply with these obligations constitutes a breach of obligations and the bank (or other lender) may be entitled to impose fines on the target company or, in some cases, declare its technical default which would further lead to enforcement of cross-default provisions in other effective loan agreements, if present, previously concluded by the target company.

Violation of antimonopoly legislation

Any failure to obtain approval of the Anti-Monopoly Committee of Ukraine (if required) may result in the imposition of a penalty on the respective founders (shareholders) in an amount of up to 5 percent of their respective groups' income (turnover) in the year immediately preceding the year in which the penalty is imposed. There is a five year statute of limitations applicable to any Anti-Monopoly Committee of Ukraine investigation which could result in the imposition of a fine. The statute of limitations starts to run from the date when the Anti-Monopoly Committee of Ukraine becomes aware of any violation.

In addition, the failure to obtain the Anti-Monopoly Committee of Ukraine's approval may lead to invalidation of the target company's establishment at a claim of an interested party.

Labour relations

In Ukraine many companies often aim to 'minimize' their tax obligations by paying unofficial salaries (so called 'under-the-table salaries') to their employees. While this practice is common and well-known in Ukraine, foreign investors are often reluctant to conclude an M&A transaction while such scheme is functioning within the target company, as such practice, if known to the state authorities, would lead to severe monetary

sanctions. At the same time, the potential foreign investor may use this fact as the basis for bargaining a better price. Nevertheless, we recommend inclusion of the respective warranty clause into the M&A agreement under which the seller is required to cover all tax liabilities arising from the use of any 'under-the-table salaries' scheme.

Other risks

Other risks involve the absence or expiry of certain necessary licences and permits for business activities, significant influence of related parties on the target company, poor quality of financial information, legal defects in contracts with clients and suppliers, pending material disputes involving the target company and its assets, violation of the process of privatisation of assets, breach(es) of intellectual property rights, etc.