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Sayenko Kharenko reveals ‘ins and outs’ of due diligence in Ukraine

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Vladimir Sayenko, partner at Kyiv’s Sayenko Kharenko

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In this Kyiv Post interview, Vladimir Sayenko, partner at Kyiv’s Sayenko Kharenko law firm, and group lawyer Leonid Antonenko reveal the ins and outs of due diligence when it comes to the complex risks that exist in doing business within Ukraine. **Kyiv Post: When an investor is pondering whether to buy an asset in Ukraine or enter into a partnership, what are the five essential concrete steps in terms of Due Diligence that should be taken to minimize risk and protect the investment?**

Leonid Antonenko: Due diligence usually refers not to the entire process of acquisition but rather to investigation of the asset which the investor considers buying. Under the rules of corporate law of the investors’ home countries or rules of stock exchanges where most major international investors are listed, directors and managers of a corporation exercise “due diligence” in their major decisions. Therefore the first step of due diligence process is to investigate the asset being bought.

This thorough investigation is what can be called due diligence in the narrow sense. However, when this investigation uncovers potential legal, tax and other problems with the asset, there are several measures investors usually take to safeguard their interests. These measures are part of due diligence in a broader sense.

First, perhaps the most commonly used of these measures is the use of escrow accounts. Essentially, the buyer of an asset (in major acquisitions this is usually a block of shares) pays part of the purchase price into a special account, to which the seller has no access and which is managed by an independent intermediary, an escrow agent. The money is then gradually released to the seller. This means that part of the purchase price may not be released to the seller if certain risks uncovered during due diligence materialize or if after taking over the management of the acquired business the buyer uncovers new risks and flaws in the asset.

For example, if the seller assured (in English legal language the term used in the contracts is “warranted”) to the buyer that there are no major unpaid taxes and after buying the company the investor finds that the company has substantial tax arrears, part of the purchase price is not released to the seller from the escrow and returned to the investor.

The second tool is indemnities. This tool is most closely linked to specific risks uncovered during due diligence investigation. Indemnity is a contractual obligation of the seller to compensate the buyer for costs which may arise if certain risks in fact materialize.

For example, if during due diligence the buyer’s lawyers find that one of the factories being sold to the buyer was built without complying with all construction regulations (e.g, it was not properly commissioned or put into operation etc.) the seller may be required to compensate the seller for the costs if after the seller takes over the factory Ukrainian state authorities impose fines for violation of construction rules during construction and commissioning of the factory. Indemnity is commonly used because it allows the buyer and seller to account for uncertainty associated with most risks.

In our example, even though one of the factories may not be properly commissioned, the state authorities may never fine the company operating it and it is difficult to predict how likely such a fine would be. That is why it may not make sense to reduce the price outright because of this risk which may and may not materialize. This is where an indemnity is used.

The third tool is the Ukrainian business owners' personal guarantees. The reason for using this tool is that escrows and indemnities alone may not fully protect the buyer. On the one hand, part of the purchase price cannot be tied up in an escrow account indefinitely: the usual escrow ranges from 6 months to 3 years at the most. But many risks may materialize much later.

If the escrow arrangement is over or the funds in the escrow account are insufficient to cover the costs, the indemnities must come out of the seller's assets. However, in standard acquisitions of Ukrainian assets the seller is usually a "shell" company created in a low-tax jurisdiction. That is why when the push comes to shove, this "seller" company may not have any assets to cover its liabilities, it may not have any funds to cover the cost of indemnities.

That is why the personal guarantee of the actual owners of the Ukrainian business as individuals may offer a little more protection to the buyer since theoretically the buyer may seize the personal assets of such individuals. However, it is precisely for this reason that business owners are usually quite reluctant to provide such guarantees.

The fourth tool is price reduction. This is, of course, the most certain way of securing the rights. Business valuation models allow the buyers to put a monetary value and "price in" certain risks uncovered during due diligence. If a risk is potentially very large or very certain to occur, it may make sense for the buyer to directly limit their exposure by reducing the price they are ready to pay for the business.

For example, some international investors discover that a Ukrainian business they wish to purchase has the level of profit it has only because it has substantial tax "savings" by paying employees in "grey" unreported cash. Most Western investors, if they buy business, would change that and seek to pay most salaries officially.

For this reason the investor may then order its tax advisor to calculate additional costs (over the years) of changing this system and paying real salaries officially. The purchase price is then reduced in proportion to additional tax costs.

Finally, a very particular tool to secure investors' interests is needed if international investor is prepared to work in partnership with Ukrainian owners rather than buy full control of their business outright. However, when investors buy less than a controlling stake in the company they need to make sure that certain decisions are made not by majority but unanimously.

Unfortunately, Ukrainian law makes it difficult to protect the investor in this situation. It essentially allows only two radically opposite situations.

First, if a person controls more than 75 percent of shares that person has full control over the company and the minority, no matter how large (if short of 40 percent that allows to block a quorum at the shareholders' meeting) has no protection.

Second, if nobody has at least 60 percent, none of the shareholders fully controls the company and full control effectively belongs to the current chief executive. In other words, Ukrainian law only works for all-or-nothing situations. The person either has full control or no control at all and there is no middle ground. However, this situation is too restrictive and primitive and cannot accommodate all the variety of arrangements used in international business.

For example, the investor may want to own only 49 percent of shares but still have some control over major decisions. In international practice this is resolved through shareholders agreements where the partners can agree exactly and precisely all the nuances of joint control over business.

Unfortunately, in Ukraine shareholders agreements do not work properly in Ukraine because of numerous mandatory rules and because courts often do not recognize the freedom of contract. For this reason, the main way of securing the rights of investors who desire to create a joint venture with Ukrainian partners is to reorganize Ukrainian business by transferring ultimate ownership of the Ukrainian companies to a holding company created outside of Ukraine. As is well known the most popular place for such companies is Cyprus.

After this foreign holding is created international investor and Ukrainian partners become shareholders of the foreign holding company and write a shareholders' agreement regulating all of their relations as they see fit.

Such agreements are not subject to restrictive regulation of Ukrainian law and provide protection to the minority partner, the investor. For example, if an investor controls only a third of the company the partners can stipulate that the investor appoints 1 out of 3 directors of the holding company but that this 1 director would have veto power over all major business decisions.

Kyiv Post: There are various forms of due diligence: legal, financial, reputation, etc. To whom should an investor turn to get all the potential red flags checked out? How does the process work?

Vladimir Sayenko: In Ukraine three main groups of advisers – legal, tax and business – are hired to conduct due diligence of acquisition targets. The legal, tax and business teams usually each conduct their own separate investigations although there can be some overlap and varying degrees of coordination.

For example, law firms often have tax practices that can offer tax due diligence, while accounting firms traditionally sell full service that includes legal due diligence. Reputation due diligence is rarely offered as a separate service, but is often covered by lawyers.

Sometimes the so-called "intelligence" due diligence is also used. Within this due diligence, reputation and connections of the business owners are thoroughly investigated to uncover, for example, any connections the sellers may have to illegal activities or operations.

The common sources for this sort of inquiry are usually private security industry and state law enforcement and intelligence agencies. Western investors increasingly appreciate the importance and value of this sort of due diligence in Ukraine realizing that in Ukraine reputation and connections of business owners may matter much more than legal form and nitty-gritty of their operations.

Many law firms emphasize the ability to handle these sorts of investigations, but only few handle such investigations properly. Because Ukrainian laws establish severe sanctions, including criminal liability, for collection of confidential information, commercial secrets and personal data, any investigations must be conducted in such a way that will not get clients into trouble.

For example, while the activity of private detectives is not permitted in Ukraine. Journalist can conduct investigations in connection with the exercise of their duties and can be engaged for such purpose.

Leonid Antonenko, lawyer at Kyiv's Sayenko Kharenko

Kyiv Post: What are the Top Five most common red flags or problems uncovered by due diligence work involving Ukrainian assets or potential partnerships between investors and local groups?

Which are serious risks to a potential investment or partnership?

Which are minor and can be handled?

Leonid Antonenko: In deciding which problems are serious and which are less so different needs of different clients need to be appreciated. In some cases due diligence results can really have impact on the acquisition decision or at least on acquisition price.

However, in many other cases decision in principle to acquire business precedes due diligence and therefore due diligence serves as one of the items to be ticked off by the buyer.

This is something which simply must be done because Western corporations are required by law or stock exchange rules to conduct due diligence. In such cases due diligence also serves as a source of information about the business they are about to acquire. Because local companies, as well as companies from some neighboring countries, such as Russia, generally are not constrained by legal requirements to do due diligence and know local Ukrainian conditions much better than Western investors, they sometimes do not do extensive due diligence on their Ukrainian acquisition targets.

This diversity of needs means that what constitutes a deal-breaker for some may not be so serious for others. Generally speaking, examples of the most common and serious problems are:

1) Conflicts around shares of the companies to be acquired might be the main deal-breaker;

2) Regulatory risks in foreign trade (e.g., export restrictions on agricultural commodities) and in other heavily regulated areas;

3) If a business to be acquired needs a license to operate, like mining licenses for oil and extractive industries, and there is a dispute over validity of the license or where the license in set to expire and there is uncertainty as to whether the license would be renewed;

4) Major conflicts with tax and customs authorities;

5) All matters related to corruption are very sensitive for American clients and now increasingly British clients. America's famous and aggressively enforced Foreign Corrupt Practices Act (FCPA) makes in a crime under federal law for officials of American companies or their subsidiaries abroad to engage in such practices as bribery and kickbacks.

Therefore an American investor will be very cautious of buying Ukrainian business if its profitability directly depends on such practices. For example it is common knowledge that in Ukraine most companies can obtain VAT refunds only by paying substantial kick-backs. Therefore if a Ukrainian company cannot remain profitable without VAT refunds (this is the case with many exporters), an American investor might be forced into practices prohibited by FCPA and therefore would have to stay away to avoid sanctions in the United States.

The other matters are generally less serious. Problems uncovered in less sensitive areas rarely serve as deal-breakers.

Minor risks include technical incompliance with a myriad of stock market rules during corporate reorganizations, technical problems in the chain of title to shares, acquisition of businesses without proper approval from the Antimonopoly Committee, development of new production facilities without proper commissioning procedures. Of course, as with everything in Ukraine, much depends on the circumstances and caution is your friend: minor problems for most may become major ones for some.

KP: From a standpoint of due diligence, what are the Top Five "hardest to uncover risks" for investments and partnerships in Ukraine, and what can be done by the government and other interested parties to bring more transparency?

LA: Like in many other jurisdictions, the "hardest to uncover risks" in Ukraine are those that relate to fraud. No due diligence can discover a contract by which a CEO of the company has agreed sell a major asset or provide a large loan, especially if such transaction does not require an approval of the shareholder's meeting, in a situation where the CEO decides to hide such contract.

Moreover, if the CEO or another authorized signatory keeps a few stamped sheets of paper (to which the corporate seal of the company has been affixed in advance), then such contract can even be backdated after the investor has acquired the target. Such fraud cases are usually treated as a criminal offence and the only peculiarity in Ukraine is the difficulty of collecting evidence to prove fraud and the burdensome procedure for initiation of criminal proceedings for economic crimes.

In addition, there are some unique features of Ukrainian legal system that make thorough due diligence difficult.

First, Ukrainian law is very bad about forgetting old mistakes and therefore a company can potentially have problems based on events which occurred years and years ago. In most countries after a certain number of years pass after a contract has been made or property has been acquired, whatever legal problems existed at the time if the so-called “statute of limitations” period has passed no legal action can be initiated based on such long past events. This principle is intended to promote legal stability.

In Ukraine, the general statute of limitations is three years (subject to certain specific exceptions). This means that in theory courts should not examine claims based on long past events. For example, a debt outstanding for more than three years cannot be collected.

However, in practice courts are very willing to disregard statute of limitations and examine claims based on events in the distant past if the court believes there are “good reasons” for this. Moreover, Ukrainian courts sometimes do not respect the concept of a bona fide purchaser.

This concept means that if A sells an asset to B without having a right to do so and then B sells the asset to C who does not know that A did not have the right to sell, C is considered an innocent party, in lawyer’s parlance - a bona fide purchaser, and can keep the asset despite an illegality by A. In Ukrainian court practice, C and even a party many steps removed from A is not guaranteed to enjoy this protection.

So for example, if a plant was sold by company A’s director to company B and A’s director did not have proper authority to sell (for example, from shareholders), and then B sold the plant to C, C to D, D to E, and E to F, company A could then come to court and demand that E return the plant to A because the original transaction was invalid, irrespective of the fact that there were 4 transactions in-between and F could not know anything about the problems between A and B.

This means that events from the distant past can come back to haunt businesses in Ukraine. For example, recently the prosecutor’s office successfully sued a wide range of companies all over Ukraine to return to the state a number of resort facilities which formerly belonged to the state, then were donated to the Soviet trade unions, were then privatized and have been resold on the open market many times. Wait for the good part: the prosecutors’ case rested on an obscure resolution of the Council of Ministers of the Ukrainian Soviet Socialist Republic issued in 1960!

Naturally, such historic events are very difficult to investigate during due diligence in part because many companies do not and cannot store all their documentation for so long. In Ukraine there are rules as to how long businesses are supposed to store key documentation. In many cases documents need not be stored for more than 3 years.

Along with this fascination of Ukrainian courts with history, another key difficulty in uncovering the risks comes from deep divide which often exists in Ukraine between business as conducted on paper and actual reality.

It is no secret that Ukrainian business is often a world of smoke and mirrors and many things are not what they appear to be. One transaction on paper may often cover something else entirely in real life.

To take the most common example, a services agreement under which a company pays to a private entrepreneur for services often conceals an employment contract allowing the company to save on payroll taxes. Another example is the common use of pre-payments under contracts that are never performed because the parties merely intended to provide a loan. But since the documents tell a different story in requires knowledge of how things really work in Ukrainian business to discern such things.

A company having 100 consultancy agreements with private entrepreneurs may make no sense until one realizes that such consultants are in reality usual employees.

This problem makes it often difficult to establish a real situation in many aspects of Ukrainian business. Key examples include:

1) Real level of compensation, especially compensation of top management. It is not uncommon even for CEOs of Ukrainian companies to receive, on paper, only a minimum wage; and

2) Real business purpose for various contracts, from consultancy and loans to insurance.

In fact many contracts which apparently make no business sense can be used to save on payroll taxes by paying employee compensation in forms other than traditional salary or simply to siphon off unreported cash from the business in order to then use such cash in “grey” economy or in corrupt practices such as kickbacks.

Sometimes it is essential for Western buyers, to reveal any such grey area practices that the business is engaged in so that they can evaluate whether the business can still be profitable without them. On the other hand Ukrainian business owners often refuse to acknowledge, understandably, that they engage in such practices. They often fail to understand that the purpose of due diligence is not to incriminate anyone, but to clearly understand how things work in practice.

Therefore, an important skill of a due diligence advisor, in particular legal advisor, is to get the sellers to open up about such practices. Usually such sensitive questions must be asked at least three times. The first answer is usually bland, something to the effect that “everything is done according to the law”. More informative answers may only come after the same question is asked, in a slightly different form, for the second or third time.

Finally, often there is no way to establish that company engages in certain regulated activities other than by the company actually acknowledging it. For example, if a manufacturing company actually does construction work on the site without a license, such work would often be off-the-books.

Due diligence teams would be hard pressed to find this out based on the analysis of the documents alone. Therefore, even in the modern world of virtual data rooms and understandable desire of business people to cut on legal fees, the importance of proper on-site due diligence cannot be underestimated.

In such cases interdisciplinary approach often helps. For example, during legal due diligence a lot can be learned by examining the target company’s own advertising materials and presentations, because the sellers of business are usually eager to disclose any business expansion. It would then be up to the legal team to check whether the new plant has been properly commissioned.

The best contribution that the government can make to ensuring greater transparency in Ukrainian business would be to do nothing and not to interfere with organic development. When Ukrainian business realizes the value of transparency, there will be greater transparency. Otherwise government efforts are only bound to make things worse.

The good sign is that major Ukrainian business groups already understand the importance of transparency, proper corporate governance and other classical corporate values that affect the cost of capital at the international markets. Many of the recent improvements in Ukrainian law were lobbied by these business groups and this inevitable and natural process is likely to continue as the country develops.

Investors themselves can help improve the depth and usefulness of due diligence by encouraging a more interdisciplinary approach to due diligence.

For example, lawyers investigating employment contracts and intra-group agreements should be asked to comment not only on the purely legal but also possible tax aspects and risks in these areas. Naturally, this can be only accomplished by lawyers knowing and understanding business and not confining themselves to only formal legal analysis.