

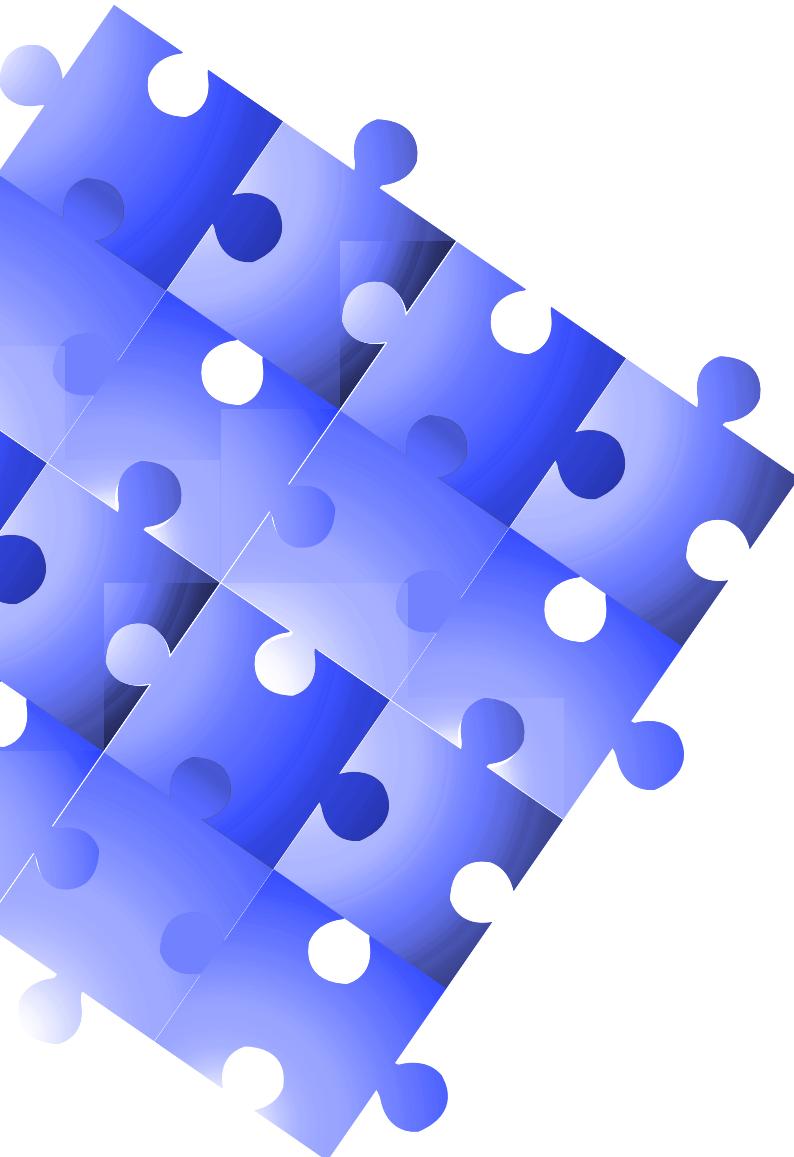


GRATA
INTERNATIONAL

DUE DILIGENCE FOR M&A PURPOSES



INTRODUCTION

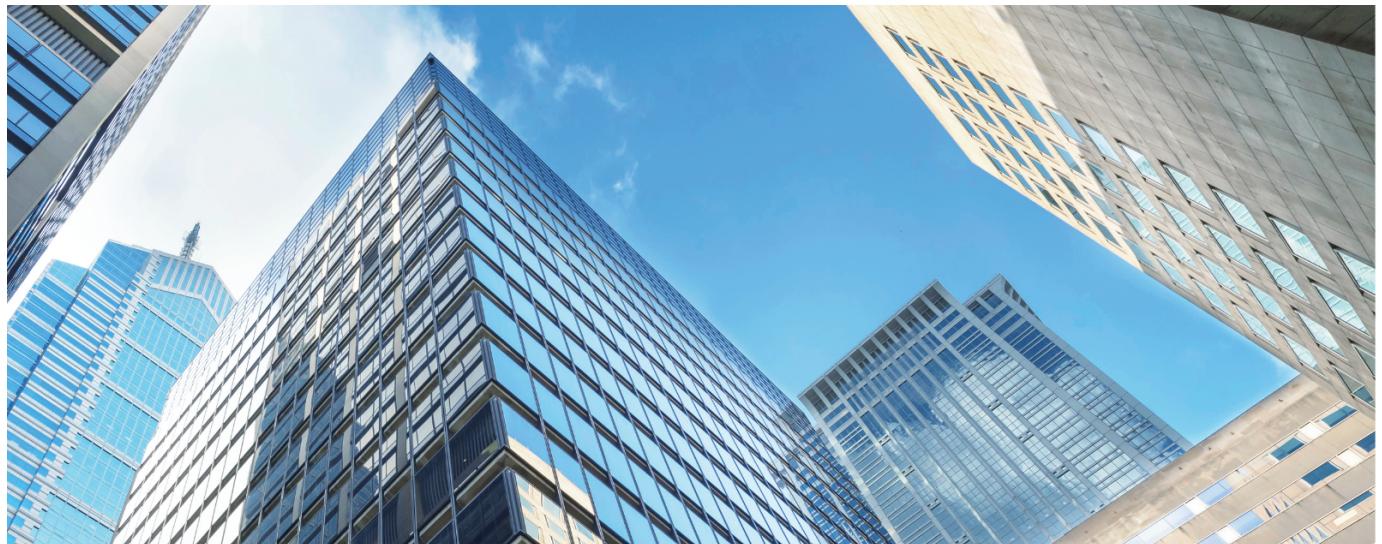


The structuring of M&A transactions, both national and international, requires careful preparation, including due diligence.

The conclusions obtained as a result of due diligence allow us to identify the main risks associated with the planned transaction, effectively negotiate the price and other commercial terms of the transaction, and include in the transaction documentation mechanisms to eliminate or minimize the identified risks.

A team of leading specialists from the corporate law practice of GRATA International from Azerbaijan, Georgia and Russia prepared brief reviews on the specifics of due diligence in the framework of mergers and acquisitions in these countries. The reviews address issues such as:

- scope (range of issues) of due diligence for the purposes of mergers and acquisitions; sources and procedure for access to information for due diligence;
- content of the audit report.



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About GRATA International

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DUE DILIGENCE FOR M&A PURPOSES IN AZERBAIJAN



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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;
- 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.



LEGAL DUE DILIGENCE FOR M&A PURPOSES IN GEORGIA



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Legal due diligence is one of the critical parts of legal work before merger and acquisition transactions. Due diligence is a process of investigation of a target company's business prior to a potential investment. Due diligence reports prepared by lawyers allow interested parties, mostly potential acquirers, to receive confirmation on facts related to the target company's corporate structure, material contracts, employment relations, IP and property rights, ongoing and potential litigations, etc.

It is also a common practice for owners of the target company to hire external lawyers to conduct. This may attract potential investors and speed up a sale of the target company.

1. Scope of legal due diligence

Scope of legal due diligence depends on various factors, such as a type of business activity, corporate structure, jurisdictions, where the target company is incorporated or carries out its business, etc. Scope of legal due diligence is preliminarily agreed with an interested party, as in some cases a due diligence of limited scope might be preferred.

With the scope of due diligence, an information checklist is agreed between a lawyer and an interested party, an acquirer or a seller.

The checklist is a list of documents and information to be reviewed by the lawyers and covering mainly the following issues:

- capitalization and shareholder structure;
- organizational structure;
- rights of the target company over its real estate;
- intellectual property rights of the target company;
- potential or ongoing bankruptcy / insolvency proceedings;
- authorizations, approvals, licenses allowing the target company to conduct its business, compliance of the target company's goods and services with applicable regulations;
- litigation – list of potential, ongoing and closed commercial litigations, arbitral proceedings, government investigations or disputes with government authorities;
- material contracts;
- related party transactions;
- financing;
- insurance;
- compliance with mandatory regulations of labor law and commitments under employment contracts.

2. Access to the Information

In practice information to lawyers is provided by an interested party through virtual data rooms. In case of strict confidentiality requirements access may be granted only to the hard copies of the document without authorization to make any kind of copies of the target company's documents or information.

Before granting access to the data room lawyers are required to sign a non-disclosure agreement putting them under a confidentiality obligation.

Part of information such as the target company's corporate and shareholder structure or real estate rights are obtained through investigation of the publicly available sources.

In Georgia this information is available through electronic databases of National Agency of Public Registry (NAPR):

- registry of Real Estate;
- registry of Entrepreneurs and Non-entrepreneur Legal Entities;
- registry of Economic Activity;
- registry of Public Law Restrictions and Tax Liens and Mortgages.

The following information might also be available through the publicly available database of the Service of Accounting, Reporting and Auditing Supervision:

- financial and Management Reports of the Entity;
- information about the Group of Entity;
- information about the Entity's Auditors;
- profile information about the Entity.

3. Legal Due Diligence Report

Structure of a report depends on the scope of due diligence agreed between the lawyers and an interested party. Though, in most cases full scale due diligence report is structured in the following way:

- 1) Introductory Section generally includes:
 - disclaimers, limitation of liability clauses;
- general Information about the target company: name, field of its business activity, legal organizational structure, jurisdiction(s) where the target's business is conducted, overview of a general business environment of a country where the target is incorporated or carries out its activity;
- scope of a due diligence report;
- sources from which information about the target company is received: data room, management of the target company, publicly accessible sources, etc.

2) Definitions – this part of due diligence report defines all terms and abbreviations used later in the document.

3) Executive Summary provides main findings and risks identified during the due diligence study.

4) Detailed due diligence report provides overview of information and documentation further to the scope of due diligence agreed with the acquirer or any other interested party.

5) Legal advice on the planned transaction – upon request of the acquirer or any other interested party due diligence report may include description of steps and procedures for entering into and closing the planned transaction.

6) Appendices and schedules to the due diligence report:

- a list of documents received from the target company;
- a list of documents obtained from publicly available sources through independent research carried out by lawyers;
- a list of real estate assets of the target company;
- a list of the Intellectual rights of the company;
- a list of ongoing or potential litigation of the target company.



DUE DILIGENCE IN MERGERS AND ACQUISITIONS IN RUSSIA (MOSCOW)



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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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