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Attracting Foreign Investment: A Lawyer's View

By [Ian Ivory]

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Ian Ivory
Partner
Goltsblat BLP

Russian companies often seek foreign capital for a number of different reasons, such as greater access to global markets and brands, the benefits of foreign expertise and new technologies and more opportunities for on-going operational autonomy than might be the case with a domestic investor. New foreign entrants into the Russian market may be prepared to pay a higher valuation, recognizing that by buying into an existing business they are gaining immediate market access and local resources and connections which would take much longer to build from scratch.

Transparency

An initial challenge foreign investors face in entering the Russian market is finding information on targets and the business environment. Many companies in Russia, especially small to midsized businesses, do not seek publicity on their business activities and strategy.

When communicating to potential foreign investors, it's important for Russian companies to remember that many foreign investors are unfamiliar with Russia, and may even have some very fixed (and often negative) views about doing business in Russia, despite in many cases never having visited the country themselves. In part this is driven by historical attitudes and by negative Western media press coverage.

Even where the investor has a Russian presence and/or is well-advised by lawyers and other consultants based in Russia, in many cases the decision-makers outside of Russia will lack a nuanced and up-to-date view on what it is like to do business here. The track record of the performance of foreign investment into Russia is very good, overall, so there is every reason for Russian companies to express an optimistic and positive view of the business climate and help to dispel investors' misconceptions.

Kyle Davis
Partner
Goltsblat BLP

Russian companies can attract more interest from foreign investors by doing such things as having a frequently updated website, maintaining contacts with bankers, lawyers, auditors, business consultants who frequently deal with foreign investors, sending representatives to take part in conferences and trade fairs (both in Russia and abroad) and cultivating contacts with English-language mass media and others.

A transparent business model is also recommended: for example, a simplified corporate structure, use of reputable consultants (legal, audit and others) and well-maintained records.

Due diligence

The foreign investor will want to conduct due diligence review of your business and its operations. Depending on the size and terms of the investment, your company and its staff should expect visits, reviews, questioning and assessments by teams of lawyers, accountants, commercial experts and industry-specific consultants. This process is normal and necessary. However, it is also disruptive to your business if not properly managed. It is always a good idea to appoint external lawyers with experience to help manage the process and to help keep business disruption to a minimum.

One thing that is attractive to foreign investors, but which doesn't come naturally to many Russian companies, is to be open, welcoming and responsive during the due diligence exercise. Some Russian business people become concerned at the information-gathering stage that the due diligence review will lead to breaches of confidentiality, or possibly even a tax audit or other official investigation. In practice these concerns are unfounded when you are dealing with a reputable investor. As noted in the point below, turning your company into an "open book" at the diligence stage can mean a more commercially attractive deal for the target and its owners.

Approach to negotiations: formulating a plan

The more the foreign investors like and understand what they have seen at the stages preceding the negotiations, the less contentious and frustrating the negotiations will be.

As in Russia, personal relationships and trust are key. However, very few foreign investors (especially those who need approval from decision-makers outside Russia) will be satisfied with "trust us" and "this is how it is done here" as answers, even if there is a trusting personal relationship. The more concerns that are raised in the lead-up to final negotiations (even if such concerns are based only on a lack of clarity, information or understanding on the foreign investor's part), the more likely the foreign investor will insist on stricter warranties, indemnities, price adjustments, holdbacks and earn-outs. This can all make the foreign investor's offer look much less attractive.

Foreign investors, particularly Western ones, will expect both sides to make some compromises when negotiating the deal. "Take it or leave it" positions are often not taken seriously unless the party taking this position has truly dominant leverage. However, it is fine to take a hard line and be tough in negotiations. It is important for positions to appear logical and justified. Some Russian shareholders prefer not to give a detailed explanation to an investor as to why a position is being taken, because it seems unnecessary or might jeopardize the seller's commercial position. When this occurs the negotiations can enter a frustrating and unproductive phase. Also, if you decide to change your position in the course of negotiations, it is best to have a plausible, logical-sounding explanation.

Beware the valuation trap!

Try to avoid agreeing a firm valuation price with the foreign investor before it has completed its detailed due diligence exercise, particularly if you sense that the investor will react badly to any issues discovered. Otherwise this leaves it open for the investor to demand discounts, price reductions, indemnities, holdbacks, escrows or the like for any problems uncovered in due diligence.

This is particularly relevant in a county like Russia, where many current laws have been in existence for 20 years or less and are still being updated and adapted, often with little court practice or interpretive guidelines to follow. As a consequence, you quite often see grey issues arising on due diligence. While (in most cases) the problems spotted in due diligence are not deal breaking issues, they all give the foreign investor good bargaining ammunition to price chip against its original valuation.

Where you do have to agree a firm valuation at the outset, try to include an acknowledgement that this already factors in a risk discount for the types of issues that are likely to arise — explain that the foreign investor is choosing to do business in an exciting growth market and must recognize that with the potential rewards come some potential risks.

To take one example of a situation where Russian sellers can be caught in the "valuation trap", it is not uncommon for a Russian company to "take a view" and not challenge a state authority when the agency makes a minor technical error in an approval, certificate, title document or license. This approach is often perfectly understandable: A hard-won approval that has the wrong stamp or signature on it is probably unlikely, in the ordinary course of business, to be revoked by the agency that issued it, and going back to get the document re-issued can damage relations with the agency or open the door for additional requirements. However, this can be difficult to explain to a foreign investor whose lawyers are advising him that technically, the approval is vulnerable to challenge if not corrected — if he can, the foreign investor will put the risk of any problems on the sellers, even though (in the selling shareholders' view) it's unreasonable and unrealistic for any business owner in Russia to expect that every official document will be perfect.

Confidentiality

Confidentiality is of course also key. The foreign investor should first be made to sign up to a suitable confidentiality undertaking and should put procedures in place to keep information confidential. In an auction situation, a data room is usually set up to keep the key documents in one place and to reduce the disruption to the business. Many contracts with third parties will also contain confidentiality clauses and these should be checked to see whether and on what terms copies can be given to the investor. Also, staff may become unsettled about their own future jobs if lots of unknown professional advisers turn up in the office asking for documents and information — this is another good reason for setting up a data room, ideally off-site or on-line, and for forming a small internal deal team to deal with information requests.

Legal contracts

Legally documenting the investment is a time consuming and document-heavy process. Foreign investors will usually insist on using English law for Russian deals, in order to utilize the wide and flexible legal concepts available under English law and to refer any disputes to the English courts or International Arbitration. Most foreign investors are still very reluctant to use Russian law or to have their disputes referred to the Russian courts.

Thought also needs to be given at this stage to the various external consents and clearances that may need to be obtained, which may include things like shareholder and bank consents, change of control consents under commercial contracts, Federal Anti-Monopoly Service (FAS) clearance, strategic industries clearances and so on.

Limiting your liability

Foreign investors will expect extensive warranties to cover all the matters reviewed in due diligence. This is to make sure that all the relevant information has been revealed to them and to serve as a (sort of) post-completion price adjustment mechanism if problems do arise after the deal has closed. In many cases the investors will also ask for indemnities against specific risks.

Although it's unavoidable that the foreign investor will require protection against risks, make sure that your liability under the legal contracts is limited. Time and financial limits are usually included as standard. Consider other more detailed provisions dealing with things like the conduct of any claims, recovery from insurers and other third parties and so on.

Consider also who should be giving the warranties and indemnities. If the company receiving the investment capital is well established and is in good financial shape, then requests for personal guarantees from shareholders or directors might be resisted.

'Money now' is better than 'money later'

Many investments will be structured so that not all the money is immediately payable on closing of the deal. There may be deferred payments or earn-outs (subject to performance targets). Some of the price may be offered in loan notes or shares (and not cash) and subject to claw-backs and set-off arrangements in case of claims under warranties and indemnities. Investors often hold back some of the purchase price in a retention account with a third party escrow agent, only to be released after an agreed period (typically 1-3 years) if no claims have arisen.

In cases where the company is seeking to raise investment capital via the issue of new shares, options or convertibles, the foreign investor may stagger its investment into tranches for release over time, often subject to financial performance. Alternatively, they may seek to implement an off-shore holding company, with different classes of share and loan capital, preferential returns and share ratchets to enhance their returns on an exit.

If possible, at the beginning of the process when indicative terms are being agreed, establish an understanding of what circumstances will cause the investor to demand such mechanisms.

Calling the shots — who takes control?

Most investors will expect to receive regular financial information (audited accounts, unaudited management accounts, annual budget, business plan) and to have basic vetoes or consent rights to protect its investment. For larger investments, investors will want board representation and the ability to block key business decisions, often with "shoot out" provisions in the legal contracts if a deadlock cannot be solved amicably. Majority investors will usually expect to take corporate control altogether.

End game — looking for the exit

All foreign investors will be thinking about their eventual exit strategy from their investment. This may be a "soft" intention in the contract, to sell or IPO within say 5 years. Alternatively it might be definitive and binding, such as a tag right (to tag along when the others sell), a drag right (to force a sale), or perhaps put and call options to give the investor a liquidity route, by selling its stake back to the other shareholders, if it cannot find a third party buyer in the market.

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