HOW TO CONDUCT LEGAL DUE DILIGENCE WHEN ACTING FOR A PURCHASE OF EITHER SHARES IN A BUSINESS OR THE BUSINESS

A. General Information

In any acquisition transaction the purchaser (the "Purchaser") always wants to ensure that the seller (the "Seller") and the company which is being bought (the Target) has good title to the assets it owns and to understand the full extent of any liabilities the Purchaser might acquire with the Target.

For any acquisition transaction the principle of caveat emptor (i.e. buyer beware), always applies. It is therefore paramount that the Purchaser carries out its own due diligence review (i.e. investigation) of the Target before entering into the share purchase agreement to acquire the Target.

B. Types of Due Diligence

Due diligence is an audit of the Target's legal, business and financial affairs.

There are 3 types of due diligence:

a. Business due diligence looks at issues such as the business' strengths and weaknesses, production and sales, etc. Business due diligence helps to identify what is required of the Purchaser to take control of and reduce risk in the Target.

b. The scope of the legal due diligence investigation will depend on the purpose of the acquisition. Furthermore, it should be noted that the extent of the legal due diligence is guided by practical realities, such as time and expense. Usually, in any acquisition transactions time is of the essence.

c. Financial due diligence is not the equivalent of an audit and the financial due diligence should usually focus on those areas of the Target's financial affairs that are material to the Purchaser's decision so that the Purchaser can assess the financial risks and opportunities.

Usually the Purchaser's team carrying out the due diligence must involve its legal and financial advisers. Only the Purchaser will be able to make the effective judgements as to the potential risks discovered.

Cynthia KL Le Poer Trench (Solicitor, Hong Kong) Principal

2nd Floor, Albwardy Building
PO Box 21832, Dubai, UAE
T + 971 (0) 4 355 3146
F +971 (0) 4 355 3106
E info@trenchlaw.com
W www.trenchlaw.com

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A full due diligence enquiry may not be appropriate and a long investigation might allow another buyer to approach the Seller and outbid the Purchaser as well as interrupting the normal running of the Target's business.

The key to effective due diligence is communication between the Purchaser and the advisers during this exercise. Any due diligence should be taken very seriously, carefully planned and properly carried out and with the involvement of the Purchaser during the undertaking of the legal, business and financial due diligence exercise.

C. Information required

The foundation of the due diligence exercise is the questionnaire or information request which sets out a list of questions and enquiries to be provided to the Seller. This questionnaire may be updated with the further due diligence questions as the Purchaser learns more about the Target. The questionnaire should always be tailored so that they are relevant to the Target.

As well as the questionnaire, information about a Target company can be obtained from various other sources. Particularly with the expansion of the internet the volume of publicly available data has seen raid expansion.

Despite this the more "traditional" sources of information are still likely to be the most important.

1. Corporate Information - There are two types of areas by which corporate entities can be established in the UAE, Free zones and Mainland, that is, established in the UAE, but outside one of the free zones.

   Each free zone has its own administration and licensing authority responsible for issuing free zone licences and registering companies. The majority of free zones are located in Dubai and tend to focus on attracting companies from specific industries. There are sometimes variations between the type of corporate entities that can be established within the free zones. However, the main entities involved in private acquisitions are free zone establishments (typically single shareholder companies) and free zone companies (typically companies with more than one shareholder).

   Mainland corporate entities commonly involved in private acquisitions are limited liability companies.

   Companies are required to file their annual reports and audited accounts to the relevant authorities. As part of their due diligence the Purchaser should request a copy of the audited accounts from the previous years, at least three years. Furthermore, as part of their due diligence the Purchaser should asses whether or not they wish to take on the liabilities associated with the Seller's employees.

2. Employees - Dependent upon the terms agreed between the Purchaser and Seller, the Seller may need to terminate an employee's contract by providing the required notice or

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payment in lieu of notice, and settle any statutory and contractual dues, including end of service gratuity. The Purchaser may then re-hire the employee on substantially the same or new terms of employment. Alternatively, the Purchaser may agree to assume all liabilities of the employees to ensure continuity of service. In this case the accrued entitlements transfer with the employees and become the responsibility of the Purchaser under the UAE Labour Law (however, the sale price may have to be re-adjusted to take into account the employee's accrued entitlements). If an employee does not wish to be employed by the Purchaser, his employment can be terminated, subject to the terms of the contract of employment and statutory requirements. In such circumstances, liability for the employment termination typically remains with the Seller.

Under the UAE law there is no statutory concept of redundancy. However, an employee's entitlements may include, subject to the terms of their contract: (i) payment in lieu of notice (if notice is not being served/worked by the employee), (ii) payment for accrued salary up to the termination date, (iii) payment for allowances, including education, transport and housing and (iv) Payment for accrued and untaken annual leave. End of service gratuity may be payable under statute, subject to the employee's length of service.

3. Intellectual property **-** Searches can be made, which will reveal the existence of any patents, registered trade marks and registered designs, including any applications that have been filed. If required, details can also be obtained on any assignments that have been recorded, licences that have been entered into or security interests that have been noted on the appropriate register.

4. Commercial agreements - Every business will have a suite of agreements that are material to the success of its operation. These might include (i) Supply agreements, (ii) Intellectual property licences (for example, patent or trademark licences), (iii) Service contracts (for key employees), (iv) Leases for equipment, (v) Property leases, (vi) Shareholders' agreements, (vii) Loan agreements.

   The due diligence enquiries should highlight those agreements which are material to the Target's business and that will affect the price the Purchaser is willing to pay for the Target or those which pose liability or material business or liability risk. The due diligence questionnaire will usually state the criteria by which a contract will be considered material by the Purchaser, for example, by value.

   The main commercial terms of the material agreements should be noted. The following are relevant to almost all enquiries:
   1. Parties.
   2. Execution of the agreement.
   3. Assignment clause.
   4. Change of control clause.
   5. Confidentiality.
   6. Warranties, guarantees, indemnities.
   7. Term and termination.
   8. Liability, indemnity and exclusion clauses.

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In order for the review of these agreements and their results to be presented in a clear way, it is helpful for a pro forma checklist to be filled in for each agreement that is reviewed.

D. Practical Steps

During the due diligence exercise the Purchaser is able to establish contact with the Target's management and discuss the important aspects of the business with them.

1. Data Room - A Seller will usually set up a data room, the data room could be either physical or virtual. Before giving access to the data room the Seller will typically require the Purchaser to enter into a non-disclosure agreement. The Seller will be disclosing to the Purchaser sensitive/important information about its business to enable the Purchaser to conduct its due diligence exercise. The Seller will want to ensure the information is kept secret and is protected from further disclosure and from misuse by the Purchaser. Nowadays data rooms are either sent via encrypted software or even just drop-boxed. There are many applications available to facilitate the setting up of proper data rooms.

2. Non-disclosure agreements are commonly used in the UAE. Although enforceability of non-disclosure agreements can be challenging due to the difficulties of obtaining injunctions. However, any breach of non-disclosure agreements is punishable with fines, imprisonment, or both under the UAE Penal Code (Federal Law No. 3 of 1987).

3. The next step in the review is to consider the completeness of the responses to the enquiries. Have all documents requested been supplied and all questions satisfactorily answered?

E. The Due Diligence Reports

Once the enquiry is finalised, the information will be summarized in the due diligence report, the report should cover the areas of the investigation. This may be a fairly informal report focusing only on matters material to the transaction. Or it could comprise a complete audit of the Target's business including an in-depth summary of the Target's material contracts. It should be written in such a manner that it is understood by a layperson bearing in mind that it will be read by non-lawyers. The executive summary should summarise all of the key findings of the due diligence review.

F. The Share or Assets Sale & Purchase Agreement and Disclosure Letter

The due diligence review is usually undertaken concurrently with the negotiation of the acquisition and drafting of the share purchase agreement. Any significant information that might affect negotiations should be communicated to the Purchaser even if the due diligence exercise is yet to be completed.

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Warranties and indemnities are usually included in the share purchase agreements. The scope of warranties will be subject to negotiations between the Purchaser and the Seller.

Warranties and disclosures have to be considered together. Should a warranted fact be untrue, the Purchaser may have a claim for breach of contract irrespective of whether they relied on the warranty. No claim will lie if the facts which give rise to the breach were disclosed.

A disclosure letter is a key document in any acquisition transaction. If a Seller makes inadequate disclosures, it may find itself on the receiving end of breach of warranty claims as discussed below. A disclosure letter will most likely be the best source of information on the Target business especially in situations where the purchasers find they have limited time to undertake a full due diligence.

It is in both parties interests for a full and proper disclosure exercise to take place. It could provide protection to the Seller for a breach of warranty claim. As for the Purchaser it will supplement the due diligence exercise and provide a complete picture of the Target company. For the Purchaser it is better to have sight of any irregularity of the Target's accounts or other such issues before the purchase rather than have to litigate later.

The disclosure letter itself is normally in the form a letter from the Seller to the Purchaser. It usually consists of two parts: "general disclosures" and "specific disclosures". Attached to it will be copies of the documentation being disclosed (known as the "disclosure bundle"). The general disclosures will usually be much shorter than the specific disclosures.

General disclosures cover certain matters which are publicly available or which the Purchaser should be aware on the basis of its due diligence undertaken, or which a Purchaser would normally undertake.

Where the general disclosures refer to the disclosure of documents such as, correspondence between lawyers, the Purchaser should insist that they are specifically disclosed by being included in the disclosure bundle, both in the interests of certainty and to ensure that everyone focuses on their contents. As a rule, the Purchaser should seek to limit general disclosures where appropriate.

Specific disclosures, disclose actual matters which, would or might constitute a breach of warranty should they not be disclosed. Specific disclosures are made by reference to the warranties themselves. Against a "no litigation" warranty, the Seller would need to disclose details of any current litigation affecting the Target. As such warranties are a prompt for the disclosures. The Seller will want to avoid liability for breach of warranty, and therefore warranties serve to flush out information. Certain warranties may also specifically require information to be listed in the disclosure letter.

Two copies of the disclosure bundle should be prepared: one copy to be delivered to the Purchaser with the disclosure letter and the other to be retained by the Seller.

To avoid the risk of a claim for breach of warranties, the Seller should ensure that all

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disclosures are complete. It is also a benefit for the Purchaser that the disclosures are complete, as it is better to know about something before completion, so that terms of the transaction can be negotiated on that basis, instead of discovering it later and litigating for breach of warranty.

G. Conclusion

Relations with the Seller can be of importance to a successful acquisition. The Seller retaining any involvement in the Target is something the Purchaser and Seller will usually agree at the outset. The Purchaser should consider what constraints may be necessary to ensure the Seller does not damage the Target. These should be agreed in writing, as terms of the share purchase agreement and could include (i) non-compete provisions to prevent the Seller from competing with the acquired business for a set period of time after completion, (ii) non-solicitation of employees or customers, (iii) no announcements to be made, (iv) restrictions on the Seller pursuing any debtors for a period of time after completion and (v) the Seller agreeing to pass on orders or other information it receives.

Open communication is essential if fears regarding changes following an acquisition are to be allayed. The sooner people are made aware of any changes and their consequences, the sooner they are likely to accept it.

Success is more likely if senior managers are involved in the early stages of the acquisition process. To assist this links should be established during the due diligence process.

As stated earlier, the Purchaser will have negotiated a number of warranties about the business and sought certain indemnities from the Seller as part of the share purchase agreement. Warranties take the form of assurances or guarantees by the Seller. In its due diligence, a Purchaser will seek to understand as much as possible about the business but may not find out everything. The warranties therefore give the Purchaser the ability for price adjustment after completion where a warranty is subsequently revealed to be untrue resulting in a reduction in value of the business or assets. By contrast, an indemnity seeks to provide a guaranteed remedy in circumstances where a breach of warranty may not give rise to a quantifiable loss as a result of the breach.

Following completion, it is essential that the Purchaser ensures that the matters covered by the warranties are monitored so that potential claims can be assessed. Warranty claims litigation is rare and maybe in decline as purchasers, and sellers become more aware of their disclosure obligations.

If the Seller gave a warranty that is untrue, the Purchaser may have a contractual claim for damages to cover the loss it suffers due to the breach. Contractual damages are calculated on a case-by-case basis and the UAE courts have a wide discretion. The Purchaser may potentially recover actual loss, loss of profit, moral damages and loss of opportunity and the Purchaser can also seek specific performance of the contract following the breach.

An action for breach of contract must normally be brought is ten (10) years from breach (Article 95 of UAE Federal Law No. 18 of 1993 ("UAE Commercial Transactions Law")).

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However, the share purchase agreement usually limits the time period two or three years after contract or completion. This limits the time within which the Seller is liable for claims and to encourage the Purchaser to deal with breaches in a timely manner.
The share purchase agreement should set out the procedure for notification of a breach of warranty claim. Commonly, the Purchaser is required to notify the Seller of its claim in writing within a certain period. The notification must provide reasonable details of the event, matter or default which the Purchaser believes gives rise to the claim, the breach which results, and the amount claimed. It is very important that the claim is identified in sufficient detail in the notification to comply with the agreement. Procedures for claims will vary from agreement to agreement.

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