INSIDE THE MINDS

Business Due Diligence Strategies

Leading Lawyers on Conducting Due Diligence in Today's M&A Deals

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Lost in Translation: Unique Due Diligence Challenges that Arise in Middle East Business Transactions

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Introduction

Attorneys with clients conducting business in the Middle East often find it necessary to create customized solutions for the unique challenges that arise in cross-border Middle East transactions. Attorneys need to be highly proactive in due diligence and often need to craft novel solutions for addressing legal risks.

Three primary factors contribute to the challenges faced: differences in legal systems, cultural and political differences, and translation issues. This chapter explores these issues through sharing the author's experience in Middle East transactions and is written for the perspective of US attorneys, although the lessons can be generally applied for any jurisdiction.

Legal and Regulatory Gaps

To state the obvious, the business laws of the Middle East and the United States are markedly different. Whereas the United States can be described as having a highly complex, detailed, and responsive legal system, the various Middle East jurisdictions are, in comparison, basic and general and often do not address current business practices. The gaps produced by these differences, along with the desire of US and international clients to achieve the same results legally in the Middle East as they expect in their home markets, create great challenges and opportunities for attorneys. Much of good Middle East deal lawyering lies in successfully navigating these gaps and creating customized solutions that satisfy the ultimate objectives of the client within a wholly different form.

Local Ownership Requirements

One of the most common issues that demonstrate how lawyers practically resolve the issues stemming from the different legal systems is the issue of local ownership requirements. For example, in the United Arab Emirates (UAE), the law generally requires local parties to own 51 percent of any business; therefore, foreign parties are restricted to a maximum of 49 percent ownership. Further complicating matters, UAE laws generally do not allow parties to alter statutory rights by contract. Whereas, in the United

States, parties may often agree by contract to profit distribution percentages and voting rights that do not match their respective shareholding percentages, in the United Arab Emirates, profit distribution is usually mandated by statute to be in accordance with shareholding.

Although lawyers and businesses within and outside the United Arab Emirates have created various structures to circumvent the local ownership rules, none of these structures is clearly enforceable under UAE law. An example of one of the more common structures is a shareholder loan, possibly governed under the laws of a jurisdiction outside the United Arab Emirates, whereby the foreign party lends the local party the share capital for the local party's purchase of shares, which loan is then secured by a pledge from the local party of its shares to the foreign party and the creation of a voting proxy in favor of the foreign party. Other common solutions include the use of management and royalty agreements to achieve the desired profit distribution percentages or structuring the foreign party's capital contribution as debt instead of equity to achieve preferential treatment for distributions.

The gaps between the various structures agreed to by foreign and local parties to circumvent local ownership rules and the strict legal requirements create serious due diligence challenges. When reviewing UAE corporate documents on behalf of a foreign client that is seeking to purchase shares in a UAE business from an existing foreign shareholder, for example, the officially registered documents may show that the local party owns 51 percent of the shares, while a memorandum of understanding and shareholders agreement between the foreign party and the local party may state that the foreign party owns 90 percent of the shares. An attorney in this situation must determine how to treat this matter in due diligence in light of common market practice and the mutual intent of the parties.

Although a violation of governing law and questions about enforceability of key transaction documents would be viewed as major issues and potential deal-stoppers under normal circumstances, attorneys must turn to analyzing the market practice and understanding the risks involved to fully advise their clients on the issue. Rather than accept a cut-and-dried

analysis from local counsel of what is legal and what is illegal, the attorney is called on to push the analysis with local counsel to understand the relative risks associated with a particular structure and the degree of informal acceptance by authorities of the structure, determine the likely outcomes if the arrangement is challenged, and ultimately assist the client in risk assessment and mitigation strategies. A similar approach must be adopted for many common "gap" issues in addition to local ownership rules which arise in Middle East transactions, such as enforcing minority shareholder protections, creating preferred shareholding structures, and statutory capital regulations.

Securities Offering Regulations

Another common set of issues faced by lawyers dealing with Middle East transactions involves the relative lack of detail and administrative guidance for important regulations governing a transaction. For example, the United Arab Emirates has recently enacted new securities offering regulations that, in part, prohibit foreign funds from conducting private placements within the United Arab Emirates unless they go through an approval process and appoint a locally licensed placement agent. These regulations come after decades of established market practice when there were no private placement regulations in the United Arab Emirates, and foreign funds would routinely market there in line with the general principles governing private placements in their home jurisdictions. In enacting the new regulations, the UAE authorities did not address the long-established market practice, nor did they define the types of activities that are considered a private placement for purposes of the regulations. Rather, the new rules simply enact a blanket prohibition on conducting private placements in the United Arab Emirates without fulfilling the approval and other requirements.

Despite this seemingly clear prohibition on private placement activities, lawyers and fund sponsors active in the UAE market have quickly developed new market practices wherein foreign funds are, in fact, conducting certain private placement activities in the United Arab Emirates without complying with the new regulations. The developing market practice is based on extensive consultations with the UAE

regulators, local counsel, and the key sovereign wealth entities, which are typically investors in the foreign funds. This collaborative process has clarified the regulations and provided much needed guidance on which types of activities the regulations are meant to govern. It is important, however, to note that the guidance provided by UAE regulators has no force of law, and the new regulations seemingly prohibit the activities in question.

Faced with this gap between the text of the law and market practice, how should an attorney advise a client that is conducting a due diligence review of the private placement regulations in the United Arab Emirates? Creative and proactive lawyers have been able to informally replicate procedures available in their home jurisdictions, such as no action letters, in the United Arab Emirates, while also analyzing likely outcomes and risks to clients under the new market practices. At the same time, an attorney must be careful to identify the specific and limited areas of activities that may be acceptable under the market practice versus the many activities that would clearly be prohibited under the new regulations.

Cultural and Political Dynamics for Middle East Business Transactions

It has become cliché to discuss the cultural and political differences between the United States and the Middle East, and much of that discussion is only marginally relevant to business transactions, given the large number of successful business transactions completed each year between the United States and the Middle East. Certain differences are quite real, though, and continue to have a major impact on due diligence and general legal considerations.

One example that relates directly to due diligence is the difference in business cultures toward sharing information and answering "tough" questions. Despite the prevalence of non-disclosure agreements, Middle Eastern business cultures are generally more hesitant to share business details during due diligence until the overall business deal is highly developed and in the final stages. Middle Eastern businesses often have a heightened concern regarding misuse of information and lack of confidence

in legal protections, in case any information disclosed in due diligence is misused. An attorney involved in Middle East due diligence must, therefore, be aware of such dynamics and be ready to conduct due diligence in stages and prepare the client for the same.

Another key issue is to understand the political structure in the Middle East country where business is being transacted. The political structure often impacts legal issues directly. Countries such as Qatar, Kuwait, Saudi Arabia, Bahrain, and others are either absolute monarchies or constitutional monarchies, whereby sovereignty is often vested in royal family members. Royal family members in these jurisdictions may also be involved in key businesses, may have ultimate management responsibility for sovereign wealth institutions, or may serve as heads of key ministries. An interesting challenge can arise, therefore, when there is a conflict between the rules issued by a regulatory body and the practices of a local business, when both the regulatory body and the business are ultimately headed by the same person or closely related royal family members. In this case and similar situations, a lawyer has to be as familiar with the political hierarchy and traditions of the country in question as with the technical rules to best advise a client on the legal risks.

Recent events in the Middle East highlight the risks associated with political instability. Far from being mere boilerplate in the risk factors section of a legal document, countries such as Egypt and Libya have undergone political revolutions that have put many aspects of their prior legal systems and business transactions into question. Termination provisions, force majeure clauses, and remedy provisions must be reviewed carefully for political risk by attorneys conducting due diligence in Middle East jurisdictions.

Translation Issues

Arabic language documents present unique challenges for the non-Arabic speaking lawyer conducting diligence for Middle East transactions. Similar to the general state of the legal systems in the Middle East, the modern Arabic language does not have exact word matches for complex international business and legal terms. Further, there are a limited number

of specialized Arabic-to-English translation companies with international business experience, so many translations are handled by local Middle Eastern translation services that are not familiar with the technical business and legal jargon in the English language. The result is that key due diligence points can be, literally and figuratively, lost in translation. Accordingly, a critical view must be adopted toward English translations of original Arabic language documents, and if an attorney is not fluent in the Arabic language, several different translations should be obtained for key provisions in documents or statutes that represent critical due diligence issues.

Conclusion

When doing business in the Middle East region, the broader context of the region's legal systems, cultures, politics, and business dynamics must be understood. Successful deal making and lawyering in the region requires an appreciation of the differences and challenges confronted when conducting business in the Middle East, along with an ability and willingness to think creatively about legal issues and risk mitigation.

Political and economic trends point toward increase and diversification of business and trade between the Middle East and the United States over the long term, which means that new developments and issues should be expected for lawyers and their clients doing business in the region. One of the greatest challenges and rewards of working on Middle East transactions is that a lawyer must always keep abreast of a rapidly developing business environment and often utilize first principles of legal analysis for resolving novel legal issues.

Key Takeaways

- Be willing to view legal issues from a different perspective and appreciate that market practice and informal advisory opinions are important parts of many legal systems in the Middle East.
- Focus on quantifying and qualifying legal risk and developing legal risk mitigation strategies for your client, but also keep mindful of basic requirements and legal compliance issues.

- Recognize that politics and culture may have a direct impact on any legal issue you face, so be sure to understand the political and cultural dimensions of any critical legal issues before deciding how to resolve them.
- Do not take the first answer received from local counsel or regulators as final, and be willing to push for creative solutions in collaboration with local counsel and regulators.

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