M&A deals in the Middle East key Practical issues

by Izabella Szadkowska - i.szadkowska@tamimi.com - Dubai Maze Tower

February 2014

With global economies recovering from the financial crisis and major financial hurdles in the United States coming to an end, mergers and acquisitions ("M&As") have started to pick up around the world.

Introduction

Businesses operating in the Middle East and the Gulf Co-operation Council ("GCC") region are yet again considered, by foreign investors, attractive acquisition targets, especially in light of the World Expo 2020 to be hosted by the United Arab Emirates ("UAE") and the Qatar 2022 FIFA World Cup. It is estimated that in 2012 the Saudi, Qatari and UAE economies grew 6.8%, 6.6% and 3.9%, respectively whereas major GDP growth rates were 2.2%, 0.2% and 0% (the United States, United Kingdom and France, respectively).

One may think regional M&A deals are no different to those carried out in other parts of the world – the purchaser finds the target company, conducts legal, financial and business due diligence, decides on the deal structure and implements it, assuming the business case appears attractive.

However, although the region's practices have, to some extent, been influenced by Western, particularly British, ways of doing business and carrying out transactions, the fundamentals of the legal frameworks of most Middle Eastern countries remain deeply rooted in civil law principles (due to the influence of the French dating back to 1798 and (Napoleonic) Civil Code which was adopted in Egypt).

When advising clients in relation to some regional M&A transactions, I have made some practical observations as to what a purchaser contemplating making an investment in a Middle Eastern company should always pay attention to.

In this article, I will share some of my findings and highlight some of the key practical issues concerning M&A deals in the Middle East, focusing on M&As of private companies.

1. Local Ownership Restriction

One of the most important practical considerations for a foreign investor contemplating acquiring a stake in a Middle Easter company is consider the maximum foreign shareholding allowable in respect of the target company under the laws of the relevant jurisdiction.

Most Middle Eastern legal regimes, in an attempt to protect their national entrepreneurs, have implemented local ownership restrictions which either:

1. do not allow any foreign ownership of companies operating in particular industries (e.g. oil and gas, construction or recruitment) or ownership of real estate outside designated areas); or
2. limit the percentage of shares in other local companies that are available for foreign ownership (e.g. 51% local ownership restriction in the UAE, Kuwait and Qatar; 30% in Oman (excluding US purchasers); 25% in respect of trading and professional companies in the KSA). These

limitations may not apply in economic free zones.[1]

To comply with the local ownership restrictions, a foreign investor is often required to have a local sponsor for the target company and, in case of a branch office, appoint a local registered agent.

In order to mitigate some of the practical hardships of the local ownership restriction and to ensure a foreign investor can, in practice, exercise a satisfactory level of control over the target company, foreign investors often enter into nominee arrangements with the target company's local partners and shareholders, so the investor acquires an economic ownership of shares in the target company above the allowed registered shareholding threshold (in addition to the legally permitted registered title to target company's shares).

Although the nominee arrangement seems simple enough from a common-law standpoint, Middle Eastern countries, being civil law jurisdictions, do not recognize any trust concept and as such, give no recognition to beneficial title, particularly in the context of shares, so a grey area will often exist, leaving investors exposed to changes in regulatory interpretation and procedure.

For this reason a foreign investor, before entering into a nominee arrangement with a local partner to acquire a beneficial stake in the target company, should keep the above in mind and consult local experts to find out how nominee arrangements are viewed in the state concerned.

2. Deal Structure

In general, under Middle Eastern legal regimes the type of assets an entity can own depends on:

1. where the business has been registered; and/or
2. what activities it is licensed to carry out.

As a result:

1. a business license to operate the business is attached to the target company, so asset deals cannot be undertaken without a potentially problematic re-licensing process.
2. the asset is often not suitable for transfer on to the purchaser.

Consequently, in order to benefit from the asset, a purchaser – regardless of being interested in buying only the asset (e.g. a facility plant, factory, production line, drilling rig, plot of land) owned by the target company – may have no practical choice other than to purchase the shares in the target company itself and deal with actual potential limitation of the target.

It is worth noting that because of the difficulties in acquiring assets alone, Middle Eastern M&A deals are usually done by way of share acquisitions, not asset acquisitions.

3. "Professional" License Holders

Some commercial licenses (so called 'professional licenses') can only be held by individuals who are nationals of the country in question, e.g. pharmacies and real estate brokerage firms in the UAE; restaurants in Oman; law firms in Qatar.

As such, a target company holding a professional license may not be a suitable investment vehicle at all.

4. Public Records

Although Western lawyers are accustomed to being able to find general background information about the target company by way of conducting some standard background checks through public registers (e.g. corporate, real estate, bankruptcy, insolvency, and court registers), such registers have either not been established in some Middle Eastern states or information held there is not available to the public.

This makes it difficult to source written records from public authorities to verify even basic information about the target company, so a buyer usually has to rely on information furnished by the seller.

5. No Case-Based Precedents

In case you require clear-cut opinions on potential issues, or there is a dispute with the counter party, you need to keep in mind that in the Middle East (unlike in common-law jurisdictions) there is no binding system of precedent, so previous judgments do no have to be followed (although they can be persuasive).

As such, you should treat previous decisions by Middle Eastern courts issued in similar cases only as broad guidelines rather than a precise indication as to how the matter at stake will be decided should it end up before a local court.

6. Offer Revocation

Once you make an offer in a contractual context, under Middle Eastern legal systems, you may not be able to revoke it freely or at all.

Whereas under common law an offer may (in principle) be revoked or varied until the moment it is accepted (and until such time when consideration is given), in general, under civil law principles an offer has binding character and cannot be revoked after being given If it is, damages may be payable.

7. Assessment of Damages

Under Middle Eastern legal regimes a party that has suffered loss, regardless of the contractual provisions, will still be required to prove the loss suffered before being awarded damages. This means that liquidated damages clauses, e.g. common in English law governed share purchase agreements (and which provides for a pre-agreed amount of damages to be paid in the event of breach so that an innocent party needs not prove its loss), are not strictly binding.

What is more, even if the share sale and purchase agreement has set out a liability cap under indemnity clause, should the party that has suffered losses prove the actual losses exceed the cap on liability, it may be awarded the amount of the actual loss, despite the contractually agreed upon liability cap.

8. Remedies

Middle Eastern court systems generally do not grant interim orders. Procedural rules throughout the Middle East do not recognise prohibitive injunctions which restrain a party from doing something or mandatorily compel a party to do something pending full trial. There are some exceptions (e.g. asset freezing orders) but generally orders of the type described are available after the full trial and judgment.

9. Public Announcement

When preparing a timetable for all M&A deal in the Middle East, you should allow time for public announcement of the proposed share transfer, as this is often required under local laws (e.g. in respect of UAE private joint stock companies).

10. Pre-Emption Right

Finally, even if constitutional documents are silent on pre-emption rights, statutory pre-emption rights of existing partners and shareholders in a Middle Eastern business (allowing them to buy the shares from the existing owners or subscribe for shares in the increased capital of the business) are common in the region.

In practice, this means that at completion, all the shareholders in closely held companies must co-operate in the process of signing notarised documents.

CONCLUSION

Despite the practical issues indicated above, the Middle East offers a friendly business environment and has continued to be an attractive part of the world for the purposes of making investments, starting or growing a business. We expect M&A activity to continue to increase, and as ever it is important that expert local advice is sought to avoid any pitfalls, such as those highlighted above.