

*Analyses and empowerment  
from due diligence  
for Sale & Purchase Agreements*



**KNOWLEDGE  
IS POWER!**

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## *Materiality of breaches*

- Legislation does not differentiate breaches between material and immaterial.
- The Government may terminate the contract unilaterally for two violations

This is important as when you do identify a problem you need to understand your reaction: Jumping through the roof or able to remedy?

E.g. Can the Government take away the subsoil use right from the company you are buying (like it did from Moldovian Stati, American Big Sky or Canadian Petrokazakhstan, etc.) ?

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## *Materiality of breaches 2*

One of the issues that we come across in our legal practice is the immaterial breach. The Subsurface Use Law provided that a subsurface use agreement can be terminated for any two breaches that are not cured within the time period set by the competent authority. There is no materiality concept there. Hence, any breach can theoretically lead to termination.

Nearly all subsurface users may have breached some provision of the subsurface use agreement. Often these breaches are very minor, but they may exist. In reality, the competent authority will only terminate for *extreme cases of non-compliance*. However, for a new client entering Kazakhstan, the fact that a subsurface use agreement can be terminated for any two breaches, regardless of materiality, is unsettling.

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## *Areas of breaches / where to focus first*

- Working programs and budget underspending
- Procurement
- Insurance
- Kazakhstani content
- Labour issues
- Issues of securities (local bonds, international notes and shares)
- Regular reports to various authorities

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## *Areas of breaches / where to search first 2*

In the due diligence of Kazakhstani companies, we can frequently see these types of breaches. The most significant in our view is a failure to comply with the Work Program and Budget. Often we see breaches of annual work programs and budgets, but sometimes previous overfulfilment is carried over to the next years. This provides an argument that the work program and budget in its entirety is fulfilled. We see a lot of breaches of procurement legislation. Subsurface users often do not have required insurance. *There are always labour law breaches.*

Another problem that we often see is with respect to stock issuances. The law does not allow a subsurface user to issue shares directly without approval from the government (in the form of a consent and waiver of preemptive right). Often a subsurface user will obtain approval for issuance of shares on a stock exchange. The subsurface user will then issue the shares in compliance with the approval.

However, later the same company will issue additional shares, not covered by the approval, in connection with an employee stock option program or perhaps to a strategic investor. The issuance is not a large amount, but this usually is a violation of the law. The additional issuance, even if a small amount, is a violation of the law if it is not covered by the approval.

The subsurface users issue additional shares for their employees as part of stock option program and forget about approval. So the approval was granted only for stock exchange. Or they do a private placement to a strategic investor who does not take a control of the company but provides some funding, typically a convertible loan into shares [at the level of parent offshore company. People normally get the approval if they sale the majority of the participation interest. But additional issuance is not covered by the approvals obtained.

An issuance of shares without approval from the government triggers a right of termination.

Reporting is another issue. Often we find that records are sloppy. Sometime there is no evidence of submission of reports. There are no acknowledgement receipts from governmental authorities. This makes it understand whether the subsurface users really comply with the reporting requirements.

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## ***Basis to terminate the subsoil use contract***

- Competent authority may unilaterally initiate early termination of the contract's validity:
  - failure to eliminate more than 2 breaches by the given deadline as set by the subsoil use contract or in ancillary documentation
  - transfer of the subsoil use right (or objects thereof) without permit from the Competent Authority
- Full remedy of the breached provisions in the contract within the timeframe set by the Competent authority may not be basis for stripping away the subsoil use right

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## ***Renewal of subsoil use contract's validity***

- Competent authority may renew the validity in the following events:
  - decision to terminate the subsoil use right was based on inaccurate data; or
  - confirming that reasons that lead to non-performance were outside of subsoil user's control
- The formal reason may be the application from the entity which was party to the terminated contract provided that such application is filed within 6 months as of the termination

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## ***Preemption right and permit to transfer the rights and objects of subsoil use***

Required for the following events:

1. alienation of the subsoil use right to another entity on the basis of both onerous and non-onerous contracts;
2. alienation of objects related to the subsoil use
3. contribution of the subsoil use right into the charter capital of another legal entity
4. alienation of the subsoil use right that takes place in the privatization process
5. alienation of the subsoil use right that takes place as a result of bankruptcy
6. charging the subsoil use right when claiming debts
7. alienation of the subsoil use right that takes place in the legal entity that is directly or indirectly determines decisions of the Kazakhstani subsoil user (provided that its main activity is related to subsoil use in Kazakhstan)



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## ***When consent of the Competent authority is required***

Debut issue of securities on the organized market including shares of:

- Subsoil user; or
- legal entity that is *directly or indirectly determines decisions* of the Kazakhstani subsoil user (provided that its main activity is related to subsoil use in Kazakhstan)

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## ***Waiver from the preemption right and issue of permit by the Competent Authority***

- up to 70 business days
- application with mandatory data and documents
- The procedure runs through the Competent authority, Inter ministerial Commission комиссия, Experts Commission and again Competent Authority

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## *Exemptions / Carve outs*

Permit from the state is not required for:

- transactions on sale of securities that are already in circulation on the organized securities market
- sale to subsidiary which is owned by the subsoil user not less than **95%** or sale between legal entities where each party is owned for at least **99%** by the same entity
- for transfer of less than **0.1%** of participation interest (shares) in the charter capital of the subsoil user

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## ***Pledging subsoil use right***

- During enforcement of court claims the sale of subsoil use right shall be conducted via public auction
- Access to participate in such public auction is given to entities that received permit from the Government
- Satisfying claims of the pledge holder shall be made from the cost of the pledged subsoil use right and only through judicial process
- Should the public auction be declared void the pledge holder may take over the pledge as its owner

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*Empowerment from the results of due diligence when entering in Sale and Purchase Agreement*

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## ***Impact of due diligence on sale & purchase agreement***

- Reflect issues/problems found in the legal agreements
- Define:
  - Barriers destimulating attractiveness of the deal;
  - Structure and particular terms of the transaction;
  - Expanding representations and warranties;
  - Indemnifying damages;
  - Additional Conditions Precedent and Conditions Subsequent (especially when due diligence is completed after the signing of the share sale agreement);

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## *Impact of due diligence on share sale agreement 2*

- Identify:
  - Required alternative mechanisms:
    - Escrow account;
    - Purchase Price Change (increase or decrease);
    - Correction of the Purchase Price (when due diligence is done after the signing of the share sale agreement);
  - Which party gives what representations and warranties

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# *The Transaction*



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## *Sale and Purchase Agreement (“SPA”)*

- Foreign-law governed SPA for transfer of a Kazakhstan subsurface user is of questionable enforceability under Kazakhstan law
- Foreign-law governed agreements between Kazakhstan persons (legal entities) are not permitted except in limited circumstances
- Kazakhstan persons (legal entities) cannot agree to international arbitration in contracts without a foreign party thereto

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## **Governance of Kazakhstan law**

The first issue is that the law provides that agreements between shareholders must be governed by KZ laws. [Civil Code] This has been interpreted to mean that the English law governed SPA in relation to transfer of the subsurface user is not enforceable or may be enforceable but must be governed by Kazakhstan law.

Hence, some commentators believe that SPAs to acquire an interest in a KZ legal entity must be governed by KZ law, as opposed to English or New York law. Many purchasers want English or New York law because this is the international standard.

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## ***Governance of Kazakhstan law***

The next issue is that, with certain limited exceptions, contracts between KZ legal entities with no foreign party must be governed by Kazakhstan law. There can be a situation where there are two Kazakhstan legal entities, a buyer and a seller, both 100% foreign owned, that must use a KZ-law governed SPA instead of English-law governed.

The third issue is that Kazakhstan legal entities cannot agree to international arbitration in their contracts if no foreign party is involved. Hence, there can be a situation where there are two Kazakhstan legal entities, a buyer and a seller, both 100% foreign owned, that must use KZ courts (or KZ arbitration) for dispute resolution.

See below provisions for references:

Article 1114 of the Civil Code. / Item 1 of Article 1091 / Item 1 of Article 1084 / Paragraph 2 of item 13 of Article 36 of the Subsurface Use Law / Paragraph 2 of item 1 of Article 32 of LLP law

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## *SPA Options*

- Kazakhstan law-governed SPA with full set of representations and warranties and indemnities
- Foreign law-governed SPA with Kazakhstan “Act on Transfer” for re-registration purposes
- Kazakhstan law-governed SPA with foreign-law governed Deed of Indemnity (“Deed”)
  - Consolidated (cross-reference) international arbitration provision in both SPA and Deed
- Introduce foreign party to the SPA and/or Deed (a guarantor) to obtain foreign law and/or international arbitration

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## **Solutions on SPA form**

The simplest option is to have a Kazakhstan-law governed SPA. Kazakhstan does have a generally workable legal system. However, the problem is that the concepts of representation, warranties and indemnities are not well developed in KZ laws.

There are some enforceability questions. If you had an enlightened, honest, highly educated judge who is commercially-minded judging your SPA, then the KZ-law governed SPA is probably workable. However, KZ law is still evolving in certain areas, and so there can be enforceability issues if you are thrown into KZ court.

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## Solutions on SPA form

Another option is to have a foreign-law governed SPA but use a Kazakhstan-law governed “Act on Transfer” to conduct the re-registration. In this instance, the parties are taking the risk of having a foreign-law governed SPA, in which case, a KZ court could rule that the SPA must be governed by KZ law in any case or sever provisions that do not comply with KZ law.

The parties then use a simple KZ-law governed “Act on Transfer” to transfer the participation interest in an LLP, for example. This option is useful in relation to *notaries in Kazakhstan who often refuse to notarize documents that are unfamiliar* to them.

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## Solutions on SPA form

A sale and purchase agreement for the transfer of a participation interest in a KZ LLP must be notarized. With this option, only the Act on Transfer would be notarized. In US notary just witnesses the signature, but here in Kazakhstan the notary checks the compliance with Kazakhstan law, and a notary may refuse to notarize an SPA that is non KZ-law governed.

The reason you have an Act on Transfer is that if you go to a notary with 100 pages New York or English-law governed SPA, the notary will check each clause and *may refuse notarization*.

Then Act on Transfer is only for re-registration purposes in Kazakhstan only. This goes usually as an Appendix to SPA governed by English or NY law. Another way to do it is to have KZ law-governed SPA with foreign-law governed Deed. This arguably complies with the law. Please note that in using this option, there should be a consolidated international arbitration provision in both the SPA and the Deed.

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## Solutions on SPA form

The consolidated arbitration provision would allow for any dispute arising under either agreement to be heard in one arbitration. In the absence of a consolidated arbitration provision, a claim may be made to split the arbitrations.

If there are multiple arbitration proceedings regarding disputes between or among the same Parties, whether under this Agreement or the Deed of Indemnity, the subject matters of which are related by common questions of law or fact and which could result in conflicting awards or obligations, then all such proceedings may be consolidated into a single arbitral proceeding. Furthermore, and not in derogation of the foregoing, any disputes, controversies or claims raising common questions of law or fact under this Agreement and the Deed of Indemnity may be submitted initially to one consolidated arbitration.

Another option to obtain English or NY law and international arbitration is to have a non-Kazakhstan party (a guarantor for example) sign the SPA or Deed as a party thereto. This would help in getting international arbitration, but it still does not entirely solve the issue of SPAs relating to KZ legal entities being governed by KZ law. Another problem is that the agreement may be interpreted to apply foreign law only with respect to the obligations of the foreign party.



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## *No LBOs*

- Kazakhstan law requires any loan for which a subsurface use right is pledged to be used only for funding of performance of subsurface use obligations

Finish with a few general transaction issues.

Kazakhstan law requires that any loan for a which a subsurface use right is pledged be used only for funding performance of subsurface use obligations.

This means no leveraged buy-outs, otherwise known as an LBO. An LBO is when the assets and shares of a target are used to finance its own acquisition. of the subsurface user in order to finance the acquisition of the subsurface user.

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## *Shareholder Agreements concepts*

In the event of a partial acquisition of a Kazakhstan legal entity, certain standard international oil and gas joint venture concepts may not be enforceable under Kazakhstan law if included in the constituent documents of such Kazakhstan legal entity:

Shareholder agreement concepts such as

- “tag-along” or
- “drag-along”
- “put-option”
- “call-option”, etc.

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## *Shareholder Agreements concepts 2*

In the event of a partial acquisition of a Kazakhstan legal entity, the shareholders may want to agree to a shareholders agreement. KZ JSC's cannot have shareholder agreements. For KZ LLP.s certain standard international oil and gas shareholders agreement concepts may not be enforceable.

For example, tag-along rights and drag-along rights may not be enforceable.

A **tag-along right** is a legal concept in corporate law. The right assures that if the a shareholder sells his stake, the other holders have the right to join the deal and sell their stake at the same terms and conditions as would apply to the selling shareholder. Tag-along rights are fairly standard terms in shareholders agreements.

**Drag-Along Right** is a legal concept in corporate law. The right assures that if a shareholder sells his stake, other holders are forced to join the deal.

A **call option**, often simply labeled a "call", would be a term in a foundation agreement that permits on shareholder to “call” or force a purchase of another shareholder’s interest. The seller is obligated to sell the participation interest should the buyer so decide. The buyer pays a fee (called a premium) for this right.

KZ Partnership Law is still evolving and concepts like tag-along, drag-along and call and forced sale/ withdrawal are also not widely used and may not be enforceable. The easiest solution is to have an offshore vehicle that in turn owns the KZ legal entity 100%.