Costa Rica

Negotiated M&A Guide 2022

Corporate and M&A Law Committee

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1. INTRODUCTION

The main regulation of corporate law in Costa Rica is embedded in the Code of Commerce. In addition, there are several statutes and decrees governing certain industries that are subject to administrative surveillance (eg, banking, insurance and telecommunication). Since 2017, the Minority Investor Protection Law has been in effect, which aims to protect minority shareholders. This law forced any ordinary company to comply with certain corporate governance rules, such as authorisation of all transactions representing 10 per cent or more of a company´s assets by the board of directors or equivalent authority body. Such rules were typically applicable to listed companies, or at least companies where there is a difference between ownership and management.

On 29 August 2019 Costa Rica enacted a new law, which significantly reformed the competition and antitrust regime in Costa Rica and aligned it with Organisation for Economic Co-operation and Development (OECD) standards in these matters. The Antitrust Law has introduced an *ex ante* merger control notification requirement with suspensory effects, which means that parties cannot close a transaction prior to obtaining antitrust clearance from the Antitrust Authority. The law provides for the imposition of significant sanctions for companies that infringe this merger control notification; it adopts a two-phase procedure, with the initial stage devoted to identifying problematic transactions and quickly clearing non-problematic ones. The thresholds for antitrust notice are:

(a) at least two parties to the transaction must have conducted activities in Costa Rica at any time during the last two fiscal years (presence in Costa Rica is understood as sales or assets in Costa Rica);
(b) a combined threshold of US$23,410,000 (gross sales/value of Costa Rican assets of all parties involved in the transaction during the last fiscal period); and
(c) an individual threshold of US$1,170,000 (gross sales/value of Costa Rican assets of at least two parties of the transaction during the last fiscal period).

For some specific industries, parties must obtain antitrust clearance from the respective administrative authority prior to completing any transaction. For example, the Telecommunications Regulatory Authority, which is responsible for the regulation of the telecommunications sector, is also responsible for enforcing antitrust law in the telecommunications sector.

Due to Covid-19, the volume of M&A transactions in Costa Rica was considerably affected during 2019 and 2020. However, by 2021, there had been a significant recovery and increase in in M&A activity. Within the legal framework, Covid-19 mainly impacted labour regulations through important reforms and new regulations, such as remote work regulations.

2. STRUCTURE OF THE TRANSACTION

The most common structures used to perfect an M&A transaction in Costa Rica are stock purchase, merger and sale of assets (understood as the bulk of the business).

Most of the M&A transactions carried out locally are structured as an equity sale governed by a stock purchase agreement. However, it is also common to see certain transactions carried out in the form of other business combinations, such as merger agreements in the form of a reverse merger, merger cash out or a triangular merger. It is common to carry out M&A transactions through an asset purchase agreement (which requires a specially regulated bulk sale proceeding), with certain additional features and legal requirements that makes it a good alternative under certain circumstances.

Since September 2012, an income tax rule applies to tax real estate transactions when property is sold indirectly through a share acquisition. Due to this amendment, the structuring of M&A transactions as a bulk sale of the assets of the business has increased – notwithstanding the demanding steps established by the Code of Commerce and the Tax Law that need to be undertaken for that type of structure.

The type of structure chosen by the parties will depend on the business conditions and efficiencies to be determined by the parties with their legal and fiscal advisers.

A typical M&A transaction involves each of the following steps:

(a) execution of pre-agreement documentation;
(b) legal and financial due diligence by the purchaser aimed at detecting any contingency affecting the target company;
(c) execution of the main transaction agreement; and
(d) post-closing conditions.

The legal impact (from the corporate, tax and labour perspective) of each structure should be analysed on a case-by-case basis. However, it is important to highlight the stamp duty for the execution of these types of transactions in Costa Rica. This stamp duty is 0.5 per cent of the contract's value, payable when the acquisition agreement is executed. If the agreement is either signed in Costa Rica or filed with a local competent authority for enforcement, both parties (seller and purchaser) usually share the cost. If the agreement is executed outside of Costa Rica, and overcomes a claim, the party filing the claim usually pays it.

3. PRE-AGREEMENT DOCUMENTATION

The M&A process usually starts by negotiating the pre-agreements, such as the letter of intent (LoI): a non-binding document that summarises the key components of the transaction that the prospective parties are willing to explore and/or complete.

In practice, LoIs will include a description of the assets to be acquired (in the form of shares or assets); the purchase price and the mechanism for its adjustment; the basic content of the final document and the ancillary agreements; the duty of the seller not to negotiate with third parties; exclusivity provisions and a timetable for the deal.

3.1. Termination penalty

Pursuant to the execution of an LoI, parties may agree to establish an escrow account in which the purchaser will deposit a percentage of the purchase price as a guarantee. If the potential buyer terminates the process without completing the transaction, the escrowed amount will be released to the seller if such termination by the potential purchaser is not due to a good cause (eg, a material contingency emerging from due diligence). If the deal moves forward and is completed, then the escrowed amount can be allocated to the purchase price and released in favor of the sellers. However, the execution of an engagement escrow is not typical practice in Costa Rica.

Under certain circumstances, it is also possible to execute a binding document, such as an option/promise agreement subject to an engagement escrow. This type of preliminary document has been observed in certain markets where the players know the competitor and do not want to run a competitive process.

3.2. Participation of the board of directors and/or shareholders in the transaction

The participation of the board of directors of the target company is mandatory, since the board of directors must authorise all transactions that represent 10 per cent or more of the company's assets.

In addition, the company's shareholders must always authorise any merger of the company with any other entity.

4. DUE DILIGENCE

The legal due diligence process is conducted by the buyer during a period that, depending upon the size of the company or assets, lasts 30–60 days. The speed and efficiency of this process will depend on the delivery of information and documentation required to conduct the corresponding review.

From a practical perspective, it is common to create a virtual data room administered by the seller or the seller's advisers, rather than a physical data room (which is an unusual practice in these transactions).

Once the purchaser's advisers have access to the data room, they will have the opportunity to submit information requests to the seller to ask for additional documents or clarifications regarding the information and documentation uploaded in the data room. If any material contingency emerges during due diligence, then the process may be terminated or may continue with possible new agreements and amendments to the LoI, if applicable.

Fiscal, labour and environmental matters are the most common deal-breakers in M&A transactions. However, if the parties are willing to take a certain level of risk, these potential contingencies are also typically addressed through a purchase price adjustment and/or representations and indemnification provisions in the acquisition agreement.

At this point of the deal, it is a general rule that the parties will have entered into a non-disclosure agreement (NDA) pursuant to which the purchaser commits not to use the information that has been made available in the data room for purposes other than the evaluation of the target company or its assets. Within the conditions of said NDA, a penalty clause is quite advisable and common. The due diligence stage is terminated when agreed by the parties and at that moment the data room is closed. It is not common to extend the term for which due diligence is conducted.

5. MAIN TRANSACTION AGREEMENTS

At an advanced stage of the due diligence process, it is common to begin drafting and negotiating the transactional documents. The typical documents involved in an M&A deal are the asset or stock purchase agreement, depending on the transaction's structure, or a merger agreement. Depending on the type of agreement and the type of industry in which the target company is involved, it is common to see the following ancillary arrangements:

(a) intellectual property (IP) licence agreements in which the owner of trademarks, patents and/or any other IP rights grants to the purchaser the rights to use such IP, or in which such rights are transferred to an IP holding company of the purchaser;
(b) escrow agreements in which a portion of the purchase price is deposited in the account of an impartial third party as a guarantee for the contingencies that may affect the companies.

The amount of the portion of the purchase price that is deposited in escrow varies based on several factors. Extremely rare are cases where the sale is on an 'as is' and 'where is' basis, except if the purchase price is extremely favourable to the buyer or in an ongoing business that is well known by the purchaser;

(c) employment and consulting agreements between key executives and employees (typically prepared by the purchaser);
(d) shareholders' agreement, if the purchaser acquires only a part of the target company's shares;
(e) assignment and transfer agreements for certain assets;
(f) change of control consents (if applicable); and
(g) resignation letters from the Company's board of directors.

5.1. Escrow agreements

There are two different escrows that might be signed in an M&A transaction: the engagement escrow and the escrow for contingencies. The engagement escrow is rarely executed in Costa Rican transactions, while the escrow for contingencies is almost a general rule; however, not every transaction has an escrow agreement for contingencies. Sometimes, instead of an escrow for contingencies, a hold-back structure is implemented, meaning that part of the purchase price of the transaction is retained by the buyer, who pays interest to the seller. The amount retained is paid upon the end of the survival period of the representations and warranties.

The percentage of the purchase price transferred to the escrow agent varies from a range of 5 per cent to 15 per cent. However, it is difficult to say there is a general rule in this regard considering that many factors may have an impact on the escrowed amount. It is common to have partial releases of the escrowed amount until the end of the survival period of the representations and warranties.

5.2. Acquisition agreement

The acquisition agreement typically includes the following provisions.

5.2.1 Representations and warranties

Regarding taxes, labour and environmental matters, representations are usually given for a term equivalent to the statute of limitations of any kind of claim regarding such matters. For the standard representations, the survival period granted by the seller varies from 18 to 48 months.

The typical qualifications to the representations and warranties granted by the sellers are 'material adverse effect' and 'to the knowledge of the seller'. However, there is no case law defining the scope of those qualifications, particularly on how they affect the effectiveness of the representations.

Most claims may be subject to a materiality criteria if the parties have included a *minimis* clause or a basket provision in the agreement. In case of a *minimis* clause, any acceptable claim must be estimated to be in an amount greater than the *de minimis* amount. In a basket provision, the purchaser will not be entitled to file a claim until the aggregate amount of all claims is greater than the basket amount. Basket provisions are more commonly used as a threshold rather than as a deductible.

5.2.2 Change of control provisions

Most of the deals are structured with a gap between signing and closing. Such a situation most often occurs when the target company´s affairs are subject to change in control provisions, in which case the sellers need to obtain the consents of certain commercial suppliers. Most of the change in control provisions are: (1) included in corporate loan agreements with banks and/or (2) contractual relationships with public authorities or concessionaires.

When there is a gap between signing and closing, the most common covenants of the seller are:

(a) to conduct the business in a way which is consistent with past practice;
(b) to keep the buyer informed of any material change in the target business; and
(c) to use its best commercial efforts, together with the purchaser, to obtain waivers or consents from the contractual counter-parties of the target company (if applicable).

5.2.3 Indemnification provisions

The typical indemnification provision usually includes the following sections:

(a) the survival period of each of the representations and warranties;
(b) the quantitative restrictions to the claims, (*de minimis*, baskets etc.), if any;
(c) events that are not the basis for a claim (eg, when the purchaser can receive compensation from an insurance policy);
(d) indemnity caps; and
(e) the effect of disclosure, where typically any contingency that has been disclosed to the purchaser cannot be the basis for a claim.

5.2.4 Dispute resolution

When there is an element of internationality in an M&A transaction, the most common venue for dispute settlement is arbitration in Florida or New York, depending on the selected governing law. The proceedings are usually conducted using the American Arbitration Association rules and/or the UN Commission on International Trade Law (UNCITRAL) rules.

For local transactions, Costa Rican jurisdiction is commonly selected. However, for local transactions, New York, Miami, Panamá and Colombia (Bogotá) are commonly selected places for dispute resolution via arbitration.

6. POST-CLOSING

Typical post-closing agenda should note:

(a) limitation periods related to amounts to be paid;
(b) deadlines of the representations and warranties, indemnification provisions, and any other obligations agreed between parties for this period; and
(c) all post-closing covenants the parties had agreed to, such as corporate amendments in the target, third-party notifications (either public institutions or private parties) etc.