Costa Rica

Negotiated M&A Guide

Corporate and M&A Law Committee

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INTRODUCTION

The main regulation of corporate law is embedded in the Code of Commerce. In addition, there are several statutes and decrees governing certain industries that are subject to administrative surveillance (e.g. banking, insurance, telecommunication). Listed companies have other regulations and due to the limited size of the Costa Rican stock market the “comply or explain” rule does not apply to listed companies. Effective as of 2017 a new law aimed to protect minority shareholders was enacted. This new law has been intensively criticized because it forced ordinary companies to comply with certain governance rules which are more typical of listed companies or at least of companies where there is a difference between ownership and management.

The Antitrust Law, amended and enforceable since April 5th 2013, has introduced the legal obligation of parties to obtain prior consent from the antitrust authority when a business combination results in a change in control. Now as a general rule there is an *ex ante* control of business combinations. Since 2013 around 100 transactions have been object of antitrust clearance. As a result 1 deal has been rejected, 5 conditioned and the remaining transactions has been approved.

Typical M&A transactions must be reported to the Antitrust Authority before the business combination perfection or within five business days following its execution date and shall be conditioned to the approval of antitrust authorities. The economic threshold established in Costa Rica is around US$15M, thereby covering most medium size transactions.

Prior to the 2013 amendment, the General Telecommunications Act, the Retirement Funds Management Act and the Insurance Market Act had regulated the merger control of companies in those industries by establishing the duty of the parties to obtain the approval from the respective administrative authority prior to completing any transaction.

STRUCTURE OF THE TRANSACTION

Most of the M&A transactions carried out locally are structured as an equity sale governed by a stock purchase agreement. In most of the cases the deal is executed abroad in order to avoid any tax implication and to preserve the confidentiality of the deal. Notwithstanding the foregoing, it is also common to see certain transactions perfected in the form of other business combinations, mainly merger agreements in the form of a reverse merger, merger cash out or a triangular merger. Since 2015 it has been also a trend in the market to perfect the M&A transactions through bulk sales, which is a sort of asset sale transaction with certain additional features that makes it a good alternative under certain circumstances.

A September 2012 amendment to the income tax rule now applies to tax real estate transactions when property is sold indirectly through a share acquisition. Prior to the amendment, real estate developers in Costa Rica could avoid the real estate transfer tax by titling the real estate in the name of a Costa Rican corporation and then selling the shares of the corporation to the prospective buyer, instead of transferring the underlying real estate. The amendment abolished that practice by creating the concept of “indirect transfer” in determining a taxable event. Consequently, 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 accomplished for that type of structure.

A typical M&A transaction involves each of the following steps: (i) execution of a letter of intent, memorandum of understanding, and/or term sheet; (ii) legal and financial due diligence by the purchaser aimed at detecting any contingency affecting the target company; and (iii) execution of the master agreement, in the form of a stock purchase agreement and/or a merger agreement, according to the characteristics of the requirements and goals of the parties. It is a general rule that the definitive agreement is executed with several ancillary documents (e.g. a non compete, and escrow/trust agreement) or side letters, as the case may be.

(a) <u>Letter of Intent</u>:

This non binding document summarizes the key components of the transaction that the prospective parties are willing to explore and/or complete.

The LOI usually is signed if: (i) the transaction is not competitive, that is to say, if there is only one bidder pursuing the acquisition of the target company, and (ii) the parties have reached agreement on basic terms, such as the purchase price or at least the way to determine it and/or adjust it. The purchase price is usually established with EBITDA as a reference for the valuation of the company, as adjusted/normalized to exclude extraordinary expenses.

On the other hand, if the acquisition is a competitive process, then the LOI is usually executed after each bidder has received certain limited information and each has submitted to the seller an estimated offer. The information that is made available to the prospective bidders varies from case to case but in general the aim is to provide the bidders with accurate information concerning the financial, commercial and technical performance of the company.

Alternatively and under certain circumstances it is also possible at this stage to execute a binding document, commonly in the form of an option/promise agreement subject typically to an engagement escrow. This type of preliminary document has been observed in certain markets in which the players know the competitor and do not want to run a competitive process.

(b) <u>Due Diligence</u>:

The financial and legal due diligence process is conducted by the buyer during a period that, depending upon the size of the company, lasts between 1 and 2 months.

From the sellers' perspective it is highly advisable to conduct its own pre-due diligence that will allow the sellers to detect and correct any deficiencies that might have an impact on price.

From a practical perspective, for medium and large companies it is common to create a virtual data room administered by the investment bank advising the sellers, rather than a physical data room.

Once the buyer's advisors have access to the data room, if the process is duly conducted and planned they will have the opportunity to submit information requests to the sellers to asking for additional documents or asking for clarifications regarding the information in the data room.

If any material contingency emerges during due diligence, then the process may be terminated or may continue with a possible amendment to the LOI.

It is not a local practice in M&A to create a formal document stating the data room rules but a process letter is always advisable detailing the duration of each stage of the process. Notwithstanding the foregoing, 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 to 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. 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 in which due diligence is conducted.

(c) <u>Final agreements and ancillary documents</u>:

In parallel with the due diligence, it is common to start with the drafting and negotiation of the final documents of the transaction. Stock purchase agreements, merger agreement and sale of bulk of business transactions are the most common legal structures used to perfect the transaction.

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: (i) IP license agreements in which the owner of trademarks, patents and/or any other intellectual property rights grants to the purchaser the rights to use such intellectual property or in which such rights are transferred to an IP holding company of the purchaser; (ii) 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 varies according to several factors, but it is usually not greater than 20% of the purchase price. Money is not only the unique guarantee that is used in the market. Stand-by letters of credit and assets are sometimes collateral that are used in M&A. Extremely rare are the sales "as is" and "where is", except if the purchase price is extremely favourable to the buyer; (iii) non compete agreements in which the sellers undertake the commitment, for a term that is not usually greater than 5 years, to not be involved in the same activity carried out by the target company, within an agreed territory; non compete should as well establish penalty clauses (iv) employment agreements in those frequent cases in which the owners of the company and/or its management are one of the most important assets of the company. Earn-out agreements and stock option plans are components that sometimes are included in the conditions of these employments agreements.

PRE-AGREEMENT

(a) <u>Letter of Intent</u>:

Commonly used M&A structures have been following the process carried out in US with similar or the same kind of documents. Certainly the execution of an LOI is the general rule in the local business environment. It is used to set out the basic terms of the transaction and, depending on the complexity of the transaction and the sophistication of the parties, it may have more or less content. The general rule of an LOI is that it is non binding, with some exceptions depending on the nature of the deal. There are no precedents in the local courts regarding the enforceability of a LOI. However from a civil law perspective a binding LOI seems to fit more in the category of a promise purchase agreement, and that is the type of agreement that it is more advisable to execute.

In the practice, LOI's will include a description of the assets to be acquired (in the form of shares and or assets properly); the purchase price and the mechanism for its adjustment; the basic content of the final document and the ancillary agreements; the duty of the sellers not to negotiate with third parties; exclusivity provisions and timetable of the deal. Fiduciary-out provisions are not common in Costa Rica.

It is in the best interest of the members of the board of directors of the target company to include a fiduciary out provision within the body of the LOI, even if the LOI is not binding. This is particularly important in those companies in which the stock capital is spread among different shareholders, not all of them participating in the deal.

Finally, when an LOI has been executed, it is common, but not a general rule, to establish an escrow account pursuant to which the purchaser will deposit an amount of money. If the purchaser terminates the process without completing the transaction, then the escrowed amount will be released to the sellers, but only if the behaviour of the purchaser is not due to a good cause (e.g. a material contingency emerging from due diligence). If the deal moves forward and is completed, then the escrowed amount will be allocated to the purchase price and released in favour of the sellers.

(b) <u>Participation of the Board of Directors</u>:

In Costa Rica the participation of the board of directors of the target company is not mandatory according to our corporate law. As a matter of fact we do not have anti-hostile takeover statutes. When it comes to listed companies there is a duty of impartiality and non-interference placed on the board of directors, although certainly they must give an opinion regarding the transaction. The participation of the target company is mandatory only in a tender offer and is limited to advising the shareholders whether to approve or reject the transaction. In this context, it is common, as a deal protection device of the buyers, to execute with controlling shareholders an inducement letter pursuant to which the controlling shareholders commit to accept the offer placed by the prospective buyer in the future tender offer.

Notwithstanding the foregoing, in most of the M&A transactions carried out locally in which an investment bank advises the sellers, it is common to have a market test in which the investment bank undertakes a competitive process or searches for prospective buyers providing the highest value to the target company.

In Costa Rica, due to its economic structure in which family business prevail, there is no case law regarding the liability of directors for breaching their fiduciary duties, however, in the applicable statutes there are principles establishing the liability of the board under the duty of care and duty of loyalty.

ACQUISITION AGREEMENT

(a) 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 former rarely is signed while the latter is almost a general rule, however, not every transaction has an escrow agreement for contingencies; sometimes instead a hold back structure is implemented, meaning that part of the price of the transaction is retained by the Purchaser, 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% to 15%. However, it is difficult to say there is a general rule in this regard considering that many factors may have an impact on the amount. It is common to have a portion of the escrowed amount released every year and to retain the balance of the escrowed amount until the end of the survival period of the representations and warranties.

(b) Representations and Warranties:

Regarding taxes, labor 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 in a range from 18 to 36 months..

The typical qualifications of 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 the effectiveness of the latter.

Most of the representations and claims may be subject to materiality criteria if the parties have included in the agreement a de minimis clause and a basket provision. According to the former, any acceptable claim must be estimated to be in an amount greater than the de minimis amount. According to the latter, the purchaser will not be entitled to file a claim until the aggregate amount of all claims is greater than the basket amount. In connection with the basket provision, it is more common to be used as a threshold rather than as a deductible.

(c) Change in 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 consent of certain commercial suppliers. Most of the change in control provisions are: (i) included in corporate loan agreements with banks; and /or (i) contractual relationships with public authorities or concessionaires.

When there is a gap between signing and closing, the most common covenants of the seller are: (i) to conduct the business in a way which is consistent with the practice of the last years (ii) to keep the buyer informed of any material change in the target business; (iii) to use its best commercial efforts, together with the purchaser, to obtain the waivers from the contractual parties of the target companies.

As indicated above in addition since 5th April 2013 there is an ex ante control antitrust to any business combination.

(d) Indemnification provisions:

The typical indemnification provision usually includes the following sections: (i) the survival period of each of the representations and warranties; (ii) the quantitative restrictions to the claims, that is to say de minimis and basket provisions, if any; (iii) events that are not the basis for a claim (e.g. when the purchaser can receive compensation from an insurance policy); and (iv) the effect of disclosure, according to which any contingency that has been disclosed to the purchaser cannot be the basis for a claim.

(e) Dispute resolution:

When there is an element of internationality in the M&A transaction, the most common venue for dispute settlement is arbitration in New York and/or Florida, depending on the selected governing law. The proceedings are usually conducted using the American Arbitration Association rules and/or the UNCITRAL rules. For local transactions, Panama and Colombia (Bogotá) are common selected places for arbitration resolution.

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