El Salvador

Negotiated M&A Guide

Corporate and M&A Law Committee

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APPLICABLE LEGISLATION

M&A transactions are governed by the following Salvadoran laws and regulations:

(a) Constitution:

Based on the liberty of contract granted by the Salvadoran Constitution, parties may enter into merger or acquisition transactions and may determine the law and jurisdiction that shall govern the transaction. Salvadoran law will govern the formalities and requirements for perfecting the transfer of Salvadoran stocks or assets.

Article 110 of the Constitution expressly prohibits monopolies, except for those granted in favour of the state or the municipalities, and only when public interest demands it. Additionally, this article also sets the basis for regulating and enforcing antitrust statutes as follows: "in order to guarantee economic freedom and consumers, monopolistic practices are prohibited". It is clear that the Constitution does not punish a monopolistic position, but the abuse of such position.

(b) Commercial Code:

Business entities are regulated in El Salvador under the Commercial Code *(Código de Comercio).* It generally leaves the parties with enough freedom to agree on many issues of corporate structure and governance. The Code also regulates mergers, and its effects on shareholders and creditors.

(c) Civil Code:

The rules contained in the Civil Code supplement those in the Commercial Code and regulate more formal aspects of a transaction, such as formalities, capacity and contractual rules.

(d) Tax Code and its regulation:

The Tax Code contains the main and general tax obligations of corporations and companies in El Salvador. The Tax Code is complemented by its own regulations and other special laws, such as the Income Tax Law, Value Added Tax Law and the Real Estate Transfer Tax Law.

The Salvadorean tax system is based on the territorial principle. Therefore, income derived from the following is subject to income tax:

- Movable and immovable property in El Salvador
- Activities carried out in El Salvador
- Services rendered by non domiciled entities and used in El Salvador

Capital gains derived from the sale of movable and immovable property are subject to income tax. This includes stocks or shares in companies, to which the Income Tax Law establishes a special regime. Capital gains derived from transfers of real estate are taxable under the rules applicable to capital gains.

The value added tax rate is currently 13 per cent and applies to the provision of services and the sale of goods. This may also apply to a transaction that is configured as an asset deal. Capital assets (applicable only to movable property) that are under 4 years of acquisition will be subject to VAT. Also the inventories will be subject to VAT. In this case, the time of the acquisition of the inventories is irrelevant.

(e) Real Estate Transfer Tax Law:

There is also a real estate transfer tax which exempts transactions with a value up to 250,000.00 colones, approximately US$28,600, and taxes at a flat rate of 3 per cent any amount above that limit.

(f) Labour Code:

The Labour Code regulates the relationships between workers and employers. The major areas of coverage are: a) individual labour rights, such as conditions of employment, contracts, the enforcement of wage, hour, and benefit laws, personnel management, and employment termination and dismissal; b) collective bargaining rights and industrial relations; c) the administration and application of social and workplace benefits; and d) labour inspections. Constitutionally recognized rights included in the Labour Code are: freedom to enter into collective bargaining agreements, freedom to associate, creation of labour unions and the right to strike, and workers inability to waive any of their rights.

Whenever an employer substitution takes place, the existing labour agreement does not end and the new employer is liable jointly with the former employer, for those obligations that arose before the substitution. This shared responsibility is for a period of 60 days following the substitution. After that period, the new employer is the only party responsible for any labour liabilities. The Labour Code establishes that an "employer substitution" is not a cause for termination of labour agreements, nor does it adversely affect the rights of an employee.

In cases of occupational hazards, retirement, and other similar situations in which the original employer had obligated itself, by will or by law; all the obligations payable in the form of pension shall be the responsibility of the new employer and it will be bound to the payment from the time of the substitution.

Article 609 of the Salvadoran Labour Code also states that labour court cases and disputes pending against the previous employer will be assumed by the new employer, whether or not the new employer was part of the original dispute.

The law says nothing about the document or agreement that the parties should sign for the "employer substitution". Nevertheless, it is advisable when the transfer of the company takes place, to elaborate an agreement for the "employer substitution", which must be submitted to the "General Office for Labour Inspections".

(g) Competition Law and its regulation:

The Competition Law (CL) went into effect on January 1st, 2006. Since then, the legal and transactional landscape of El Salvador has changed because of the broad definitions contained in the law regarding the subject matter jurisdiction of the Competition Superintendence (the CS) and the cases that have to go before the CS.

Conceptually speaking, the CL focuses more on anticompetitive behaviours than on market structures and views mergers with a preventive focus. The CL does not punish market share or dominant positions, but attempts to avoid abuse of dominant positions. The CL regulates all economic agents, a term that is defined in the law as *"any person, natural or juridical, public or private, dedicated directly or indirectly to an economic activity, be it for profit or not"*.

The CL dedicates a chapter to the issue of 'concentrations' or monopolistic mergers, that is, mergers that substantially lessen competition or tend to create monopolies in either a product market or a geographic market. In order to determine whether there is a concentration, the law establishes a two-tier test, the first tier examining whether:

> *"… between the previously independent economic agents there are acts, contracts, agreements that have as a result a merger, acquisition, consolidation, integration or combination of their business in whole or in part …"*

and

> *"… when one or more economic agents that already control at least another economic agent acquires by any means the direct and indirect control in whole or in part of more economic agents."*

The second tier of the test is a quantitative examination and it will determine whether the:

> *"… combined total assets exceed 50,000 minimum yearly salaries or combined total revenue exceeds 60,000 minimum yearly salaries…"*

For purposes of the CL, control is defined as:

> *"… the capacity of an economic agent to influence another through the exercise of property or use rights, of all or part of the assets of the economic agent or through agreements that confer substantial influence in the composition, voting or decisions of the decision making bodies, administrator or legal representatives of the economic agent."*

In the second tier concentration cases abovementioned, it is necessary to obtain the authorization of the CS. The CS has 90 days to approve or deny concentration requests, which cannot be rejected if the interested party proves the following: (i) the operation will result in significant advantages that will reduce costs and will produce direct benefits to consumers; (ii) it cannot be obtained by other means; and (iii) market supply will be not reduced. *(h) Intellectual Property Law and its regulation:*

The laws and regulations regarding intellectual property regulate all issues concerning trademarks, copyrights, related rights, patents and industrial designs.

(i) Securities Market Law:

If there is a public offer for the acquisition/transfer of shares, the Securities Market Law must be complied with, and the procedure will be supervised by the Securities Superintendence (SS).

(j) Other regulation:

If the companies are subject to specific regulation, other statues should be examined depending on the nature of the companies involved (for example, banks, insurance companies). In these cases, the Financial System Superintendence also supervises the procedure.

If at least one of the companies operates in El Salvador as a pension fund administrator, the Pension Savings System Law must be complied, and the Pension Superintendence (PS) will supervise.

The Energy and Telecommunications sectors are also regulated in El Salvador. In these cases, the Electric and Telecommunications Superintendence (ETS) may supervise the procedure according to the Electric Law and the Telecommunications Law.

STRUCTURE OF THE TRANSACTION

The acquisition of a business may be structured in a variety of ways, including as an asset sale or a stock purchase. The structure of the transaction will depend on what the buyer is aiming to achieve and, in some cases, on the corporate structure of the seller.

If the buyer is only interested in one part of the business of the seller and not in its entire business, then an asset deal will probably be its best option. On the other hand, the buyer who intends to acquire the entire operation of the seller (i.e. regional operations), a share deal is generally recommended.

Asset deals are regulated by the civil laws and they usually involve the purchase of fixed assets (i.e. real property, machinery, etc.). The transfer of intellectual property is regulated by a special law. Share deals are regulated by commercial laws and involve the acquisition of all assets, intellectual property rights, liabilities and other elements of the seller.

Most share deals take place at the level of a holding company, usually incorporated in foreign countries (i.e. BVI, Panama, Luxembourg). This may involve retaining counsel from such jurisdictions, in addition to local counsel, to perform due diligence on both the holding and operating companies.

DUE DILIGENCE

Our law does not establish particular requirements for a merger or acquisition that does not involve a public offer or a regulated company. Therefore, the parties may determine the information that will be disclosed. The minimum information that should be required for a Salvadoran target includes: corporate structure and relationship between the holding company, affiliates, subsidiaries, and/or joint ventures; internal rules; corporate and accounting records; identity of the majority/controlling shareholders; any agreement that could limit or prevent the transfer of shares; shareholders agreements; financial statements and other relevant financial instruments such as deeds; listing of assets; contracts and liaisons either inter-company and/or with third parties; all licenses and permits granted by government institutions and required for the company's operation, particularly those granted by regulatory entities; a certificate of good-standing for fiscal and municipal taxes; labour agreements, union situation, social security and pension funds; requiring a certificate of solvency which proves that the company is up to date with its social security and pensions funds obligations; environmental practices and permits; and judiciary administrative and non-judiciary proceedings, both concluded or pending.

PRE-AGREEMENT

(a) Letter of Intent:

There is no regulation in El Salvador regarding the enforceability of a Letter of Intent (LOI). Our Commercial Code establishes that a contract may be constructed by an offer and an acceptance and obligations will arise from such acts. Nonetheless, usually, LOIs are not binding on the parties in their entirety, especially when the LOI constitutes only the intent of the parties and is not signed by the parties.

However, some provisions such as non-disclosure agreements, “stand-still” or “no-shop” provisions entitling exclusive rights to negotiate may be enforceable. Normally, in this case, the LOI will be executed by both parties and in some cases, is referred more to as a “Memorandum of Understanding” (MOU).

Therefore, it is always advisable to include in an LOI or an MOU a clause that determines the law and jurisdiction that shall govern all the situations and disputes between the parties that may arise from this document. Salvadoran law is not always recommended for this kind of document.

(b) Procedure and requirements for a merger:

Each Salvadoran company must approve the merger in an extraordinary shareholders’ meeting, the minutes of which are registered at the Registry of Commerce. The extraordinary shareholders’ meeting shall be held pursuant to the following rules (unless the by-laws of the company establish additional requirements):

- The quorum required on first call (i.e. on the first date stated in the notice of the meeting) is 75 per cent of the paid-in capital and the resolutions must be passed at the shareholders' meeting by the favourable vote of the same percentage of shares attending the meeting.

- The quorum required on second call (i.e. on the second date stated in the notice of the meeting) is 50 per cent plus one of the paid-in capital and the resolutions must be passed at the shareholders' meeting by the favourable vote of 75 per cent of the shares attending the meeting.

- In case the meeting cannot be held for lack of a quorum in the first and second calls, a third notice shall be made. A shareholders' meeting held on the third call will be valid regardless of the number of shares present, and resolutions will be passed by a simple majority vote (i.e. 50 per cent plus one) of the shares attending the meeting.

- In shareholders' meetings held to approve a merger, all the shares will have a right to vote, including the shares with limited or restricted voting rights.

- The articles of incorporation of a company may increase the minimum attendance and voting quorum requirements. However, parties may not contract out of these requirements through the articles of incorporation.

The merger process follows these steps: once the merger has been approved at the shareholders' meeting, the articles of incorporation of the new company or the necessary modifications to the articles of incorporation of the acquiring company shall be drafted and approved in an extraordinary shareholders meeting for each of the companies.

Before registering the merger agreement at the Registry of Commerce, the filing party must obtain the certificate of good standing or the non-taxpayer certificate, which are issued by the Treasure Ministry (*Ministerio de Hacienda* in Spanish).

Once the merger is recorded with the Registry of Commerce, the merger agreement and the last balance sheet for the companies shall be published in the Official Gazette and in two Salvadoran newspapers on three alternate occasions. The merger shall come into force 90 days after the last publication, provided no legal challenge.

Any interested party may file a judicial action to oppose the merger within the aforementioned 90-day period. Interested parties may include dissenting shareholders or creditors. Every shareholder, including those with limited or restricted voting rights, can bring an action to object to the resolutions passed by the shareholders meeting, including the decision to merge the company, provided that the following conditions are met: (a) that the resolution objected to involves a violation of the law or of the articles of incorporation of the company; and (b) that the resolution does not involve the liability of the administrators or the persons in charge of the company's auditing. A merger may not negatively affect minority shareholders' rights.

It is important to note that the shareholders of the merged companies may receive stock in the new or acquiring company in a proportion equal to the amount they held prior to the merger, unless otherwise provided for in the merger agreement.

(c) Minority and dissenting shareholders' rights:

Minority shareholders' rights may be set forth in the articles of incorporation. However, the law does set forth minority shareholders' rights. Shareholders who do not agree with a merger (i.e. 'dissenting' shareholders) may withdraw from the company by exercising their appraisal rights. Local law does not establish the right for dissenting shareholders to be bought out by other shareholders. Nevertheless, they may exercise appraisal rights over their capital participation in the corporation.

If a dissenting shareholder decides to withdraw, such appraisal rights shall be exercised within the period of 90 days of the date of publication of the merger agreement. The shareholders may not exercise such appraisal rights if, as consequence of the withdrawal, the capital of the company falls below the minimum permitted by law. The value paid by the corporation to the dissenting shareholder for each share shall be the result of dividing the book value of the shareholders' equity by the number of shares in circulation, all according to the last balance sheet approved by the general shareholders' meeting.

ACQUISITION AGREEMENT

The acquisition agreement in international transactions is generally governed by foreign law. This is particularly true in share deals where, as mentioned above, the acquisition usually takes place at the holding company level. The choice of foreign governing law is due to the fact that Salvadoran laws are not as "sophisticated" as the laws of other jurisdictions.

(a) Representations and Warranties:

The seller and the buyer will make representations and warranties to the other in the acquisition agreement. The seller's representations and warranties will typically constitute the largest part of the acquisition agreement. Coupled with the buyer's due diligence, they will enable the buyer to learn as much as possible about the seller's business. Additionally, the seller's representations and warranties provide a mechanism of protection for the buyer, enabling it to walk away from, or possibly renegotiate the terms of the acquisition if the buyer discovers facts that are contrary to the representations and warranties between signing and closing or post-closing. Furthermore, the seller's representations and warranties provide the framework for the seller's indemnification obligations to the buyer after the closing.

From the seller's perspective, if the buyer is paying the purchase price in cash at the closing, the most important representations and warranties the seller can elicit from the buyer are those governing the buyer's corporate authorization and financial condition (i.e., the buyer's ability to pay the purchase price). If the buyer is paying the purchase price over time or by issuing stock, the seller will require more extensive representations and warranties from the buyer.

Representations and warranties in acquisition agreements of Salvadoran entities usually involve seller's and buyer's corporate organization and capitalization, pending and threatened litigation and arbitration, current and potential liabilities, taxes, financial statements, contracts, employment matters, environmental matters, compliance, intellectual property, etc. Nevertheless, many of these representation and warranties will be specific to the seller's industry.

In many cases, representation and warranties are supported by the issuing of a certificate of good standing (i.e. financial obligations) or a solvency form from a government office (i.e. taxes, payment of pension contributions, etc.).

The survival of the representation and warranties will depend on the timeframe specified by the parties in the agreement.

(b) Conditions of closing of the buyer and seller:

Conditions of closing will vary depending on the industry of the seller and the buyer. Such conditions may involve governmental filings or approvals from the regulators for the transaction, and may include: environmental permits, pre-merger authorization from the anti-trust authority, approvals from the financial regulator, securities exchange regulator, etc. Other conditions may involve corporate approvals or corporate restructurings.

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