Post-closing tax liabilities among the greatest challenges for M&A deals

Monday, 19 December 2016 *(1 week ago)* by Joe Rowley

Whether it is regulatory uncertainty, tax litigation or aggressive antitrust enforcement, foreign investors undertaking M&A transactions in Latin America may find half the challenge lies after they close the deal. At Latin Lawyer's 7th annual M&A conference, corporate counsel, private practice lawyers and the vice-president of Brazil's antitrust regulator discussed the common pitfalls companies commonly encounter and what they can do to avoid them.

"Being an M&A lawyer in jurisdictions like Portugal and Spain, we believe it's easy to come to [Latin America] because we speak the same languages and think everything is going to work out," reflects Maria da Paz Tierno Lopes, a partner at Cuatrecasas, Gonçalves Pereira in São Paulo. "But then we try to explain the complexity that is the tax regime in Brazil; the amount of taxes, the fact that sometimes liabilities can affect the shareholder…or sometimes that the escrow is not enough. That's a concept that most of the time our clients do not understand."

Even those companies that take all available steps to minimise their risk, the final outcome of their investments can still prove to be uncertain. Tax liabilities can emerge months or even years after the transaction closed and may result in litigation lasting years. "What we face on a day-to-day basis is that, even if you do all the proper due diligence…and if you take all the necessary protections, such as insurance or even escrow accounts, sometimes it's hard to predict what's going to happen in the future," says Rodrigo Cardozo Miranda, corporate counsel at steel producer Companhia Siderurgica Nacional. "One of the most important things here in Brazil that may be different to other countries or other jurisdictions is that four to five years within the statute of limitation period, it's not uncommon to have an unfortunate surprise."

Currently, deals worth some US$150 billion are being disputed in Brazil, with 70% of that total concentrated in 707 cases out of thousands, according to Miranda. Besides Brazil's fiendishly complicated (and occasionally ambiguous) tax code, he adds that the "innovation and creativity" of Brazil's Inland Revenue Service, and its focus on goodwill amortisation and M&A transactions ("because they know that the [deep pockets] are there") are helping increase the number of litigation cases.

Escrow accounts can help future-proof companies from the risk of tax liabilities arising from M&A transactions, but Bart le Blanc, a partner at Norton Rose Fulbright in Amsterdam, says timing can often pose a challenge. "Generally, tax assessments arise four, five, six years after you've closed the deal and that usually conflicts, to a large extent, with escrows, because generally the escrow doesn't last for that period of time."

Insurance can help mitigate the financial risk of future liabilities, but policies are unlikely to cover every eventuality. "Insurance companies may review the due diligence that has been performed and base their analysis…on the existing due diligence, but they would definitely carve out any compliance issues that may

arise in the future," explains Le Blanc. "We've acted for a number of the insurance companies on bigger transactions in Europe and they're very strict on the risks that they're willing to take on, so they would generally take on tax risks that relate to the business, but definitely not those that relate to compliance issues or other difficult issues."

Sometimes the multijurisdictional nature of certain M&A transactions can raise further issues; particularly when guarantees are negotiated outside of Latin America, or are designed to cover multiple jurisdictions. "A concern we have is that guarantees that have been negotiated, most of the time don't even address the issues that we may encounter [in Brazil]," says Lopes. "They are negotiated for all the jurisdictions; they are in a package and they are structured in a major transaction, and...[often] the escrow that is created for the whole deal will not cover Brazil."

Another challenge for companies may lie in obtaining antitrust approval, which was the subject of the second panel moderated by Priscila Brólio Gonçalves, a partner at Vella Pugliese Buosi e Guidoni - Advogados (São Paulo). Brazil's antitrust regulator, for example, requires that all mergers above a certain threshold, namely where one party has at least 750 million reais (US$224 million) in annual income and the other at least 75 million reais (US$22 million) be submitted for approval, and does not differentiate between different types of merger or investments from investment vehicles, such as private equity funds. Even association contracts between companies that run for more than two years and lead to greater concentration within a particular market must seek approval.

For example, a recent case involved the main producers of silicon carpet in the Brazilian market, which signed an agreement that would allow the inputs to be produced in Paraguay (where electricity costs are around 50% lower) and the product finished in Brazil. Although CADE approved the agreement, the small number of major companies in the Brazilian market meant the association between the companies represented a high risk of collusion, particularly if the companies began sharing secretive technology for finishing the carpets.
The regulator imposed several behavioural remedies, including requirements that the companies implement certain corporate governance rules, a Chinese wall structure to prevent collusion, have different distributors and send annual reports to CADE.

While Brazil's competition rules may be clear, merger clearance can take time, particularly for those involving complex effects. However, Alexandre Cordeiro Macedo, commissioner at CADE, says there are steps that companies can take to speed up the process. "Every lawyer thinks about how hard it is to do a transnational merger and that they have to deal with a lot of antitrust agents, sometimes two, three or four [on a particular case]," he says. "All of those academic theories about jurisdiction don't work at all; what can really work is cooperation. You can pick up the phone and call the other agents and ask: "What are you doing right now? In what phase are you?"

Besides regular contact with the antitrust authorities, regulatory clarity can help increase the predictability and efficiency of cross-border M&A deals; an aim Macedo claims is central to CADE's approach. Similarly, in Mexico, the country's antitrust regulator is developing rules to ensure mergers and JVs are approved as quickly as possible, particularly rules governing investments by private equity funds, which remain undefined. However, Fernando Carreño, partner at Von Wobeser y Sierra SC, argues that a more rigorous enforcement process means that approval is likely to take longer than in previous years. "In the past, the Mexican Commission used to be, I would say, lax, and the review conducted by the commission into private equity transactions was relatively fast," he says. "At least in non-horizontal mergers, they only asked for limited information because they understood that usually, in private equity transactions, there are certain partners of the private equity groups that are completely unrelated to the transaction; they would not have any kind of influence, so it was relatively easy to deal with the commission in this kind of transaction."

Carreño adds: "After the famous Panama Papers, the Mexican commission discovered that in certain cases, companies used private equity structures in order to hide information and precisely because of that, now the approach they are taking is very conservative and very aggressive in terms of the amount of information that has to be disclosed to the authorities.

Comments

There are currently no comments