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Legal entity simplification — A better approach

One unintended consequence of Mergers & Acquisition ("M&A") activity in recent years is unwieldy legal entity structures. In many large companies, the number of redundant legal entities can be overwhelming, and considerable internal resources (and costs) are potentially devoted to maintaining the excess entities. Simplifying the legal entity structure can, however, be a challenging undertaking in itself, and some companies have avoided it because of the perceived price tag. One way to reduce this cost of transformation, and increase the likelihood of success in simplifying the structure, involves approaching the problem from a completely different angle.

Background — Why simplify?

Other than making the legal entity chart easier or even possible to print, why would companies try to simplify their legal entity structure? For most companies, the answer comes down to cost savings or risk reduction, or often some combination of those two drivers.

Cost reduction

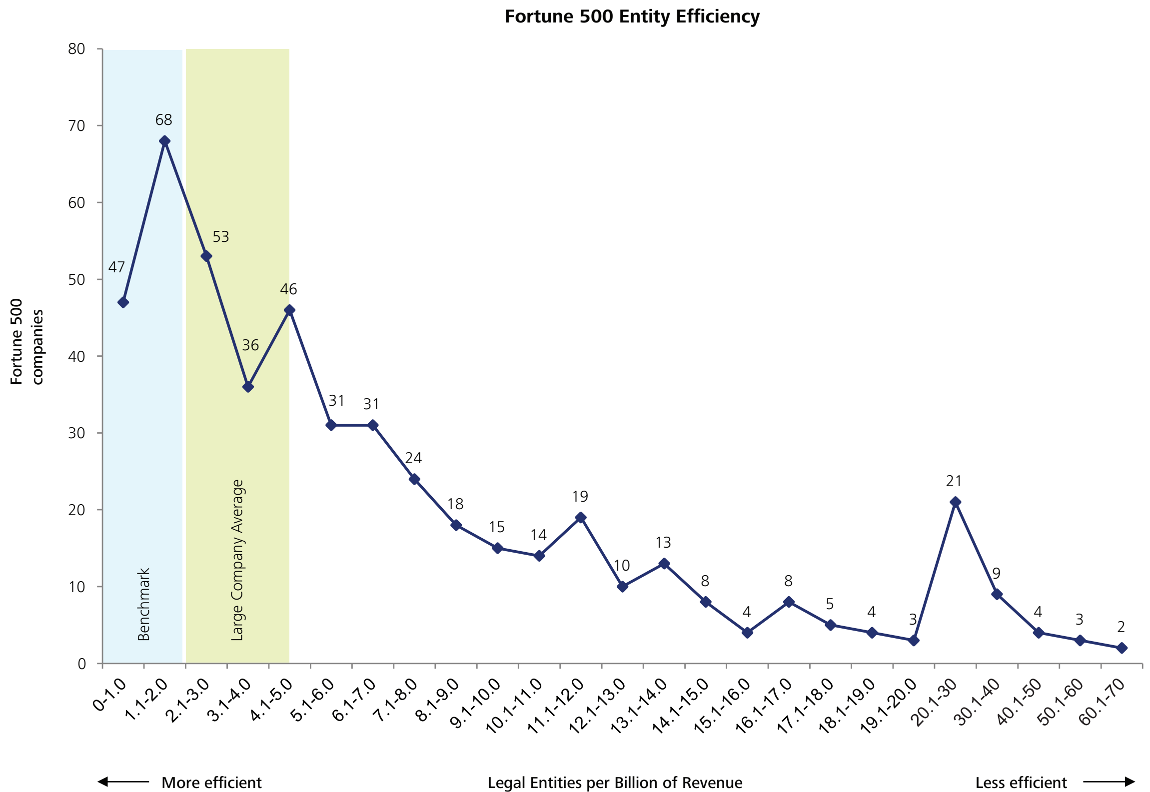
From a cost reduction standpoint, there are potential savings in both the support and operations sides of many businesses. The list below provides some of the more common savings by functional area.:

Function	Potential sample savings
Legal and regulatory	• Reducing fees and costs relating to redundant minimum taxes, licensing, permitting, registration, registered agent, public notices filing, record maintenance, tax compliance and other filing.
Finance and treasury	• Reduction in bank account service fees, transaction charges, capital costs associated with minimum deposit requirements, debt covenant compliance, and cash forecasting.
Accounting	• Reduction in fees and costs relating to statutory audit, redundant and inefficient shared services resources, monthly/quarterly/annual reporting, intercompany accounting (e.g., streamlining voluminous intercompany journal entries and reconciliations) and IFRS implementation.
Operations	• Reduction in external spend through vendor rationalization. • Reduction in costs that resulted from duplicative administrative/shared services, misaligned operating model, duplicative insurance policies/premiums, and intercompany accounting. • Reduction in lost sales/revenue resulting from artificial barriers to doing business.
Information technology	• Reduction in costs relating to general ledger input/coding, system configuration, incremental system capacity.
Human resources	• Reduction in costs relating to administrative and shared services, insurance/premium, vendor rationalization, and redundant compensation and benefits programs. • Managing loss of employee mobility.

Mitigating risk

Risk reduction is a somewhat counterintuitive benefit. After all, doesn't the imposition of additional corporations between certain legal and financial risks and the parent company tend to increase safety? If that is the case, shouldn't enterprises increase, rather than decrease, the number of legal entities? While that question is ultimately one of state law and therefore beyond the scope of this article, companies should consider whether having too many legal entities in their structure introduces new organizational risks, where the number of legal entities is so overwhelming that the enterprise cannot keep legal entity financial records, maintain updated intercompany agreements, or enforce arm's-length intercompany transactions. Would it in fact be safer to have fewer, better maintained entities?

For many enterprises, a more relevant risk is transfer pricing: This is certainly more common than those risks described above involving placing a subsidiary into bankruptcy. While some transfer pricing risks may be inherent in deliberate tax planning an enterprise has undertaken, the far more common transfer pricing issue is one that arises from random excess legal entities that were acquired from transactions. Successful transfer pricing challenges by taxing authorities can have the impact of moving income into higher tax jurisdictions, trapping tax attributes into entities that cannot easily use them, and increasing indirect taxes. The common theme: With fewer legal entities comes less transfer pricing risk.



*Information on this graph is based on a Deloitte Tax analysis of 2010 public company data.

So, how bad is it?

The chart above shows the number of legal entities it takes to generate a billion dollars of revenue. Obviously, having fewer legal entities to generate the same amount of revenue, all things being equal, is an indication of greater efficiency. So companies that are closer to the left of the chart are more efficient — perhaps a few entities per billion of revenue, versus having 30 or more legal entities for companies on the right-hand side of the graph. The vertical axis shows how many of the Fortune 500 companies are in each group — for example, 168 companies from the Fortune 500 have between 1 and 3 companies per billion dollars of revenue.

There are many factors that come into play when determining the "right" number of legal entities, such as number of countries served, industry, etc. But the bottom line is that companies that have been acquisitive in the recent past and have not engaged in a focused entity simplification are very likely too complex, and could realize savings and risk mitigation if they slimmed down.

The two traditional approaches to entity simplification

As companies attempt to simplify their structures, we commonly see either of these two approaches (or sometimes a combination of the two):

1. Dormant first—Recognizing that dormant entities are easier to eliminate, some companies attempt to focus there first. The advantage of such an approach is that a quick start is often possible, and progress (at least measured by number of legal entities removed) seems certain. The primary drawback is that only very small cost savings are possible. The real need that legal entity simplification is supposed to address — excess cost and risk — is missed.
2. Outside-in — Similar to the process for putting together a jigsaw puzzle, this approach gets its name from the way people perform the activity (work on the edge pieces first, then put together puzzle pieces of the same color, etc.). But fundamentally, it is a trial-and-error approach as the company attempts to decide, on a one-off basis, which entities are a good fit for combination. The advantage is that it does begin to address the real issue — reducing excess costs and risks associated with complexity. The fundamental drawback is that the process can be too slow, which creates a host of challenges. First, for companies that remain active in the M&A marketplace, the new entities may be coming in faster than the existing entities can be eliminated. Second, like any longer-term project, it can be interrupted by other corporate priorities that arise, especially since there is no explicit deadline to finish the legal entity simplification activity—it's just too easy to delay if not altogether stall out. Finally, these projects tend to not be ambitious enough and lack overall vision—because of the tedious nature of this approach, these projects tend to have goals to reduce entities by, say, 25 percent rather than 90 percent.

The Straw Man approach

Companies will normally achieve better results by employing a third approach, the Straw Man. Under this approach, the existing legal entity structure is ignored, at least in the beginning stage. Instead, the project begins by developing a structure that would exist if the company were to be created from scratch today. Put another way, if a new buyer were formed to purchase the worldwide assets of the existing enterprise, how would that newly formed buyer be structured? An example of what that might mean is a Straw Man structure of one or two operating entities per country as the initial goal—a far cry from where the company is today, and perhaps a good distance from what it might be capable of achieving if it started with the existing entity chart.

Of course, the Straw Man structure is just that—an initial starting point for discussion. As the project progresses, there will be entities that simply cannot be combined (due to existing legal liabilities, regulatory constraints, non-transferrable rights, local labor issues, costs, etc.), but even as these exceptions are made, the vast majority of the entities are subject to combination and significant reduction can potentially be achieved.

There are several distinct advantages to this Straw Man approach:

1. The default mindset is changed from "can this company be eliminated?" to "this company must be eliminated, unless a special exception exists." This change, by itself, can make a significant impact.
2. It is much easier to get support from the affected constituencies — such as legal, regulatory, human resources, accounting, information technology, finance, etc. — when focusing on the actual goal driven by the Straw Man approach as it provides more clarity.

3. It is often easier to align the legal entity structure with the business model by essentially starting over, especially if the existing entity structure is almost completely attributable to acquisitions made years ago and long since integrated from a business perspective. Moving incrementally from the existing structure to the current business model is simply too complex.
4. The Straw Man approach tends to result in structures that are much closer to the way the business is actually operated. Structures that are aligned with business operations are cheaper to maintain and easier to explain to executives and employees, which is important when it comes time for implementation. Most importantly, structures that are aligned with the business are far more likely to be respected by the business going forward — everything from correctly coding entries in accounting to having the correct company contract with the customer or vendor.

Conclusion

While there are obvious costs and disruptions associated with entity simplification, there can be significant benefits as well. By using the Straw Man approach, companies can often achieve these benefits more quickly, and in measurably larger amounts, than may be possible using more traditional approaches, shifting the equation more in favor of a simplification effort.

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