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FOREIGN INVESTMENT

BNA Insights: The Vagaries of the M&A Process in Brazil

BY SANJIV K. KAPUR

As asset values in Brazil have fallen with the economic downturn that has hit the country, many multinational companies are acquiring Brazilian targets. Doing business in Brazil is complicated, even more so than in much of Latin America. It has its own nuances. Brazil is ranked 120 out of 189 countries for ''ease of doing business'' by the World Bank and the International Finance Corporation.

Nevertheless, there are certain advantages in the process of buying a business in Brazil that are not often seen in the U.S. or Europe. For example , asset or stock purchase agreements often include pro-buyer indemnification provisions for all pre-closing liabilities supported by an escrow of between 15-30 percent of the purchase price.

But as would be expected in situations where complicated laws and business practices exist, a robust due diligence process is advisable. Three key areas stand out:

1. Complicated, Costly Labor Laws: Most Brazilian companies have a large number of pending lawsuits, often in excess of ten per cent of the size of the work force, that arise from a failure to adhere to complicated laws. Such laws dictate terms of employment and fringe benefits, including payments upon separation. All employees must belong to a union representing their industry or profession; the employer is required to comply with the relevant collective bargaining agreement. Finally, contingencies arise when companies sidestep labor laws by using independent contractors and sales representatives.

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2. Complex Tax System: Brazil has a tax regime with a myriad of taxes imposed at the national, state and local levels. Many privately owned Brazilian companies take aggressive tax positions, which may be challenged years later and be subject to high interest and penalty charges. Even if the likelihood of tax authority challenge is remote, FIN 48 of the U.S. GAAP accounting standards require U.S. companies to prepare financial statements where tax contingencies are accrued based on the assumption that all tax positions will be examined by the appropriate taxing authority.

3. Lack of Transparency: The diligence process often uncovers inappropriate payments to governmental authorities, usually in connection with tax, labor, governmental permit or customs matters. Investors need to identify such issues, and put in place controls and training systems to ensure such practices do not continue after consummation of the acquisition. Brazil's Clean Companies Act has imposed requirements similar to the U.S. Foreign Corrupt Practices Act that makes entities acquired liable for restitutions and fines.

A buyer of a Brazilian business should also take into account the following:

- Buying assets as opposed to the equity interest of the company does not avoid ***successor liability***. There can be group-wide liability for tax, labor and environmental matters. The statute of limitations is five years for tax contingencies. The period is five years on labor contingencies for a current employee, and two years from the date of termination for a prior employee.
- In order to ensure the repatriation of the original investment, the purchase should be made by funds that are ***registered with the Brazilian Central Bank***. To avoid complications resulting from fluctuating exchange rates, the purchase price should be fixed in Brazilian currency.
- ***Tax planning*** is often key. To obtain partnership tax treatment for U.S. tax purposes, the entity

acquired should be a ''limitada'' (limited liability company), not a ''sociedade anonima'' (corporation). Acquisitions are often structured by creating a Brazilian entity that acquires the shares of a target company, which a few months later merges into the target company to obtain certain tax write offs.

- ***Sales agency agreements*** are regulated by a specific Brazilian law that requires payment upon termination equal to one twelfth of all consideration paid to the sales representative during the lifetime of the relationship.
- Brazil now requires ***prior antitrust approval*** by its competition authority (CADE) for acquisitions surpassing certain thresholds (e.g., Brazil revenues in excess of 750 million Reais by one economic group, and 75 million Reais by the other economic group). Transactions leading to combined operations with a market share of more than 20% require a laborious ''long form statement'' to be filed.
- Licensing transactions resulting in payments of ***royalties on trademarks, patents and knowhow*** outside of Brazil must be registered with the INPI, the Brazilian patent and trademark office. Under Brazilian law, know-how is not licensed but rather deemed to be transferred by the party possessing the know-how.
- Post-employment ***non-competition*** obligations are difficult to enforce, and in any event, require payment of compensation during the post-employment non-competition period.
- To the extent certain executives are to be retained in management roles — particularly in the administrator role of a limitada — there is a possibility of using so called ***pro-labore*** agreements to avoid the mandates of the Brazilian labor laws.
- Although there is increasing confidence in the decisions of Brazilian courts for commercial disputes, ***arbitration*** is the preferred dispute resolution mechanism, and if decisions have to be enforced in Brazil, the arbitration is better conducted on Brazilian soil. Arbitration decisions rendered outside of Brazil must be ''homologated'' before they are enforced by Brazilian courts.
- In acquiring a controlling interest in a publicly traded company, relevant rules of the Brazilian securities and exchange commission or CVM can require that **mandatory tender offers** be commenced for the free float. The by-laws of the company often contain ''poison pill'' provisions that may extend such tender offer requirements.
- With Brazilian publicly traded companies, the financial institution acting as the ***transfer agent*** will require certain documents to register the shares in the name of the purchasing entity, and may impose restrictions upon future transfers of shares.

A final matter that should not be ignored is that successful transactions require the development of relationships during the course of negotiations in Brazil. As such, the process necessarily is longer than one would see in the U.S. and Europe. Aggressive negotiating tactics with ''take it or leave it'' stances are usually counterproductive.

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