Time To Be Bullish To Buy Brazilian Businesses?

BY SANJIV K. KAPUR

In March of 2016, the Brazilian Ibovespa stock market index had its best monthly performance since October of 2002 and posted a 17% increase. During the same month, the Real appreciated by 10% against the Dollar. Fueled by the impending impeachment of President Dilma Rousseff, Brazilians are optimistic that they will be freed of her disastrous economic and legal policies. Should this sudden euphoria be a signal to international companies to buy businesses in Brazil, especially as asset values have fallen with the recent economic downturn and the Real has devalued in the last five years relative to the United States Dollar by more than 100%?

Impeachment by itself will not improve Brazil's "ease of doing business" ranking of 120 out of 189 countries by the World Bank and the International Finance Corporation — a ranking that makes the M&A process particularly challenging. To get rid of the added cost of doing business in Brazil or the *"Custo Brasileiro"* will require more than a change in the President. In addition, foreigners looking to invest in Brazil need to take into account some of the peculiarities of Brazilian law and custom.

Transparency

Corruption is an important element of the *Custo Brasileiro* that makes the M&A process formidable. The diligence process, especially those involving privately held companies, often uncovers inappropriate payments made by the target to governmental authorities, often in connection with tax, labor, governmental permitting or customs matters. In light of the mandates of the United States Foreign Corrupt Practices Act and other relevant laws, before consummating any transaction, an investor needs to identify such practices and implement controls and training systems to ensure that such practices do not continue post-acquisition. In addition to hiring an auditing firm to examine accounting records, retaining a private investigator to do background checks on the target company and its executives and shareholders is common.

The Clean Companies Act, which went into force in January of 2014, has imposed requirements similar to those of the United States Foreign Corrupt Practices Act. In the case of an entity acquired through merger, the law makes the successor entity liable for restitutions and fines up to the value of the assets transferred in the transaction. In addition to the decrease in illicit practices as a result of the new law, investors can take some comfort that Brazilian executives, unlike their counterparts in Asia, often will when queried usually come clean and admit to their past infidelities.

The lack of transparency also affects trust in judicial authorities. Arbitration is the preferred dispute resolution mechanism in M&A agreements. If arbitration decisions will have to be enforced in Brazil (because a party only has assets in Brazil), the arbitration should be conducted on Brazilian soil; those rendered outside of Brazil must be "homologated" before Brazilian courts will enforce them. Arbitration in Brazil can be in the English language using international rules.

Labor Laws

Another part of the *Custo Brasileiro* are complicated labor laws. They dictate the provision of various fringe benefits and terms of employment, including severance obligations upon termination. At will employment is a concept that does not exist in Brazil.

All employees in Brazilian companies are automatically members of the union that represents their industry or profession; the employer must comply with the requirements of the relevant collective bargaining agreements. Most companies have a large number of pending labor lawsuits (for example, a well-known international company with 18,000 employees in Brazil has 2,000 pending labor litigation matters).

Salaries for qualified executives can often be higher in Brazil than those for comparably situated executives in the United States, given the high cost of living and relative scarcity of educated professionals. If key executives are to be retained in management roles (particularly in the administrator role of a limitada), *"pro-labore agreements"* can be used to avoid the mandates of Brazilian labor laws. Post-employment non-competition obligations, however, are difficult to enforce, and require payment of compensation during the non-compete period (non-competition obligations imposed upon sellers of a business, in contrast, do not require payment of separate consideration).

Many companies avoid labor laws mandates by using independent contractors and sales representatives who may later challenge their status in employee-friendly labor courts.

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Moreover, the Brazilian sales agency law requires payments upon termination equal to one twelfth of all consideration paid to the sales representative during the lifetime of the relationship.

Taxation

A third contributor to the *Custo Brasileiro* is the convoluted tax regime with a myriad of taxes imposed at the national, state and local levels. The difficulty in complying with the complicated tax system is compounded by aggressive tax planning. Many of these tax positions may be challenged years later, and can be subject to high interest and penalty charges. Even if the likelihood of discovery and challenge of the tax position 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 in fact be examined by the appropriate taxing authority.

Tax planning is an important part of the Brazilian M&A process. To obtain partnership ("check the box") tax treatment for United States tax purposes, the entity acquired should be a *limitada* (limited liability company) and not a *sociedade anonima* (corporation). Acquisitions are often structured by creating an entity in Brazil that acquires the shares of a target company that a few months after the acquisition merges into the target company to obtain certain tax write offs.

Civil Law Mandates

The civil law tradition of Brazil also limits flexibility in structuring transactions. Buying the assets of a business as opposed to the equity interest of the company does not avoid successor liability for labor, tax and other contingent liabilities. In fact, the acquiring company can be ensnared with group-wide liability for tax, labor and environmental matters. As such there is a heightened focus on applicable statutes of limitations. For tax contingencies, there is a five-year statute of limitations and for labor contingencies the statute of limitations is five years for a current employee and two years from the date of termination for a prior employee.

To guarantee repatriation of the original investment and dividends, an investment should be made by funds that are brought into Brazil and registered with the Brazilian Central Bank. Licensing transactions which result in payments of royalties on trademarks, patents and know-how outside of Brazil must be registered with the INPI, the Brazilian patent and trademark office. Royalties between related parties on trademarks and other rights are often limited by the INPI. Under Brazilian law, know-how is not licensed but rather deemed to be transferred by the party possessing the know-how.

Antitrust Considerations

Brazil now requires prior approval by the antitrust authority (CADE) of acquisitions surpassing certain statutory thresholds (revenues in Brazil by one economic group in excess of 750 million Reais and revenues of the other economic group in excess of 75 million Reais). Transactions in which the combined operations will result in a market share of more than 20% in the relevant market require the filing of a laborious "long form statement," which allows the authority more time to review the filing. From an operational and diligence perspective, buyers need to take into account that there is greater scrutiny of anti-competitive behavior including price fixing.

Public Company Issues

Investment in publicly traded companies is impacted by the rules of the CVM, the Brazilian securities and exchange commission, and the listing rules of the BMF Bovespa. Acquisition of a controlling interest can require that mandatory tender offers be commenced for the free float of the publicly traded company. The bylaws of publicly traded companies often contain "poison pill" provisions that extend such tender offer requirements to where only a 10 or 20% interest is acquired. In acquisitions where the target will remain publicly traded, the transfer agent of a publicly traded company may require certain information or other actions in order to register the shares in the name of the purchasing entity. Transfer agents sometimes also impose limitations and restrictions upon future transfers of shares.

M&A Customs and Practices

The customs that surround M&A agreements can be helpful to buyers. For example, asset or stock purchase agreements, unlike in the United States, often contain pro-buyer provisions indemnifying for all pre-closing liabilities, with no cap or one equal to the purchase price, with baskets or less than 1% of the purchase price and with indemnification time periods that range from three to five years. Escrows of between 15 to 30% of the purchase price for the indemnification term are not uncommon. The limited caps and time periods for indemnification and baskets that one sees in United States indemnification agreements, however, are gaining favor in Brazil.

To avoid some of the complications that might result from fluctuating exchange rates, it is advisable to fix the purchase price in the Brazilian currency. Fixing the price in local currency is consistent with a valuation that is based on revenues and costs in local currency and simplifies the process of introducing the correct amount of funds for Central Bank registration purposes.

A final important matter that cannot be gainsaid is that negotiating transactions in Brazil often becomes a process where counterparties get to know each other. As such, the process necessarily is longer than one would see in the United States. Getting down to business immediately or aggressive negotiating tactics with "take it or leave it" stances are usually counterproductive and do not facilitate getting the deal done.[1]

[1] This article is adapted from an article he published in Bloomberg BNA's Mergers & Acquisitions Law Report, Vol. 19, No. 13, pp. 490-491" (March 28, 2016). Copyright 2016. The views and opinions expressed herein are the personal views or opinions of the author; they do not necessarily reflect the views or opinions of the law firm of which he is a partner.

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