JONES DAY

JUNE 2016

COMMENTARY

Time to Be Bullish to Buy Brazilian Businesses?

In March 2016, the Brazilian Ibovespa stock market index had its best monthly performance since October 2002 and posted a 17 percent increase. During the same month, the Brazilian *real* appreciated by 10 percent against the U.S. dollar. Fueled by the impending impeachment of President Dilma Rousseff, Brazilians are cautiously optimistic that they may be freed of what her critics have termed 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 by more than 100 percent relative to the U.S. dollar in the last five years?

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 can make the M&A process particularly challenging. Getting rid of the added cost of doing business in Brazil, or the "*Custo Brasil*," will require more than a change in the Brazilian president. Foreigners looking to invest in Brazil need to take into account a number of economic and other factors, including the peculiarities of Brazilian law, custom, and culture.

Transparency

Corruption is an important element of the *Custo Brasil* that can make the M&A process formidable. The due diligence process, especially involving privately held companies, may uncover inappropriate payments made by the target to governmental authorities, frequently in connection with tax, labor, governmental permitting, or customs matters. In light of the mandates of the U.S. Foreign Corrupt Practices Act and other similar relevant laws, before entering into any transaction, an investor needs to identify such practices and implement the necessary controls and training systems to ensure that these 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 Brazilian Clean Companies Act, which went into force in January 2014, imposes requirements comparable to those of the U.S. Foreign Corrupt Practices Act and the UK Bribery Act. In the case of an entity acquired through merger, the law makes the successor entity liable for restitution and fines of 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 many of their counterparts in other parts of the world (and unlike some Brazilian politicians!), when queried often will come clean and admit to their past questionable practices.

The lack of transparency also affects trust in judicial authorities. Because of concerns about transparency (whether perceived or actual) and inordinate delays in Brazilian courts, arbitration is the preferred dispute resolution mechanism in M&A agreements. If arbitration decisions will have to be enforced in Brazil (because a party's principal assets are 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 key part of the *Custo Brasil* is Brazil's 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.

Most 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*, or limited liability company), some Brazilian lawyers suggest that "*pro-labore* agreements" might provide more flexibility than what would otherwise be required by employment agreements under Brazilian labor laws. Post-employment noncompetition obligations, however, are difficult to enforce and require payment of compensation during the noncompete period (noncompetition obligations imposed upon sellers of a business, in contrast, do not require payment of separate consideration).

Many companies seek to avoid labor law mandates by using independent contractors and sales representatives, who may later challenge their status in employee-friendly labor courts. 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 Brasil* is the convoluted tax regime, with myriad 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 they 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 requires 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 U.S. income tax purposes, the Brazilian entity acquired should be a *limitada* and not a *sociedade anônima* (corporation). Brazilian tax lawyers often recommend that acquisitions be structured by creating a Brazilian entity that acquires the shares of a target company, which merges into the target company at some point after the acquisition to secure certain tax advantages as part of the transaction.

Civil Law Mandates

The civil law tradition of Brazil may also limit 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 generally a statute of limitations that covers tax liabilities for five full tax years, and for labor contingencies, the statute of limitations is generally five years for a current employee and two years from the date of termination for a former employee.

To guarantee repatriation of the original investment and dividends, an investment should be made with funds that are brought into Brazil and duly registered with the Brazilian Central Bank. Licensing transactions that result in payment 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 CADE, the Brazilian antitrust authority, of acquisitions surpassing certain statutory thresholds. Transactions in which the combined operations will result in a market share of more than 20 percent in the relevant market require the filing of a laborious "long form statement" that allows the authority more time to review the filing. From an operational and due diligence perspective, buyers need to take into account that there is greater scrutiny of anticompetitive behavior, including price fixing.

Public Company Issues

Investment in publicly traded companies is affected by the rules of the CVM, the Brazilian securities and exchange commission, and the listing rules of the BM&F Bovespa. Acquisition of a controlling interest can trigger a mandatory tender offer for the free float of the publicly traded company. The bylaws of publicly traded companies can contain what is termed by Brazilian lawyers as "poison pill" provisions that extend such tender offer requirements to where only a 10 or 20 percent 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 and practices surrounding Brazilian 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 preclosing liabilities, with no cap or one equal to the purchase price, with baskets of less than one percent of the purchase price, and with indemnification time periods that typically range from three to five years. Escrows of between 15 and 30 percent 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 U.S. acquisition agreements, however, are gaining favor in Brazil. In addition, in cross-border M&A transactions where the target is Brazilian, New York, Delaware, or other U.S. state law may be used as the governing law of the transaction documents (as is often the case in other Latin American countries).

Brazilian law generally requires that contracts governed by Brazilian law specify payments in Brazilian *reais*. In cross-border transactions governed by laws other than those of Brazil, to avoid some of the complications that might result from fluctuating exchange rates, it may still be 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 ignored is that negotiating transactions in Brazil often becomes a process where the counterparties get to know each other. As such, the process generally is longer than one would see in the United States or Europe. 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.

This Commentary *is adapted from an article that appeared in the May 2016 issue of the Cleveland Metropolitan Bar Association's* Bar Journal*, which was adapted from an article the author published in* Bloomberg BNA's Mergers & Acquisitions Law Report*, Vol. 19, No. 13, pp. 490-491 (March 28, 2016). Copyright 2016.*

Lawyer Contacts

Jones Day is not licensed to practice Brazilian law and does not provide advice on Brazilian law. In cross-border transactions in which Jones Day acts as international legal counsel providing advice on matters of non-Brazilian law, such as the laws of New York or Spain, clients must separately retain Brazilian counsel to obtain advice on matters of Brazilian law. For further information, please contact your principal Firm representative or one of the lawyers listed below. General email messages may be sent using our "Contact Us" form, which can be found at www.jonesday.com/contactus/.

Sanjiv K. Kapur
São Paulo / Cleveland
+55.11.3018.3911 / +1.216.586.7114
skapur@jonesday.com

S. Wade Angus
New York / São Paulo
+1.212.326.3755 / +55.11.3018.3914
swangus@jonesday.com

Marcello Hallake
São Paulo / New York
+55.11.3018.3933 / +1.212.901.7058
mhallake@jonesday.com

Luis Riesgo
São Paulo
+55.11.3018.3939
lriesgo@jonesday.com