



WHITE PAPER

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Major Liberalization of Brazilian Law: Use of Agricultural Land as Security Interest for Financial, Other Transactions

Brazil has changed its laws to facilitate the use of fiduciary liens as security interest over agricultural lands. Some of the most valuable lands in Brazil are agricultural lands, but because of existing laws that limit foreign ownership of rural lands, there was legal doubt whether fiduciary liens could be granted over agricultural lands. To the extent a foreign controlled company was offered a security interest in rural lands, the only instrument that appeared available on a risk-free basis, before the change in law, was a mortgage.

Mortgages, unlike fiduciary liens, are not bankruptcy remote. A secured party with a mortgage cannot act to foreclose on a mortgage without approval of its credit in a bankruptcy reorganization plan, where the secured party is often subject to a haircut on what it can recover. With the change in law specifically authorizing the grant of fiduciary liens over rural lands, foreign controlled entities can now obtain a security interest in rural lands that is generally not subject to frustration in an insolvency proceeding. This change in the legal framework should facilitate an increase in financings and other transactions with foreign investors with a concomitant increase in foreign investments into Brazil.

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Brazil has taken a major step to facilitate transactions with foreign or foreign-controlled entities involving rural lands. In a country where grants of security interests or guarantees consisting of liens over real estate assets are commonplace to secure obligations, foreign-controlled entities can now rely on a fiduciary lien (“*alienação fiduciária*”) on rural lands. Law No. 13.986/2020, commonly referred to as MP do Agro, was signed into law by President Bolsonaro on April 7, 2020.¹

Given Brazil’s strong agricultural sector, some of the more valuable properties consist of rural lands. Under Brazilian law, ownership of rural lands by foreigners is subject to several restrictions and limitations. Notwithstanding such limitations on foreign ownership, MP do Agro makes clear foreigners are entitled to receive fiduciary liens on such properties; as a result of foreclosure of such fiduciary liens they can also own rural lands. Previously, if rural lands were to be the subject of liens to be granted to foreign or foreign-controlled entities, the only legal instrument that did not pose risks of enforcement was that of a mortgage (“*hipoteca*”). Mortgages are more difficult to execute upon than fiduciary liens, especially in the context where the party granting the security interest has become subject to insolvency or judicial restructuring proceedings. MP do Agro, however, also now permits foreign-controlled secured parties to become owners of the rural lands subject to the mortgage.

To better understand the impact of the changes imposed by MP do Agro, it is worth exploring the current limitations on foreign ownership of rural lands as well as the nature of mortgages and fiduciary liens and the foreclosure procedures used with each such instrument.

RESTRICTIONS ON OWNERSHIP OF RURAL LANDS BY FOREIGNERS

Since 1971, Brazil has had in effect Law No. 5,709/71 that limited ownership of rural lands by foreigners. But until August 10, 2010, that law was interpreted to not apply to entities formed in Brazil that were controlled by foreigners. In Opinion AGU/LA 01/2010 issued by the Office of the Attorney General, the administration of President Lula da Silva formally changed the interpretation of the existing law to indicate that it was applicable to entities created under Brazilian law that are controlled by foreigners.

The underlying law that was interpreted to apply to foreign-controlled Brazilian entities does not prohibit the ownership of rural lands in all circumstances. Rather, the Brazilian legal framework requires approval from the National Institute of Colonization and Agricultural Reform (“*Instituto Nacional de Colonização e Reforma Agrária*” or “INCRA”) before acquisition of such land.² It also imposes prohibitions on a county (“*município*”) basis in terms of the percentage of rural lands that can be owned by individuals or entities controlled by any single nationality or all foreigners on an aggregate basis.³ In addition, rural land parcels that are of a size greater than 100 indefinite exploration modules (“*modulos de exploração indefinida*” or “MEIs”)⁴ require Brazilian Congressional approval before they are acquired by foreigner-controlled entities.

Although these restrictions on foreign ownership will continue in effect in Brazil, where a foreign-controlled entity acquires rural land through foreclosing on a fiduciary lien or mortgage, the foreign-controlled entity is free of any restrictions related to the rural land that might otherwise apply if it attempted to purchase such rural land. The provisions that became part of MP do Agro were originally drafted to contain some restrictions on the foreign owner if it became owner of the property through the foreclosure of the fiduciary lien or mortgage, such as a requirement that the foreign owner simply be the owner of the property, and not by itself develop or otherwise directly exploit the rural land, and that it sell the property within five years of its acquisition. Those limitations contemplated by the original draft of the proposed legislation were not incorporated into what ultimately became the law.

TRADITIONAL MORTGAGES AND THEIR SHORTCOMINGS IN INSOLVENCY SITUATIONS

There are two basic types of security interests on real property that can be granted under Brazilian law. The more traditional form is that of a mortgage. The mortgage deed must identify the property on which the lien is being granted, as well as the term and other conditions of the mortgage grant. Among such other terms, the mortgage must specify the amount of the debt secured by the mortgage. Although not required, it is recommended that the mortgage deed also specify the market value of the property in light of the limitations on sale of the property discussed in the next paragraph. If the mortgage involves a real estate asset with a value in excess of 50,000

reais, the mortgage must be prepared before a public deed notary (“*tabelionato de notas*”) and filed with the real estate registry (“*cartório de registro de imóveis*”) in order to be effective and perfected.

In order to act upon and foreclose upon the mortgage, the secured party must commence judicial proceedings. As part of the proceedings, the court can require that the market value of the property be redetermined based on new appraisals. Thereafter, an auction is held for the property with the law imposing a floor price on the sale (usually at 50% of the market price specified in the mortgage deed or as redetermined by the court). Many courts have often imposed additional obligations that the sale in an auction be at a higher price up to 60% of the market price.

In the auction, the secured party is able to use its credit specified in the mortgage deed to participate in the auction. The proceeds from the auction are used to first pay the secured party in the amount of the debt specified in the mortgage deed. Any excess is thereafter paid to the owner. The owner and the secured party can, of course, outside of the mortgage deed, agree that the excess proceeds be destined for other uses. The foreclosure proceedings for a mortgage can take up to two years in practice.

If prior to or during the foreclosure procedures, the owner of the real estate enters into insolvency or judicial restructuring proceedings, foreclosure of the property can only proceed in accordance with the reorganization plan that is proposed by the owner and approved by the creditors as part of the judicial restructuring. Notwithstanding the fact that it has a security interest in a property that fully covers its debt, most secured parties are often forced to take a reduction or haircut on their debt as part of any reorganization plan that is ultimately approved by the court.

ADVANTAGES OF THE FIDUCIARY LIENS

The second type of security interest that can be granted on real estate in Brazil is a fiduciary lien, which is in effect a provisional transfer of ownership of the real estate. Unlike the case of foreclosing on a mortgage deed, foreclosing upon a fiduciary lien deed, where the owner is part of judicial restructuring does not

require that the secured party credit be approved as part of the reorganization plan—including being subject to a discount or haircut that is proposed in a reorganization plan. The only situation in which the court managing the bankruptcy proceeding can intervene is when the assets subject to the fiduciary lien are viewed as essential to the continued operations of the owner. Such “capital goods” may not be sold during the stay period that consists of 180 days from the acceptance of the reorganization proceeding by the court under Article 49, paragraph 3 of Law 11,101/2005. Otherwise, a fiduciary lien can be foreclosed upon outside of the bankruptcy proceeding. Multiple precedents from the Superior Court of Justice confirm that credits collateralized by fiduciary liens as well as the underlying assets are not subject to a judicial reorganization proceeding.⁵

A fiduciary lien deed is similar in many respects to a mortgage deed. It must describe the property and the term of the fiduciary lien as well as specify the market value of the property and the amount of the debt that is subject to the fiduciary lien. Although a fiduciary lien is not a public deed, like the mortgage, a fiduciary lien is registered with the relevant real estate registry.

Foreclosure of a fiduciary lien deed, however, is done outside the purview of a court proceeding in an extrajudicial auction initiated by the real estate registry office. Under the relevant law, there are two auctions. The first auction is held with a floor price equal to the market value specified in the fiduciary lien deed. If there is no sale in the first auction, a second auction is held with a floor price equal to the value of the debt, plus costs and taxes incurred in respect of transferring the real estate asset. If there is no sale in the second auction, full ownership in the property is vested in the secured party and the secured party is entitled to take possession of the property. To the extent either of the auctions results in a sale for proceeds above the referenced applicable floor prices, the debt owed to the secured party is first paid, and any excess proceeds belong to the owner unless the parties have contractually agreed outside the fiduciary lien deed as to what is to occur with such proceeds. The foreclosure process usually takes four to nine months.

Both the mortgage deed and the fiduciary lien deed customarily have other matters included within their provisions, including any requirements on maintenance of insurance of the property or whether in a foreclosure, the purchaser must

honor any lease. If the mortgage deed or fiduciary lien deed is silent on the subject of what happens to existing leases of the property, the purchaser has the right for 90 days after foreclosure to terminate any lease on the subject property.

CURRENT LEGAL STATUS OF THE USE OF FIDUCIARY LIENS FOR RURAL LANDS

As noted at the outset, given the restrictions on foreign ownership of rural lands, there was legal doubt about the availability of fiduciary liens where rural lands were involved. There are

court rulings where courts have held that fiduciary liens can be obtained by, and are enforceable by, foreign and foreign-controlled entities on rural lands. In a case decided in January 2019, an appeals court in the State of Goias overturned a lower court decision that had held that fiduciary liens could not be granted to a foreigner on rural lands. The lower court decision had been based on the restrictions on foreign ownership of rural lands.⁶ Now, under the newly enacted MP do Agro, the legal doubts that led to the Goias litigation have been eliminated. MP do Agro should facilitate greater foreign investment in Brazil by permitting the grant of security interests in rural lands using the more easily enforceable instrument of the fiduciary lien.

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This White Paper was adapted from an article titled “Brazil prepares to loosen restrictions on foreign security interests over rural land,” written by Sanjiv K. Kapur and Domicio dos Santos Neto and published in Latin Lawyer News on March 31, 2020.

ENDNOTES

- 1 The law is known as MP do Agro because it is an outgrowth of a provisional presidential decree (“*medida provisória*”) that related to reforming various matters related to the financing of agricultural ventures, but such decree did not cover the topic of facilitating the use of fiduciary liens by foreigners for rural lands, which was only added in the law itself.
- 2 In order to obtain such authorization, a proposal on the development of the rural land must be prepared by an agronomist engineer and submitted to INCRA, attesting to the economic viability of such project. This process usually takes more than a year to obtain approval.
- 3 There is a legal limit of 25% of rural land in the same county owned by foreign individuals, foreign companies and/or Brazilian companies of foreign capital, and a the legal limit of 10% per cent of land in the same county owned by foreign individuals, foreign companies and/or Brazilian companies of foreign capital of the same nationality.
- 4 A MEI consists of between 5 and 100 hectares and reflects the relevant development of the area in which the MEI is being determined. In more developed rural areas a smaller number of hectares will comprise one MEI.
- 5 REsp 1202918/SP and REsp 1263500/ES.
- 6 Interlocutory Appeal (Agravo de Instrumento) No. 5166595.48.2018.8.09.0000/GO.

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