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Overview of M&A in Brazil – Legal Aspects

This article presents a brief overview of the main legal aspects related to M&A transactions in Brazil.

Summary

1. Market Trends and Political Scene

The market for M&A in Brazil is going through a process of recovery after some years of instability. The government has been pushing for some necessary reforms that have shifted perspectives on the country's economy. Congress has already approved a review of the Brazil's outdated labor laws, significantly improving flexibility in the labor relations and sustainability of employment. High hopes are now placed on the reform of social security, which is expected to enable the government to sustain healthy levels of public debt.

The interest in some key sectors of the economy, like agriculture, has remained steady during the past few years and these remain strong as sources of business opportunities. They have counterbalanced the period of economic turmoil, explaining the maintenance of a moderate degree of activity in the recent past. At present, and combined with the devaluation of the local currency, we can safely say that there are good opportunities for foreign investors to enter the market in strategic positions and at attractive prices.

2. Geographic Distribution

With over 220 million inhabitants, the mere size of Brazil's consumer market has long been attractive for investors. The main hub for M&A, however, is the country's southeast, with a heavy concentration in São Paulo, where most companies of national stature have their headquarters and the largest number of law firms, banks and financial services are located.

3. Cultural Aspects

Much of the experience with doing business in Brazil is similar to the international standard, especially in the larger transactions. It is in the smaller deals, or in those involving family businesses, that a foreign buyer may face more challenges. This is when the intermediation of experienced locals can be most relevant, as the language barrier and local customs may be softened or neutralized by professionals who understand the different backgrounds of key players.

A recurring issue is the lack of a substantial understanding of the financial components of the deals by some sellers. In many cases, Brazilians tend not to get deeply involved in the negotiations or not to dedicate the time to understand some key factors of price formation and adjustment, or the implications of liability after closing. These issues inevitably arise at some time, and often near the closing date, creating confusion and delays.

Therefore, it is imperative that all advisors understand the importance of a constant monitoring of the clients' attention to all points of the negotiation throughout the process.

4. Applicable Laws

M&A under Brazilian law follows many laws and regulations, but the most basic sources are the Civil Code (Law 10,406, of 2002) and the Corporations Law (Law 6,404, of 1976). The Civil Code covers a number of different topics besides Business Law – for instance, it contains the basic rules on obligations, contractual relations, property, family and inheritance. The Corporations Law, in turn, is a special law that is solely designed to govern Brazilian corporations, either listed ones or privately held.

5. Corporate Formats

The most common corporate formats used by Brazilian companies are the limited liability company (sociedade limitada) and the corporations (sociedade anônima). Despite the nomenclature, corporations also have limited liability. As an alternative to the typical company types, another form of investment available in Brazil are private funds, with the nature of a condominium, which have become very common due to tax advantages. Lesser corporate formats are either used in very specific and exceptional situations or have become practically non-existent.

The system is based on a general outline that the law prescribes for each company format, with liberty to structure the company in aspects that are not in conflict with the mandatory rules. The law typically determines aspects like the number of shareholders, the structure of governing bodies, company and shareholders' liabilities and registration requirements. If the legal requirements are observed, shareholders are free to regulate their relations in the companies' bylaws directly or in private shareholders' agreements.

Foreign companies or individuals may hold any and all shares of companies incorporated under Brazilian rules, as long as they appoint a person who is domiciled in Brazil to represent them and receive service of process if the case may be.

5.1. Limited Liability Companies and Corporations

Most of companies incorporated in Brazil adopt the LLC format, given its simplicity. It requires a minimum of two shareholders, with at least one manager, who acts as its legal representative.

As opposed to the LLC's, corporations must have 10% of the subscribed capital paid at the incorporation, and the company is required to set aside 5% of its profits in a Legal Reserve (until the fund equals 20% of capital). It must have at least two officers (compared to only one in the LLC), with executive powers. Both corporations and LLC's may adopt a Board of Directors, with deliberative functions.

Corporations have a more robust structure and are, therefore, suited for larger ventures, even though this is not a rule – sometimes, the different levels of share ownership required for the control is the main factor determining the choice between a LLC or a corporation.

5.2. Listed and Privately Held Corporations

Corporations may be listed in the stock market or privately held. The peculiarity of listed corporations is that they have their stocks traded in the market, created as such from the beginning or pursuant to an IPO. In these cases, they are subject to the rules of the Brazilian capital market system composed by multiple regulatory entities such as the Central Bank and its National Monetary Council, securities commission, which is called Comissão de Valores Mobiliários – CVM and the Brazilian Stock Exchange, which is based in São Paulo.

5.3. Eireli (Individual Company of Limited Liability)

Brazil did not have a limited liability company format for a single shareholder until as recently as 2012. Until then, a single entrepreneur was subject to risking all of its personal assets in case his business incurred liabilities or was unsuccessful, it being necessary to opt for one of the common corporate formats that require at least two partners in order to segregate (in theory) one's assets from those of the legal entity. Then, Law 12,441 came into force and created the "Eireli", which stands for an "individual company of limited liability" in Portuguese (even though the limitation of liability, in the Eireli as well as in other types of company, are subject to several exceptions in the Brazilian system).

Eirelis must have one only owner, there being no requirement in terms of residency and nationality. However, it is not possible for the owner of such a company to have more than one EIRELI. Management may be conducted by the owner directly or by one or more different individuals.

An important aspect of the Eireli is that it does require a minimum capital amount for its constitution, equivalent to 100 times the minimum wage in force at the time of its incorporation. This initial capitalization, as well as subsequent capital increases, require full payment upon their subscription.

5.4. Private Equity Investment Funds

Another method of investment that has been widely used in Brazil are private equity investment funds (FIPs), which have some attractive tax advantages. Their nature is that of a condominium, and not one of the typical corporate formats available under Brazilian law. For that reason, their constitution documents are initially registered at a notary office and then in the Brazilian securities commission (CVM), and not at the Trade Board. They require an independent managing entity that is accredited by the CVM – these are often a branch of a solid financial institution.

FIPs are sometimes meant to be publicly open for any investors, and in other cases they are private. It is possible for an investor, for instance, to search for a managing entity to set up the fund, while the investor commits to supplying a significant portion of the initial investment, prior to a public offering of the quotas. In other cases, a group of investors might use the FIP structure to gather funds for a specific project, without raising funds publicly.

FIPs are required to invest at least 90% of their net worth in specific kinds of assets, including shares of limited liability companies or corporations, among others. Their regulation requires that the funds take part in the decision-making process of the companies in which they invest, which can occur through (i) the holding of shares that guarantee control over those companies, (ii) the terms of a shareholders' agreement or (iii) other arrangements that enable them to influence the invested entities' governance and strategic policies.

Each FIP must have a set of rules where investors have access to the investment policies, types of assets that will form the fund's portfolio, rules on the payment of dividends and other guidelines to be observed by the management.

6. Corporate Control

Quite often, the process of acquisition and the decision on what percentage a buyer will take rely on the level of control that the shares will grant.

Under Brazilian laws, this varies according to the type of company (LLC, corporation or others), where the basic rules are as follows.

LLC's require 75% of votes for transactions of merger, dissolution and for the conclusion of liquidation. Approval of the accounts and remuneration of the officers, as well as any matters not specifically mentioned in the law, require more than 50% of the votes (50% plus one, at least). But given the fact that amendments to the bylaws (including change of the company's name, address, purpose and capital amount) require 75% of the votes, this is the percentage that counts most for a buyer who intends to have full control of an LLC.

It is recommended that shareholders with less than 25% of the shares request that their approval be given prior to any amendments to the bylaws, or they can be left out of important deliberations, including the corporate purpose or distribution of profits.

In contrast, the general rule for corporations is of a 50% majority for the company's deliberations, which applies to common shares with voting rights. This percentage may be increased in the bylaws, for specific matters or as a general rule. Sometimes, a transformation from a corporate type into another may be considered as a means to shift control between shareholders (transformation, however, requires unanimity). In any case, it is important to make a detailed evaluation of the quorum requirements, since the law contains a vast number of rules that apply in specific situations.

7. Management Bodies

There is freedom to organize the administration of Brazilian companies, as long as certain minimum rules are observed. For instance, LLC's require the appointment of one single administrator, at least; it does not require a Board of Directors, though it is possible to create one. LLC's may be governed by the Corporations Law if the shareholders so wish, in regard to issues that are not addressed by the Civil Code.

Corporations require a minimum of two officers, and the Corporations Law contains the rules for the creation of a Board of Directors, which is optional for privately held Corporations and mandatory for listed ones.

8. Corporate Governance and Compliance

Corporate governance and compliance aspects have gained more relevance in M&A deals in the past 10 years. With the development of the Brazilian business environment and its capital market, allied to a strong flow of foreign investment, Brazilian companies have been obliged to adapt its governance patterns in order to comply with foreign standards and new local rules.

This has been helping to improve and develop important management tools, providing more transparency and security to companies' financial statements and minimizing other liabilities which could arise from the management's acts.

Listed corporations shall engage with corporate governance proceedings established by the Brazilian Stock Exchange, according to the applicable level of governance required. Higher levels of corporate governance demand a company´s compromise with some obligations, which may affect the transactions involving partial share purchases of listed corporations with multiple shareholders, especially in regard to minority rights.

Privately held corporations and LLC's, however, have no additional corporate governance obligations besides those stipulated on the applicable legislation.
In what concerns compliance constraints, Brazil has enacted a new anticorruption law (Federal Law 12.846) in 2013, which has gained significant importance in M&A transactions.

With major politicians and companies under investigation for corruption and given the wide media coverage that this subject has received, there is a strong concern with avoiding, or at least mitigating, the liabilities that may arise from illegal practices of purchased companies, which are inherited by the new owner.

Upon the transfer of assets, the successor may inherit liabilities related to illicit acts against the Administration: penalties and damages may be charged from the successor, limited to the amount of the transferred assets; however, only in case of fraud will additional sanctions apply against the successor. Affiliates (controllers, controlled or sister companies) may also be held jointly liable with the company directly involved in unlawful practices, and so can be the foreign companies with a subsidiary or office in Brazil.

Under the anticorruption law, companies that engage in unlawful activities can now have their penalties reduced if they adopt internal compliance procedures such as implementing regular audits, encouraging the revelation of wrongdoings and applying ethical principles in the business. Since there may be an attempt to conceal illicit activity, the due diligence investigations will typically attempt to obtain a declaration from sellers that the company has not been involved in such practices – which is tied to the indemnification clauses, besides requesting evidence that compliance measures have been adopted.

9. Minority Rights

Minority rights is a theme that becomes relevant when multiple shareholders coexist in a given company, and is not an issue in the case of wholly-owned or family enterprises without conflicts of interest. Since Brazilian laws regulate the quorum for deliberations in detail, they must often be taken into consideration for determining a shareholder's level of control pursuant to acquisitions or any change in the voting powers of a company's owners.

The law provides certain assurances to minority shareholders. However, these assurances are few, and it is recommended that additional ones are negotiated and included in the bylaws or shareholders agreements. This is the case of preemptive and first refusal rights, call and put options, tag and drag along rights, lock-up periods, among others.

The Civil Code contains little topics of protection to the minority shareholders of LLC's. The Corporations Law, on the other hand, brings a few rules for the protection of the minorities within corporations – and these rules may be applicable for LLC's if the shareholders so determine. These include, among others: the right not to be excluded from participation in profit distributions and in the assets remaining after liquidation; a right to information and access to all matters involving the company; the right to subscribe to new share issuances, thus avoiding dilution; a 50% minimum for the approval of specific matters in shareholders' deliberations; the right to leave the partnership in case of disagreement on certain issues.

The scheme where two partners share equal ownership of a company, both holding 50% of the voting power, is not advised unless there are clear rules in place for resolving deadlocks. Otherwise, that shareholding configuration may require that all decisions are made by mutual agreement, which has a potential for leading to judicial disputes.

10. Due Diligence

After preliminary negotiation, the legal process of acquisition typically starts with due diligence on the target company belonging to the seller, particularly relevant in Brazil due to the intricate set of rules regarding succession of liability.

Conduction of these procedures has shifted ever more to the virtual data room system, with remote analysis of the documentation, which brought a significant cost reduction for clients. A visit and interview with the seller is always important, but the need to deploy a whole team for a data room at seller's location has been more and more rare.

The seller and its advisors play an important role in the efficiency of the due diligence investigations. Some information is publicly available, and though the information should ideally be provided by the seller, it is possible to rapidly obtain many certificates or compare the information provided in the data room with information gathered independently.

In general, it is possible to obtain a list of the administrative proceedings and lawsuits in course against a given company or person in the civil, criminal, tax and labor spheres. Depending on the matter, the research may have to be conducted in several locations (including different States), as the competence for processing certain claims will vary according to several factors. It is also possible to verify compliance of a company or individual with tax authorities, though the details of the tax situation are protected by constitutional secrecy and the information will be, in some cases, very limited.

Much of the corporate information of companies can be obtained online, though the system varies from State to State and, in the case of corporations, the shareholding is anonymous, and it depends on entries in the corporate books, which are not public.

Brazil adopts a real estate registration system which is also local, there being no unified national database. Furthermore, many properties are not taken to registration given the notary and tax costs, with land owners holding merely the title that will enable them to complete the transfer eventually. All of this requires careful examination and must be resolved prior to the closing of a transaction, or properly addressed in the negotiation and in the purchase agreements.

When the business of the players involved in the transaction has a potential to originate any environmental impact, the due diligence shall cover this relevant aspect as well, given that Brazilian environmental legislation is extremely severe with the succession of liability over damages caused by illegal practices, which may result in heavy fines and penalties for the companies and its representatives.

11. Taxation

11.1. Goodwill Amortization arising from corporate acquisitions in Brazil

Federal Law nº 12.973 of 2014 brought new regulations for entities that intend to seize the tax benefit of goodwill amortization in corporate acquisitions.

The first requirement consists in the segregation of the investment value in equity interest, as follows:

i. Net equity;
ii. Surplus value of assets, corresponding to the difference between the fair market value and the net equity value, in the proportion of the investment; and
iii. Goodwill based on future profitability.

Once the investment value is segregated, the goodwill shall be determined by the Purchase Price Allocation method, which consists in the remaining balance between the acquisition price and the adjusted net equity, added by the

The valuation of the fair market value must be based on a report prepared by an independent expert prior to the investment date and filed with the Federal Revenue Service of Brazil or registered in a Registry of Deeds and Documents up until the last working day of the 13th month following the acquisition.

If Brazilian tax authorities believe that the data contained therein presents defects or inaccuracies of a relevant nature, they may disregard the expert's report.

In order to amortize the goodwill based on future profitability, both the investor and the invested entity must be the object of a merger, reverse merger, spin-off or consolidation transaction.

A tax benefit arises from said corporate restructuring, as the goodwill generated in the acquisition becomes tax deductible for the purposes of ascertaining Corporate Income Tax (IRPJ) and Social Contribution over Net Profit (CSLL). The goodwill amortization can only be made at a maximum rate of 1/60 for each verification period.

It is important to highlight that the goodwill tax benefit is only applicable if the transaction is performed between non-dependent parties.

Furthermore, it should be noted that tax amortization of goodwill based on expected future profitability is an extremely controversial issue before Brazilian tax authorities.

As general rule, tax authorities tend to challenge corporate restructuring if they believe that:

a) The investing entity was used as a vehicle company strictly for goodwill amortization purposes, fol lowed by corporate restructuring; or

b) The transactions that generated the goodwill lacked economic substance.

With the lack of further information from tax authorities, it is quite common to face questions over the form and content needed to produce effective support documentation for goodwill purposes.

This is also a controversial issue in administrative case law. There are past rulings from the Federal Administrative Court (CARF) which allowed goodwill amortization through "vehicle companies", and others that did not.

Given the need to comply with several legal requirements, the lack of information from tax authorities and the uneven administrative court precedents, it is crucial for investors to seek legal advice before acquiring equity interest in Brazil, as the acquisition structure directly influences the fate of goodwill amortization.

11.2. Tax Liability on the Succession of Legal Entities

The succession of tax liabilities directly affects the parties involved in a corporate restructuring.
The statute of limitations for taxes is generally five years in addition to the following year of the tax event.

Whoever acquires real estate is a successor for real estate taxes related to the asset. Thus, the liability for taxes such as ITR (tax levied over rural real estate properties) and the IPTU (tax levied over urban real estate properties) is fully transferred to the new owners of the asset (land plots) acquired.

The company resulting from acquisition, merger, consolidation or spin-off shall hold liabilities for taxes due up to the date of the restructuring. Such provision applies on the extinction of legal entities, whenever the respective activity is continued by any remaining partner, or its assets are under the same or a different company name, or under individual companies.

In the event of extinction of a legal entity, as a result of a corporate restructuring, the tax liability is held by the entity that continues the business.

Moreover, in the event of business (fundo de comércio) or place of business (estabelecimento comercial) acquirement only, the liability is primary and equal to the seller's if the seller ceases its operations; and secondary if the seller continues its operations or, within six months from the sale date, initiates new activities whether in the same or another line of business.

When acquiring a legal entity from an economic group, it should be noted that liabilities from another entity from that same group could be passed on to another, even after the acquisition by a non-related party.

In general, Brazilian tax authorities cannot charge taxes from a company belonging to the same economic group as the debtor, since the Disregard of Legal Entity is an exception in regard to tax matters.

However, the companies from the same economic group will be jointly and severally responsible in case: (a) they have common interest in the fact that constitutes the taxable event of the principal obligation; and/or (ii) if it is expressly determined by law (the joint and several liabilities referred herein do not provide the benefit of order).

The Federal Revenue Service of Brazil established a broader concept so that a corporate group may be qualified as an "economic group" whenever two or more companies are under direction, control or administration of one of them, forming an industrial, commercial or other kind of business group.

In order to redirect the tax liability from one company to another of the same economic group, the Brazilian Superior Court of Justice decided that the companies must necessarily act together in the situation that leads to the taxable event, being irrelevant the simple participation in one's profits by the other.

Regarding social security contributions, all companies from the same economic group and under the same management may be considered jointly and severally liable, even in cases that do not involve fraud and deceit.

In cases of corporate entity abuse, fraud and/or deceit, companies from the same economic group may be jointly and severally liable regarding all sorts of taxes.

Unless the law provides otherwise, the effects of joint and several liability are: (i) the amount paid by one of the required parties benefits the others; (ii) tax exemption or remission exonerates all of the required parties unless it is granted personally to one of them, remaining, in this case, the solidarity among the others towards the balance; (iii) the interruption of the statute of limitation, in favor or against one of the required parties favors or affects the others.

12. Successor Liability – Statute of Limitations

Successor liabilities being a key factor in the preparation of the purchase agreement, it is crucial to take the statute of limitations in consideration, especially when negotiating the duration of seller's liabilities. The general rules (subject to variations based on the specificities of each case) are the following:

- The statute of limitations for tax and social security claims is generally five years, in addition to the year of the tax event.
- Regarding labor claims, an employee may file a suit for over amounts due in the period of the five previous years, but in case of dismissal, the lawsuit must be initiated within two years.
- For civil claims, the statute of limitations may vary between one to ten years, depending on the case. Claims concerning administrative improbity are usually limited to five years, although the reimbursement of public funds could be claimed by a Public Prosecutor at any time.

• Environmental claims are subject to different time limitations depending on whether the claim occurs in the administrative or judicial spheres, and if they are of a civil or criminal nature. The prevailing interpretation is in the sense that environmental damages – civil – are not subject to limitations and can be made at any time, although there is some dispute regarding that theory. Administrative claims are normally possible within five years and criminal charges obey a range that depends on the nature of the offence.

13. Officers' Liability

Officers, which have different denominations depending on the corporate format (administrators in the LLC's and directors in corporations, to mention the most relevant ones) are typically responsible for the legal representation of the company, either alone or in conjunction with others, depending on the rules adopted by each entity in particular. Under Brazilian laws, they may be held liable for debts and obligations of the company, generally (but not exclusively) when they deviate from their statutory duties or act against the law, or in contrast to the company's directives.

14. Acquisition in the context of Judicial Recovery and Bankruptcy

Given the severe rules of Brazilian laws regarding the extension of liability from a company to its shareholders, as well as to the officers, this issue is normally the most sensitive in any acquisition. However, there are two situations where it is possible to eliminate the risk entirely, which represent the only forms of acquiring participation without concerns of suffering any negative consequences of succession.

That solution is provided by the Bankruptcy Law (Law 11,101 of 2005). In the context of judicial recovery – a Court-organized restructuring, prior to bankruptcy – or in case of declared bankruptcy, the law permits the transfer of specific assets or productive units without carrying former liabilities.

This may not always be easy to implement, given that it requires approval by the creditors or by a judge (depending on the case) and a sale of assets which may not find a purchaser. Some restrictions apply regarding the identity of the purchaser, which cannot be related to or acting on behalf of the former shareholders, which would represent fraud. Still, it is a method of acquiring a clean asset.

15. Regulatory Concerns

When entering into an M&A process in Brazil, certain fields of activity will require a thorough regulatory examination.

In particular, health and sanitation, financial institutions, security and surveillance, aviation, telecommunications and energy are heavily regulated and demand the support of a specialist.

Rules such as minimum capital requirements, mandatory licenses and approvals – sometimes lengthy and very bureaucratic, requirements as to certain percentages of participation by Brazilian nationals or adoption of a certain amount of national components are typical in these situations.

16. Antitrust Rules

Antitrust clearance from the Brazilian authority (CADE) is mandatory in certain situations that could originate economic concentration, where the criteria for determining such need is based on thresholds of revenue of the companies involved.

Federal Law 12,529 of 2011 sets forth the values in its article 88, later modified by a joint decision of the Minister of Justice and the Minister of Finance (Portaria Interministerial 994 of 2012), as permitted in the law. As a result, the current rules are the following:

> I – at least one of the groups involved in the transaction must have a gross revenue, from its activities in Brazil, during the year preceding the acquisition, equal or higher than R$ 750,000,000.00;
> II – at least one other group involved in the transaction must have a gross revenue, from its activities in Brazil, during the year preceding the acquisition, equal or higher than R$ 75,000,000.00.

The two conditions are cumulative, so it does not suffice that one group exceeds the threshold - both conditions must be verified simultaneously.

17. Conclusion

As exposed above, M&A transactions in Brazil involve multiple relevant legal aspects, which generally trigger important concerns in foreign investors.

Given the complexity of the Brazilian legislation structure and its peculiar conditions, the parties should always hire and count on the support of high-quality legal advisors for such transactions in order to ensure that all important legal aspects of the deal are observed and to help mitigate any risks.

This article is meant to provide an overview of the M&A environment in Brazil. It is meant to serve solely for information purposes and is not to be used as legal advice. Legal norms are subject to change, and these occur frequently. Despite the generality of the subjects presented herein, circumstances of a particular situation may significantly affect the application of any rules mentioned or referenced in this article, and for this reason TMBJ does not give any warranties of completeness, accuracy or reliability of any such information, and will not be held liable for any losses or damages resulting from its use. For actual legal advice, please consult us.

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