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Making the past, present and future more certain

Luís Gustavo Haddad and Bruno Robert of Lilla Huck Otranto e Camargo Advogados explore three past, present and future legal issues affecting M&A deals in Brazil

There are three key legal issues affecting M&A deals in Brazil. Besides their close connection with Brazilian laws, regulations and institutions, these issues also have in common their potential relevance for planning and executing M&A deals in Brazil. From a broader perspective, the first issue is tied to the past. It was raised by a new interpretation of a rather old statute imposing restrictions on the acquisition of rural land by non-residents. The second is a present one, related to Brazilian competition law in force since May 2012. The third issue draws our attention to the future, especially to the prospects of regulations and self-regulation in M&A deals involving public companies.

Shadows from the past

One of the distinguished competitive advantages of the Brazilian economy is the strength of its agribusiness sector. Animal protein (both processed and in raw form), sugar and ethanol, soybeans and related products, orange juice, corn, pulp and paper, among others, play an extremely important role in the country's exports. In spite of the well-known hurdles in infrastructure, such as the under-capacity of roads and ports, Brazilian agribusiness remains competitive and represents a crucial driver in the country's economic growth and development. A natural consequence of this strength is the interest of foreign investors in Brazilian agribusiness companies. Approximately 10 years ago, the sugar and ethanol companies, for instance, were controlled almost exclusively by Brazilian nationals. Since then, and especially after the financial crisis of 2008, foreign investments in this field have increased substantially.

It is quite evident that among the most relevant assets of these agribusiness companies are the farmlands that they own or lease. In the sugar and ethanol industry, for example, it is strategic to assure the availability of raw materials (sugar cane, for example) – and land, as a consequence – in areas close to the industrial facilities, since the cost of freight directly affects the margins and the competitiveness of the business as a whole. Alongside the international demand for agricultural commodities, these kinds of factors have been responsible for a significant impact on the price of farmland in Brazil during the last years. Not only an ordinary operational asset, farmland is also perceived by investors as an alternative to ordinary financial assets, capable of reserving economic value and leveraging profitability over the time.

As from 2010, however, the Brazilian legal environment became potentially hostile and it was unclear whether foreign investors could have control over Brazilian companies owning farmland.

The root of the problem resides in the interpretation of Brazilian Federal Law No 5,079, of 1971, in light of the Brazilian Federal Constitution. Article 1, paragraph 1 of the 1971 statute expressly extended the limitations on acquisition of farmland by foreign individuals and companies to Brazilian companies controlled by non-residents (individuals or companies). Brazilian real estate registries, though, have never been prepared to exercise a strict surveillance on the capital and control structures of companies acquiring farmland in Brazil. From 1971 to 1988, although the legal restriction existed, it was never put in practice. In 1988, the then new Federal Constitution, in its article 190, provided for the imposition of restrictions to the ownership of farmland by non-residents, but did not mention Brazilian companies controlled by non-residents. It was widely understood that the rule extending the limitation to Brazilian companies controlled by non-residents was no longer accepted by the Federal Constitution. Further to that, in 1995, the Federal Constitution was amended in its articles 170 and 171 to abolish general different legal regimes applicable to Brazilian companies according to the cir-

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cumstance of being controlled by Brazilian nationals or foreigners. Accordingly, under this perspective, the limitation contained in the 1971 statute appeared to be dead and buried.

A famous Brazilian economist once said that, in Brazil, not only the future is uncertain; the past may be uncertain too. This proved to be true in 2010, when a legal opinion issued by Federal Attorney-General argued that article 1, paragraph 1 of the 1971 statute was in fact compatible and consistent with the Federal Constitution (in spite of the 1995 sixth amendment) and should be immediately enforced by all real estate registries, which should reject any real estate transaction involving companies that could not be proven to be controlled by Brazilian residents (Parecer da Advocacia Geral da União – LA – no 01/2010). Such legal opinion created a significant uncertainty in the Brazilian agribusiness sector. Would the legal opinion remain in force, as mandatory advice for all federal authorities, irrespective of the immediate backlash by the business community? How would it impact transactions already concluded? These are just two of the multiple questions that the intended revival of the 1971 limitation raises. No one can deny that the aforementioned opinion resulted in a critic legal issue to all M&A deals involving Brazilian companies having rural areas in its assets. Something like a shadow from the past haunting the present and the future.

It is not yet possible to make straightforward assertions about how this scenario will develop. From an investor-oriented standpoint, however, there are two recent pieces of good news that need to be considered. Firstly, by September 2012, there were two projects being discussed in the Brazilian Congress aiming at the modification of the 1971 statute, with special regards to extinguish the limitation on the acquisition of rural areas by Brazilian companies controlled by foreigners (Projects 2,289/2007 – Dep. Homero Pereira; and 4,059/2012 – from the Agriculture Commission). Secondly, on top of these projects, on December 2012, the São Paulo Estate Court of Justice – with jurisdiction over real estate registries in São Paulo – expressly rejected the enforcement of the 1971 statute, claiming it is unconstitutional and unable to restrict the ownership of farmlands by Brazilian companies controlled by foreigners. The decision is still limited to the State of São Paulo, but it is expected to encourage other initiatives to counterbalance the 2010 federal legal opinion.

An expected adjournment: the new competition law

On May 29 2012, Brazil's New Competition Law (Law no. 12,529/11) entered into force. It introduced reforms in different important aspects of Brazilian competition policy and has significantly impacted the way in which M&A deals are framed, subject to competition control, and implemented.

The most immediate and relevant modification to M&A deals is the shift from a post-merger review system to a pre-merger review system. Under the old Brazilian Competition Law (Law No 8,884/94), mergers could be, and usually were, consummated before the competition authority issued its opinion. According to the new Competition Law, the consummation of mergers meeting the thresholds set forth in law have the previous approval by the Council for Economic Defence (Cade) as a condition precedent to their implementation. No deal considered relevant, for competition purposes, may close until Cade issues a final decision assuring a green light to the transaction.

> "The most relevant modification to M&A deals is the shift from a post-merger to a pre-merger review system"

The implementation of the pre-merger review system seems to be an attempt to provide incentives for the parties involved in merger transactions to cooperate and to accelerate the competition review processes, and to facilitate the imposition of post-merger remedies by Cade.

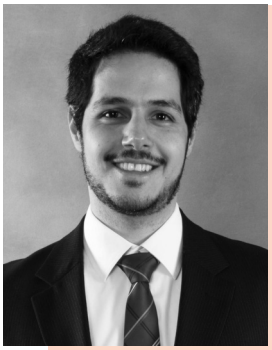
Another reform introduced by the new Competition Law concerns thresholds for triggering mandatory merger filings with Cade. In the first place, the market share test – which considered relevant the market shares resulting from the merger that exceeded 20% of a particular relevant market – was excluded from the new Competition Law.

The new statute foresees a secondary objective parameter. The revenue threshold test set forth in the new Competition Law requires not only that one of the parties involved in the deal has reached in Brazil group-wide revenues of at least R$750 million ($380 million), but also that another party to the deal has reached in Brazil group-wide revenues of at least R$75 million (*cf.* Interministerial Ordinance No 994/2012). This means that the revenues of more than one party involved in the deal are considered for triggering mandatory filings.

In spite of establishing the pre-merger control, the new Competition Law also authorises Cade to review transactions on a retrospective basis, within one year of the consummation of the deal, even if the revenues of the parties involved fall below the above mentioned figures. The new monetary threshold was aimed at reducing the amount of mergers submitted to Cade that had no significant impact on competition, such as cases in which a large company acquired small businesses.

Transactions subject to mandatory filing and consummated before being filed with Cade will be regarded as null and void, and the parties involved in the deal may be subject to fines ranging from R$60,000 to R$60 million.

The business community had concerns about how long Cade would take to approve transactions under the pre-merger review system. In the post-merger review era, the analysis of Brazilian competition authorities sometimes took years to be concluded, which turned into a nightmare under the



About the author

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pre-merger review system. Fortunately, and up to this moment, Cade has managed to analyse and decide the cases in a rather expedited way. Transactions with a low or medium level of competition complexity are being reviewed, on average, within 20 to 40 days. It is worth noting that once Cade's decision is rendered, the deal may only be actually closed after a 15-day period elapses. These are relevant milestones to be taken into account in planning M&A transactions and in drafting transaction documents.

The new Competition Law appears to be taking Brazil's competition policy to a new level, clearly closer to international standards. This is happening in an important moment, since the Brazilian economy is facing positive momentum and significant foreign investment inflows are becoming a regular feature of the country's business environment. From an M&A perspective, it is certainly good news that the new competition statute moves Brazil towards the group of solid and reliable jurisdictions with respect to competition law and enforcement.

Next stop, the future

In spite of its history of highly concentrated corporate control, familiar ownership structure, and archaic business environment, Brazil is now becoming a land of more sophisticated corporate governance regulation.

What looks like a paradox at a first glance, finds explanation in the significant development of the Brazilian capital markets in recent years. The last decade witnessed an unprecedented increase in the complexity and popularity of investments in listed companies, fuelled by a boom on the economy, consumption, and foreign investments.

The Brazilian stock exchange became one of the biggest globally, had some of the larger securities offerings in history, listed more than one hundred new companies in a couple of years, revealed the securities world to thousands of new investors, and implemented one of the most successful experiences in self-regulation and corporate governance, the Novo Mercado.

The corporate and M&A markets in Brazil grew proportionally, and transactions involving listed companies, or benefiting from capital markets tools, became a reality.

Conversely, securities regulation is still catching-up and also recently became a new must-take-in-consideration for new transactions.

> **"The last decade witnessed an unprecedented increase in the popularity of investments in listed companies"**

Among the main innovations, aiming at the construction of a regulatory framework that prepares the country for an era of M&A linked to the capital markets, three deserve to be highlighted: the enactment of *Parecer de Orientação* No 35 by the Brazilian SEC (CVM); Rule CVM No 481; and the creation of the *Comitê de Fusões e Aquisições* (CAF).

The first, *Parecer de Orientação No 35*, is a safe harbour established by the CVM in connection with transactions involving related companies. In accordance with the document, the organisation of independent committees in each of the companies involved, responsible for effectively negotiating the conditions of the transactions, and the submission of the transaction to approval, in both companies, exclusively by non-controlling shareholders, are considered by the regulator as steps that lead to an assumption of fairness in the transaction.

Transactions that do not follow those guidelines will likely, and inversely, be subject to closer scrutiny by the CVM.

The second, Rule CVM No 481, besides providing comprehensive transparency and informational requirements in case of transactions proposals, also makes up the first ever proxy solicitation legislation in Brazil.

One of the sensitive issues within the scope of the rule is director nomination. Section 28 requires the inclusion in the company's proxy material of nominees to the board of directors indicated by minority shareholders owning at least 0.5% of the totality of the company's shares.

Another interesting feature of Rule CVM No 481 concerns the cost allocation structure for proxy solicitation. Following international regulations, the Brazilian rule shifts the cost burden by providing that companies are responsible for reimbursing expenses incurred by shareholders with proxy solicitation. Particularly, such rule gives incentives for the use of internet-based systems, as it shifts the cost burden exclusively to companies that do not employ online proxy solicitation mechanisms.

All in all, it is clear that the Brazilian market is already prepared to use proxy machinery as a catalyser or a blocker of transactions involving listed companies, which is a relevant piece of information for the M&A sector.

The third, the CAF, is a self-regulatory entity created with grounds based on the experience of the UK Takeover Panel.

It is a private entity created to overview transactions involving listed companies that spontaneously decide to adhere to the CAF's self-regulatory norms. Its rules are not binding on companies that decide not to take part, and do not overrule any legislation or securities regulation.

The panel is responsible for evaluating whether the prescribed steps to assure fairness, independency, and transparency in the transactions have been taken. It does not make any business judgment.

The Brazilian SEC has publicly granted its institutional support to the CAF and formally decided to recognise an assumption of correctness in all transactions that follow the CAF's norms.

No transaction has been submitted to the CAF yet, and the norms are still under elaboration and discussion. But once operational, the entity is likely to contribute to renovate the legal framework for M&A transactions in the country.

About the author

Bruno Robert graduated in law from the Universidade de São Paulo and holds a master's degree in corporate law from the same university and an LLM in financial and securities regulation from Georgetown University Law Center. He has worked for the Brazilian and the US SEC. He is a member of the Brazilian Bar Association (OAB). Robert's practice is focused on corporate and securities law.

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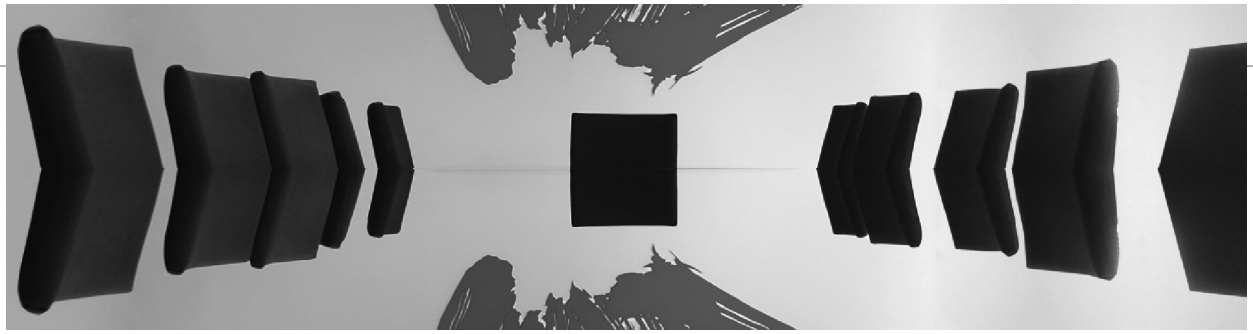

M&A

The M&A area is a main pillar for Lilla Huck Otranto e Camargo Advogados.

Our professionals have worked together for many years, making them a cohesive team which combines experience and solid academic formation.

The office is capable to serve clients of all sizes – and operating in virtually any economic sector – in merge and acquisitions. The team acts on operation planning (both contractual or corporate transactions), conducting or overseeing due-diligences, negotiating and concluding contracts, submitting operations to regulatory agents and the anti-trust system, as well as advising clients during all the stages of closing and after-closing operations, including the design of the corporate governance framework for all sorts of investment structure and business combinations.

Especially since the enactment of Federal Law Nº 11.101/05, we have also developed important expertise in debt restructuring processes, project finance, warranties analysis and structuring, purchasing assets in special situations – including judicial and extra-judicial reorganizations proceedings. The office has advised debtors, creditor and investors on the main corporate reorganizations in the country, always with bespoke multidisciplinary working groups.

The team also advices listed companies and other securities market agents on regulatory matters regarding M&A transactions and corporate reorganization, dealing with all the steps concerning regulation, negotiation with shareholders and other stakeholders, transactions approval on shareholders meetings, proxy solicitation, and before the Brazilian Securities and Exchange Commission (Comissão de Valores Mobiliários – CVM).

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