Private Equity in Brazil

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General Overview

Private equity activity in Brazil has increased significantly, especially since 2004, when the Brazilian economy showed considerable stability and the IPO market flourished.

Among the industries targeted by private equity investors are sugar cane and ethanol, real estate, consumer goods, technology and infrastructure (which is expected to be very promising for private equity since there is a strong need for infrastructure investment in Brazil).

I. The Private Equity Vehicle

A. Equity Investment Fund

In 2003 the Brazilian Securities and Exchange Commission (*Comissão de Valores Mobiliários* - "**CVM**") issued Rule No. 391, which governs the so-called *Fundo de Investimento em Participação - FIP* ("**FIP**"), which is the typical private equity fund vehicle in Brazil.

The FIP is an investment fund whose purpose is to raise funds in the capital market with the objective of making investments in accordance with applicable rules and its investment policy as set forth in the FIP's charter (*regulamento*). As such, the FIP is subject to a set of rules aimed at protecting its investors.

The FIP is a closed-fund having a defined period of duration and is permitted to invest in private or public corporations (*sociedade anônima* - "**S.A.**").

As a general rule, the FIP may acquire shares, debentures, subscription bonuses and securities convertible into shares issued by private[1] or public S.A.s. FIPs are required to participate in the decision-making process of such issuers and exert real influence on their strategic policy and management (especially through the appointment of members of the board of directors). The FIP is not allowed to invest directly in other types of companies (e.g., limited liability companies) or real estate properties, or to invest abroad.

1 In order for the FIP to invest in a private S.A., the latter must meet certain minimum corporate governance requirements set out in CVM Rule no. 391.

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In order to subscribe or acquire FIP quotas, the investor must be a "qualified investor". As defined in CVM Rule No. 409, promulgated in 2004, "qualified investors" are: (i) financial institutions, (ii) insurance companies and capitalization companies (*sociedades de capitalização*), (iii) open or closed complementary pension entities, (iv) individuals or legal entities with financial investments exceeding R$300,000 and which confirm that they are qualified investors by means of the execution of a specific statement, (v) investment funds aimed exclusively to qualified investors, (vi) administrators of securities portfolios and securities advisors authorized by the CVM, with respect to their own funds, and (vii) certain social security regimes organized by the Federal Government, Federal District, States or municipalities.

The minimum amount to be subscribed by each investor is R$100,000.

Some features of the FIP are outlined below:

1. *Portfolio*: As briefly mentioned above, the FIP may acquire shares, debentures, subscription bonuses and securities convertible into shares issued by private or public S.A.s, and shall exert real influence on their strategic policies and participate in their management. The participation of the FIP in the decision-making process of the invested S.A. may be effected by means of: (i) ownership of shares that are part of the invested S.A.'s share control, (ii) execution of a shareholders' agreement, or (iii) execution of a different type of arrangement or adoption of a procedure giving the FIP actual influence on the definition of the strategic policy and participation in the management of the invested S.A..

2. *Registration with the CVM*: The commencement of the activities of the FIP is dependent on previous registration of the FIP with the CVM. In general terms, this registration will be automatically granted upon the filing of certain documents and information with the CVM. New distributions of quotas of the FIP are also conditioned upon their prior registration with the CVM, which registration will also be automatically granted upon the filing of certain documents and information with the CVM.

   In principle, the CVM will only register FIPs that carry out the public distribution of their quotas by means of an institution that is part of the Brazilian securities distribution system.

3. *Management*: The FIP must be administered by a legal entity registered and authorized by the CVM to perform professional portfolio management services, which may also retain a manager (gestor), provided that it is also registered and authorized by the CVM. If retained, the manager's main duty is to decide on the investments to be made by the FIP and on the sale of its assets.

   If the administrator is not a financial institution member of the Brazilian securities distribution system, it must retain such an institution to perform services relating to the distribution of quotas and treasury, such as: (i) the opening and operation of bank accounts in the name of the FIP,

(ii) the receipt of funds/proceeds upon the issuance or payment of quotas, and the payment upon the amortization or redemption of the quotas or the liquidation of the FIP, (iii) the receipt of dividends and other proceeds, and (iv) the financial settlement (liquidação financeira) of all transactions performed by the FIP.

The administrator is empowered to exercise all rights relating to the securities held by the FIP, including attending the shareholders' meetings of the invested S.A.s and granting such powers to the manager. The FIP may have a committee whose purpose is to share with the administrator or with the manager the decisions regarding the FIP's investments.

The FIP's charter will set out the fees to be paid to the administrator (which may include a performance fee) or provide the criteria for its calculation.

4. *Possibility of granting different rights to the quotas/investors*: In principle, each quota will grant to its holder one vote at the investors' meetings. Nevertheless, according to the currently applicable rules, the quotas of a FIP may grant different voting (political) rights to the investors, provided that the rights conferred by each class of quotas are duly defined in the FIP's charter.

   The quotas of a FIP will grant the same economic rights to all investors, except that the FIP's charter may provide that different classes of quotas may be responsible for different fees to the administrator of the FIP, including performance fees.

   Please note that the quotas of a FIP cannot be redeemed and that the profits and proceeds obtained by the FIP are distributed to the investors through amortizations (amortizações).

5. *Disclosure Requirements*: The FIP is subject to disclosure requirements, including but not limited to, the need to prepare and to submit to the CVM (as well as making available on the CVM's website) annual and semi-annual financial statements prepared in accordance with specific rules. In addition to other information, the FIP will also (i) make available an opinion with respect to its operations and results, (ii) disclose its net worth and number of quotas issued every quarter, (iii) disclose its portfolio and the amounts charged from the FIP every semester, (iv) disclose the net worth value of the quotas and their profitability in the fiscal year, and (v) disclose material facts or acts relating to the FIP.

   The annual financial statements of a FIP must be audited by an independent auditor registered with the CVM.

6. *Certain Restrictions on the Operation of the FIP*: Among others, FIPs are prevented from obtaining or granting loans, except as defined by the CVM (i.e., loans from multilateral entities - *organismos de fomento*); granting

guarantees or pledging their assets; investing funds abroad; investing funds in the acquisition of real estate properties or in the subscription or acquisition of the quotas they issued.

Generally, foreign investors seek to make their investment in the FIP through a specific mechanism provided by the Central Bank of Brazil (Banco Central do Brasil) for the remittance of cash to Brazil for investment in the Brazilian capital markets. Resolution No. 2,689 issued by the Brazilian Monetary Council (Conselho Monetário Nacional) in 2000 governs this mechanism and sets out the applicable requirements. Investments made in accordance with this resolution may afford the investor beneficial tax treatment with respect to Brazilian withholding income tax, provided that the investor is not domiciled in a low-tax jurisdiction and certain other requirements are met.

Because of the characteristics and requirements imposed on the FIP, some investors may prefer to set up a Brazilian company. The most commonly used type of company is the limited liability company - s*ociedade empresária limitada* (“**Ltda**.”), although in certain cases S.A.s may be the preferable option. In addition to not being under the supervision of the CVM (except in case of public S.A.s), companies may afford more flexibility in terms of management and the possibility of granting different economic rights to their equity holders.

B. Limited Liability Company

Outlined below are some features of the Ltda.:

1. *Activities*: The Ltda. is not qualified to carry out certain regulated activities such as banking and insurance (only S.A.s are).

2. *Equity holders*: A minimum of two equity holders is required. Equity holders may be individuals or legal entities (whether or not Brazilian). Non-residents must appoint Brazilian resident individuals to represent them locally.

3. *Capital*: Generally, no minimum capital requirement applies. The capital of a Ltda. is divided into quotas that are represented in the articles of association of the Ltda. The capital may be increased only after it has been fully paid-up. Each quota shall grant the right to one vote (generally, up to fifty percent of the shares of an S.A. may consist of non-voting preferred shares). The articles of association of the Ltda. may set out different rights for the quotas with respect to the participation in the profits, provided that no equity holder can be prevented from participating in the profits.

4. *Management*: The Ltda. is managed by at least one Brazilian resident individual (officer). In order to act as officer, foreign individuals must hold a permanent visa. The officers may or may not be equity holders. If the articles of association authorize the management of the Ltda. by third parties (non-equity holders), their appointment is subject to the approval by: (i) all equity holders, if the quotas are not fully paid-up; or (ii) equity

holders representing at least two-thirds (2/3) of the Ltda.'s capital if the quotas are fully paid-in. If the officer is an equity holder, his/her appointment in the articles of association is subject to the approval by at least three-quarters (3/4) of the Ltda.'s capital, and, if the appointment is made in a separate document, to the approval by equity holders representing more than half of the Ltda.'s capital.

5. *Audit*: Audit is not required, unless the Ltda. (or group of companies under common control) had, in the previous fiscal year, assets in an amount equal or exceeding R$240 million or gross revenues exceeding R$300 million. In such case, the Ltda. will be audited by an independent auditor registered with the CVM and the provisions of the Brazilian Corporations Law (Law No. 6.404, promulgated on December 15, 1976, as amended) regarding accounting records and preparation of financial statements will apply.

   The Civil Code authorizes the installation of an audit committee (*conselho fiscal*) composed of at least three (3) members.

6. *Disclosure requirements*: There are no requirements regarding publication of financial statements. Only specific decisions of the equity holders need to be published in the press.

   With regard to direct foreign investments in Brazilian companies such as Ltdas. or private S.A.s (i.e., performed outside the securities market), the cash remitted to acquire or to increase the capital of the Brazilian company must be registered with the Central Bank of Brazil's electronic system as direct foreign investment in the Brazilian target company (the so-called *RDE-IED* registration).

C. Other Vehicles

Other vehicles may be appropriate depending on the circumstances, such as the real estate investment fund (*fundo de investimento imobiliário*), the emerging companies investment fund (*fundo de investimento em empresas emergentes*) or the infrastructure investment fund (*fundo de investimento em participações em infra-estrutura*).

II. Acquisition of the Targeted Company

Private equity investments are commonly made through the acquisition and/or subscription of equity participation in the target company (i.e., quotas of a Ltda. or shares of an S.A.), which, in many cases, consists of a minority stake. It is important to bear in mind that FIPs can only hold direct investment in S.A.s.

Acquisitions in Brazil are not usually implemented by means of mergers. According to Brazilian law, a merger is a transaction under which a company is absorbed by another company, with the latter becoming the owner of all the assets and liabilities of the former. In exchange for their equity participation in the merged company, the equity holders of the merged company are issued shares of the surviving company, at a ratio to be established as provided in the Brazilian Corporations Law.

Private equity investments in Brazil are often made through a company acting as an acquisition vehicle. One of the reasons for such structure is the fact that private equity entities organized as a FIP are not allowed to borrow money (except from multilateral entities). However, this restriction would not apply to the acquisition vehicle. The leverage component in buyouts will, of course, depend on the interest rates available in the market.

Another reason for making the investment through a Brazilian acquisition vehicle is the possibility, subject to careful analysis by tax advisers on a case-by-case basis, of amortizing the goodwill paid in the acquisition and deducting such for income tax purposes upon a subsequent merger of the acquisition vehicle into the target company, or vice-versa (please see item V.6 below).

However, bear in mind that a merger may not be effected if debt incurred for the acquisition is outstanding and the target company is a public S.A. Generally, this form of debt cannot pass to the target company and, indirectly, to its minority equity holders.

Private equity investment is usually seen by sellers of the target company's quotas/shares as a means to (i) increase the company's value, (ii) make the company a stronger competitor in its market by providing capital to reach strategic goals, (iii) change the image of certain businesses, especially family-run businesses, and (iv) in many cases, prepare the company for an IPO. Private equity investment may also offer a rescue for distressed assets or underperforming businesses.

III. Most Commonly Used Exit Strategies

The most commonly used exit strategy is still the sale of the investment, which may be made to a strategic buyer, to the existing equity holders and management or, in the context of a secondary buyout, to another financial buyer.

In sale transactions, private equity funds/entities are usually reluctant to give representations and warranties other than with respect to title to the shares, in part because they are often not directly involved in the day-to-day management of the invested company.

An IPO is also a desired exit alternative. In this respect, the São Paulo Stock Exchange (*Bolsa de Valores de Sao Paulo* - "**BOVESPA**") offers different trading segments for Brazilian public S.A.s in accordance with the level of corporate governance practices adopted by them.

In addition to the traditional BOVESPA market, there are currently three different trading segments: *Nível 1, Nível 2* and *Novo Mercado*. The adherence to any of such segments is made through the execution of an agreement with BOVESPA, under which the public S.A. agrees to comply with all applicable corporate governance rules. The corporate governance requirements increase from *Nível 1* to *Nível 2* and from the latter to the Novo Mercado. Currently all trading within the BOVESPA markets is made electronically through a system called *Mega-Bolsa*.

Another option is the *BOVESPA Mais*, which is an organized over-the-counter market created by BOVESPA in 2005 for the trading of securities of S.A.s which are interested in a more gradual access to the Brazilian capital markets. It was developed targeting mainly small and mid-size businesses which seek exposure to the capital market while agreeing to adopt certain corporate governance practices.

Other exit strategies may also be available, such as the redemption of the shares (i.e., their cancellation upon payment of their value to their holders).

IV. Main Legal Documents and Issues

The documents necessary to implement a private equity investment will vary on a case-by-case basis and will depend on the structure elected. However, in most cases, they will include:

A. Documents for the organization of the private equity entity

If private equity fund is organized as a FIP, the organizational documents will include a charter, prospectus, agreements with the FIP's services providers (administrator, auditor, etc.). If the private equity fund is organized as a company, the organizational documents will include an articles of association or bylaws, etc. A shareholders'/investors' agreement may be desirable depending on the nature of the investors' relationship.

B. Documents for the acquisition of the target company

A stock purchase agreement and/or a subscription agreement would be entered into. Other documents common to M&A transactions are also usually necessary, such as a letter of intent, confidentiality agreement, etc. However, these agreements are adapted to the fact that private equity acquisitions differ from strategic M&A since the acquirer is a financial buyer. Antitrust filings and other actions common to M&A transactions may also be required.

C. Shareholders' agreement

A shareholders' agreement between the private equity entity and the other equity holders of the invested company would also be entered into. The rights and obligations to be provided in such agreement will vary from case to case depending, for instance, on whether the private equity entity will hold a minority or majority stake, but will usually include:

1. *Supermajority quorum or veto rights in connection with the equity holders' decisions*: Precisely which matters will be reserved to whom will be a matter for negotiation, and will depend on the nature of the transaction and the equity involvement of both management and the investors in the

company. Generally, matters that are reserved to the investors are major decisions such as altering borrowing requirements, significant transactions and significant changes to the company's constitutional documents or business/deviations from the business plan. Less important decisions, which are generally more day to day operational matters, are often left to the board of directors;

2. *Rights with respect to the management of the invested company*: Including the right to appoint directors and officers and supermajority quorum/veto rights in connection with the board of directors' decisions,[2]

3. *Restrictions on Share Transfers*: Equity holders are given a right of first refusal in the transfer of an equity interest or a right of first offer. Carve-outs for transfers should be considered (e.g., transfers to (a) family members of individual equity holders or equity holders of equity holders that are entities, (b) affiliates of equity holders, (c) individuals pursuant to an estate planning transaction, (d) to the market pursuant to an offering or (e) third parties in compliance with provisions regarding rights of first offer, tag-along rights and drag-along rights (discussed below)).

4. *Tag along rights and drag-along rights*: In the context of a proposed transfer of equity interests in the target company to a third party, such provisions grant (i) non-transferring equity holders the right to join in the such proposed transfer (or "tag along") or (ii) transferring equity holders the right to force non-transferring equity holders to transfer their equity interests (or "drag along"), in each case on the same terms and conditions as the proposed transfer. In crafting a tag-along right, attention should be paid as to how the total number of shares that may be sold by a selling equity holder after the exercise of tag along rights by other stockholders is calculated (i.e., whether equity interests to be sold by other equity holders should displace or be additional to the equity interests being sold by the selling equity holder). In the case of drag-along rights, parties should consider the threshold of approval required of approving equity holders to trigger the right to force other equity holders to sell their equity interests (e.g., majority-in-interest or some higher threshold).

5. *Exit rights and obligations*: Such as put option rights, redemption rights and rights in connection with an IPO. One of the main objectives of the investors will be to realize a return on their investment (ideally in the short term); to this end they need an exit strategy. This clause should specifically acknowledges that it is the intention of the parties to exit as soon as possible whether by way of a trade sale or auction sale of shares or assets, a buyout, or by way of listing the company's shares on a recognized stock exchange. In a trade or auction sale or in a buyout the investors will not be prepared to give warranties in relation to the company or its assets.

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2 In the specific case of FIPs, it is important to bear in mind that they must participate in the decision-making process of the invested S.A., with actual influence on its strategic policy and management, especially through the appointment of members of the board of directors.

This burden falls to the management team. As the key objective of the investors is to get a return on their position, if an exit hasn't been achieved in a particular time frame (typically 5 years), they will reserve their right to appoint professional advisers to examine and report on exit opportunities. The investors are likely to insist that the company picks up the fees of any such advisers.

6. *Information rights*: The company will be asked to supply regular information updates to the investors and/or to the members they appointed in the board of directors. The principal purpose of this clause is to ensure that financial and other information is provided to the investors in a timely manner. If the company fails to produce the information in a timely manner, the investors will reserve the right to appoint an independent firm of accountants to review the company's books and records.

7. *Registrations rights*: Registration rights regarding listing in the United States of America may also be included as part of the shareholders' agreement or be the subject of a separate agreement; Registration rights are a US securities law concept. They are needed because (subject to certain exemptions), securities can only be offered for public sale in the US if they have first been registered with the Securities Exchange Commission (SEC). This registration process can be time consuming and costly, and involves the company providing significant amounts of information about its operations and financial condition for inclusion in the registration statement. Unlike the UK and other European jurisdictions where it is common for all of a company's shares to become tradable on a listing, in the US, a company is not required to register all of its outstanding shares. Any shares that are left unregistered in the US can only be traded subject to certain restrictions, and this can greatly diminish their value. Consequently, investors in companies that may consider a US listing usually require the company to grant demand and/or piggy back registration rights. Demand registration rights give the investors the right to demand registration of their shares at any time. Piggy back registration rights give investors the right to have their shares registered along with any other shares in the company being registered.

D. Documents to Create Incentives for Management

Such documents usually take the form of options to acquire or subscribe shares/quotas. Depending on the circumstances and if the managers are already equity holders of the invested company, this matter may be addressed in the shareholders' agreement.

E. Financing Documents

In case of leverage buy outs, all the documentation necessary to formalize the financing and the guarantees to be offered.

V. Certain Local Tax Considerations

The type of vehicle that will be used to channel the investment by private equity investors is a key issue in determining the overall tax treatment of the structure. One crucial issue is whether the relevant vehicle is considered a legal entity for Brazilian tax purposes (in the case of a Ltda. or an S.A.) or not (in the case of a Brazilian investment fund, which, except in certain circumstances, is not considered a legal entity for Brazilian tax purposes).

A. Deductibility of interest - financing costs

As a general rule, financial costs related to interest qualify as operational expenses by a Brazilian legal entity (borrower), so these costs are normally considered deductible expenses for Brazilian corporate income tax purposes. In any event, a careful analysis is required on a case-by-case basis. In addition, to the extent that the Brazilian entity (borrower) pays interest to foreign related parties, the Brazilian transfer-pricing rules may impose certain limitations on the interest deductibility if the loan is not properly registered with the Central Bank of Brazil.

With respect to loans and financial instruments in general, the Brazilian transfer-pricing rules state that the annual interest due to a foreign related party, as a result of a contract not registered with the Central Bank of Brazil, shall be deductible only up to the annual limit of Libor (London Interbank Offered Rate) plus three percent.

B. Withholding taxes

The withholding income taxes may vary depending on the nature of the funds that are remitted abroad.

In the case of an international loan, the payment of interest by a Brazilian legal entity to a foreign lender is in general subject to a fifteen percent withholding income tax (or twenty five percent if the beneficiary is resident in a low-tax jurisdiction). Some exceptions may apply, such as if the lender is domiciled in Japan, in which case the withholding income tax is reduced to twelve point five percent (based on a treaty to avoid double taxation between Brazil and Japan).

With respect to dividends, the repatriation of funds from a Brazilian entity to its foreign equity holders in the form of dividends is currently not subject to any withholding income tax in Brazil, regardless of the domicile of the equity holders.

Brazilian law provides an alternative for the distribution of profits in Brazil, which is called “interest on equity.” A Brazilian company can pay interest on equity to its equity holders, provided that it has retained earnings or current-year earnings and that the foreign investments made in the Brazilian company are registered with the Central Bank of Brazil. Brazilian legislation sets out specific rules in connection with the maximum amount of interest on equity that may be paid by a Brazilian company.

The amount declared as interest on equity is treated under the tax rules as an operational deductible expense of the Brazilian company. Conversely, the payment of interest on equity is subject to a fifteen percent withholding income tax (or twenty five percent if the beneficiary equity holder is domiciled in a low-tax jurisdiction).

C. Stamp tax

There is no stamp tax in Brazil, including in the case of acquisition of shares and/or quotas of a Brazilian entity.

Note, however that different Brazilian taxes may apply (such as VAT, turnover taxes) in the case of assets acquisition.

In addition, several types of remittance of funds to and from Brazil are subject to the Brazilian financial tax (*IOF*) at 0.38 percent. Specific rules and rates apply depending on the nature of the remittance and other relevant matters.

D. Capital duty

There is no capital duty in Brazil.

E. Capital gains tax

In the case of a sale of a Brazilian entity by a non-resident equity holder, a fifteen percent withholding income tax will normally apply on the gain incurred on the sale (except if the non-resident seller is domiciled in a low-tax jurisdiction, when the withholding income rate is increased to twenty five percent).

Some exceptions may apply. For example, if a foreign investor (not domiciled in a low-tax jurisdiction) lawfully acquires shares in the Brazilian stock exchange through the mechanism set out in Resolution No. 2,689 of the Brazilian Monetary Council and subsequently sells these shares in the Brazilian stock exchange, no capital gain tax is triggered in Brazil, provided that specific requirements are complied with.

F. Depreciation of goodwill

From a Brazilian tax standpoint a buyer that is a Brazilian legal entity may benefit from the tax amortization of the goodwill paid in a stock acquisition, provided that certain conditions are met. To benefit from the tax amortization of the goodwill, the acquisition must be followed by a merger of the Brazilian target company into the Brazilian buyer (acquisition vehicle), or vice-versa and this goodwill must be justified based on the expectation of future profits and supported by a study (e.g., appraisal)prepared at the time of the acquisition. After the merger, the goodwill can be amortized by the surviving entity up to the limit of 1/60 per month (minimum term of five years). Other goodwill and amortization rules may apply, depending on the case.

Private Equity

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Please note that in connection with the changes introduced by Law 11.638/2007 regarding accounting procedures to be followed mainly by Brazilian corporations, the auditors are performing a more detailed analysis of the nature of the goodwill, related accounting entries and applicable amortization rules.

In addition, there are rumors that a new tax law will be issued by the end of the year, revoking or restricting to certain situations the possibility of amortizing the goodwill for Brazilian tax purposes.

G. Taxation of the FIP

Currently, the FIP is not subject to taxation on the acquisition and disposal of investments in Brazil. In addition, the income received from such investments is normally not taxed at the FIP's levels. Conversely, the S.A.s in which the FIP holds equity participation are normally subject to all Brazilian taxes applicable to a standard legal entity.

The payment of income from the FIP to its foreign investors may be subject to Brazilian withholding tax, which usually varies from zero percent to fifteen percent, depending on the case.

The capital gain incurred by the foreign investor upon a sale of the FIP's quotas may be subject to Brazilian income tax, which normally varies from zero percent to fifteen percent, depending on the case.