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## Financial Contracting Choices in Brazil - Does the Brazilian Legal Environment Allow Private Equity Groups to Enter into Complex Contractual Arrangements with Brazilian Companies

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FINANCIAL CONTRACTING  
CHOICES IN BRAZIL  
DOES THE BRAZILIAN LEGAL  
ENVIRONMENT ALLOW PRIVATE EQUITY  
GROUPS TO ENTER INTO COMPLEX  
CONTRACTUAL ARRANGEMENTS WITH  
BRAZILIAN COMPANIES?

*Cinthia Daniela Bertan Ribeiro \**

ABSTRACT

This paper examines whether Private Equity (PE) and Venture Capital (VC) groups (jointly called PE-VCs) can and do enter into complex contractual arrangements with Brazilian companies. This is done first by identifying the financial contracting structures used in both developed and developing countries. This paper will then review Brazilian legislation for securities and corporate control, cash flow, and control rights used by PE-VCs in stock-purchase shareholders agreements with Brazilian companies, and structures employed in Brazil compared to PE-VC contracting choices in other countries. Both the influence of enforcement in contracting choices and recent developments in the Brazilian legal environment are also examined to provide a full picture of investment conditions in Brazil. Literature presents evidence that developing countries with French civil law origin, such as Brazil, have the worst environment for PE-VC investment. But interviews with PE-VCs operating in Brazil reveal that some of the main rights found in the United States and other developed countries are also found in local financial contracts. For example, convertible securities have been significantly used and minority positions with contingencies have been frequent. Economic stability and sustained growth in the past four years, added to the capital markets development, PE-VCs' experience growth in the country, institutionalization of arbitration, and other improvements in the legal framework are likely to have fostered the use of complex contractual structures in Brazil. On the other hand, deficiencies in the court system in Brazil remain a severe drawback. Some PE-VCs still require full control and rely on

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common stocks, which is a typical characteristic of low enforcement countries.

## I. INTRODUCTION

THE main objective of this paper is to determine whether investors can and do enter into complex contractual arrangements with privately-held Brazilian companies. The more sophisticated the contractual structures adopted in investment transactions in a given country, the more investors depend on the set of contractually established rules. Consequently, more parties rely on the country's regulatory framework and legal enforcement.<sup>1</sup> Therefore, the systematic use of complex financial contracts could be a good indicator of the quality of a country's institutional environment. A second goal is to understand whether the recent changes in Brazil's regulatory environment have encouraged investment in privately-held companies.

This review starts with an analysis of recent literature showing the differences in contractual structures across countries. Scholars present evidence that financial contracting is influenced by the legal regime, enforcement efficiency, and other institutional features. This means that an investor willing to purchase stocks in privately-held companies with similar operations, but located in different regions, would likely adopt different contractual structures in each country in order to fit in local legal requirements, avoid risks of non-enforcement, and adapt to local economic conditions.

Then the contractual relationship between private fund providers and Brazilian privately-held companies will be examined. This investigation is conducted through the analysis of PE and VC groups' transactions due to their representativeness and PE-VCs' distinctive technique of allocating cash flow and control rights separately, which allows comparing their contractual choices across different environments.

The core focus of this paper is on provisions related to three sensitive areas for investment: cash flow rights, control rights, and enforceability of contracts. The typical structures used between PE-VCs and privately-held companies in Brazil will be identified and compared with the ones used in high and low enforcement countries.<sup>2</sup> If the structures used more

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1. According to La Porta, Silanes, Shleifer, and Vishny's and Lerner and Schoar's findings, the legal environment significantly impacts financial contracting. See Rafael La Porta et al., *Legal Determinants of External Finance*, 52 J. FIN. 1131, 1149 (1997); Josh Lerner & Antoinette Schoar, *Does Legal Enforcement Affect Financial Transactions? The Contractual Channel in Private Equity*, 120 Q. J. ECON. 223, 224 (2005). For a contrasting view, see Steven Kaplan & Per Stromberg, *Financial Contracting Theory Meets the Real World: An Empirical Analysis of Venture Capital Contracts* (Center for Research in Security Prices, Working Paper No. 513, 2000).

2. See Josh Lerner & Antoinette Schoar, *Transaction Structures in the Developing World: Evidence from Private Equity* 12-13 (Nat'l Bureau of Econ. Research, Working Paper No. 10348, 2004).

closely resemble those used in high enforcement countries, it may indicate developed regulations and a higher investor perception of protection and contract enforceability. Conversely, if the structures utilized are more similar to the low enforcement developing countries, it may suggest deficiencies within the legal environment.

The findings of this paper are a result of the analysis of previous empirical studies conducted by researchers in Brazil and other countries. Also, interviews were conducted with seven PE and VC practitioners of funds operating in Brazil—representing over ten percent<sup>3</sup> of the total groups actively pursuing transactions in the country, as well as legal advisors and scholars involved with the PE-VC industry in Brazil. The questionnaire sent to the seven groups investigated the frequency with which the funds included certain provisions related to cash flow, control rights, and dispute resolution methods in their contracts, and the reasons for choosing, or not choosing a number of suggested contractual structures. From the seven funds interviewed, six are based in Brazil, but most are comprised by foreign investors, and one is based in the United States. Four of the firms could be classified as traditional PE funds, and three as VC funds. The funds' answers were based on a sample of 112 transactions, most of them closed within the last four years (Table 1).

TABLE 1 – PE-VC GROUPS INTERVIEWED

| Fund         | Type | # of transactions | Period (years) |
|--------------|------|-------------------|----------------|
| A            | PE   | 4                 | 5              |
| B            | VC   | 16                | 4              |
| C            | VC   | 25                | 4              |
| D            | VC   | 50                | 1              |
| E            | PE   | 9                 | 8              |
| F            | PE   | 3                 | 4              |
| G            | PE   | 5                 | 4              |
| <b>Total</b> |      | <b>112</b>        | <b>4</b>       |

It is important to note that the focus that VC funds have on early stage companies, in contrast to PE funds' focus on more mature companies, often implicate different contractual structures. VC funds tend to dedicate more efforts to structuring incentives to management given the higher risks associated with the success of a new venture. In turn, PEs are likely to be more concerned with the conduction of a detailed due diligence and draft of an extensive list of representations and warranties

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3. See ANTONIO G. DE CARVALHO ET AL., *PRIVATE EQUITY AND VENTURE CAPITAL IN BRAZIL: THE FIRST CENSUS* 2, 26 (2005). Their study identified sixty-three domestic and international PE and VC organizations with offices in Brazil in December 2004 and with intention to continue operations in the country (this number excludes the funds that planned to end operations in Brazil).

in order to avoid the risks associated with contingencies and unknown liabilities of a long existing company.<sup>4</sup> Despite this inherent difference, VC and PE funds were analyzed as one single class in this paper because the objective is to understand the contractual sophistication of the main players of private funding in Brazil, and not to enhance the particularities of each type of venture.<sup>5</sup>

The paper proceeds as follows: section two briefly reviews the main literature relevant to the research topic. Sections three and four analyze and compare the structuring of cash flow and control rights in Brazil and other countries. Section five analyzes the influence enforcement efficiency exerts on contracting choices and examines the dispute resolution method used by PE-VCs in Brazil. Section six briefly analyzes recent developments in the Brazilian regulatory framework relevant to PE-VC investment. And finally, conclusions are included in section seven.

## II. RELATED LITERATURE

### A. LITERATURE ON PE OPTIMAL FINANCIAL CONTRACTING

PE-VC stock-purchase and shareholders agreements with invested companies are extensively studied. The literature shows that PE-VCs are likely to employ a typical set of provisions related to cash flow, control, and liquidation rights, which normally consists of convertible preferred stocks and contingencies. These are deemed to represent optimal contracting by many U.S. scholars in the finance and legal areas.<sup>6</sup> In their view, the closer a contract is to the U.S. standard the better the legal environment in a third country is likely to be.

Diverging from most of the U.S. literature, Gilson and Schizer<sup>7</sup> and Cumming<sup>8</sup> argue that the convertible preferred structure may not always be the optimal contracting choice in VC finance. They demonstrate that it is possible to use different instruments to achieve similar results and justify that the convertible preferred stocks' frequent use in the United States is due to a tax bias.<sup>9</sup> Likewise, referring to substantial literature on

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4. JACK S. LEVIN, *STRUCTURING VENTURE CAPITAL, PRIVATE EQUITY AND ENTREPRENEURIAL TRANSACTIONS* 4-64 (2006).

5. The literature also conducts joint analysis of VC and PE investments. See Lerner & Schoar, *Transaction Structures in the Developing World: Evidence from Private Equity*, *supra* note 2, at 12. When comparing their work based on a PE sample with Kaplan and Stromberg's one on VCs, they noted that legal texts suggest they would have observed similar patterns if they had examined only PE transactions.

6. See Steven Kaplan et al., *How Do Legal Differences and Learning Affect Financial Contracts?* 8, 21-23 (Nat'l Bureau of Econ. Research, Working Paper No. 10097, 2003). In their study, which encompasses primarily developed countries, they found that convertible preferred is the most used security in the United States as well as in the other twenty-two countries surveyed.

7. Ronald J. Gilson & David M. Schizer, *Understanding Venture Capital Structure: A Tax Explanation for Convertible Preferred Stock*, 116 HARV. L. REV. 874, 876-78 (2003).

8. Douglas Cumming, *Capital Structure in Venture Finance*, 11 J. CORP. FIN. 550, 550-85 (2005).

9. Gilson & Schizer, *supra* note 7, at 876-78.

capital structure choices and based on empirical evidence from a sample of 3,083 Canadian VC transactions, Cumming demonstrates that the optimal financing structure depends on the agency problems that may arise from a particular deal; and therefore, investors should seek a mix of financing instruments in order to minimize these costs.<sup>10</sup>

#### B. DETERMINANTS OF PE-VC CONTRACTING CHOICES ACROSS COUNTRIES

Comparative studies about contracting choices related to the allocation of cash flow, control, and liquidation rights in financial contracts abound. Kaplan and Stromberg,<sup>11</sup> Kaplan, Martel and Stromberg,<sup>12</sup> Lerner and Schoar,<sup>13</sup> and Cumming<sup>14</sup> analyze the different contracting choices across countries and correlate them to factors such as a country's legal origin, stage of economic development, rule of law, quality of legal enforcement, and sophistication of the parties involved in the structuring of the transaction.

La Porta et al. are the first to demonstrate the impact of the origin of laws on private contractual relationships. Through their analysis of forty-nine countries, including Brazil, they show strong evidence that the legal regime significantly influences investor protection laws, enforcement, and ownership concentration.<sup>15</sup> The poorest investor protection laws and lowest quality of enforcement are found in French civil law countries—one of which is Brazil—while the most protective laws and most efficient enforcement are in common law countries.<sup>16</sup>

Later research by Lerner and Schoar<sup>17</sup> confirms the above findings. From an analysis of 210 PE transactions in developing countries, they extract that common law developing countries, as opposed to civil law ones, are likely to have better enforcement and contracts similar to the United States. The authors suggest that “the contractual channel,” which is “the ability of investors to enter into complex, state-dependent contracts”<sup>18</sup> is heavily impacted by the quality of a country's enforcement.<sup>19</sup>

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10. Cumming, *supra* note 8, at 550-54.

11. Kaplan & Stromberg, *supra* note 1, at 1.

12. Kaplan et al., *supra* note 6.

13. See generally Lerner & Schoar, *Does Legal Enforcement Affect Financial Transactions? The Contractual Channel in Private Equity*, *supra* note 1; Lerner & Schoar, *Transaction Structures in the Developing World: Evidence from Private Equity*, *supra* note 2.

14. See Douglas Cumming et al., *Legality and Venture Governance Around the World*, (Center for Fin. Studies, Working Paper No. 2004/17, 2004) (last revised Apr. 11, 2006), available at <http://ssrn.com/abstract=537243> (last visited Aug. 28, 2006); Cumming, *supra* note 8, 550-554.

15. Rafael La Porta et al., *Law and Finance*, 106 J. POL. ECON. 1113, 1132 (1998).

16. *Id.* at 1114-18.

17. Lerner & Schoar, *Does Legal Enforcement Affect Financial Transactions? The Contractual Channel in Private Equity*, *supra* note 1, at 224-25.

18. *Id.* at 224.

19. *Id.*

In addition, contemporaneous work by Kaplan and Stromberg advances a new argument to explain different contractual choices other than the ones related to differences in a country's institutional environment. The authors suggest that funds are more likely to use U.S. style contract terms as their size, age, and experience with the U.S. increases, and that some funds implement U.S. contractual features across all the institutional environments that they invest in.<sup>20</sup> They argue that the more sophisticated the fund, the more likely it is to implement U.S. style clauses, regardless of the country's legal environment.<sup>21</sup>

### C. RELEVANT LITERATURE IN BRAZIL

When contrasted with the U.S. literature, Brazilian literature on the local PE and VC industry and contracting choices is scarce. Research about PE-VC investment in Brazil dates back to 2001 with Checa, Leme and Schreier,<sup>22</sup> and started to flourish in 2005 with Mariz and Savoia,<sup>23</sup> Ribeiro,<sup>24</sup> Carvalho, Ribeiro and Furtado,<sup>25</sup> and Rechtman and Brito.<sup>26</sup> The very recent research interest in the topic can be explained by the history of the PE-VC industry in the country. Equity investment in Brazilian private companies started in the 1970s through the National Economic and Social Development Bank (BNDES) and Brasilpar, but it remained very restricted until the mid-1990s.<sup>27</sup> Actually, the first cycle of PE-VC investment started only in 1994, the same year the Brazilian version of the U.S. limited partnership structure was created, and ended in 2004.<sup>28</sup> This strategic period in the PE-VC history in Brazil and the recent local boom in PE-VC funding<sup>29</sup> are likely to have generated the research interest. Still, none of these papers focus on contractual issues of PE-VC investment. Rather, they provide a general perspective of the PE-VC industry in Brazil, which includes highlights on the legal environment. More relevant for the objectives of this paper are the findings from Carvalho, Ribeiro and Furtado's survey, who obtained responses from all

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20. *Id.*

21. *Id.*

22. See Gonzalo Checa et al., *The Venture Capital and Private Equity Industry in Brazil*, 4 J. PRIVATE EQUITY 46, 46-67 (2001).

23. See Frederic de Mariz & Jose Roberto Ferreira Savoia, *Private Equity in Brazil: A Comparative Perspective*, 9 J. PRIVATE EQUITY 74, 74-87 (2005).

24. Leonardo de Lima Ribeiro, *O Modelo Brasileiro de Private Equity e Venture Capital* (2005) (unpublished thesis, on file with the Universidade Estadual de São Paulo).

25. CARVALHO ET AL., *supra* note 3.

26. See MARCOS RECHTMAN & BRUNO BRITO, *BRICS AND PRIVATE EQUITY* (2005).

27. See Checa et al., *supra* note 22, at 48-49.

28. CARVALHO ET AL., *supra* note 3, at 25. According to their survey, approximately 80 percent of the funds in Brazil have been operating for less than nine years.

29. In 2004, according to the Latin American VC Association, PE funds increased \$1 billion to invest in Latin America, and Brazil is considered to have the most developed PE industry in the region. See John Barham, *An Awkward Renaissance: The Private Equity Industry is Undergoing a Rebirth Around the World, but Latin America Might not Benefit from Boom Times in the Business*, 173 LATIN FIN. 37, 37-39 (2005).

the PE and VC organizations active in the country.<sup>30</sup> They presented some interesting findings related to control rights, which will be analyzed in section four below.

### III. CASH FLOW RIGHTS

A firm can obtain external financing through debt or equity. Unlike the debt-friendly environment found in the United States, the high cost of capital in Brazil<sup>31</sup> does not allow many companies, especially small and mid-sized ones, to grow substantially through bank debt. For these firms PE-VC investment may be more attractive because the returns on most of the capital provided depend on the company's performance, as opposed to financing from banks, where payments have to be made even if the company is short of cash.<sup>32</sup> Although PE-VCs often provide capital by holding a combination of debt and equity securities, they are in essence interested in the upside potential provided by an equity partnership. Equity investments are often made through common, preferred, and convertible preferred stocks, as well as debt through debentures or loans (straight debt). Even debt or debt-like structures such as non-convertible debentures and non-convertible preferred stocks are often attached to warrants to purchase common stocks.<sup>33</sup>

#### A. THE OPTIMAL FINANCING STRUCTURE: CONVERTIBLE PREFERRED STOCKS AND SIMILAR STRUCTURES

From all the above mentioned types of securities, convertible preferred stock is by in large the most used one in the United States.<sup>34</sup> Theoretical work justifies that convertible preferred stocks are superior over other securities because they provide their holder with (1) preference in liquidation, (2) dividends preference, and (3) they allow the separation of control and cash flow rights.<sup>35</sup> Additionally, convertibles are typically accompanied by a series of contingencies that may impact cash flows, such as vesting, earn-out, and anti-dilution provisions.<sup>36</sup> This combination of rights is considered optimal for PE-VC investments because it mitigates agency costs, reduces risks to the PE-VC, and creates incentives to

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30. CARVALHO ET AL., *supra* note 3, at 26.

31. Brazil has one of the highest costs of capital in the world. The SELIC rate (official short term rate) reached 26 percent in 2003, and in April 2007 was at 12.75 percent, one of its lowest values in the past years, but still very high for international standards. World Interest Rates Table, <http://www.fxstreet.com/fundamental/interest-rates-table/> (last visited on April 15, 2007).

32. This does not mean though that PE financing is cheaper than a bank loan. As Levin reminds, if the business is very successful the founder will probably end up paying more than if it had borrowed from a bank. LEVIN, *supra* note 4, at 1-6.

33. *Id.* at 1-4.

34. According to evidence from Kaplan et al., *supra* note 6, at 8.

35. See Gilson & Schizer, *supra* note 7, at 882-86; see also William A. Sahlman, *The Structure and Governance of Venture-Capital Organizations*, 27 J. FIN. ECON. 473, 504 (1990).

36. Kaplan et al., *supra* note 6, at 8.



the entrepreneur.<sup>37</sup>

First, the right of preference in liquidation gives its holders a preference in relation to common stockholders. But the holders of preferred stock are still behind all debt creditors in the liquidation line. So this preference may not mean much if the objective is protection in the case of bankruptcy, since upon this event assets are often not enough even to pay creditors. But it may be more relevant if the liquidation preference is triggered by other events, such as a sale or merger—where the preference may result in higher payments to the PE-VC<sup>38</sup>—or the failure to reach certain milestones, which would allow the PE-VC to redeem its participation in the company.

Second, the preference in distribution of dividends means that preferred shareholders should receive their dividends before common shareholders. But if common shareholders decide not to distribute dividends, nothing will be received by preferred owners unless stocks are structured as cumulative.<sup>39</sup> The latter guarantees the PE-VC a return, which brings a cumulative preferred stock closer to the concept of a debt security. But the PE-VCs' goal is not to receive fixed monthly payments; rather they are interested in the upside potential provided by the stocks. Actually, many times it makes more sense to reinvest the profits in the business than to distribute them. Therefore, the dividend preference is ultimately a way of minimizing the downside risks.

Third, the separation of cash flow and control rights is considered the most relevant feature of convertible preferred stock because it allows for the alignment of incentives between the PE and the entrepreneur, reducing the risks associated with uncertainty, information asymmetries, and agency problems.<sup>40</sup> Control can shift depending on performance, and entrepreneurs also appreciate not having their stocks so diluted as if the PE-VC were purchasing straight common stocks.<sup>41</sup> In practice, this enables a minority shareholder PE-VC to take control of the invested company if management does not reach certain goals,<sup>42</sup> or a structure may be created

37. Gilson & Schizer, *supra* note 7, at 875-76.

38. Gilson & Schizer illustrate this event,

[A]ssume that venture capitalists invest \$1 million in a firm for 10,000 shares of convertible preferred, which would represent 50% of the common stock upon conversion, while managers pay \$10,000 for 10,000 shares of common. If the firm is ultimately sold for \$1.3 million, the venture capitalists would not convert; instead, they would collect their \$1 million liquidation preference, while common shareholders would receive \$300,000.

*Id.* at 884.

39. *Id.* at 882.

40. *Id.* at 879. The authors explain that uncertainty is related to unpredictable contingencies and information asymmetry is about one party knowing more about certain aspects and facts of a business than the other party. Agency problems refer to conflicting interests between the management and the shareholders.

41. Cumming et al., *supra* note 14, at 2.

42. Lerner & Schoar, *Does Legal Enforcement Affect Financial Transactions? The Contractual Channel in Private Equity*, *supra* note 1, at 226.

whereby a shareholder is entitled to 20 percent of a firm's dividends but has the majority of seats on the board.

Empirical work shows that convertible preferred stocks have been used significantly across the world, but still far less frequently than in the United States. Kaplan et al. analyzed VC investments in developed countries. Their study results show that while convertible preferred stock is the most utilized security by VCs located both in the United States as well as in the other twenty-two countries surveyed, the frequency of its use differs quite a lot.<sup>43</sup> For example, the rate of frequency in the United States is 95 percent, contrasted with a 54 percent frequency rate in other developed countries.<sup>44</sup> The study also shows that outside the United States there is relevant use of senior common stock (14.5 percent), which is close to the concept of the convertibles in the sense that it has a liquidation preference.<sup>45</sup> In contrast, common stocks are used in 28 percent of transactions outside the United States and in fewer than 1 percent in the United States.<sup>46</sup> What could be the reasons for such a difference, especially considering the scholars targeted a quite homogeneous group?

In fact, the features of convertible preferred stocks can be replicated for common stocks.<sup>47</sup> For instance, it is possible to create different classes of common stock from which different rights derive, and holders of one class can have liquidation rights, dividend preference, or more voting rights than the other class. If such alternatives exist, how can the ubiquity of convertible preferred stocks in the United States be explained? With this question in mind, Gilson and Schizer found a plausible explanation; these securities are subject to reduced taxation in the United States.<sup>48</sup> Kaplan et al.'s and Cumming's research corroborates this finding.<sup>49</sup> Cumming analyzed a sample of 3,083 transactions between U.S. VCs and Canadian firms and found that convertible preferred stocks are not used as often in transactions in Canada, where the tax incentive does not exist.<sup>50</sup>

These studies demonstrate that local institutional factors, such as taxes, security costs, and the likelihood of local enforcement, must be taken into account when designing a financial contract. What is optimal in one country may not be so in another jurisdiction. There are many practical examples of unsuccessful transplantation of products from one country to another. To illustrate the potential dimensions of the problem, we can recall what happened during the first wave of high-yield bonds (junk bonds) in Europe in the mid-1990s. Lawyers and bankers did not adapt

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43. Kaplan et al., *supra* note 6, at 8-9.

44. *Id.* at 8.

45. *Id.*

46. *Id.*

47. *Id.*; Cumming et al., *supra* note 14, at 2-3.

48. According to Gilson and Schizer's research, managers and entrepreneurs are benefited with a tax deferral and a preferential tax rate on incentive compensation. See Gilson & Schizer, *supra* note 7, at 876.

49. See Cumming et al., *supra* note 14, at 2.

50. *Id.*

the U.S. style high-yield bonds to the environment in Europe.<sup>51</sup> Transplantation proved to be a disaster, with bondholders of European bankrupt companies being left in a very weak position compared to U.S. high-yield bondholders in the same situation.<sup>52</sup> The reason for this was related to particularities in the European economic and legal environments, which did not provide investors the important protections found in U.S. legislation.<sup>53</sup>

Nevertheless, evidence indicates that issues related to transplantation have indeed been considered by PE-VCs. Concerning transactions in higher-income European countries, empirical work suggests that the more experienced U.S.- and U.K.-based PE groups are, the more likely the groups are to use convertible preferred stocks across countries that have provisions very similar to the ones in their home countries.<sup>54</sup> As for developing countries, although PEs based in the United States and the United Kingdom tend to use preferred securities, the PEs have to make several adjustments to adapt transactions to local conditions.<sup>55</sup>

Therefore, despite the substitutability of convertible preferred stocks for other structures and the dangers of transplantation, the large use of convertible preferred stocks across countries and the advantages of this technique for financial contracts are evident. Actually, because of its complexity and high dependency on contractual provisions, the convertible preferred structure would not be suitable in a low enforcement environment. Thus, its use in a relevant scale in a given jurisdiction can be a good indicator of the quality of a country's legal environment.

In this sense, when analyzing PE transactions in developing countries, Lerner and Schoar found that on average, 54 percent of the transactions used common stock and 21 percent used convertible preferred stock.<sup>56</sup> These averages are much lower percentages than those observed in developed countries.<sup>57</sup> Within this sample they also found that in countries with greater contractual protections, investors use more convertible preferred stock, and use less common stock and straight debt.<sup>58</sup> On the con-

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51. See Michael D. Goldhaber, *Junk Culture*, THE AM. LAW. ON THE WEB, June 1, 2006, <http://www.law.com/jsp/tal/PubArticleTAL.jsp?id=1150448714123> (last visited August 29, 2006).

52. *Id.*

53. *Id.* Goldhaber points out that in the United States junk bond investors had the protection of Chapter 11, which provided debtors with the automatic stays of assets to prevent action from senior creditors. Also, European investors faced problems related to the subordination of the credit in the operating company (usually bonds are issued through an affiliate, and not through the operating company). The result was that while in the United States investors would typically recover forty-five cents on the dollar, in Europe the average would go down to twenty cents.

54. Kaplan et al., *supra* note 6, at 21.

55. Lerner & Schoar, *Does Legal Enforcement Affect Financial Transactions? The Contractual Channel in Private Equity*, *supra* note 1, at 27.

56. Lerner and Schoar, *Transaction Structures in the Developing World: Evidence from Private Equity*, *supra* note 2, at 12.

57. *Id.*

58. *Id.* at 27.

trary, in nations with fewer protections, normally the ones with French civil law origin, PEs tend to rely on common stock and straight debt and to own the majority of the equity.<sup>59</sup>

## B. CASH FLOW RIGHTS IN BRAZIL

The aforementioned findings elicit inquiry about the legal environment for financial contracting in Brazil. The first question is whether legislation allows for the creation of the cash flow rights techniques discussed above. The second question is whether or not these structures are significantly used by PE-VCs. If the creation of these techniques are allowed by law but not used in practice, this may mean local institutional deficiencies exist.

### 1. *Brazilian Legislation*

When it comes to investments in privately-held companies, there are no significant legal restrictions on the use of any type of security, or on the use of provisions related to contingencies and control rights. According to Law 6404/76, companies may issue common (article 15) or preferred (article 15 and 17) stocks, warrants (article 75), debentures (article 52), convertible preferred stocks (article 22) or convertible debentures (article 57).<sup>60</sup> The Law also explicitly allows the creation of shares with different classes,<sup>61</sup> where different rights can be conferred to each class.

Convertible preferred stocks of privately-held companies<sup>62</sup> can also be structured in a variety of ways, making it possible to adopt the features ordinarily used by PE-VCs in the United States. The Law only states that preferred stocks must have some preferential right in relation to common stocks, be it in the distribution of dividends or a priority claim in the event of liquidation.<sup>63</sup> Like those in the United States,<sup>64</sup> owners of preferred stocks in Brazil can enjoy voting rights<sup>65</sup> as well as fixed and cumulative dividends.<sup>66</sup> But there is a statutory limit on the number of preferred stocks that can exist without voting rights, or with restrictions

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59. *Id.*

60. *See* Lei Das Sociedades Anonimas, Lei No. 6.404, de 15 de dezembro de 1976, D.O.U. de 1.12.1976. (Brazil) (Business Corporation Act) [hereinafter Lei No. 6404/76].

61. *See* Lei No. 6404/76 at art. 15, para. 1.

62. If the company is public, there are further requirements to be followed. *See, e.g., id.* at art. 17, para. 1.

63. *Id.*

64. *See* Joseph W. Bartlett & Kevin R. Garlitz, *Fiduciary Duties in Burnout/Cramdown Financings*, 20 J. CORP. L. 593, 594 (1995).

65. *See* Lei No. 6404/76 at art. 17, para. 1, art. 18.

66. Traditionally publicly traded preferred stocks in Brazil have no voting rights, except in some specific situations (Lei No. 6404/76 at art.17), and owners of the stocks are not legally entitled to any fixed or cumulative payments. This explains the negative image commonly associated with this type of security in the public capital markets. So it is that Novo Mercado (a listing section at BOVESPA with higher corporate governance standards) has banned the use of preferred stocks. Before going for an IPO, companies must liquidate all preferred stocks or convert them into common stock. But when it comes to private contracting, preferred

to voting rights, which cannot exceed 50 percent of the total number of a company's stocks.<sup>67</sup>

In general, the Brazilian corporate legislation<sup>68</sup> establishes only minimum standards for the parties and provides private contracting with a fairly large degree of flexibility, allowing the local replication of most of the structures used in the United States. Even in situations where there is no equivalent legal mechanism in the Brazilian law, which is the case with escrow accounts,<sup>69</sup> private parties can adapt to existing structures and create figures similar to the ones available in the United States.

## 2. *PE-VC Contracting Choices on Cash Flow Rights in Brazil*

The next issue is whether convertible preferred stocks or similar instruments are, in practice, included in contracts with Brazilian companies. According to the interviews, from a sample of 112 transactions, approximately 46 percent used common stocks, 50 percent convertible preferred stocks, and 24 percent convertible debentures.<sup>70</sup> But if we remove from the sample the deals of the three VC groups, which represent approximately 80 percent of the deals in the sample, the share of common stocks rises to 79 percent, and the shares of convertible preferred stocks and convertible debentures drop to 24 percent and 16 percent, respectively. From another perspective, by examining the frequency with which the different types of securities are used by each PE-VC group (Table 2)—regardless of the number of transactions closed—it can also be verified that many more PE-VCs are likely to employ common stocks instead of convertibles.<sup>71</sup>

First, these findings suggest the existence of significantly different financing patterns between PE and VC groups operating in Brazil, which contrasts with evidence in the United States.<sup>72</sup> Second, as Table 3 shows, if all responses are considered, from both VCs and PEs, contracts in Bra-

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stocks can adopt the features used in the United States, since Brazilian corporate law just sets minimum advantages for preferred shares.

67. See Lei No. 6404/76 at art. 15, para. 2.

68. Lei No. 6404/76 brings the most relevant rules related to cash flow, control, and liquidation rights.

69. Escrow accounts are widely used by investors in the United States as a way of protecting their capital from contingencies in the invested firm.

70. The percentages are an approximation. Our questionnaire asked practitioners about the frequency of use of each security in the total number of transactions closed. Possible answers were always 100 percent, usually 100 percent to 70 percent, often 70 percent to 50 percent, sometimes 50 percent to 15 percent, or never 0 percent. We then calculated the average for each response. For example, if a fund said common stocks were often used in a total of ten transactions, we would then multiply ten transactions times 60 percent (the arithmetic average of 70 percent and 50 percent).

71. But some funds claim to normally use a mix of financing instruments in each transaction. This mix may consist of a combination of common stocks and convertible preferred stocks; common stocks, preferred stocks (or debentures) with or without warrants; and common stocks and straight debt. Additionally, most funds declared they sometimes structure the agreements with different classes of common stocks.

72. See Lerner & Schoar, *Transaction Structures in the Developing World: Evidence from Private Equity*, *supra* note 2.

zil seem to follow European patterns.<sup>73</sup> On the other hand, if VC transactions are disregarded (Table 3), and also as a qualitative analysis indicates (Table 2), Brazil is closer to the average in developing countries. These results do not lead to accurate conclusions. Data from a larger number of PE-VC organizations would have to be gathered in order to create a more exact assessment.

Still, it can be extracted that there has been a significant use of sophisticated financing instruments in contracts with Brazilian companies. Its condition as a developing civil law country should place Brazil among the lowest enforcement environments, however, the use of convertibles in Brazil is above the average found in developing countries even in the worst-case scenario (without VC transactions). On the other hand, the predominant use of common stocks (Table 2) may mean some PE-VCs are still cautious about relying on contract contingencies in Brazil or this may indicate a lack of sophistication of some groups. In order to substantiate and better assess these findings this review proceeds in the following section with an analysis of control rights and contract contingencies.

TABLE 2 - FREQUENCY WITH WHICH EACH PE-VC USES EACH TYPE OF SECURITY IN THEIR AGREEMENTS WITH BRAZILIAN COMPANIES

| Type of security                            | Always   | Usually  | Often    | Sometimes | Rarely   | Never    | Total    |
|---|----------|----------|----------|-----------|----------|----------|----------|
|   | 100%     | 100%<70% | 70%<50%  | 50%<15%   | 15%<0%   | 0%       |          |
| <b>Common stocks</b>                        | <b>3</b> | <b>1</b> | <b>1</b> | <b>1</b>  | <b>0</b> | <b>1</b> | <b>7</b> |
|   | 43%      | 14%      | 14%      | 14%       | 0%       | 14%      |          |
| <b>Common stocks with different classes</b> | <b>0</b> | <b>0</b> | <b>0</b> | <b>4</b>  | <b>0</b> | <b>3</b> | <b>7</b> |
|   | 0%       | 0%       | 0%       | 57%       | 0%       | 43%      |          |
| <b>Preferred stocks</b>                     | <b>0</b> | <b>1</b> | <b>0</b> | <b>2</b>  | <b>1</b> | <b>3</b> | <b>7</b> |
|   | 0%       | 14%      | 0%       | 29%       | 14%      | 43%      |          |
| <b>Convertible preferred stocks</b>         | <b>1</b> | <b>1</b> | <b>0</b> | <b>1</b>  | <b>1</b> | <b>3</b> | <b>7</b> |
|   | 14%      | 14%      | 0%       | 14%       | 14%      | 43%      |          |
| <b>Straight debt</b>                        | <b>0</b> | <b>0</b> | <b>0</b> | <b>2</b>  | <b>0</b> | <b>5</b> | <b>7</b> |
|   | 0%       | 0%       | 0%       | 29%       | 0%       | 71%      |          |
| <b>Convertible debentures</b>               | <b>0</b> | <b>0</b> | <b>1</b> | <b>2</b>  | <b>2</b> | <b>2</b> | <b>7</b> |
|   | 0%       | 0%       | 14%      | 29%       | 29%      | 29%      |          |
| <b>Warrants</b>                             | <b>0</b> | <b>1</b> | <b>1</b> | <b>0</b>  | <b>1</b> | <b>4</b> | <b>7</b> |
|   | 0%       | 14%      | 14%      | 0%        | 14%      | 57%      |          |

Finally, the interviews revealed a lack of debt culture in the Brazilian PE-VC industry. Five groups declared they never use straight debt and

73. Kaplan's findings on convertible preferred stocks 54 percent focus on VCs, allowing comparison with our sample including VC transactions 50 percent. See Gilson & Schizer, *supra* note 7; see also Cumming et al., *supra* note 14, at 2.

TABLE 3 - PERCENTAGE OF PE-VC TRANSACTIONS WHICH USED COMMON AND CONVERTIBLE PREFERRED STOCKS

|   | Brazil<br>(interviews) | Brazil<br>(interviews<br>without VCs) | U.S.<br>(Kaplan et al.) | Europe<br>(Kaplan et al.) | Developing<br>Countries (Lerner<br>and Schoar) |
|---|------------------------|---------------------------------------|-------------------------|---------------------------|--|
| <b>Common<br/>Stocks</b>                    | 46%                    | 79%                                   | 1%                      | 28%                       | 54%  |
| <b>Convertible<br/>Preferred<br/>Stocks</b> | 50%                    | 24%                                   | 95%                     | 54%                       | 21%  |

the remaining two use it only sometimes. This represents only 3 percent of the transactions from the sample. PE-VC fund managers argue that they are interested in the upside possibilities provided by equity securities; therefore, straight debt is used only when necessary to complete a transaction. Another explanation is related to the high cost of capital in Brazil.

#### IV. CONTROL RIGHTS

##### A. KEY PROVISIONS RELATED TO CONTROL RIGHTS

A minority ownership implies greater dependence on contractual provisions and therefore a greater reliance on a country's enforcement system. Fundamental among a number of provisions that aim at ensuring minority shareholder protection are anti-dilution, tag-along, and supermajority provisions. Investors can have their preferred stocks diluted by a number of corporate events, such as a later issuance of stock at a price lower than the original one paid by the investor, stock dividends, and splits.<sup>74</sup> Anti-dilution clauses protect investors against the dilution of their participation in a company by (1) making adjustments on the conversion price of convertibles and preferred stock<sup>75</sup> and (2) by providing them with preemptive rights.<sup>76</sup> Tag-along clauses give minority shareholders the right to sell their stock for the same price and conditions offered to the majority block.<sup>77</sup> Supermajority provisions provide protection by requiring the approval of a corporate action by more than a majority of the shareholders. Examples of actions requiring a

74. For a detailed study on anti-dilution provisions, see Michael A. Woronoff & Jonathan A. Rosen, *Understanding Anti-Dilution Provisions in Convertible Securities*, 74 *FORDHAM L. REV.* 129, 130-56 (2005). Through a variety of examples, the authors demonstrate the economic significance and complexity of anti-dilution provisions.

75. *Id.*

76. Preemptive rights provide the party with the right to purchase his pro rata share in a subsequent issuance of stocks, so he can maintain his original participation in the company. See Eugene Kim, Comment, *Venture Capital Contracting Under the Korean Commercial Code: Adopting U.S. Techniques in South Korean Transactions*, 13 *PAC. RIM L. & POL'Y J.* 439, 457-58 (2004).

77. VC Experts, Tag-Along Rights and Rights of Co-sale, [http://vcexperts.com/vce/library/encyclopedia/glossary\\_view.asp?glossary\\_id=137](http://vcexperts.com/vce/library/encyclopedia/glossary_view.asp?glossary_id=137) (last visited July 10, 2006).

supermajority approval are recapitalization, issuance of debt or stocks, investments above a certain threshold amount, and corporate reorganizations such as mergers, acquisitions, and spin-offs. Other provisions related to the protection of the investment that are often found in U.S. contracts are vesting and earn-out provisions, rights of first offer and first refusal, and put and call options.

Founder vesting and earn-out provisions play the dual role of protecting the investors and creating incentives to management. These clauses are protective because PE-VCs ensure they will have at least a larger percentage of the company's shares in case the firm underperforms or if key professionals leave the company. From another perspective, these clauses pose a great incentive to management; the better the performance of the company and the longer the manager stays with the company, the more shares he or she will be entitled to. Such provisions are particularly important for VCs who invest in start-up companies where the success of the business is highly dependent on the founders' presence and performance. A vesting provision can be linked to time and/or performance and its implementation is normally done through the grant of an option to the PE-VC to repurchase at cost—or at the lower of cost or fair value—the shares that have not been vested.<sup>78</sup>

When valuing the business, founders and PE-VCs usually find significantly different numbers, even if both rely on the same historical data. The reason for this is generally related to the company's growth potential, unassailably bright for the founders, but nebulous for the PE-VC. Growth assumptions used by the founder are likely to be more optimistic than the ones adopted by the PE-VC. Earn-out provisions are typically used to overcome these different valuation perceptions. It normally consists of a formula based on indicators of performance. If in a given time in the future the company's profits are as high as the founders expected, they will be rewarded; conversely, if the business performs as the PE-VC forecasted, the group will not have overpaid for its share in the company. Another way to align interests between management and the company is through management stock options, also often used by groups in the United States.

Call options and put options can be a means of increasing the upside or minimizing risks, respectively. For this very reason while PE-VCs like to be granted calls and puts, they try to avoid giving them to founders.<sup>79</sup> A call option for the PE-VC on the shares of the founder grants the PE-VC the possibility to acquire more participation and eventually the control of the company upon the payment of a pre-defined price. Conversely, a put option for the PE-VC is usually used as an exit mechanism. The right to exercise the option can be linked to a specific period, performance goal, or other event.

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78. LEVIN, *supra* note 4, at 2-14.

79. Sahlman, *supra* note 35, at 504.



Rights of first offer and first refusal are other key clauses found in PE-VC investment contracts. The success of a business is quite often linked to the values of the founders and current management and the quality of their performance. This belief leads PE-VCs to devote a significant amount of time developing a relationship with management and to expect that they remain in the company after the investment is made. Actually, one of the worst nightmares for a PE-VC would be to witness the entrance of a new shareholder in the business without its consent. This event would be even more frightening if the PE-VC is a minority shareholder, because such a change would allow the control of the company to fall into the hands of an unknown new partner who could change policies and business plans. This situation can be easily avoided by a right of first offer to the PE-VC. The utilization of this provision imposes an obligation on the founder to first notify the PE-VC of his or her interest to sell his or her stock at a stated price. If the PE-VC does not acquire the shares at that price, the founder is free to sell them to a third-party for a price equal or higher to the one specified in the notification. But just the right to a first offer may not suffice, and a sophisticated PE-VC will most likely want to include the right of first refusal. This right grants the PE-VC the ability to preempt a third-party buyer and purchase the founder's stock for the price agreed between the founder and the third-party.<sup>80</sup> Although the PE-VC would rather overpay for the shares than have them sold to a third-party, the case may be such that the PE-VC believes the price asked is far from fair and that the founder will most likely not find any party to buy the shares at the stated price. So it would be wise to wait for a concrete proposal from a third-party and then simply purchase the shares through the exercise of the right of first refusal.

## B. CONTROL RIGHTS IN BRAZIL

A major concern of PE-VCs investing in developing countries is understanding the pitfalls of being a minority shareholder in a local company. In other words, investors want to know what the chances are of facing expropriation by managers and majority shareholders and not being able to enforce their rights.<sup>81</sup> Lerner and Schoar have identified that in developing countries with French legal origin like Brazil, PEs tend to have less contractual protections and less efficient legal enforcement.<sup>82</sup> Consequently, PEs try to protect their investment by guaranteeing their returns through the ownership of the majority of the company's equity and by requiring more board representation,<sup>83</sup> instead of relying on rights related to the protection of minority shareholders such as anti-dilution and supermajority provisions.<sup>84</sup> In these countries, ownership concentration

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80. LEVIN, *supra* note 4, at 4-65.

81. La Porta et al., *Law and Finance*, *supra* note 15, at 1151.

82. Lerner & Schoar, *Does Legal Enforcement Affect Financial Transactions? The Contractual Channel in Private Equity*, *supra* note 1, at 224-25.

83. *Id.* at 225.

84. *Id.* at 238.

becomes a substitute for weak legal protection.<sup>85</sup>

Brazil is not known for providing quality enforcement. Indeed, most practitioners interviewed do not believe Brazilian courts can properly analyze and timely enforce complex contracts. Does this mean that the financial contracting choices for low enforcement countries depicted above apply to Brazil? In order to understand this, we investigate whether PE-VCs would accept a minority ownership in Brazilian companies, and if so, which contractual contingencies they rely on.

Regarding the first inquiry, 86 percent of the PE-VCs declared they would accept a minority number of voting shares in the company if they had veto power for certain corporate activities (see Table 4). Surprisingly, just one PE stated that it would only invest in a Brazilian company through full control. In this PE's view, a majority position is fundamental given the local problems of enforcement, which subject minority shareholders to long and costly delays. Although this opinion is shared by other groups, the enforcement deficiencies found in Brazil do not prevent them from accepting a minority position or even equally shared control. Likewise are the findings of Carvalho et al. According to their survey, 28.5 percent of groups with operations in Brazil think that having control of the invested firm is essential.<sup>86</sup> Additionally, from a sampling of 325 reported deals, full control through the purchase of the majority of shares was found only in 20 percent of the transactions.<sup>87</sup>

TABLE 4 - FORMS OF PARTICIPATION IN THE INVESTED COMPANY ACCEPTABLE ACCORDING TO THE PE GROUP'S POLICY FOR INVESTMENTS IN BRAZIL

|   | # of funds | %   |
|---|------------|-----|
| Minority of shares with veto power                          | 6          | 86% |
| Minority of shares with control                             | 3          | 43% |
| Equally shared control                                      | 2          | 29% |
| Full control through the purchase of the majority of shares | 2          | 29% |
| Total Funds Interviewed                                     | 7          |     |

For the PE-VCs that would accept holding a minority ownership, we further questioned the frequency with which they used the following contractual provisions: tag-along rights, anti-dilution provisions, put and call structures, vesting provisions, right of first offer and right of first refusal, and supermajority provisions. Table 5 shows that tag along, anti-dilution, first offer and first refusal rights are ordinarily included in contracts executed in Brazil. In fact, tag-along and anti-dilution rights are statutory

85. La Porta et al., *Law and Finance*, *supra* note 15, at 1145.

86. PE-VCs had to indicate if they agreed or not with the following statement: "For us to invest, it is essential that we have the ability to acquire control." See CARVALHO ET AL., *supra* note 3, at 60.

87. CARVALHO ET AL., *supra* note 3, at 60.

rights provided by Law 6404.<sup>88</sup>

TABLE 5 – FREQUENCY WITH WHICH PE-VC GROUPS  
INCLUDE PROVISIONS RELATED TO CONTROL RIGHTS IN  
AGREEMENTS WITH BRAZILIAN COMPANIES

| Provisions               | Always | Usually  | Often   | Sometimes | Rarely | Never | Total<br>PE-<br>VCs |
|--------------------------|--------|----------|---------|-----------|--------|-------|---------------------|
|                          | 100%   | 100%<70% | 70%<50% | 50%<15%   | 15%<0% | 0%    |                     |
| Anti-dilution rights     | 4      | 1        | 1       | 0         | 0      | 1     | 7                   |
|                          | 57%    | 14%      | 14%     | 0%        | 0%     | 14%   |                     |
| Tag-along rights         | 7      | 0        | 0       | 0         | 0      | 0     | 7                   |
|                          | 100%   | 0%       | 0%      | 0%        | 0%     | 0%    |                     |
| Drag-along rights        | 5      | 1        | 0       | 1         | 0      | 0     | 7                   |
|                          | 71%    | 14%      | 0%      | 14%       | 0%     | 0%    |                     |
| Put and call rights      | 1      | 1        | 2       | 2         | 0      | 1     | 7                   |
|                          | 14%    | 14%      | 29%     | 29%       | 0%     | 14%   |                     |
| Management stock options | 3      | 1        | 1       | 1         | 0      | 1     | 7                   |
|                          | 43%    | 14%      | 14%     | 14%       | 0%     | 14%   |                     |
| Earn-out formula         | 0      | 0        | 4       | 1         | 1      | 1     | 7                   |
|                          | 0%     | 0%       | 57%     | 14%       | 14%    | 14%   |                     |
| Vesting provision        | 2      |          | 4       | 0         | 0      | 1     | 7                   |
|                          | 29%    | 0%       | 57%     | 0%        | 0%     | 14%   |                     |
| Right of first refusal   | 7      | 0        | 0       | 0         | 0      | 0     | 7                   |
|                          | 100%   | 0%       | 0%      | 0%        | 0%     | 0%    |                     |
| Right of first offer     | 4      | 0        | 0       | 3         | 0      | 0     | 7                   |
|                          | 57%    | 0%       | 0%      | 43%       | 0%     | 0%    |                     |

Finally, we asked PE-VCs about guarantees and remedies. The downside of the transactions are minimized by taking stocks of the founders (*penhor de ações*) or receivables as a guarantee, or by leaving part of the purchase price in an escrow account. In case of debt or convertible debentures, the following provisions are adopted by some groups: (1) if the company reaches certain milestones, there will be a decrease in interest rates, (2) debt is backed by the founder (*aval*) or the company, or (3) debt converts into equity if the firm defaults, with the exercise of this provision left to the PE-VC's sole discretion.

Concerning remedies for the event of payment default or covenant breach by the founder, PE-VCs cited the use of provisions such as the right to take over board control, the right to increase dividends and/or interest rates, the earlier exercise of the right of redeeming preferred shares and/or debentures, and the issuance of warrants to purchase additional common stock at a low price.

88. Lei No. 6404/76 at arts. 171 and 254-A.

All of these findings contradict the expected contracting choices for a low enforcement environment. If practitioners do not believe in the enforcement efficiency of Brazilian courts, why have groups been increasingly open to minority ownership structures? Many argued in the interviews that the choice between a minority or majority ownership depends mostly on the quality of the company and relationship with management. Also, given the lack of confidence in the enforceability of contracts, the investment process, from screening to closing, is likely to take longer in Brazil than in the United States. Thus, in Brazil it seems PE-VCs need more time to conduct detailed due diligence and make extra effort to develop a solid relationship with founders and management. Further, it could be argued that the confidence in the local environment has been increasing with the maturity of the country's PE-VC industry. As experience grows, PE-VCs have been able to better assess the real risks of investing in Brazil. A final factor may be the emergence of arbitration as an alternative dispute resolution method. As demonstrated in the section below, arbitration has been broadly adopted by the PE-VC industry.

## V. THE IMPACT OF LEGAL ENFORCEMENT ON FINANCIAL CONTRACTING

Legal protection of investors encompasses the content and enforceability of laws. First, local law has to allow the use of complex contractual structures. But the content alone is worthless if not accompanied by the assurance of enforcement.<sup>89</sup> The quality of legal enforcement has been measured through various methods. La Porta et al. created a "rule of law index" based on investors' estimates of the law and order environment in the countries where they had operations.<sup>90</sup>

Lerner and Schoar compared the time a contract dispute takes to be resolved in the courts of various countries.<sup>91</sup> Lerner and Schoar found that the longer the period, the less likely a PE-VC group is to rely on preferred stock.<sup>92</sup> Also, while in low legal enforcement countries, investors tend to seek control through the purchase of the majority of shares as a substitute to contractual protection, in effective enforcement countries, investors are likely to separate cash flow and control rights, and rely on

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89. Nicola Gennaioli, *Contracting in the Shadow of Law 1* (Jan. 2006) (unpublished working paper, Stockholm University Institute for International Economic Studies), available at <http://www.iics.su.se/~nicolacontract.pdf>.

90. La Porta et al., *Law and Finance*, *supra* note 15, at 1138. They employed a scale from zero to ten. A ten was awarded to the United States, Canada, and Australia; Brazil got a 6.32, which was one of the highest marks among the developing countries.

91. Lerner & Schoar, *Does Legal Enforcement Affect Financial Transactions? The Contractual Channel in Private Equity*, *supra* note 1, at 234.

92. *Id.*

contract contingencies.<sup>93</sup> As a practical result, in low enforcement countries, more capital has to be committed to one single investment, which may be not desirable depending on the portfolio diversification strategy of the investor.

In Brazil, a central concern of investors relates to the enforcement of contractual structures in place. Practitioners point out the long and costly process of going to court, the lack of case law, and judges' lack of knowledge in the financial contracting area. Statistics confirm that a contract dispute in a Brazilian court takes considerable time to be resolved; the process of enforcement of a contract encompasses twenty-five procedures and takes an average of 566 days—but it often takes several years.<sup>94</sup> Contrastingly, in high-income states of the Organisation for Economic Co-operation and Development the process averages eighteen procedures and 213 days.<sup>95</sup>

Until recently, the fears of facing the Brazilian judicial system would often lead foreign investors to adopt the law of New York, Delaware, London, or another location perceived to have more efficient courts. But since 1996, with the enactment of the Arbitration Act (Law 9307/96), arbitration started to be seriously considered as an alternative to Brazilian courts. Even greater support was given to this method in 2001 when the Brazilian Supreme Court recognized the constitutionality of the Arbitration Act.<sup>96</sup>

The interviews have identified a clear trend of including arbitration as the dispute resolution method in shareholders agreements and stock-purchase contracts between PE-VCs and Brazilian companies. From the practitioners interviewed, only one has never included an arbitration clause in his contracts. But even this group is now considering electing arbitration in the following deals. Additionally, according to practitioners and lawyers in the PE-VC area, the coming agreements are very likely to have an arbitration clause.

Perhaps as surprising as the broad acceptance of arbitration, is the frequent use of Brazil-based arbitration courts in the agreements. Most PE-VCs interviewed select local arbitration courts, notably the ones that belong to respected Brazilian institutions or to international chambers of commerce. The first group includes Bolsa de Valores de Sao Paulo

93. *Id.* at 224. As remarked by Lerner and Schoar, this separation is achieved through the use of securities that shift control depending on the performance of the invested company.

94. BUSINESS MONITOR INTERNATIONAL, BRAZIL BUSINESS FORECAST REPORT, Q3 28, 30 (2006). The data mentioned in the article was extracted from World Bank.

95. *Id.*

96. The constitutionality of the Arbitration Act was recognized in the process of homologation of an international arbitral award by the Brazilian Supreme Court (Agravo Regimental n. 5206). See FEDERACAO NACIONAL DAS EMPRESAS DE SEGUROS PRIVADOS E DE CAPITALIZACAO, ARBITRAGEM: SOLUCIONAR OS LITIGIOS FICOU MAIS FACIL (2nd ed.), available at <http://cbma.com.br/wp-content/uploads/2006/08/Guia%20de%20Arbitragem%20da%20FENASEG.pdf#search=%22stf%202001%20arbitragem%22> (last visited Aug. 28, 2006).

(BOVESPA) (Sao Paulo's stock exchange) and the Federation of the Industries of the State of Sao Paulo; the latter group includes the Chamber of Commerce Brazil-Canada and the American Chamber of Commerce. Even the interviewed U.S.-based group chooses a Brazil-based arbitration court. Other responses include the Paris-based court, the International Chamber of Commerce, and ad hoc arbitrators, such as investment banks, consulting firms, or law firms. Concerning the law applied, all but one PE<sup>97</sup> chooses to apply the Brazilian law.

The use of the arbitration clause in PE-VC investment contracts with Brazilian companies is a clear adaptation to the local environment in Brazil. Such provisions are not commonly found in stock-purchase or shareholder agreements between the PE-VC and the invested company in the United States. Likewise, Lerner and Schoar identified the use of arbitration clauses in some developing countries as a way of PE-VCs avoiding court delays.<sup>98</sup>

Despite the well-founded fears related to contract enforcement in Brazil, only 1 of 112 transactions has had a contract under dispute in the Brazilian courts. According to practitioners, controversies are usually resolved internally by the parties because PE-VCs strive not to bring a dispute into courts. It remains to be seen whether arbitration will encourage investors to exercise the dispute resolution provision more often instead of seeking out-of-court agreements.

## VI. RECENT DEVELOPMENTS IN THE BRAZILIAN LEGAL FRAMEWORK RELEVANT TO PE-VC INVESTMENT

The main body of rules related to investment in Brazilian privately-held companies are found in Law 6404/76 (the Corporation Act),<sup>99</sup> Law 11101/05 (Corporate Reorganization and Bankruptcy Act), and in regulations from Comissao de Valores Mobiliarios (CVM), the Brazilian equivalent of the Securities Exchange Commission in the United States. Focus is given to recent developments of the Brazilian laws that are relevant to PE-VC funds, namely laws that may impact a fund's investment and exit strategies.

### A. CAPITAL MARKETS REGULATORY FRAMEWORK

The size of a country's capital market is central for PE-VC activity. Because PE-VC investments are typically meant to last for a pre-determined period,<sup>100</sup> it is essential to analyze exit options prior to investing, as well as the contractual design of detailed rules related to exit. Therefore, although PE-VC funds focus on privately-held companies, the possi-

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97. The fund that elects the International Chamber of Commerce chooses to apply the Law of New York in case of dispute.

98. Lerner & Schoar, *Transaction Structures in the Developing World: Evidence from Private Equity*, *supra* note 2, at 27.

99. Lei No. 6404 was substantially changed in 2001 by Lei No. 10303.

100. LEVIN, *supra* note 4, at 1-3.

bility of exiting the business through an Initial Public Offering (IPO) may be determinant for taking the investment decision.<sup>101</sup> Not coincidentally, the United States and the United Kingdom, which have the largest capital markets in the world, also have the most active PE-VC industry and house the largest PE-VC deals.<sup>102</sup> Strong capital markets are characterized by a dispersed shareholder base,<sup>103</sup> which in turn is fostered by sound legislation protecting minority investors. Therefore, a well-developed legal system is the base for creating a virtual cycle of liquidity, growth, and wealth.

But exiting the business is a traditional problem associated with investing in Brazilian companies. Until recently the only realistic exit alternative for a PE-VC would be a trade sale, i.e., sale to a strategic buyer. IPOs were rare and public companies' ownership structure was extremely concentrated. This picture was a reflection of the legal framework, which was insufficient to protect minority investors and ensure good corporate governance in public companies. In 2001 substantial changes were introduced. First, Law 10303 brought significant corporate governance improvements to the then twenty-five year-old Law 6404, providing minority shareholders with more protection, such as tag-along rights,<sup>104</sup> and with minimum requirements for preferred shares negotiated in the securities markets.<sup>105</sup> Second, also in 2001, BOVESPA—Brazil's largest stock exchange and the ninth largest in the world—launched Novo Mercado, internationally recognized for its high requirements of corporate governance and accounting standards.<sup>106</sup> The effect of these regulation improvements can already be seen. Novo Mercado has been attracting a record amount of new issuers and investors since 2004<sup>107</sup> and now repre-

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101. See Leslie A. Jeng & Philippe C. Wells, *The Determinants of Venture Capital Funding: Evidence Across Countries*, 6 J. CORP. FIN. 241, 242 (2000). The authors found that IPOs are the strongest driver of VC investment, particularly for later-stage investment.

102. In 2004, PE activity was worth US\$ 60 and £ 24 in the United States and the United Kingdom, respectively. See APAX PARTNERS, UNLOCKING GLOBAL VALUE: FUTURE TRENDS IN PRIVATE EQUITY INVESTMENT WORLDWIDE 11 (2006), available at [http://www.apex.com/unlocking\\_global\\_value\\_-\\_future\\_trends\\_in\\_private\\_equity\\_investment\\_worldwide.pdf](http://www.apex.com/unlocking_global_value_-_future_trends_in_private_equity_investment_worldwide.pdf).

103. Irina Shirinyan, *The Perspective of U.S. Securities Disclosure and the Process of Globalization*, 2 DEPAUL BUS. & COM. L.J. 515, 518 (2004). In the United States and the United Kingdom companies' shares are diluted among a broad base of individual and institutional investors, creating a dispersed shareholder ownership system. Conversely, continental Europe and Brazil are characterized as having concentrated ownership systems.

104. The tag-along right is in article 254-A of Lei No. 6.404. The article establishes that the price offered for stocks of minority shareholders cannot be over 20 percent lower than the price offered for the controlling shareholders.

105. Article 17, paragraph 1, establishes minimum advantages for preferred shares without voting rights or with restricted voting rights negotiated in the securities market.

106. For further details on the Novo Mercado, see John C. Coffee Jr., *Racing Towards the Top?: The Impact of Cross-Listings and Stock Market Competition on International Corporate Governance*, 102 COLUM. L. REV. 1757, 1806-08 (2002).

107. The number of IPOs in 2004, 2005, and 2006 were seven, nine, and twenty-six respectively. In 2007, fifteen IPOs were launched until April 15th.

sents a real exit possibility for PE-VC funds.<sup>108</sup> Out of forty-two IPOs from 2004 to 2006, nineteen involved PE funds exiting the investment.<sup>109</sup> A latest effort by BOVESPA to increase the Brazilian capital markets' size is called BOVESPA MAIS, launched at the end of 2005 and aimed at mid-sized companies, which could be compared to London Stock Exchange's successful branch AIM.

## B. BANKRUPTCY LAW

Bankruptcy legislation has substantially changed, now providing both equity investors and financial debt creditors with more protection. Under previous law, both equity and debt investors faced serious drawbacks. Equity investors faced significant risk because liquidation was highly likely for companies under the old reorganization rules (*concordata*); companies did not have the necessary legal assistance or a sustainable reorganization plan put in place to enable recovery from distress. And the latter, debt investors, had very small chances of recovering their capital; secured creditors could not seize the company's assets for two years (under *concordata*)<sup>110</sup> and were behind tax and labor credits in the liquidation line.

Law 11101 of 2005 introduced the new bankruptcy and corporate reorganization legislation, providing equity owners with real possibilities of reorganizing the firm, and placing secured creditors in a more favorable position in liquidation, now before tax credits and just behind a capped amount of labor credits. The reorganization plan can be judicial or out-of-court, and must be approved by the creditors.

Another innovation is the possibility to sell the bankrupt company without transferring the succession of liabilities to the new owner. All these changes are likely to give an impulse to funds focused on distressed companies.

## C. INVESTMENT VEHICLES

In 1994, CVM (Rule 209) created the *Fundo Mutuo de Investimento em Empresas Emergentes* (FMIEE), the first national investment vehicle for PE-VCs, which was an attempt to create a structure resembling the U.S. Limited Partnerships.<sup>111</sup> There were some limitations to this vehicle that led to the creation of the *Fundos de Investimento em Participações*

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108. See Stephen Grocer, *Private Equity Firms May Flock to Invest in Latin America*, MERGERS AND ACQUISITIONS REPORT, May 9, 2005, at 3, 4.

109. CARVALHO ET AL., *supra* note 3, at 19 (brings information on the number of IPOs in 2004 and 2005). See BOVESPA Encerra 2006 com Destaques em Pontuação, Volume, Número de Negócios, Valor de Mercado, Home Broker e Ingresso de Novas Empresas, 04 de Janeiro de 2007, available at [http://home.furb.br/wilhelm/HPMC\\_arquivos/A\\_Noticias.htm](http://home.furb.br/wilhelm/HPMC_arquivos/A_Noticias.htm) (last visited on April 18, 2007) (for information on IPOs in 2006).

110. Mariz & Savoia, *supra* note 23, at 81.

111. *Id.* at 37.



(FIPs) in 2004 by CVM Rule 391. Unlike the FMIEE,<sup>112</sup> FIPs impose no limitation on the size of the invested company, and it explicitly allows control of the invested companies through the purchase of the majority of the stock or through a shareholder agreement.

The use of these vehicles by foreign investors is likely to grow with the enactment of Law 11312 in June 2006. It eliminated the income tax levied on the earnings of foreign investors who invest in quotas of FMIEE and FIPs and who are not residents in low income tax jurisdictions.<sup>113</sup>

#### D. PENSION FUNDS REGULATION

The government has also supported state pension fund investment in private equity by amending regulations in 2002 and 2003 to increase allocation of funds in alternative assets.<sup>114</sup> Petrobras, BNDES, and Banco do Brasil, the three largest pension funds in Brazil, invested around 1 percent of their funds in PE-VCs in 2005, which represents approximately \$265 million.<sup>115</sup>

#### E. ARBITRATION

Although a long existing method, the Arbitration Law was only enacted in 1996 by the Brazilian legislature, following the UNCITRAL Model Law. As discussed above in section five, arbitration is likely to become the preferred dispute resolution method for investors in the country due to the lack of efficiency of the Brazilian courts.

Despite all these improvements towards increasing investor confidence,<sup>116</sup> Brazil is still poorly positioned in recent rankings of institutional environment for investments. For instance, the country comes in twenty-ninth place in the Apax and Economist Intelligence Unit private equity environment ranking.<sup>117</sup> Among the weakest points are Brazil's judicial system and its corporate and indirect taxation system, considered "excessively complex, porous and inefficient."<sup>118</sup>

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112. Rule 209 limited investments to companies with less than \$100 million of net revenues.

113. For further details on the new taxation rules on earnings and capital gains of FIPs and FMIEEs see Walter Stuber, *Brazil: Taxation – Exemptions*, J. INT'L BANKING L. & REG. 21(6), 43-44 (2006). The author bases his comments on the Provisional Measure 281, which was later converted into the Lei No. 11312.

114. Mariz & Savoia, *supra* note 23, at 80.

115. See APAX PARTNERS, *supra* note 102, at 23.

116. In this sense, Alvaro Gonçalves, head of Brazil's VC and PE Association and executive director of Stratus Investimentos in São Paulo, stated in an interview that the new bankruptcy law and arbitration legislation are making investors more confident about doing business in Brazil. In his words, "[f]ive years ago, investors had concerns about regulations and transparency that no longer exist." See *Venture Capital on the Upswing: Local Investors are Stepping up in Brazil to Fill Funding Gaps Left After a Number of Foreign Funds Fled to Faster Growing Asian Markets*, 175 LATIN FIN. 46, 47 (2006), available at [http://www.accessmylibrary.com/com2/summary\\_0286-14292007\\_itm](http://www.accessmylibrary.com/com2/summary_0286-14292007_itm).

117. See APAX PARTNERS, *supra* note 102, at 23.

118. *Id.*

## VII. CONCLUSION

PE financing is characterized by separating the allocation of cash flow and control rights. This means PE-VCs normally rely on contingencies to exercise more or less cash flow, voting and board rights. Albeit demonstrated that the optimal contracting structure may vary according to the particularities of each transaction, the rights and contingencies associated with convertible preferred stock and minority ownership are often the best fit for the needs of PE-VC groups. For its large reliance on the contractual channel, this structure would not suit investments in low enforcement jurisdictions. Therefore, if a country's institutional environment is poorly developed, PE-VCs will most likely require full control through the purchase of the majority of common stocks to avoid risks of expropriation and non-enforcement of contractual provisions.

The Brazilian corporate legislation for privately-held companies is flexible enough to allow the design of financial contracts with a structure similar to what is used in the United States and other developed countries. There are no relevant constraints on what the private parties can contract. Brazilian legislation normally sets only minimum standards in order to protect the minority investor, and to provide parties with freedom to contractually establish more protection. Even when legal or bureaucratic constraints exist, often parties have the possibility to contract around them, reaching the original objectives through other similar legal structures.

Although common stocks seem to prevail in PE transactions in Brazil, the employment of convertible securities is above the average found in developing countries, and a large majority of the PE-VCs would accept a minority ownership with veto power. These are positive indicators considering Brazil's condition as a developing civil law country. It is also emphasized that PE groups should be aware of the potential undesired results of transplantation of provisions, but apparently it seems this issue has been considered. Contracts have included provisions directed specifically to the Brazilian environment, as is the case with arbitration provisions.

Enforcement is most likely the main legal pitfall for PE investment in Brazil. The perceived low quality of enforcement leads some funds to require full control through majority ownership of common stocks and to require longer periods of screening and due diligence. Before making the investment decision, PE-VCs in Brazil are likely to dedicate more time, not only to be better ensured of the quality of the company, but also to develop a deeper relationship with founders and management. Additionally, arbitration is emerging as the PE-VCs' preferred dispute resolution method in an attempt to avoid the deficient local court system.

While economic and political factors are central for PE activity, the legal environment also significantly impacts investment decisions. Therefore, economic stability and sustained growth since 2003, combined with the development of local capital markets, growth of PE experience in the

country, institutionalization of arbitration, a decrease of taxation on PE investment, and other improvements in the legal framework have fostered investment growth and the increase in sophistication of financing structures in Brazil.