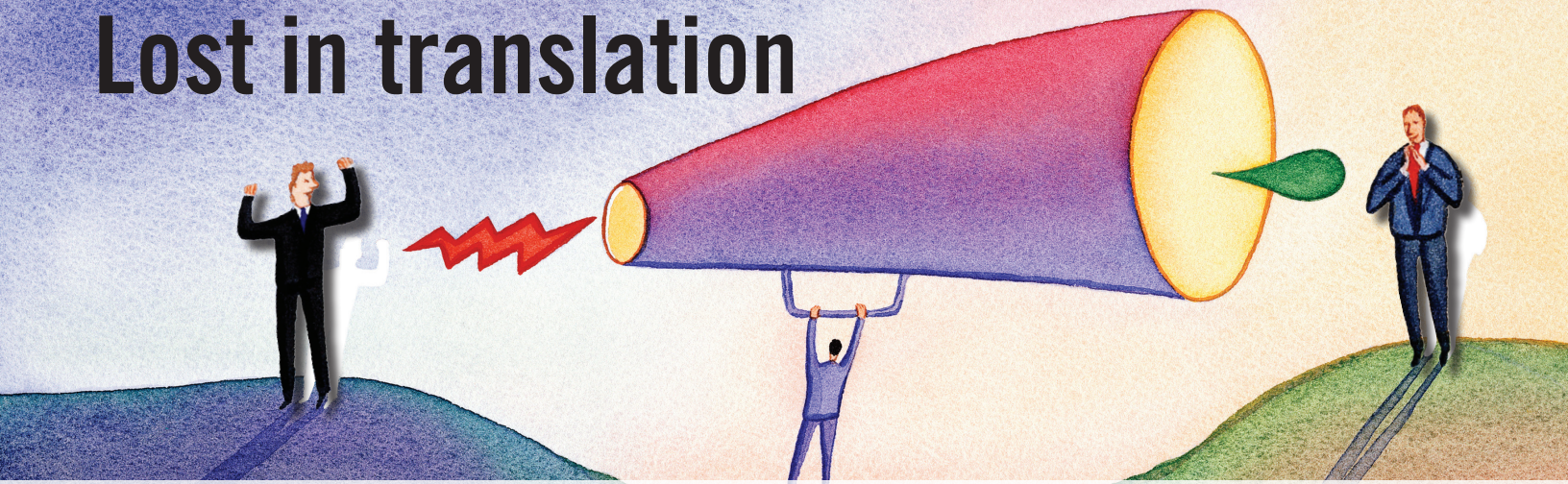


# Lost in translation



Debevoise & Plimpton LLP partner **Maurizio Levi-Minzi** and Pinheiro Neto Advogados partner **Bruno Balduccini** consider the differences in US and Brazilian legal concepts that arise in cross border M&A deals

The convergence between M&A practices in Brazil and the US in recent years is a clear sign that dealmakers in the two major M&A markets in the Americas have been learning from each other in ways that benefit international players investing in Brazilian targets and Brazilian companies investing in foreign targets, particularly in other Latin American countries. But, as Brazil and the rest of Latin America confronts more challenging economic conditions in the near future, this seems like a good time to consider whether some of the assumptions driving recent deals were entirely justified. One of the first critical decisions to be made in cross-border transactions is the choice of governing law for the transaction documents. As Brazilian and New York practice got closer and closer, the temptation to assume that the two governing laws are fungible may have grown stronger. That would be a mistake: there are still many significant differences in key legal concepts that dealmakers should appreciate in order to avoid surprises in the future.

## Good faith or *boa-fé*?

Take the principle of good faith, for instance. New York law recognises that contracts contain an implied covenant of good faith and fair dealing that protects the reasonable expectations of the parties against an attempt by one party to undermine the spirit of the deal. But the good faith covenant is often used as a gap-filler, when the express terms of a contract are either insufficiently vague or would lead to a result that is unfair or unreasonably harsh for one of the parties. Importantly, New York courts have held that a breach of the duty of good faith and fair dealing is merely a breach of the underlying contract, and the implied obligation is simply “in aid and furtherance of other terms of the agreement of the parties”. In this sense, New York courts tend to use the doctrine of good faith as simply one of many factors to be considered when determining whether one party has materially breached a contract, with a focus on economic results in relation to the contracting parties rather than broader notions of social justice or fairness.

Contrast that with the principle of “*boa-fé*” under Brazilian law. Similar to other civil law jurisdictions, Brazilian law incorporates a robust principle of good faith. In particular, the Brazilian Civil Code provides that legal transactions shall be interpreted in accordance with good faith and the practice in the place where

they are executed, and requires contracting parties to observe the principles of probity and good faith, both in the entering into of a contract as well as in its performance. The Brazilian Civil Code also contemplates that a person entitled to a right is deemed to have committed an unlawful act if, upon exercising such right, he or she manifestly exceeds the limits imposed by its economic or social purpose, good faith or good conduct. These provisions of the Brazilian Civil Code give the judiciary significant discretion when interpreting contracts to limit the rights of contracting parties or impose additional obligations upon such parties if the court finds that one of the parties acted in bad faith. As a general matter, Brazilian law tends to take a more expansive view of the principle of good faith than New York law, and therefore parties to a cross-border M&A deal involving a Brazilian target or investor should be mindful of the heightened good faith obligations that Brazilian law may impose, both in the negotiation of the transaction documents and the performance of the transaction. It could be a good thing or a bad thing. *Caveat emptor*.

## Indemnification

Indemnification clauses in Brazilian law and New York law agreements may look similar, but their effects can be quite different. Buyers can obtain similar protections only if they are properly advised because the differences are quite significant. Under Brazilian law, a breach of contractual provisions may be compensated to the extent a non-breaching party suffers direct losses or damages, which may include both actual damages and loss of profits. Indirect losses and punitive damages are usually not recognised on the grounds that indemnification is meant to restore the non-breaching party to the position it would have been in if the breaching party had complied with the contract, and not to punish the breaching party for its conduct. The concept of “diminution in value” of an asset does not exist under Brazilian law and, unless the contracting parties expressly agree otherwise, there is a risk that Brazilian courts or arbitrators may consider diminution in value to be an unenforceable indirect loss. Consequently, a buyer that wishes to be indemnified for any potential diminution in the value of the shares it has purchased should make sure that its contract expressly identifies those breaches that could give rise to a diminution in value of the

shares of the target and clearly establishes that any such diminution in value should be considered a direct loss that is indemnifiable by the breaching party. In many situations, it will be the target company and not the buyer that suffers direct losses from a breach of representation, leading to a diminution in value for the buyer, and therefore it is also advisable to include the target company as an indemnified party that may be compensated by the seller for such direct losses.

Conversely, under New York law, indirect damages may be indemnified, and investors often seek to include diminution in value, loss of profits and consequential damages within the scope of indemnifiable losses. However, the New York law of consequential damages is quite complex and enforcement can be difficult. Generally speaking, damages that are speculative in nature cannot be recovered under New York law, which requires that damages be within the contemplation of the parties or reasonably foreseeable; however, there exists a great deal of confusion and uncertainty around the meaning and scope of “consequential damages” and whether such damages should be recoverable, and consequential damage waivers have been scrutinised in numerous legal articles and publications. Sellers often seek to include in acquisition agreements a broad waiver of “consequential damages” which often include consequential, indirect, special or incidental damages, as well as lost profits and diminution in value, without regard as to whether such damages are reasonably foreseeable results of a breach. The inclusion of such a broad waiver may inadvertently result in a buyer giving up its right to recover the only true “direct” damages it might have in the form of lost profits, lost revenues and diminution in value resulting from breach of the contract.

### Materiality

Many compromises between buyers and sellers are reached by introducing “materiality” as a bridge between the parties. Are the implications of materiality similar under Brazilian and New York law? Not quite. Despite the fact that the concept of “materiality” is by its very nature an inherently fact-specific finding, there is a significant amount of US jurisprudence and literature on the subject, particularly with respect to securities fraud claims and the meaning of “material adverse change”. In the context of securities fraud claims, the US Supreme Court has defined “material information” as information presenting “a substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the ‘total mix’ of information made available.” When compared to the standard of materiality required to trigger a disclosure obligation by a public company, New York law imposes a higher burden of proof on a party that wishes to rely on a material adverse change (MAC) clause to walk away from a deal. Such party must prove that the event claimed to be a MAC substantially threatens the overall earnings potential of the target in a “durationally-significant” manner. Although it may be difficult to convince a New York court that a MAC has occurred, in recent years (and particularly during the financial crisis) buyers have used well-drafted MAC clauses as leverage to negotiate more favourable terms or even terminate a deal that has become unattractive.

Brazilian jurisprudence has not yet elaborated a framework

for the concept of “materiality.” As a result, it is difficult to predict how a Brazilian court or arbitrator may interpret such concept without any significant precedents to rely on. With that in mind, contracting parties may wish to limit the use of materiality qualifiers in acquisition agreements by including objective criteria (such as dollar thresholds, scheduled items or flat obligations) where feasible to reduce uncertainty and the risk of disputes. Similarly, the lack of any well-developed Brazilian case law on MAC clauses may also encourage parties to identify more specific conditions to closing rather than relying on a broad MAC clause.

### Force majeure events

Under both Brazilian and New York law, force majeure provisions may excuse non-performance of contractual obligations upon the occurrence of events that are outside the control of either party. Typical examples of force majeure events include natural catastrophes such as storms (which caused Vale to declare force majeure on iron-ore supply contracts in December 2013) and fires (which caused Copersucar to issue force majeure notices to third-party sugar traders after a fire at its terminal in October 2013), as well as riots, war and terrorism. Similar to most civil law jurisdictions, the Brazilian Civil Code includes specific force majeure provisions; however, certain types of force majeure events do not excuse non-performance (eg, strikes, labour disputes, etc) if such events were reasonably foreseeable. Conversely, under New York law there is a trend to expand the definition of force majeure events to include events that make performance commercially impracticable; however, a party may still find it difficult to meet the standard of impracticability if such events were foreseeable or if the effects of such events could reasonably have been avoided or overcome by alternate performance.



### Enforcement of shareholders' agreements

The shareholders' agreement of a Brazilian target company is required to be governed by Brazilian law, and target companies often join shareholders' agreements as intervening parties. In order to be valid and enforceable against third parties, the company's management and the company itself, a shareholders' agreement must be registered at the company's headquarters and made available for consultation by the interested parties, in which case such shareholders' agreement may be specifically enforced, including by means of the company's secretary being forbidden to count votes by the board of directors in violation of such shareholders' agreement.

Under shareholders' agreements governed by New York law, the target company is often a party to the agreement, with an obligation not to take any actions that are not approved in accordance with the agreement. If a shareholder suspects that the company is planning to take an action that would be a breach of the shareholders' agreement, such shareholder may seek an injunction to prevent the company from taking such action.

### ...and the bottom line is

Ultimately, we think that properly advised buyers and sellers can protect their interests under either Brazilian or New York law. But, avoiding potentially costly “lost in translation” assumptions is the first step to striking a good deal.

