LATIN LAWYER
THE BUSINESS LAW RESOURCE FOR LATIN AMERICA

NEWS

A YELLOW BRICK ROAD FOR BRAZILIAN INVESTORS?

29 July 2016

Against a backdrop of doom and gloom in Brazil, Mattos Filho, Veiga Filho, Marrey Jr e Quiroga Advogados partner Hiram Pagano Filho and Debevoise & Plimpton LLP partner Maurizio Levi-Minzi find reason to be positive

The turbulence of the political and economic situation in Brazil continues to be front-page news in the US and Europe. These days the narrative in the press is often about a seemingly endless economic and political crisis punctuated by high inflation and alarming currency volatility. Against this drum roll of negative news, it is easy to miss developments that, in the long term, could make Brazilian investments more attractive to international investors. One potentially positive development is the recently enacted Brazilian code of civil procedure. The new code matters to international investors because it should increase the predictability of legal outcomes in Brazilian courts. In this article, we will discuss why shareholders' agreements of Brazilian companies are most often governed by Brazilian law, the concerns that international investors have in connection with the choice of Brazilian law and strategies that are adopted to mitigate such concerns, including the potentially positive impact of the new code of civil procedure.

What governing law?

Although not mandatory, Brazilian law is often preferred by international investors entering into shareholders' agreements for Brazilian companies. There are historical, legal and practical reasons for the prevalence of Brazilian law in governance documents.

Historically, Brazilian courts have resisted enforcing contractual provisions governed by foreign law. If the parties were unable to reach an amicable solution, litigating the issue in Brazilian courts applying Brazilian law was almost inevitable. After a Supreme Court's ruling recognised in 2001 that arbitration was a constitutional method of settling contractual disputes in Brazil, arbitration became increasingly popular as a way to avoid time-consuming judicial proceedings. In fact, arbitration in corporate and commercial matters became so widespread that the São Paulo stock exchange (BM&FBovespa) decided to require that corporations listed on its higher segments of corporate governance include arbitration clauses in their by-laws. Although the Brazilian Arbitration Act allows contracting parties to choose a foreign governing law and requires courts to enforce such choice, Brazilian law has continued to dominate shareholder agreements. The shift towards legal systems that are more familiar and predictable for international investors (New York or English law) has not occurred because Brazilian law offers important enforcement benefits that may or may not, at least from a practical standpoint, be available under foreign law.

The Brazilian Corporations Act contains fast-track procedures that allow a shareholder to enforce its rights under a shareholder agreement without recurring to court action. Most importantly, if a shareholders' agreement is filed at the headquarters of a corporation, the chairman of a shareholders' meeting has the authority to reject on its own authority votes in violation of provisions of such shareholder agreement. This self-executing feature of a shareholders' agreement governed by Brazilian law has considerable appeal given the potential challenges of obtaining court relief in Brazil. The fact that the law also imposes an obligation on directors appointed pursuant to a shareholders' agreement to abide by the provisions of such agreement is also often cited as a strong reason to prefer Brazilian law.

While there is nothing in the Corporations Act suggesting that foreign law-governed agreements will not be eligible for fast-track enforcement, Brazilian lawyers often recommend against foreign law because: (1) the chairman of a shareholders' meeting will likely be less comfortable in enforcing an agreement governed by a foreign law, (2) a Brazilian court would probably take more time before it granted injunctive relief based on a foreign law agreement and (3) claims based on shareholders' agreements often have some level of interplay with a corporation's by-laws and statutory rules applicable to its internal affairs, which are mandatorily governed by Brazilian law.

Looking for precedents

With all of that as a background, are there any factors to be taken into account when considering Brazilian law for shareholder agreements? In our experience, there are three issues to be considered: the so-called risk of rebalancing, the good faith risk and, most importantly, the lack of precedents to guide the interpretation of shareholders' agreements.

The Superior Court of Justice, Brazil's highest court for non-constitutional matters and usually the tribunal in which complex contractual controversies are finally resolved, has issued only a limited number of decisions dealing with shareholders' rights and obligations. State courts have been somewhat busier with shareholders' claims, but their decisions have been inconsistent. Arbitral tribunals have rendered many more important decisions concerning shareholders rights, but their decisions are often kept confidential so that they have not added much to the body of relevant precedents. Given this situation, Brazilian lawyers often look at decisions by the Brazilian securities commission, the CVM, for guidance in matters involving a corporation's internal affairs (such as fiduciary duties and exercise of control power), but the decisions of the CVM do not address many important contractual terms that go beyond the corporation's internal affairs, like puts and calls, for example. As a result, CVM precedents have limited precedential value.

Fortunately, the new code of civil procedure enacted in March this year could help mitigate the problem of lack of precedents because it provides that lower courts and trial judges will need to follow precedents decided by higher courts. Each tribunal must keep its decisions consistent to create a stable, coherent set of precedents. Judges are now required to identify precedents and decide if a case fits the same fact pattern, as well as to respond whether or not precedents cited by litigants are applicable to the dispute. While it is early days to assess the full implications of this change (and the implementation of the new code has been somewhat problematic), it is reasonable to hope that the effective adoption of the principle of stare decisis will, over time, enhance the breadth and strength of the Brazilian body of precedents on shareholders' rights.

Rebalancing and good faith

The Brazilian Civil Code contains provisions that may allow a party to a contract to seek termination or rebalancing of the equities in the contract if circumstances have changed as a result of extraordinary events that were not predicted at the time the contract was entered into and, as a result of such changed circumstances, the contract has now become excessively burdensome. These provisions are sometimes mentioned by investors as a reason to worry about choosing Brazilian law as the governing law for shareholder agreements. How serious is this risk and what can be done about it? While we are not aware of any comprehensive study on this point, based on our own experience and anecdotal evidence, we tend to think that this risk is quite limited when it comes to shareholder agreements. Nevertheless, more conservative investors could also consider moving the economic provisions of a shareholder agreement that create the greatest "rebalancing risk" in an ancillary agreement governed by foreign law. Of course, the difficulties of having agreements governed by different laws applying to the same transaction should also be taken into account.

The other issue that concerns investors from common law jurisdictions relates to good faith. As seasoned investors know, Brazilian general contracts law provides for a broad notion of good faith, which may allow judges to imply or modify contractual obligations even when dealing with undisputed facts and unambiguous provisions. This principle has been deployed to surprising effect by many Brazilian courts, including the Superior Court of Justice.

However, the rules governing the existence and enforcement of shareholder agreements are governed by the Corporations Act rather than general contracts law. The fact that the Corporations Act does not contain a good faith-type provision should imply that judges have less interpretive discretion. Instead of pursuing fairness or attempting to devise the parties' intent, courts should be limited to enforcing the obligations expressly written in the agreement. Although there are court decisions that declared that general contracts law principles apply to shareholders agreements, Brazilian lawyers are generally not concerned with the possibility of courts implying or modifying contractual obligations when it comes to shareholders' agreements.

But, at least some international investors are concerned with this risk. What can be done to mitigate it? Some practitioners believe that the risk of a "good faith" attack would be lower if the parties choose arbitration as the dispute resolution mechanism because arbitrators tend to be more reluctant to decide cases based on "good faith". Other practitioners choose the more radical approach of putting the provisions at risk in a separate foreign-law governed ancillary agreement. Given that clauses dealing with related but distinct matters, such as

non-competition obligations, executive compensation arrangements and transfers of technology, would not be subject to the fast-track enforcement procedures provided for in the Brazilian Corporations Act, it may be an alternative for the parties to include such provisions in an ancillary agreement governed by foreign law, especially considering that Brazilian courts are now required to enforce governing law and choice of forum clauses under the new code of civil procedure.

And the good news is…

As briefly shown above, international investors and local partners have additional options to structure transactions and choose the most suitable legal framework for each contract. With the aid of the strategies outlined above and the improvements that are expected as a result of the new code of civil procedure, foreign investors may actually find a path to the "yellow brick road" of greater predictability in Brazilian transactions.

Rafael Thor, an associate at Debevoise & Plimpton LLP, also contributed to this article.

First published on the *Latin Lawyer* website, 29 July 2016
www.latinlawyer.com