

THE NEW BANKRUPTCY LAW AND THE RISK OF INCREASED SHAREHOLDER WITHDRAWALS FROM COMPANIES IN REHABILITATION

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Recently approved by the House of Representatives, Legislative Bill n° 4,376 of 1993 introduces new guidelines for bankruptcy and debt rehabilitation (*concordata*) proceedings, seeking to adapt such proceedings to the rapidly-changing social context and economy. The Bill awaits final approval from the Senate in order to be submitted for presidential sanction and, thus, become effective, revoking former Decree-law n° 7,661/45. Even if final approval of the new law is postponed – mainly because 2004 is election year –, the opinion among experts is that the law will certainly be enacted.

With a strong concern for recovery of companies and maintenance of sources of production, the Bill innovates in a positive manner, especially with respect to the replacement of preventive protection against creditors (*concordata preventiva*) with judicial and out-of-court “rehabilitation”. In connection with the former, all creditors will be subject to the new procedure, which, without a doubt, represents one of the greatest innovations of the Bill. This is due to the fact that, currently, preventive protection against creditors only affects general unsecured creditors (*credores quirografários*), who represent, in most cases, a small part of the debts of the distressed company, which remains subject to all types of judicial actions by other creditors. In practice, therefore, the procedure, which was conceived precisely for the purpose of rehabilitating a company in financial, has become ineffective.

The matter becomes even more serious when the statistics are considered: almost 80% of requests for preventive protection against creditors are not fulfilled and the companies end up facing an irreversible bankruptcy proceeding: a situation that causes thousands of lay-offs, creating mass unemployment and severe social problems.

Due to this scenario, the Bill for the new Bankruptcy Law seeks to preserve the company as a productive source of jobs as much as possible, by means of rehabilitation mechanisms for companies in financial difficulty. In this respect, article 50, II was included in the Bill, providing for spin-offs, mergers and consolidations of the debtor company as means of rehabilitation, as long as all shareholders’ and quotaholders’ legal rights are respect.

The possibility of such forms of rehabilitation, if confirmed, will represent an undeniable legislative progress. It is necessary, however, to face the consequences that it will cause. Essentially, one of the main concerns is related to the fact that such corporate events in a rehabilitating company will cause a deluge of withdrawals by dissenting shareholders or quotaholders – which, paradoxically, will place the rehabilitation of the company in financial difficulty at severe risk, and increase, in theory at least, the company’s indebtedness.

Such a consequence is predictable if one considers that the shareholders of a company, mainly the preferred shareholders – whose main objective is to receive a return on their investments, which have already been sacrificed by the rehabilitation process –, will see such corporate events (spin-off, merger and consolidation) of the debtor company as a way of recovering their invested capital. Ultimately, if the attempt is not successful and the company is declared bankrupt, its shareholders will be classified as subordinated creditors, which means they are the last creditors to receive payment, ranking even after general unsecured creditors.

01

THE NEW BANKRUPTCY LAW AND THE RISK OF INCREASED SHAREHOLDER WITHDRAWALS FROM COMPANIES IN REHABILITATION

02

NEW ACCOUNTING RULES EMPHASIZE THE IMPORTANCE OF PROTECTION MECHANISMS FOR INTELLECTUAL PROPERTY

03

FOREIGN PARTICIPATION IN COMPANIES UNDER THE 2002 CIVIL CODE: NEW AND OLD ISSUES

04

PROINFA IS PUT INTO PRACTICE
 PEDRO BATISTA MARTINS, ARBITRATION SPECIALIST, JOINS BM&A

05

CRSFN AND CVM DECIDE ON CONFLICTS OF INTERESTS

06

CONTROVERSIAL ASPECTS OF THE NON-CUMULATIVE PIS/COFINS CREDIT

Therefore, in addition to bearing all the debts of the company in judicial rehabilitation, it would still be necessary to face all the withdrawal requests, making the conclusion of any of the corporate events described in article 50, II of the Bill much too costly, to the extent that the dissenting shareholder must be paid either an amount equal to the equity value of the shares, or such other amount as may be stipulated in the company's bylaws, which could lead to the decapitalization of the company.

Moreover, withdrawal rights are imperative, and any agreement that prevents or restricts the exercise of such rights is considered to be null and, therefore, ineffective. Not even the general meeting of creditors, which, under article 36 of the Bill, is the body that has powers to accept or reject the plan for judicial rehabilitation and the proposal for out-of-court rehabilitation, can, in principle, reverse this situation.

For these reasons, article 50, II of the new Bankruptcy Law runs the risk of becoming a dead letter from its "birth", to the extent that use of the mechanisms contemplated in the provision will only cause an increase in the rehabilitating company's indebtedness.

In fact, it was because of these concerns that Provisional Measure n° 1,182, which introduced the Program for Fostering Financial Restructuring and Strengthening of the National Financial System - PROER, established that financial institutions which enter the program are exempt from complying with the provisions of the Corporations Law that deal with respect to the right of withdrawal granted to dissenting minority shareholders in the event of consolidation, merger or spin-off of public companies.

Despite the legislator's commendable intention in including spin-offs, consolidations and mergers as forms of rehabilitation in the new Bankruptcy Law, a solution for the issue discussed in this article must be found, and indeed has been found for financial institutions under Provisional Measure n° 1,182. If not, the cost of withdrawal may prevent the restructuring of a company and so compromise the social purposes of the law, since failure to rehabilitate distressed companies it would make it impossible to maintain them as sources of production, to the prejudice of the whole community of creditors and the shareholders of the rehabilitating company. The problem should be corrected now, before it becomes a reality.

NEW ACCOUNTING RULES EMPHASIZE THE IMPORTANCE OF PROTECTION MECHANISMS FOR INTELLECTUAL PROPERTY

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Last January, CVM Circular n° 01/2004 became effective, establishing accounting principles and rules for the preparation of financial statements. Among other provisions, the Circular expressly prohibits the revaluation of intangible assets based on market value. The same rule is adopted under US GAAP, which does not allow accounting revaluations of intangible assets. International accounting principles (IAS - International Accounting Standards), on the other hand, do allow revaluation of intangible assets, although only in very specific cases.

The rule adopted by the CVM, which is shared by US GAAP, is criticized because it ignores the current situation of accelerated technological development. In fact, the value of intellectual capital has risen to unparalleled levels and, in the last few years, we have witnessed an unprecedented appreciation of intangible assets.

Two cases, which both received extensive press coverage, speak for themselves. In 1999, Cisco Systems, a company in the technology sector, paid almost US\$ 7 billion for a company called Cerent that owned so-called "tangible" assets worth around US\$ 50 million, representing less

than 1% (one percent) of the acquisition price. Meanwhile, again in 1999, a valuation demonstrated that the estimated value of the Coca-Cola trademark was US\$ 84 billion, representing something like 60% (sixty percent) of its market value.

Examples of the value of intellectual property can be found in companies of all sizes and in various sectors of the economy. With the opening of the Brazilian economy over recent years, as well as the significant growth of new technical and legal mechanisms to diffuse and conserve intangible assets, the protection of intellectual property has become absolutely essential.

In effect, now that revaluation of intangible assets based on market value is prohibited in Brazil, recourse to Intellectual Property law is even more important in protecting the value of intangible assets. With the proper assistance and advice on intellectual property law, companies, regardless of their size and line of business, can profit from their intellectual property and ensure that they have adequate legal protection in the increasing number of transactions involving intangible assets.

FOREIGN PARTICIPATION IN COMPANIES UNDER THE 2002 CIVIL CODE: NEW AND OLD ISSUES

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On January 30, 2004, Law n° 10,838/04 was enacted, extending the deadline for associations, companies and foundations incorporated under earlier legislation to adapt to the provisions of the 2002 Civil Code from one year to two. The extension of the deadline set out in article 2,031 of the Civil Code was considered a providential, because a significant number of entities had not taken any measures to make the necessary adjustments. Their resistance is due to a state of general perplexity: most of the innovations introduced by the 2002 Civil Code in the chapter entitled “Company Law” are the target of harsh criticism by specialist scholars. The postponement of the deadline for adaptation makes the discussion even more appropriate, with emphasis on those provisions that, according to many, should be amended or even excluded before the grace period expires.

One such case is the legal provision that deals with the operation of a foreign company in Brazil (article 1,134), which refers to the requirement for prior authorization from the government. The rule is important because of the large number of limited liability companies (*sociedades limitadas*) whose capital is made up of foreign investments.

According to the terms of article 1,134 of the 2002 Code, “a foreign company, regardless of its purpose, may not operate in the country without the authorization of the Executive Branch, even through subordinate establishments, although it may, except in those cases expressly provided for by law, be a shareholder of a Brazilian corporation.”

On one side, some specialists argue that article 1,134 prohibits, purely and simply, non-authorized participation by a foreign company in a Brazilian company. The exception made in the rule refers only to corporations that are not subject to any legal restrictions.

On the other side, some argue that the issue is not that simple and requires an historic, not merely grammatical, examination. In fact, Decree-Law n° 2,627/40 – which governed corporations in the past – had a similar provision in its article 64. Since DL n° 2,627/40 governed only corporations, there was no need to make exceptions for the possibility of foreign companies participating in other types of corporate entities in Brazil.

At the time, some authors went so far as to argue that the participation of foreigners in corporations would be an indirect means of operating in Brazil, and, therefore, the unauthorized participation would be a way to circumvent the requirement established in article 64.

Nevertheless, the dispute was resolved by the facts, since foreigners have held interests in Brazilian companies, both corporations and other types of companies, without the need to obtain authorization from the Executive Branch, except for specific cases now provided for in the 1988 Federal Constitution and ordinary legislation. The exceptions have been compiled, for registration purposes, in the schedule to Instruction n° 76/1998 issued by the National Department of Commercial Registration – DNRC.

The 1976 Corporations Law did not revoke the part of Decree-law n° 2,627/40 that dealt with foreign companies. Currently, because the 2002 Civil Code contains a Section that governs the same matter in its entirety, some sustain that the 2002 Civil Code tacitly revoked Decree-Law 2,627/40. However, unlike former Decree-law n° 2,627/40, the provisions of the 2002 Civil Code are not restricted to corporations, questions about foreign participation in other types of legal entities have arisen.

In the context of the increasing economic globalization, it is undeniable that the tendency, in Brazil as well, is to facilitate and encourage foreign investment, as exemplified by the Constitutional Amendment to article 222 of the 1988 Federal Constitution, which permitted foreign participation in

media companies and radio sound and image broadcasting companies, limited to 30% of total and voting capital (EC n° 36/02).

The Law is converging in this direction: Bill n° 7,160/2002, already examined by the Constitution, Justice and Editing Committee of the House of Representatives, proposes that article 1,134 be amended to allow foreign companies to become (subject to legal restrictions) not only “shareholders” of Brazilian companies, but also “partners” or “quotaholders.”

Even if the amendment does not occur during the grace period for adaptation to the new rules under the 2002 Civil Code, it is possible to argue that the rule in article 1,134 – an exception to the principle of free enterprise – does not expressly provide that foreign companies must obtain authorization to invest in other corporate entities; therefore, the exceptional nature of the rule, which requires a restrictive interpretation, and the rule of law, under which whatever is not forbidden is permitted, leads to the conclusion that the prohibition does not apply. In addition, the complications that would arise if the theory supporting the necessity of authorization were adopted, not only in terms of bureaucracy but also, and most importantly, with respect to intertemporal law: would companies that today have “unauthorized” foreign investors suddenly find themselves in breach of the law?

Lastly, strictly from a practical point of view, Instruction n° 98/03 issued by the DNRC should be mentioned. The Instruction approves the Manual that governs registration of the corporate acts of limited liability companies. The Manual reinforces the position that authorization from the Executive Branch is not required, since it does not include such authorization in the list of documents required for the registration of corporate acts of a limited liability company which has a foreign partner.

PEDRO BATISTA MARTINS, ARBITRATION SPECIALIST, JOINS BM&A

Pedro Batista Martins, a prominent specialist in Arbitration Law, has joined the law firm Barbosa, Müssnich & Aragão Advogadas (BM&A). Pedro will lead the firm’s Arbitration area and promote awareness and understanding of arbitration mechanisms among clients from various sectors. Co-author of the Brazilian Arbitration Law (Law 9307/96), Pedro was General Counsel of Embratel from May 1999 to August 2003. He has also worked in Globo Cabo Holding S.A. and Texaco do Brasil S.A.

Since the 1980s, Pedro has worked, studied and written on the subject of arbitration. He has acted as mediator and arbitrator and represented clients in various national and international arbitrations. He was named Chairman of an International Arbitration Tribunal by the Arbitration Court of the International Chamber of Commerce (ICC) in Paris.

Pedro also holds the position of coordinator of post-graduate courses in arbitration at the Getúlio Vargas Foundation in Rio de Janeiro and São Paulo and lectures in commercial law at the Judicature School of the State of Rio de Janeiro.

PROINFA IS PUT INTO PRACTICE

On March 3, 2004 ELETROBRÁS published the first Public Call for the selection of projects for generation of wind and biomass energy and for small hydroelectric plants (PCHs) in connection with the Incentive Program for Alternative Sources of Electric Energy - PROINFA. In this Call, projects will be selected for the production of no more than 3,300 MW. Selected projects will benefit from differentiated prices paid by Eletrobrás for the energy they generate and long-term financing from BNDES, at better-than-market conditions. ELETROBRÁS has advised that there will be another call during the second half of 2004.

CRSFN AND CVM DECIDE ON CONFLICTS OF INTERESTS

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In January 2004, the Appeals Council for the National Financial System (CRSFN) decided two administrative appeals in proceedings dealing with conflicts of interests dealt with in article 115 of Law n° 6,404/76 (Brazilian Corporations Law), which had been decided at first instance by the Brazilian Securities Commission (“CVM”).

The issue is one of the most complex and controversial in Corporate Law. The heated dispute in the jurisprudence is reflected in the opinions, which are antagonistic, handed down in the proceedings that lead to the two appeals, demonstrating that the issue is far from being settled.

The controversy is based on the last part of article 115 of Law n° 6,404/76, which provides that a shareholder may not vote in any matters (1) that may represent a “personal advantage” to the shareholder; or (2) in which the shareholder has an interest that conflicts with that of the company.

At issue in Appeal n° 4,120 was whether a controlling shareholder may vote to approve an agreement entered into between the controlled company and the controlling company of the shareholder in question (the agreement also provided for payment of royalties to the controlling company of such shareholder). Appeal n° 4,585, on the other hand, deals with a shareholder vote (in this case, a minority shareholder) cast at a general meeting to approve a services agreement entered into with a company in which the shareholder held an indirect interest (also a minority holding).

In both appeals, the final decision found that there was a conflict of interests, and both shareholders were found to have acted contrary to the law. Although the reasoning that prevailed is not very clear – since the opinions (both written and verbal), in addition to being numerous, largely ignored the reasoning in other opinions –, it is possible to infer some tendencies.

In this context, the decision maintained the principle recognized by CVM according to which a conflict of interests must be substantial, i.e., verified *a posteriori*, on a case by case basis (although, according to the majority opinion, the shareholder should consider *a priori* the possibility of finding himself in a situation of conflict). Therefore, the shareholder’s voting rights are preserved, without prejudice to a subsequent determination of the legality of the vote and consequences that the conflict of interests may cause.

Nevertheless, in the cases described in the Appeals, the conclusion reached by CRSFN seems to contradict the principle described above, since the CRSFN found that a shareholder who contracts with the Company is necessarily in a situation of conflict of interests, by position that the “personal advantage” mentioned in article 115 of Law n° 6,404/76 affects the

shareholder when he or his controlling company is the other direct party entering into the agreement with the company.

This conclusion, in our opinion, does not find support in the majority of the jurisprudence or in the opinions of CVM, given, for example, Circular/CVM/SNC/n° 001/00 which clarifies “that the mere fact that two or more parties represent related parties does not necessarily mean that the transactions carried out among such parties give rise to any type of advantage”.

CRSFN’s position that the possibility of a “personal advantage” also applies to a minority shareholder as well as the controlling shareholder of the company which would potentially receive the advantage (a discussion brought to Appeal n° 4,585), only aggravates this misguided reasoning.

In other words, the CRSFN has adopted a new understanding of the law, under which even the minority shareholders may be punished based on the criteria of “personal advantage” established in article 115 of Law n° 6,404/76.

In effect, the majority opinion in Appeal n° 4,585 did not accept the distinction made by CVM in its decision at first instance, to the effect that a controlling entity’s situation would be different from that of the minority shareholder. According to the CVM, a practical analysis shows that “personal” advantage could only be gained by the controlling shareholder of the company that is allegedly benefit, not by the minority shareholder, since the advantage in question does not reach the minority shareholder “personally”, but only to exactly same extent that it benefits the other shareholders.

Although the shareholder votes were found to be in conflict with the interests of the company and, in the case of Appeal n° 4,585, were also considered to be decisive for the approval of the matter object of the general shareholders meeting (in light of the abstention and the contrary votes by other shareholders), the meetings under discussion were not annulled by the decisions of the CRSFN, since only the courts have the authority to do so. A mere pecuniary penalty was imposed on the legal entities involved.

The plurality of contradictory views and discordant opinions, in addition to the inherent complexity of the issue, left unanswered many other relevant issues raised in the proceedings: (i) is it necessary to prove that the shareholder has a personal advantage or interest that is *in opposition* to the interests of the company? (ii) is it essential to submit incontrovertible evidence of wrongful intent or of damage to the company in the shareholder’s vote? These and other unanswered questions reflect the extent of the legal uncertainty that affects the subject of conflict of interests today.

CONTROVERSIAL ASPECTS OF THE NON-CUMULATIVE PIS/COFINS CREDIT

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The non-cumulative application of the Contribution to the Social Integration Program and to the Public Servants' Fund Financing Program ("PIS/PASEP") introduced by Law n° 10,637/02 and the Social Security Financing Contribution ("COFINS"), introduced by Law n° 10,833/03, is based on the premise that certain costs and expenses may be included in the calculation of tax credits to be set off against tax debits.

The types of costs and expenses which may be included in the calculation of PIS/PASEP and COFINS credits are those expressly listed in article 3 of both Law n° 10,637/02 (PIS/PASEP) and Law n° 10,833/03 (COFINS). Among such costs and expenses, financial costs arising from loan and financing transactions and payments in commercial lease transactions, dealt with in article 3, V of both Laws, merit attention.

The requirement related to the legal nature of a transaction capable of generating a financial expense which may be included in the calculation of PIS/PASEP and COFINS credits should be closely examined by PIS/PASEP and COFINS taxpayers. Many instruments available to, and used by, companies to raise funds are not necessarily loans or financings, such as debenture issues (convertible or not), securitization of receivables (standalone or not) and advances on exchange contracts (ACC), among others.

Equally problematic are those financial expenses arising out of transactions, which, in principle, do not fall within the definition of a loan or financing, as in the case of payment of interest on capital. May such expenses be included in the calculation of PIS/PASEP and COFINS credits?

Interest on capital represents a financial income for those who receive it and a financial expense for those who pay it, according to article 9 of Law n° 9,249/95. However, this does not necessarily mean that interest on capital results from a loan or financing as traditionally defined, since customarily the borrower is required to return to the lender the amount of the principal plus a certain remuneration or return on the principal.

On the other hand, interest on capital was created precisely to serve as an alternative for companies to raise funds for their businesses, at a lower cost and with a tax advantage (deduction of interest paid from taxable profit for the purposes of corporate income tax and the Social Contribution on Net Profits).

For that reason, it can be argued that the general terms of the provision of the Laws (which refers with loans and financings, without specifying types) would permit self-financing through the payment of interest on capital to be included among eligible "loans and financings", particularly because the applicable legislation makes interest on capital financial income for those who receive it and a financial expense for those who pay it.

To date the Federal Revenue Service has not made any official pronouncement on the matter, but it is likely that the tax authorities will adopt the traditional definition of loan and financing, and thus seek to prevent the financial expense represented by payment of interest on capital from being included in the calculation of PIS/PASEP and COFINS credits.

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