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## CADE AND REVIEW OF CONCENTRATION ACTS INVOLVING FINANCIAL INSTITUTIONS

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Recent events promise to intensify the debate on the question of whether Brazil's Administrative Council of Economic Defense (CADE) has authority to review and decide on concentration acts, such as mergers and acquisitions, involving financial institutions: In a decision issued at the end of October 2004, concerning a concentration act involving Mellon Bank and ABN AMRO, CADE squared off against the federal Advocate General's Office.

Earlier, in 2001, the Advocate General's Office issued an opinion that the Central Bank of Brazil has exclusive jurisdiction to review and decide upon concentration acts involving members of the Brazilian financial system. The question has been the subject of heated debate ever since: various specialists believe that it is wrong to exclude CADE entirely from the review and judgment of concentration acts of this type. Although concentration acts between financial institutions are a special case because they involve risks to the financial system, removing CADE completely from decisions on mergers and acquisitions between financial institutions is not, according to the specialists, the best solution.

CADE's recent decision suggests that despite the turnover in the board members (four were replaced, including the chairman) CADE continues to believe it has a role to play in deciding on concentration acts involving financial institutions.

The opinion expressed by the board members in the October decision points out a need for a rapprochement between CADE and the Central Bank, in order to establish cooperative procedures between the agencies that will promote a competitive environment in the financial sector. The decision acknowledges the Central Bank's exclusive jurisdiction in certain matters (where a risk to the financial system exists, for example) but suggests that there are situations in which the most suitable institutional arrangement would be a concurrent jurisdiction in CADE, which would exercise its powers in cooperation with the monetary authority.

Regardless of the debate over CADE's jurisdiction, the continuing uncertainty as to which agency or agencies have jurisdiction to review transactions involving financial institutions is harmful to the financial sector and society as a whole. These negative effects have led the Brazilian Congress to discuss the possibility of a legislative solution to the question, which could finally put an end to the controversy.

## ANATEL SUBMITS PROPOSED REGULATIONS ON THE USE OF “REVERSIONARY” PROPERTY

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Anatel recently concluded Public Consultation no. 545 concerning the “Regulation for the Monitoring and Control of Reversionary Property Used in Providing Telecommunications Services in the Public System”, which commenced on July 28, 2004. Through the consultation, Anatel sought comments from telecommunications service providers in particular and from the population in general on the adoption of regulations detailing the administration of reversionary property.

Because of the importance of the proposed regulations, service providers submitted various suggestions for the text presented by Anatel. The three issues that most concerned the service providers, and on which they had converging views, were: (i) the precise definition of reversionary property; (ii) the manner in which Anatel should monitor and control such property and, lastly, (iii) the procedures for alienation, encumbrance and replacement of such property.

According to the specialists in this field, “reversionary” property is property that is essential to the provision of a public service by holders of concessions or licenses and that, at the time the concession or license terminates, is transferred to the branch of government that granted the concession or license, so as to ensure continuity of service, within the meaning of art. 102 of Law 9472/97 (the General Telecommunications Law).

The first point discussed by the service providers was precisely the definition of reversionary property proposed by Anatel. According to the agency, reversionary property is property that is essential to the provision of services and that belongs to the service provider, to companies that control, are controlled or are under common control with the service provider, or to third parties.

All the comments submitted by the service providers stressed that it would be contrary to the Constitution to extend the scope of the proposed regulation to the property of third parties which are strangers to the agreement entered into between the service provider and the government. Anatel was also reminded that the General Telecommunications Law contains a specific solution for continuity of services which are provided by means of property belonging to third parties: the government is subrogated in the rights of the service provider under the contracts with the owners of the property. Accordingly, there is no need to include third party property in the definition of “reversionary property.”

The service providers also took issue with Anatel’s proposed requirement for prior consent by the agency to the use of property that does not belong to the service providers. The telecommunications companies suggested that a simple notice would suffice and would avoid obstacles to the free operation of the service.

The second polemic question concerns Anatel’s suggestion for the monitoring and control of reversionary property. Under article 4 of the proposed regulation, the service providers would be required to maintain, at the disposition of the agency, a “real time” inventory of the property containing a variety of information, such as the name of the manufacturer and the model and series number of each item of property. The service providers considered that such a system would be unworkable in practice and submitted suggestions to simplify the description of reversionary property and the frequency of inventory updates, while at the same time ensuring Anatel’s ability to monitor and control reversionary property.

The last matter that received particular attention from the service providers was the proposed requirement for prior consent by Anatel for the alienation, encumbrance or replacement of reversionary property. This attention was motivated by the fact that reversionary property is routinely attached in judicial proceedings against service providers, and by the need for a dynamic system for replacement of equipment and installations in order to ensure quality of service.

Inappropriate regulation of these matters can create unnecessary obstacles to the service providers’ search for efficiency and quality, with serious consequences for the telecommunications sector. The comments submitted to Anatel will, it is hoped, help the agency to draft clear and precise regulations, avoiding future controversies as to their meaning. Moreover, in drafting the regulations, it is fundamental that Anatel respect the principle of reasonable exercise of regulatory powers, and impose bureaucratic controls on reversionary property only to the extent strictly necessary to achieve the objective of protecting the public interest, without excessively burdening the services provided by the telecommunications companies.

## THE SARBANES-OXLEY ACT, RISK MANAGEMENT AND OFFICERS' AND DIRECTORS' LIABILITIES

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It may seem, at first glance, that the Sarbanes-Oxley Act of January 23, 2002, created new law by imposing civil and criminal liability for failure to comply with the rules governing companies operating in the American capital market. In fact, those obligations and penalties already existed. The Sarbanes-Oxley Act simply refined, broadened and made more specific certain of the liabilities and penalties to which officers and directors are subject.

In practical terms, the Sarbanes-Oxley Act affects Brazilian companies that have issued level 2 or level 3 American Depositary Receipts (ADRs), carry out exchange offers for debt instruments registered with the Securities and Exchange Commission (SEC), such as Notes, that were originally issued under Rule 144-A and/or Regulation S, or are subsidiaries or affiliates of American multinationals whose securities are registered with the SEC.

Many of the provisions under the Sarbanes-Oxley Act are already in force and Brazilian companies have been taking action to meet the new requirements.

One example is the requirement under section 402 of the Sarbanes-Oxley Act to include information in the 20-F on all material off-balance sheet transactions between the company and its subsidiaries or other unconsolidated entities that may have a material current or future effect on its financial condition, operational results or liquidity. In Brazil, CVM Instruction 235/95 already required that listed companies set out the market value of financial instruments, whether or not shown as an asset or liability on the balance sheet, in explanatory notes to the companies' financial statements and quarterly reports to the CVM. Furthermore, under CVM Instruction 408/04, the CVM now requires that the consolidated financial statements of listed companies include not only controlled companies but also any special purpose companies (SPCs) whose activities are controlled, directly or indirectly, by the listed company.

As for officers' and directors' liability, since 2002, the Chief Executive Officer (CEO) and Chief Financial Officer (CFO) have been required under sections 302 and 906 of the Sarbanes-Oxley Act to certify reports filed with the SEC.

There are a number of differences between sections 302 and 906 of the Sarbanes-Oxley Act. The first is that the certification given under section 302 has effect under the civil law, and that given under section 906 under the criminal law. Moreover, certification under section 906 is required only for periodic reports that contain financial information. Violation of section 906 by a CEO or CFO subjects them to two types of sanctions: (a) if a "knowing

violation" is found to exist, the penalty is a fine of up to US\$1,000,000 and/or imprisonment for up to 10 years; (b) if a "willful violation" is found, the penalty is a fine of up to US\$5,000,000 and/or imprisonment for up to 20 years.

Beginning in 2006, 20-Fs must contain an assessment report on the internal controls applied in the preparation of financial information, and the report must be attested to by the company's independent auditors. In addition, from 2006 on, the certificate issued under section 302 must include a certification as to the internal control system used in preparing the financial information.

For some years now, Brazilian legislation and regulations have provided for the liability of officers and directors (and applicable sanctions) with respect to information filed by listed companies, whether financial or not.

Article 6 of CVM Instruction 202/93 provides that the investor relations officer is responsible for providing information to the investing public, to the CVM and to the stock market or organized over-the-counter market, as applicable, and for ensuring that the company's registration is up to date.

The investor relations officer is also responsible for statements of material fact. Under article 3 of CVM Instruction 358/02, the investor relations officer is required to disclose any material fact occurring in the course of, or related to, the business of a listed company, and to ensure that the information is immediately and simultaneously disseminated to all markets on which the company's securities are listed for trading. Controlling shareholders have the duty to inform the investor relations officer of any material fact so that he or she can ensure that it is properly disclosed.

Under Brazilian law, financial statements must be signed by all the officers and directors of the company.

An officer or director who makes a false statement on the financial condition of a company, or fraudulently conceals, in whole or in part, facts related to the financial condition of a company, in a prospectus, report, opinion, balance sheet or other communication to the public or to a shareholders' meeting commits a crime punishable under article 177 of the Brazilian Criminal Code by imprisonment for one to four years and a fine, if the act does not constitute a crime against the public economy. If fraud is involved and the act constitutes a crime against the public economy, the sanction is imprisonment for two to 10 years, in addition to a fine, under Law 1521/5.

Law 7492/86, which defines crimes against the financial system, makes it a crime, punishable by imprisonment for two

to six years and a fine, to induce or maintain an error with respect to financial condition or financial transactions by withholding information or giving false information.

In conclusion, the Sarbanes-Oxley Act, by imposing better control mechanisms and requiring companies' principal executive officers to monitor those mechanisms, as well as

through a number of other requirements not mentioned here (such as the creation of an independent audit committee) seeks to fill the gaps in the law that allowed executives involved in alleged frauds to defend themselves by arguing that they had no responsibility for certain information, and particularly financial information.

## REFORM OF THE JUDICIAL SYSTEM: IN SEARCH OF SWIFT AND EFFICIENT JUSTICE

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The Brazilian Senate's approval of the Draft Constitutional Amendment for Reform of the Judicial System (no. 96/92) on November 17, 2004 has sparked renewed hope that Brazil may soon have a faster, more efficient and more transparent judicial system.

The draft amendment not only seeks to streamline proceedings but above all to strengthen and give new credibility to the diminished image of the Brazilian judicial system. For example, the draft amendment proposes the creation of a National Justice Council composed of judges, representatives of the Public Ministry and lawyers, whose primary task will be to supervise the conduct of judges and other members of the judicial system.

The Council will have the power to consider and decide on complaints made against judges and other members and agencies within the judicial branch of government and to impose sanctions if they are found to have breached their duties of office. The power to remove judges found to have committed misconduct, however, was excluded from the draft amendment by the Senate.

A number of changes proposed by the draft amendment should significantly speed up the judicial process: (a) judges' productivity will be a decisive factor in career promotions, which should prevent judges from retaining case records without good reason and delaying the return of case records to the court clerk with the required order or decision; (b) the courts will operate continuously and there will be no collective vacation or recesses for first instance judges and the lower appeal courts (the higher appeal courts will have a Special Vacation Panel to decide urgent matters) and (c) proceedings will be assigned immediately upon filing, at all levels.

Other innovations are intended to give greater credibility and respect for the judicial system: (a) new judges will be required to have at least three years' practical experience in the legal profession; (b) judges will be entitled to life-time tenure only after they have completed three years in office; (c) judges will be prohibited from naming spouses, companions and relatives by consanguinity, adoption or affinity, up to the third degree, to positions within the judicial system that are filled by discretionary appointment (rather than through the competitive public service admission process) and (d) retired judges will be prohibited from acting before the courts in which they held their judgeship for a period of three years following their retirement.

However, the change that will have the greatest impact, and indeed promises to cause upheaval in the legal profession in general, is the introduction of binding restatements of precedents or *summulas* issued by the Supreme Federal Court, commented on by Teresa Negreiros and Maria Angelica Benneti Araujo in *BM&A Review no. 5*. Such *summulas* would bind the lower courts, requiring them to follow the precedents summarized in the *summulas* in cases involving similar issues.

The objective of the draft amendment, in introducing binding *summulas*, is to avoid the proliferation of lawsuits on points of law that have been settled by the courts. Binding *summulas* are expected to reduce substantially the volume of cases before the courts, and this effect will be reinforced if the House of Representatives approves the Senate's suggestion to include in the draft amendment "appeal-barring *summulas*", which would prevent any type of appeal against decisions based on a binding *summula*.

Although the draft amendment represents a very significant step forward, other measures are needed to bring about a faster and more efficient judicial system in Brazil. In fact, there are 14 bills now before the Brazilian Congress which, if passed, will substantially change current procedural law, including the law governing judicial executions, discussed by Luiz Fernando Fraga and Mario Gelli in *BM&A Review no. 5*.

## PIS and COFINS on income from sale of real estate is non-cumulative

On November 5, 2004, the Federal Revenue Service published Instruction 458 concerning the non-cumulative application of PIS/PASEP (contributions to the social integration program and the public servants' fund financing program) and COFINS (social security financing contribution) to companies operating in the real estate market. Under the terms of the Instruction, in addition to the other credits provided for under the non-cumulative regime, real estate companies that are taxed under the "real profit" regime can take advantage of tax credits arising from costs associated with real estate units, either finished or under construction, which can be deducted after the date of sale.

## The Supreme Court of Justice and advances under currency exchange contracts

On December 6, 2004, the 2nd Section of the Superior Court of Justice approved Summula no. 307, as follows: "On bankruptcy, funds advanced under currency exchange contracts must be returned before any other claim is paid." The Summula is based on precedents finding that in bankruptcy proceedings, advances made under currency exchange contracts must be repaid before any other claim, because the advances do not form part of the bankrupt's property. This statement of the law by the Superior Court of Justice is of particular interest to companies which use lines of credit for export transactions, such as Advances on Currency Exchange Contracts (ACCs) and Advances on Foreign Currency Receivables (ACEs).

## NON-COMPETITION CLAUSES AND THEIR EFFECTS IN EMPLOYMENT RELATIONS

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Non-competition clauses are becoming more and more common in employment agreements with employees who have special qualifications and hold strategic positions.

This type of clause is intended to ensure that, even after termination of employment, a former employee will not disclose confidential business information belonging to the employer company, such as customer portfolios, technical and commercial knowledge, formulas, plans, processes and any other kind of strategic information which, if transmitted to a competitor, could cause significant loss to the company and leave it at a disadvantage in the market.

The validity of non-competition clauses has long been accepted by the courts in various European countries and in the United States. In Brazil, although there are few precedents, the trend of the Brazilian labor courts is to find such clauses valid.

Recently, the 3rd Panel of the São Paulo Regional Labor Appeal Court unanimously decided that a non-competition clause contained in an employment agreement, which prohibited the employee from providing services to a competitor of the employer, was valid.

The court held that the non-competition clause was valid because (i) it reflected "an obligation of a moral nature, of loyalty"; (ii) the prohibition against working for a competing company had been established for a reasonable length of time and location; and (iii) it provided for payment of an indemnity that would allow the employee to meet his commitments, just as if he had been working.

Following the reasoning of the Regional Labor Appeal Court, it appears that non-competition agreements will be valid and compatible with the protection extended to employees under Brazilian labor legislation, provided that: (i) the employer has a legitimate interest in the agreement, which generally arises out of the risk of disclosure to the competition of strategic or confidential information to which the employee has access; (ii) the non-competition obligation is limited in time and space, by defining the period of time and the geographic area in which the employee will be prohibited from providing services to the competition; (iii) the agreement provides for monetary compensation for the employee's inability to work while the non-competition obligation is in effect; and (iv) the employee expressly agrees to the terms and conditions of the non-competition agreement.

## FEDERAL REVENUE SERVICE ISSUES REGULATIONS ON TAXATION OF REAL ESTATE DEVELOPERS' SEGREGATED PROPERTY

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Federal Revenue Service Instruction 474 was published on December 6, 2004, establishing regulations on the Special Taxation Regime (STR) created by Law 10,931 of August 2, 2004. Among other matters, Law 10,931/04 deals with real estate development projects subject to the segregated property system, under which the land, improvements and other rights and assets related to a development project are considered to be separate from the developer's property.

The STR is optional, but once the real estate developer opts for the special regime, it will apply as long as the developer has obligations to, or holds debts against, the purchasers of properties that form part of the development project. However, in order for the STR to apply, the land and improvements associated with the development project must constitute segregated property, within the terms of articles 31-A and 31-F of Law 4591/64, introduced by Law 10,931/04.

Real estate developers which opt for the regime will be subject to unified collection of Corporate Income Tax (*IRPJ*), Social Contribution on Net Profit (*CSLL*), Contributions to the Social Integration Program and Public Servants' Fund Financing Program (*PIS/PASEP*) and Social Security Financing Contribution (*COFINS*), at a total rate of 7% over monthly income received, including income from sale of properties and income from investment and monetary variations. Cancelled sales, returned sales and unconditional discounts given by the developer are deductible.

The inclusion of income from investment and monetary variation as taxable income under the STR is one of the principal factors that distinguish the STR from the "presumed profit" tax regime applicable to real estate companies. Although the total tax burden under the presumed profit regime is less than the single rate under the STR (approximately 6.73%), only operating income is taxable under the presumed profit regime. There is no minimum income limit that must be met in order for a real estate developer to opt for the STR.

Unified payment of the taxes covered by the STR must be made by the 10th business day following the month in which the income was received, and payment cannot be made in installments. For tax purposes, each real estate project will be required to have a separate registration in the National Register of Legal Persons (*CNPJ* - the federal tax register), as well as separate accounting books.

If the real estate developer benefits from suspension of any of the taxes covered by the STR, the taxes owed on the segregated property must be paid separately, at the following rates: 2.2% for *IRPJ*, 1.5% for *CSLL*, 0.65% for *PIS/PASEP* and 3% for *COFINS*.

The only tax debts of the real estate developer that may be satisfied out of land, improvements and other rights and assets forming a project's segregated property are for *IRPJ*, *CSLL*, *PIS* and *COFINS* on income pertaining to the project.

However, article 11 of the Instruction provides that in the case of a decree of bankruptcy or insolvency against the developer, if the purchasers under the project decide to continue with the construction but the tax, pension and labor obligations associated with the project are not paid, the decision to continue construction will cease to have effect, and the project property will no longer be segregated, within one year from the date of the decision or until the occupation license is granted, whichever occurs first.

In any event, the property of the real estate developer is always subject to execution for satisfaction of the tax debts of the project.

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