Understanding *the* Rules *of the* Road *for* Acquiring Companies *in* Brazil *and* India

BY ROBERT LOEWER, STEPHEN SAYRE AND MONA PEARL

You are the general counsel for a medium-sized, privately-owned manufacturing company. Your CEO has advised you that she and the board have adopted a strategy, not uncommon in your industry, to vertically integrate the company's supply chain by acquiring several key raw material suppliers, which happen to be located in Brazil and India. Although your company has experience with international acquisitions, it has no experience with acquisitions in either of these countries. Your CEO has asked you to get her up to speed on how M&A works in each of these countries and to assist her in making an assessment as to whether your company should pursue these targets based on the legal environment in each country.

Fortunately, your outside law firm has relationships with firms in each of these countries, so you arrange to speak with representatives of each firm to learn what you can about the legal framework for M&A in each country. You focus your inquiry on the following areas:

- How does the pre-acquisition phase work in these countries (i.e., letters of intent, due diligence, no-shop provisions, etc.)?
- How are transactions typically structured (i.e., set sales, stock sales, mergers)?
- How do the legal terms and conditions in acquisition agreements differ from those commonly found in US acquisition agreements?
- What regulatory approvals are required for M&A transactions in these countries?
- How does the legal landscape differ with regard to labor and employment matters? Of particular concern is whether the acquiring company is free to terminate the seller's employees and whether noncompete agreements can be relied on to prevent the seller from competing with the acquiring company after closing.
- What cultural factors should be kept in mind when acquiring a company in these countries to make the transaction proceed smoothly?


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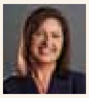
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India

Your US law firm puts you in touch with Ms. Anjuli Sivaramakrishnan, an M&A expert with the law firm of Kochhar & Co. Gurfaon, one of the largest commercial firms in India. You are relieved to learn that the ABCs of M&A practice in India are not nearly as complicated as you thought they would be.

Pre-acquisition

As in the United States, the pre-acquisition phase typically begins with a signed, non-binding letter of intent. And as in the United States, the letter of intent often includes a no-shop provision (which is binding) to give the acquirer a specified period of time during which it has the exclusive right to conclude the acquisition.

The due diligence process varies considerably from one transaction to the next, depending on the level of transactional risk and complexity. Therefore, if the dynamics of the potential acquisition justify it, then an extensive document request is unlikely to shock a target in India. As in the United States, there are publicly available databases to search for liens and encumbrances against assets being acquired, and liens not properly recorded are not legally enforceable. That said, the publicly available databases in India are generally not as accurate as in the United States, and many jurisdictions do not have computerized records. So, there may be more risk, and this process will likely take longer than it does in the United States.

Transaction structures

As in the United States, acquirers may acquire Indian companies through asset acquisitions or stock acquisitions. And, as in the United States, sellers typically prefer stock sales to asset sales due to the automatic release of all of the liabilities associated with the properties, and the avoidance of double taxation inherent in asset sales. And, of course, the transaction purchase price will reflect the agreed-upon transaction structure.

There is, however, one nuance in asset sales that is different in India that makes them less frequent than in the United States. In India, there is a concept called a "slump sale," under which a business purchased for a lump sum, with no breakup of values, may be automatically deemed to result in a long-term capital gain for the seller. In India, the long-term capital gain rate is 22.15 percent, while the short-term capital gain rate is 33.22 percent, so obtaining long-term capital gains treatment is quite important to sellers. However, in order for the transaction to qualify as slump sale and receive this favorable treatment, the entire business unit must be sold intact, including the transfer of all related liabilities. Because this negates the principal advantage for the buyer in conducting a purchase of assets rather than acquiring stock (i.e., avoidance of liabilities of the business being acquired), asset sales are less common.

Legal terms and conditions in acquisition agreements

Acquisition agreements in India mostly contain the same legal terms and conditions as US agreements, but they differ in several important respects. As in the United States, documentation in India generally contains detailed representations and warranties being made by the seller. And like US acquisition agreements, agreements in India will typically contain

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indemnification provisions, which set forth the rights and liabilities of the parties with respect to any breaches of those representations and warranties. However, unlike in the United States, where the indemnification provision is often the sole and exclusive remedy for a breach by the seller of its representations and warranties under the acquisition agreement, that is generally not the case in India, where the purchaser always retains its right to sue under the India Contracts Act of 1976. It is perhaps for this reason that there is less negotiation than in the United States over the amount of dollar caps and the length of limitation periods associated with indemnification provisions.

In addition, as in the United States, selling shareholders with large holdings will often be required to sign acquisition agreements, thereby making them personally liable for any breaches of representations and warranties contained therein.

Escrows and holdbacks also work differently in India. There are generally no earn-outs or post-closing purchase price adjustments tied to the target company's future performance or the target company's working capital balance at closing. This may explain why post-closing escrows are rare in India, even for the purpose of covering future indemnification claims. This practice may cause some heartburn to US acquirers, potentially causing them to spend more time on due diligence.

Arguably, one offsetting benefit to acquirers is that counsel for sellers are quite accustomed to providing legal opinions covering corporation organization and approval matters, and even extending to the target company's compliance with regulations and applicable laws.[1] Unlike the United States, where the practice has receded a bit, especially in middle-market transactions, the practice of rendering legal opinions by sellers in India remains alive and well.

Lastly, it should also be noted that legal disputes in India take on average seven to ten years to be resolved (the "rocket docket," it is not!), so it is important to include an arbitration provision in acquisition agreements to resolve any disputes that may arise later. A well-drafted arbitration provision, followed by a properly conducted arbitration proceeding, should result in a judgment that a prevailing party can enforce in an expeditious manner in Indian courts.

Regulatory concerns

There are various regulatory authorities in India that may be involved with the approval of an M&A transaction. Whether the transaction will be subjected to regulatory approval will be determined by the following issues:

- the industry in which the target company operates;
- whether the assets or the equity of the Indian company are being acquired;
- whether the company being acquired is a public company or a private company under Indian corporate laws; and
- the extent to which the combined entity would have a dominant position in an industry segment, thus undermining competitiveness within that industry.

Each of these issues is addressed below:

First, there are certain industries, such as telecommunications, banking, defense, atomic energy, gambling and gaming in which foreign investment is either completely prohibited or substantially limited. You are pleased when your in-country counsel advises you that no such restrictions apply to your industry.

Second, equity investments in (but not asset acquisitions of) Indian companies are subject to Indian regulations pertaining to exchange control. Specifically, the Foreign Exchange Management Act of 1999 (FEMA) provides that in the case of the transfer of shares from an Indian resident to a non-Indian resident, the shares must be purchased at not less than their fair value. Under the regulations, "fair value" is determined based on a chartered accountant discounting the future cash flows of the acquired company.

Third, there are certain additional regulations that apply to public companies in India that do not apply to private companies.[2] In India, a pubic company is generally subject to regulation under the Companies Act, 1956 (the Companies Act), and any acquisition of a public company is subject to the Substantial Acquisition of Shares and Takeovers Regulations, 1997 (the Takeover Code). Fortunately, the targets your company is considering are not publicly traded, so neither the Companies Act nor the Takeover Code would apply.

Fourth, the Competition Commission of India (CCI) is responsible for preventing anti-competitive agreements and the abuse of dominant position by an enterprise. Companies are required to submit the following agreements to CCI within 30 days of the approval of the proposal of the transaction:

- an acquisition where the transferor and transferee jointly have, or a merger or amalgamation where the resulting entity has: (i) assets valued at more than INR 10 billion or turnover of more than INR 30 billion in India; or (ii) assets valued at more than USD 500 million in India and abroad, of which assets worth at least INR 5 billion are in India, or turnover more than USD 1.5 billion, of which turnover in India should be at least INR 15 billion;
- an acquisition where the group to which the acquired entity would belong, or a merger or amalgamation where the group to which the resulting entity would belong, has: (i) assets valued at more than INR 40 billion or turnover of more than INR 120 billion in India; or (ii) assets valued at more than USD 2 billion in the aggregate in India and abroad, of which assets worth at least INR 5 billion are in India, or turnover of more than USD 6 billion, including at least INR 15 billion in India.

In the cases mentioned above, the parties to a combination are required to file a notification in the prescribed form with CCI, and the combination cannot be effected unless prior approval is obtained from CCI. Once a party files a notice of a combination with CCI, CCI is required within 30 days to render a preliminary opinion regarding whether the combination is likely to cause or has caused an appreciable adverse effect on competition within the relevant market in India. If CCI determines that the proposed combination is not likely to cause or has not caused an appreciable adverse effect on competition within the relevant market in India, then it would grant approval. On the other hand, if CCI determines that the proposed combination may cause an appreciable adverse effect on competition within the relevant market in India, or if the proposed combination needs further study and inquiry, CCI would issue a "show cause" notice under Section 29 of the Competition Act and conduct further inquiry. The Competition Act, however, provides a maximum time limit of 210 days for conducting such inquiry, and in the absence of a decision from CCI within 210 days, a combination is deemed to be approved.

Labor and employment issues; Noncompete agreements

Labor and employment laws are much more protective of employees than they are in the United States. Under Indian employment laws, the acquisition is required to be structured in a manner such that there is no break in the employment to staff. Further, in accordance with the industrial disputes law, the employee must be given the same or better terms of employment, failing which, compensation may be payable by the acquirer.

Noncompete clauses are enforceable in the acquisition context provided that the transaction involves the sale of the company's goodwill (which would generally be the case in an M&A transaction). Generally speaking, Indian courts will permit a seller-shareholder noncompete period of two to three years, and it may extend to all of India if the acquired company has operated nationally. However, non-shareholder employee noncompete agreements are ordinarily not enforceable in India.

Cultural issues

In the context of business negotiations with India, always bear in mind that they can be slow. India is a relationship-oriented society, so if trust has not yet been established in the relationship between the buyer and the seller, then time should be spent building that trust. In addition, decisions are always made at the highest level, so if the owner or CEO of the target company is not present, these are most likely early-stage negotiations (at least from the Indian company's perspective). Further, to the extent that the transaction requires government action, locating the correct office and obtaining the required action can be a lengthy process. All of this should be factored into the buyer's timeline.

In addition, in India, they do not base their business decisions solely on statistics, empirical data and detailed PowerPoint presentations. They also rely on intangible factors, such as feeling and faith, to guide them. It is very important when negotiating with Indians to exercise patience, show good character and not exhibit frustration or anger.

It should be noted that India is a male-dominated society. Older men in India are especially accustomed to dealing with other men. As our hypothetical fact pattern involves a female CEO, she should be briefed on what to expect during the negotiations from her (quite likely) male Indian counterparts. For instance, a female CEO in such a situation might not be treated like a CEO. It may be difficult for her to assert her negotiating position and persuade her male counterpart, as he may not listen attentively.

It is advisable to avoid high-pressure tactics and anything that might be considered confrontational or forceful. Criticisms and disagreements should be expressed politely. Indian society has an aversion to saying "no" as it is considered rude due to the possibility of causing disappointment or offense. This may help explain their comfort with a considerable amount of uncertainty and ambiguity in addressing a problem or issue. Therefore, it is important to listen carefully to the responses to your questions. If terms such as "We'll see," "I'll try" or "Possibly" are used, then they are likely saying "No" or, at best, "Maybe."

Brazil

To learn about M&A practice in Brazil, your local attorney introduces you to Mr. Pedro Freitas of the law firm of Veiranco Advogados, who explains to you the basics of M&A in Brazil. Here is what you learn:

Pre-acquisition

As in the United States (and India), the pre-acquisition phase normally begins with a signed non-binding letter of intent, which often includes a binding no-shop provision. In addition, with respect to the acquisition of larger companies, due diligence is a similarly detailed process; however, recordkeeping for medium-sized companies in Brazil is often not detailed enough to accommodate comprehensive due diligence. As in the United States, there are publicly available databases to search for liens and encumbrances against assets being acquired, which can help support the due diligence efforts where the records of the target, medium-sized or otherwise, are inadequate.

Transaction structures

As in the United States, acquirers may acquire Brazilian companies through either asset acquisitions or stock acquisitions, with sellers typically preferring stock sales over asset sales due to (i) the automatic release of all of the liabilities associated with the properties and (ii) the avoidance of double taxation inherent in asset sales. However, unlike the United States and India, purchasers of assets in Brazil are not as readily able to shield themselves from liabilities of the seller that are excluded from the terms of the transaction. Successor liability laws in Brazil are very strict, and unless the seller remains involved with the business subsequent to the asset sale, the purchaser can be held liable for the liabilities of the selling entity that are not satisfied by the seller.

Legal terms and conditions in acquisition agreements

Acquisition agreements in Brazil tend to be shorter than those in the United States, but they generally include representations and warranties covering similar territory. As with due diligence, the larger acquisition targets in Brazil, or those that have had greater exposure to international markets, will generally be less taken aback by lengthy acquisition agreements than medium-sized targets or those that have focused their operations exclusively in Brazil.

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Escrows and holdbacks are much more common in Brazilian M&A practice than they are in India, and appear to be quite similar to those in the United States. Acquisition agreements in Brazil often feature earn-outs, and nearly all stock deals include post-closing working capital adjustments. As in the United States, there is typically an escrow agreement if the holdback is material to the transaction.

Indemnification also works similarly to the way it does in the United States. Subject to exceptions for fraud or other specific areas of concern to the purchaser, the indemnification provision will provide the purchaser's sole and exclusive remedy for the breach of a representation or warranty. The caps in Brazil, however, tend to be much higher than in the United States, typically ranging from 40 percent to 100 percent of the purchase price (whereas, in the United States, 10 percent to 20 percent is more common).

Another difference between M&A practice in Brazil and India involves legal opinions. In Brazil, sellers are rarely requested to deliver legal opinions. It should be noted, however, that when a purchaser is able to succeed in making the seller's delivery of a legal opinion a requirement for the transaction, it typically covers the same subject matter as a US firm's legal opinion.

Regulatory approvals

In general, the regulatory approvals in Brazil are less cumbersome than in India and are very similar to the United States.

First, there are approvals required for transactions involving specific industries or assets, such as telecommunications, gas interests, energy and acquisition of mining assets within the border zones, as well as others. And it is important to note that any such approvals would need to be obtained prior to the consummation of the transaction. Once again, none of these requirements apply to your industry.

Second, pursuant to the Brazilian Competition Act, (i) transactions resulting in a company or a group of companies holding 20 percent or more market share within a particular industry, or (ii) transactions in which any of the participants (or any affiliate of one of the participants) has gross revenues of R$ 400 million, are required to be reviewed by the Brazilian Council for Economic Defense (CADE), to ensure that they will not undermine competition within a particular industry. If such approval is required, it must be obtained not later than 15 business days after the transaction closes. Approval by CADE takes approximately two years, so the parties normally treat this as a post-closing matter. In more complex cases, Brazilian authorities may impose provisional mechanisms to avoid total integration of the combining businesses before CADE renders its decision. The fact that the parties may, in many cases, be forced to wait a lengthy period of time before closing a transaction, or close with CADE approval still pending, is one of the most criticized aspects of the Competition Act, and legislation has been proposed to address this problem.

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Labor and employment issues; Noncompete agreements

Although labor and employment laws in Brazil are not as favorable to acquiring companies as laws in the United States, they seem more favorable than those in India. If the acquiring company intends to retain employees of the target company, it must retain in force the salary and benefits that the employee currently has in place. However, the acquiring company is not required to retain the employees. If not retained, they are entitled to receive certain statutory severance pay, and there are certain specified procedures that must be followed in connection with their dismissal. It should also be noted that the acquiring company will be liable for all payments due to the seller's employees — even those that arose prior to the acquisition.

Noncompete agreements in Brazil are enforceable, provided that there is some compensation paid to the employee in consideration for the employee's agreement not to compete that is deemed adequate in light of the extent and duration of the restriction. In addition, both the geographic scope of the restriction and the definition of the "competitor" will be scrutinized to ensure it does not unnecessarily restrict the employee from earning a living.

Cultural issues

As is the case in India, transacting business in Brazil relies heavily on interpersonal relationships. It is important to spend time at the outset building a relationship of trust. Indeed, perhaps even more so than in India, the relationship will work best if it transcends the business at hand and becomes more personal in nature. Not surprisingly, communication tends to be more informal, and the spoken word often is accorded more weight than the written word. Even scheduled business negotiations often begin and end with a period of small (but important) talk.

Brazil differs from India in its limited tolerance for uncertainty and ambiguity. Brazil has very detailed laws and regulations in an effort to avoid surprise and uncertainty. In the contractual context, Brazilians generally prefer to deal with issues directly and expressly rather than indirectly or by remaining silent on them.

Oral communication in Brazil can often be viewed as being theatrical and overly emotional by cultures that place great significance on the maintenance of professional reserve in business settings. Therefore, you should not be surprised or troubled by an occasional raised voice in the context of spirited negotiations. Again, this is in marked contrast to what normally occurs in negotiations in India.

Armed with information

Armed with this information, you sit down with your CEO and explain to her the M&A basics in India and Brazil. You explain to her that the rules in both India (slump sale tax rules) and Brazil (successor liability rules) make asset sales, whereby the purchaser can exclude liabilities, very difficult in practice. You also prepare for what will likely be a more difficult regulatory path in both countries than in the United States. Further, you explain that jettisoning existing employees of the target will either be quite difficult (India) or fairly expensive (Brazil). She is impressed with how much you have learned and believes that your company is ready to pursue acquisition targets in these countries with you spearheading the deal. Now, the real work begins.

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Notes

1 This, of course, assumes that one places value on legal opinions provided by outside lawyers in the first place. As opinions have become increasingly qualified by outside lawyers due to legal malpractice concerns, many in-house lawyers view them as either worthless or not worth the additional expense of obtaining them.

2 In India, typically a company with 50 or fewer shareholders that is not listed on an exchange will elect to be treated as a private company.