Earn-out, locked box and retention Q&A: Brazil

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Country Q&A | Law stated as at 31-Mar-2021 | Brazil

This Q&A provides country-specific commentary on *Practice note, Earn-out, locked box and retention: Cross-border*.

1. Is it possible/common to provide for payments of consideration to be deferred and payable by reference to the future performance of the target (a so-called earn-out)?

Earn-out payment structures are very common in Brazil. Usually, the earn-out price is calculated based on the target's future profitability when compared to prior fiscal years (aggregate) or the closing date year's profits. Earn-out formulas normally use multiples of OPAT (Operating Profit After Taxes) or EBITDA (Earnings Before Interest, Taxes, Depreciation and Amortisation).

The multiple to be used in the earn-out formula depends on the target's market and economic momentum. In more sophisticated deals, it is common to have a variable multiple to be defined based on the company's CAGR (Compound Annual Percentage Growth Rate) over the earn-out period.

2. How long do earn-out periods usually last?

Earn-out periods usually last from four to five years, with annual or biannual payments.

3. What are the accounting principles used for drawing up the reference accounts in an earn-out mechanism?

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The accounting principles used for calculating the OPAT or EBITDA in an earn-out mechanism are usually the Brazilian generally accepted accounting principles (Brazilian GAAP), which adopt the IFRS (International Finance Reporting Standards) rules. It is common to make the analysis based on the practices consistently applied by the company throughout the periods indicated, with normalisation of certain accounts.

When the buyer is a multinational group, it is also common to establish that the group's accounting policies will apply when they are not in conflict with IFRS.

The definition of "Reference Accounts" in *Standard clause, Earn-out: Cross-border: schedule: paragraph 1 (Definitions)* should be amended to read as follows:

"**Reference Accounts**: in relation to a Financial Year, the (un)audited consolidated balance sheet and the related (un)audited consolidated statements of income and cash flows (including related notes and schedules) of the Company and each of its Subsidiaries for the [12 month] period ended on the last day of that Financial Year, prepared in accordance with the accounting principles generally accepted in Brazil (Brazilian GAAP) in force for that Financial Year, as consistently applied."

Under Brazilian law, only listed corporations and large-size companies are required to have financial statements audited. It is therefore usual for targets not to have audited financial statements. Therefore, it is fairly common that unaudited financial statements are used for the purposes of calculating earn-out payments, which will then be calculated (or revised) by the buyers' auditors.

Large-size companies, according to Brazilian law, are corporations or limited liability companies which (individually or jointly with other companies which are part of the same corporate group) had in the immediately prior fiscal year either:

- Assets in the aggregate amount of more than BRL240 million.
- Gross annual revenues in the aggregate amount of more than BRL300 million.

4. Would the seller normally ask for a security or indemnity from the buyer with respect to the earn-out payments?

This is a very common request. Sellers usually request a corporate guarantee (from the buyers' parent company) or a bank guarantee (although this is very rarely accepted by buyers, due to its high cost). In the rare occasions where the buyer is an individual, sellers may ask for promissory notes.

Alternatively, sellers may request:

- The pledge of the quotas/shares being acquired by the buyer as a guarantee for the earn-out payments. Such a guarantee is not effective since, under Brazilian law, if the pledge needs to be enforced, the quotas/shares need to be sold and the proceeds used to pay the sellers (sellers cannot take possession of the quotas/shares).

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- "Pledge of dividends", whereby dividends payable to buyers will be used to pay unpaid portions of the earn-out (the company would then pay the amounts to sellers on behalf of the buyer (*pagamento por conta e ordem*)).
- A call option, whereby the buyer would grant the seller a call option to purchase back the sold quotas/shares (or a portion thereof) if the buyer fails to make an earn-out payment (the call option price would be the unpaid earn-out instalment or price).

5. What is the procedure that the parties will commonly follow if they fail to resolve a dispute relating to the calculation of an earn-out payment? Will they refer it to an expert? How would the expert be selected and appointed?

The most common procedure is for the company to prepare the relevant financial statements and a draft payment calculation. The buyer or its auditors will perform the tests necessary to confirm the calculation and deliver the final calculation to sellers.

If the sellers do not agree with the buyers' calculation, they must notify the buyer, describing the nature of the disagreement asserted, and the parties have a determined period to reconcile the numbers. If the parties are unable to reconcile their differences, they engage an expert (usually an auditing firm to be chosen from a list of auditing firms pre-established in the share purchase agreement (if the target entity is a corporation) or in the quota purchase agreement (if the target entity is a limited liability company) and, in any event, not the buyers' auditors), who consider only the items in dispute, and the expert's decision is final and binding on the parties. The experts act as experts and not as arbitrators.

The expert's fees are usually borne by the non-prevailing party (the party whose calculation are further from the expert's calculation).

No changes are required to the language of *Standard clause, Earn-out: Cross-border: schedule: paragraph 4 (Expert Determination)* for the sole purpose of complying with Brazilian law. The only comment is that the expert is not usually an individual, but rather, an auditing firm and that the clause (or a schedule to the share/quota purchase agreement) would contain a list of firms to be hired.

6. On which grounds may an expert determination regarding any dispute relating to the calculation of an earn-out payment be challenged by the parties to a share purchase agreement?

If the parties agree that the expert's determination is final and binding, the expert's calculation of an earn-out payment can only be challenged in case of fraud or manifest error. If the parties do not reach an agreement, the general dispute resolution provisions of the agreement (usually arbitration or judicial courts) apply.

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However, if both parties disagree with the calculation (for any reason) they may simply disregard it and either appoint another expert or use the general dispute resolution provisions of the agreement.

There is no standard contractual wording to cover this scenario, since the common practice is to determine that the expert's calculation of the earn-out payment is final and binding.

7.How common is it (if allowed) for cash payments under an earn-out mechanism to be carried out from the buyer's lawyers to the seller's lawyers? Would this be a valid mechanism to discharge the buyer's obligations under the earn-out mechanism?

This is not a common practice in Brazil, although there is no legal provision or professional rule forbidding it.

The buyer is not released from the payment obligations under the share/quota purchase agreement if the lawyer fails to effect the payment. In this case, the buyer is still responsible for paying the earn-out and has a right of recourse against the lawyer (if funds have been transferred to them).

8. Would the buyer usually negotiate a contractual right to set off any payment it may owe the seller according to an earn-out clause against any amounts owed to it by the seller in connection with any warranty, indemnity or tax covenant claim under the share purchase agreement? Would any mandatory provision limit the buyer's right to set off payments?

This is a common request from buyers. The amount to be set off is limited to the amount of the loss actually incurred under a claim. It is a common request from the sellers that the set-off can only take place after a final, unappealable decision (by a court or in arbitration) has determined the loss.

No changes are required to the language of *Standard clause, Earn-out: Cross-border: schedule: paragraph 2.4* for the sole purpose of complying with Brazilian law.

9. Should the earn-out clause include an undertaking from the buyer not to take any action in bad faith with the sole purpose of avoiding or reducing any earn-out payment or will this not be necessary (for example, because the buyer will be subject to a general duty to act in good faith)? Which other seller protection mechanisms are usually built-in in earn-out arrangements?

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The Brazilian Civil Code establishes a good faith principle, so it is not necessary (although it is possible and sometimes requested by sellers) to include such an undertaking in the share/quota purchase agreement. If the buyer takes any action with the sole purpose of negatively impacting the earn-out payment, the buyer may be penalised for breaching its general duty to act in good faith (the seller must be able to prove the buyer's bad faith).

Other mechanisms may be adopted to protect sellers in earn-out arrangements:

- Inclusion in the share purchase agreement of specific language in the earn-out formula establishing the rules for its calculation and clear explanation of any criteria used for normalisation of the financial statements, or of any other calculation criterion that departs from (but never conflicts with) the IFRS rules (for example, that the company's expenses with the expert will or will not be considered as expenses for OPAT/EBITDA calculation, or an assumption, for calculation purposes, that the sellers' remuneration for the entire closing year is in an amount equal to such sellers' annual post-closing date remuneration, and so on).
- To "normalise" or to make the "normalisation" of the financial statements means to re-classify certain items of the financial statements (or include certain unregistered revenues or expenses therein), to comply with the rules of the Brazilian generally accepted accounting principles. For example, if a partner of a limited liability company is remunerated for the work performed through dividends (which are free of taxes in Brazil), the "normalisation" will reclassify the amounts paid as remuneration (which is a deductible expense).
- Maintenance of the sellers in the management of the company (if the sellers are individuals) during the earn-out period, to allow the sellers to have more control and visibility of the company's business, operations and accounting.
- Hiring of independent auditing firms to audit the company's financial statements during the earn-out period.
- If the sellers continue to hold equity interest in the company after closing, they could establish veto rights for themselves in the shareholders'/partners' agreement, especially with regard to the operation, conduct of business and control of expenses of the Company, in the line of the provisions of *Standard clause, Earn-out: Cross-border: conduct of business (seller protection)*.

No changes are required to the language of *Standard clause, Earn-out: Cross-border: clause 5* and *Standard clause, Earn-out: conduct of business (seller protection): Cross-border* for the sole purpose of complying with Brazilian law. It is not uncommon for some of the items listed in *Standard clause, Earn-out: conduct of business (seller protection): Cross-border: clause 1.1* and *clause 1.2* to become veto rights (if the sellers continue to hold an equity interest in the company after closing).

10. Is it possible/common to provide for a "locked box" mechanism as a method to determine the purchase price?

It is possible to adopt the "locked box" mechanism, although it is not common in Brazil anymore.

In a locked box deal in Brazil, after (enhanced) due diligence by the buyer, the parties would negotiate and agree on a balance sheet and the corresponding purchase price, and such purchase price would be fixed. Economic risks and

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benefits transfer to buyer as of the balance sheet date (locked box date). Sellers should be prevented from paying dividends, bonuses, transferring business or assets out of the company (known as leakage) between the balance sheet date and the closing date.

11. Is it possible/common to provide for part of the purchase price to be retained by the buyer?

It is common in Brazil for a portion of the purchase price to be retained by the buyer (holdback), deferred (when payment of part of the purchase price is deferred and the buyer will have a right of set-off against the deferred consideration for any payment of losses as described below before the deferred consideration falls due for payment) or deposited in an interest bearing account (escrow), as a guarantee for the payment of losses incurred by the buyer or the company under the share/quota purchase agreement (that is, indemnification for losses incurred by the buyer or the company in relation to acts or facts that occurred before the closing date, or losses incurred by the buyer arising out of misrepresentations or breach of covenants or obligations assumed by sellers under the share/quota purchase agreement).

The calculation of the retained amounts is normally based on the company's liabilities, as calculated by the buyer's auditors (potential liabilities) and attorneys (actual liabilities). Depending on the negotiated terms, the sellers may be liable to indemnify the buyer for either:

- Any losses related to the pre-closing period.
- Disclosed liabilities only.
- Undisclosed liabilities only.

The most common situation is for sellers to be liable for all pre-closing liabilities, whether or not disclosed.

The period of retention is usually six years (the current year plus five additional years), which is the statute of limitation for most tax and labour liabilities (an employee has two years as of dismissal or resignation to file a labour lawsuit but may claim rights related to the previous five years). For civil liabilities, the statute of limitation varies, but most of the cases are also comprised within the six-year period.

Release of the holdback or escrow varies from transaction to transaction. Some transactions provide for partial purchase price releases on an annual basis, according to the amount of liabilities covered by the statute of limitation in any given year or according to an agreed percentage of the total amount (for example, release of 20% of the retained amount per year).

12. If so, is it common to put the consideration (or a portion of it) in a joint bank account or any other arrangement (for example, escrow agreement)?

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The retained purchase price may be either held back or deferred by the buyer, or deposited in an escrow account.

Sellers usually request the deposit of the funds in an escrow account (at a reputable bank), but the costs for the maintenance of escrow accounts in Brazil are high. The choice between a holdback or an escrow account depends largely on the size of the transaction and the amount of purchase price to be retained.

Escrow accounts are rarely jointly held by buyers and sellers, since only individuals resident in Brazil are entitled to own joint bank accounts (neither Brazilian nor foreign legal entities, nor non-resident individuals may own such accounts). To remedy this limitation and give sellers comfort, the parties may establish that release letters must be signed jointly by the buyer and seller.

Also, in most cases, for tax reasons, escrow accounts are most commonly opened in the buyers' name (the transfer of the escrowed amount to a bank account owned by the sellers would trigger the payment by the sellers of income tax in respect of the capital gain, even if the purchase price is still contingent and subject to reduction).

13. If an escrow account is set out, who is usually instructed to act as escrow agent(s)? Are the parties' lawyers allowed, or commonly entrusted, to act as escrow agents or do the parties usually appoint a financial institution or third-party service providers to perform this role?

Usually, escrow agents are financial institutions (a bank where the escrow account has been opened). Although there is no prohibition for the parties' lawyers to act as escrow agents, this is highly unusual in Brazil.

14. Are letters of instruction from the escrow agent(s) to the escrow bank drafted on the basis of standard forms provided by the escrow bank?

Escrow agreements are rather standard, and letters of instructions are normally a schedule to the agreements.

See below proposed changes to *Standard document, Escrow account: instructions to escrow bank: Cross-border:*

To: [NAME AND ADDRESS OF BANK]

From: [SELLER]

and [BUYER]

[DATE]

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Dear Sirs,

Bank account operating instructions

We have asked you to open an interest-bearing [instant access] deposit account, in the names of [BUYER] [or SELLER], at your [LOCATION] branch, [ADDRESS], with account no: [NUMBER] (**Escrow Account**).

The purpose of this letter is to confirm that we require you to operate the Escrow Account subject to the following conditions. A reference in this letter to a paragraph or a Schedule is to a paragraph or Schedule of this letter.

Interest

Interest shall be credited to the Escrow Account in accordance with Schedule 3.

Withdrawals mandate

Subject to paragraph 4 and paragraph 5, you will only permit a withdrawal from the Escrow Account if you receive a certificate in the form contained in Schedule 1, duly executed by the authorised signatories from Part 1 of Schedule 2 and the authorised signatories from Part 2 of Schedule 2.

Variation or revocation

Any variation or revocation of this letter of instruction must be in writing and duly executed by [two] authorised signatories, being [one] of the authorised signatories from Part 1 of Schedule 2 and [one] of the authorised signatories from Part 2 of Schedule 2. Any variation or revocation shall not take effect until received by you.

Change in authorised signatories

Any change in, or addition to, the authorised signatories for [BUYER or SELLER] (as the case may be) in Schedule 2 shall be notified in writing to you and to the other Party. The notice must be signed by each of the remaining authorised signatories of that Party (other than any signatory who is no longer an authorised signatory or who will, by reason of the notice, cease to be an authorised signatory) and (where relevant) shall contain a specimen of the signature of the new signatory.

Overriding conditions

For the avoidance of doubt, in the absence of any certificate being submitted to you in accordance with paragraph 2, you shall not permit any withdrawals to be made from the Escrow Account except on the order of a competent court [or arbitration panel] or to satisfy any liability to tax arising in relation to the sums in, or interest credited to, the Escrow Account.

Documents conclusive

You may rely without enquiry on all documents that appear on their face to be a certificate, variation or revocation (as the case may be) provided in accordance with the terms of this letter.

Your charges

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[You are entitled to deduct your reasonable and proper charges in connection with the operation of the Escrow Account from the amount for the time being standing to the credit of the Escrow Account.]

Statements of account

Statements shall be sent to [BUYER] at [ADDRESS] (marked for the attention of [NAME]) on the last business day of each month and a copy shall be sent to [SELLER] at [ADDRESS] for the attention of [NAME].

Your instruction unaffected by changes to the firms

This letter of instruction shall remain in force until revoked.

Please confirm acceptance of our instructions set out above by signing and returning the duplicate copy of this letter enclosed.

....

[SELLER]

[BUYER]

BANK'S AGREEMENT AND ACKNOWLEDGEMENT

We acknowledge receipt of your joint letter dated [DATE], of which this is a true copy, and we accept your instructions regarding the operation of the Escrow Account.

....

Duly authorised signatory for and on behalf of [NAME OF BANK]

Date:..........................

15. Can the escrow agent(s) liability be limited so that it only arises in case of their wilful misconduct or gross negligence?

Yes, escrow agreements usually provide several and comprehensive limitations to the escrow agent's liability, except if losses and damages arise as a consequence of wilful misconduct or gross negligence of the escrow agent.

Despite this, under Brazilian law, if a party suffers losses and can prove the connection between an action or omission (whether or not wilful) and the loss suffered, the party will be entitled to indemnification for the losses suffered. Escrow agents are no exception to this rule and may be held liable regardless of any limitations provided for in the escrow agreement.

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No changes are required to the language of *Standard document, Escrow letter: share purchases: Cross-border: clause 6.1 and clause 6.3* for the sole purpose of complying with Brazilian law.

16. If all or part of the consideration is paid in a form other than cash (for example, shares or loan notes) what mechanisms may the buyer consider to secure the seller's obligations (for example, taking a charge over the non-cash consideration)?

If all or part of the consideration is paid in a form other than cash, the guarantee of the seller's obligations under the purchase agreement could be the pledge of the seller's remaining equity in the target (see *Question 4* for applicable limitations), promissory notes or the seller's personal or corporate guarantee. Alternatively, if the seller owns real estate, a mortgage over real estate is also possible (although not necessarily desirable) or if the seller owns other assets (equipment or machinery), these assets may be pledged.

A more extreme alternative, if the unpaid liability is of such a magnitude to convert the business being acquired into a worthless asset or may adversely impact the buyer's own valuation or business, there may be a put option for the buyer to sell back the acquired equity (to save the buyer's business or halt a growing liability).

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