M&A AND PRIVATE EQUITY

THE ECONOMIC FREEDOM ACT, AN OPPORTUNITY FOR THE INVESTMENT FUNDS INDUSTRY

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Law No. 13,874/19 which established the Declaration of Rights of Economic Freedom,[1] was enacted in order to address many claims of the business community to improve the business environment in Brazil. Among the principle based provisions and legislative changes, it should be highlighted the new rules inserted into the Civil Code relating to investment funds,[2] in particular the possibility of limiting the liability of quotaholders and service providers of the investment fund.

In this sense, new article 1368-D of the Civil Code states that the by-laws of investment fund may, subject to the regulations of the Brazilian Securities and Exchange Commission (CVM), limit the liability of quotaholders to the value of their quotas and the liability of service providers of the fund,[3] before the condominium (the fund) and among them, to the performance of their respective duties, without joint and several liability. Although this new provision is not immediately effective due to to the lack of regulations by CVM, such provision establishes the legal basis for the regulator to update the current rules aligned with the most advanced regulatory models.

In the Brazilian legal system, investment funds have always been considered as condominium, as originally referred to in article 49, II, of Law No. 4,728/65 and subsequent legal and infralegal rules, such as CVM Normative Instruction No. 555/14,[4] related to investment funds in general, Law No. 8,668/93[5] and CVM Normative Instruction No. 472/08,[6] both applicable to real estate investment funds (FIIs), and CVM Normative Instruction No. 578/16,[7] relating to private equity investment funds.

As for the liability of the investment fund's quotaholders, civil law establishes that the condominium members are liable, in proportion to their shares, to bear the burdens and debts to which the condominium's assets are subject to (articles 1,315 and 1,317 of the Civil Code) unless joint and several liability among them is stipulated. In compliance with these legal limits, CVM's regulations applicable to investment funds generally require quotaholders to be liable for any negative net worth of the fund (article 15 of CVM Normative Instruction No. 555/14). On the other hand, the quotaholders of real estate investment funds are an exception to the rule, supported by the express legal provision limiting their liability to the payment of the subscribed quotas (article 13, II, of Law No. 8,668/93), which, in turn, was mirrored by CVM in the respective regulations regarding FIIs (article 8, II, of CVM Normative Instruction No. 472/08).

Therefore, the Economic Freedom Act established the legal grounds enabling CVM to regulate investment funds more freely, by amending the Civil Code (i) affirming the condominium nature of investment funds, but expressly carving out the applicability of the general rules on condominiums (new article 1368-C) and (ii) allowing investment funds' by-laws to limit the liability of quotaholders and their service providers, to the extent CVM's regulations are complied with (new article 1368-D).

It is reasonable to expect that the regulator will consider in the new rules criteria such as the type of investment fund, the assets and investments within the investment fund's portfolio, and the target investors, i.e., the investor profile and the degree of risk exposure that such investors are willing to take, or should take. In any case, particular attention shall be devoted to private equity investment funds (FIPs), either because of the role they play in business activity or because of the diversity of investments types they may encompass.

Regarding business activity, FIPs essentially invest in publicly-held companies, privately-held companies, or limited liability companies, and should influence the strategy and management of the invested companies. In this respect, FIPs differ from other funds, which may hold passive equity interests in listed companies for speculative purposes. Therefore, FIPs embody the most entrepreneurial side of the investment fund industry and, as such, these investment vehicles, their managers, administrators and investors should be treated in order to ensure competitiveness in their business activities. Drawing a parallel with an investment holding company, whose partners' liability is limited to the value of the subscribed capital in the holding company, except in cases of piercing of the corporate veil, there is no reason why the quotaholders of a FIP should be required to cover the negative net worth of the investment fund on an unlimited basis.

As for the various facets that a FIP may adopt, CVM Normative Instruction 578/16 establishes different categories, such as FIP-Seed Capital, Infrastructure, among others and, especially, the FIP-MultiStrategy, intended for FIPs that are not classified into other categories. It is entirely possible for a FIP to invest in special purpose companies focused solely in real estate enterprises, which makes its portfolio potentially identical to that of a FII. Therefore, it is worth considering whether this FIP should not be allowed to adopt a liability regime to its quotaholders similar to the one applicable to FIIs' quotaholders. Should it be the case that, in these scenarios, the regulations prioritize the essence of the investment over its form and, consequently, grant the FIP's quotaholders the same liability regime applicable to FII's quotaholders?

Specifically in relation to the possibility of segregating the liability of the fiduciary service providers, eliminating the joint liability among them, this provision seeks to solve an increasingly frequent obstacle in the relations among agents in the sector. Over the years, the investment fund industry has become more sophisticated, resulting in a more segregated and specialized way its agents operates. In this sense, joint and several liability among investment fund service providers has served as a disincentive for the most capable and competent agents to perform these functions, leading to race to the bottom.

With the Economic Freedom Act, the basis for a change have been laid, and it will be up to the regulator to analyze and, together with the market players, consider the paths in which regulation should follow. Regardless of the course chosen, it is clear that one cannot delay or waste the opportunity to improve outdated rules and to sort out relevant issues to the investment fund industry, promoting economic activity and fostering the development of Brazil's capital markets.

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[1] Derived from Executive Order No. 881/19.

[2] New Articles 1368-C to 1368-F of Law No. 10,406/02 (the Civil Code).

[3] Fiduciary service providers are understood to be administrators, asset managers and custodians.

[4] Article 3. The investment fund is a communion of resources, organized in the form of a condominium, intended for investment in financial assets.

[5] Article 1. Real Estate Investment Funds are established, without legal personality, characterized by the communion of funds raised through the Securities Distribution System, in the manner set forth in Law No. 6,385, of December 7, 1976, intended for application to real estate developments.
Article 2. The Fund shall be organized in the form of a closed-end condominium, prohibited the redemption of quotas, with a determinate or indeterminate term of duration.

[6]Article 2. The FII is a communion of funds raised through the securities distribution system and intended for investment in real estate developments.
Paragraph 1. The fund shall be organized as a closed-end condominium and may have an indeterminate term of duration.

[7] Article 5. The FIP, organized as a closed-end condominium, is a communion of funds intended for the acquisition of shares, subscription warrants, simple debentures, other securities convertible or exchangeable into shares issued by companies, publicly or privately held, as well as as securities representing participation in limited liability companies, which must participate in the decision-making process of the invested company, with effective influence on the definition of its strategic policy and its management.