

Brazil – Why and How to Use a Shareholder Agreement in a Joint Venture?

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Highlights:

- ✓ **The usual characteristics of the joint venture corporation** (small number of shareholders; substantial shareholder participation in its management; no ready market for its corporate shares; restricted admission of new venturers) **entail a higher risk of shareholder deadlock and dispute.**
- ✓ **War stories show that those risk factors can and sometimes do align in a way that jeopardizes the joint venture.**
- ✓ **Those very same war stories demonstrate the disastrous consequences of an uncontained shareholder deadlock: venturers engaged in protracted, costly litigation with little chances of a quick outcome while the joint venture languishes and business opportunities are lost.**
- ✓ **The shareholder agreement is the means to remove or reduce the legal risks inherent to a joint venture and to set out containment procedures for those risks that are unavoidable.**

Two Joint Venture War Stories

War Story # 1 – “R” is a private company manufacturer of metal structures with annual revenues of approximately U\$65M, with U\$25M in cash against U\$15M of net worth. Four shareholders split in two voting blocs own all of the company’s stock.

Three years ago the shareholders of “R” were not able to reach an agreement with respect to the election of two company officers by tradition appointed by

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one of the voting blocs. The deadlock escalated to the point where no further meetings of shareholders took place simply because shareholders did not agree on the appointment of the chairperson and secretary of the meeting.

Earlier this year the eighth lawsuit between the shareholders was filed. The most recent action seeks the auction sale of “R”.

In the meantime the company is run by the two remaining officers (associated to one of the voting blocs), pays only the statutory minimum dividend payout ratio and is prevented from effecting any new investments (hence the elevated cash).

War Story # 2 – Mr. G and his son own a real estate development business focused on apartment building for middle and lower middle class families. Two years ago that specific market segment started a discreet boom in Brazil. They were then contacted by an American venture capital fund interested in investing in Brazil’s real estate market. The fund management had no experience in the local market nor in real estate development for middle and lower middle class.

They agreed to an initial capitalization round to fund the building of two large condominiums. Cash flow problems led to additional rounds and Mr. G became a minority shareholder of the company he founded with no shareholder agreement to lever his voting interest vis-à-vis the VC.

Continued financial problems prompted mutual recrimination. Mr. G held VC responsible for late disbursement of the capitalization moneys. The VC blamed Mr. G and his son for the incompetent management of the company.

The feud between the partners climaxed when the VC, acting as the new controlling member of the company (a LLC), voted to remove Mr. G and his son as company officers and appointed a single officer to manage the company.

Mr. G and son sued for a declaratory judgment that their removal was illegal on the grounds that they should have been given prior notice of the proposed action and an opportunity to object. A trial court in Rio de Janeiro granted an injunction and Mr. G and son have temporarily survived as company officers.

In the meantime the company remains paralyzed, cashed-strapped, with empty apartments ready for sale while a sizable bank loan is on the verge of maturity.

These war stories have opposite background scenarios: one - “R” – is a successful business while the other evolved into a fiasco. Both situations though share a common malformation: lack of a shareholder agreement to enable faster resolution of disputes and deadlocks between the venturers.

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Shareholder agreements: governing shareholder functions in a joint venture corporation.

Presently most joint ventures are formed as closely-held corporations, i.e., a stock corporation or limited liability company, large or small, controlled by two or more shareholders (“joint venture corporation”, “JVC”).

A joint venture corporation is characterized by a (i) small number of shareholders, (ii) substantial shareholder participation in its management, direction and operation, (iii) no ready market for its corporate shares, and (iv) restricted admission of new venturers.

The first two features point to the venturers exercising the control and management functions of the JVC in the context of a face-to-face situation. While the venturers desire to carry on a business combining or adding their competences and/or financial muscle, they have to deal with their different interests, opinions, styles of communication and value systems.

Features (iii) and (iv) indicate a narrow exit way should the (ad)venture go sour.

As the above war stories show these four risk factors can and sometimes do align in a way that jeopardizes the joint venture. As in many other fields of human activity, here, risk prevention and mitigation are more efficient than conflict remediation.

The shareholder agreement is a tool widely used to eliminate, avoid or reduce the legal risks inherent to a joint venture and to set out containment procedures for those risks that are unavoidable.

The principle behind a shareholder agreement is that the shareholders of a corporation or members of a limited liability company may agree in advance to exercise their voting rights in certain ways. By such a shareholder agreement, the shareholders agree to cast their votes in a certain way for various matters such as the election of directors and company officers and specific corporate affairs. As discussed later, besides binding the parties with respect to the exercise of their voting rights, the shareholder agreements usually include buy-out arrangements in connection with share transfer restrictions and deadlock situations.

What are the functions of a shareholder agreement?

- **Establish the parties' contributions to the JVC**

For the most part joint ventures are formed in order to combine the many times different resources or competences of the venturers, such as: product/service

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technology x knowledge of a territory; product/service technology x funding; civil engineering x supply of plant and equipment.

It is therefore essential to determine each party's specific contribution to the joint venture including the corresponding time schedule and to the extent applicable any conditions, ceilings, disclaimers and limitations that qualify such contribution.

The shareholder agreement is the instrument by which the venturers covenant to perform their contributions to the JVC including applicable timetable, conditions and qualifications.

- Establish JVC policy and course of business

Besides determining their individual contributions the venturers need to establish the guidelines that will steer the management of the joint venture corporation as well as the development of the business.

The shareholder agreement is the appropriate instrument to set out at the outset basic JVC policies such as: (i) its business object, i.e., the products, services, market and/or territories aimed or excluded; (ii) the basic financial reports to be furnished by the JVC management to the venturers; (iii) maximization of profits²; (iv) noncompetition and exclusivity by and between JVC and the venturers; (v) right to control and right of entry by venturers; (vi) JVC intellectual property; (vii) insurance; (viii) accounting and auditing.

- Election of directors and officers of the JVC

Another critical topic is the establishment of guidelines for the appointment, dismissal and replacement of the JVC officers and (when applicable) directors. Experience shows that ideally each member should have the right to appoint and replace a specific officer(s) or director(s).

- Provisions against shareholder deadlock

War story #1 is an illustrative example of the disastrous consequences of an uncontained shareholder deadlock: venturers engaged in protracted, costly litigation with little chances of a quick outcome while the joint venture languishes and business opportunities are lost.

Whereas the risk of a deadlock is quite palpable in a fifty-fifty – or closely similar – joint venture it also exists in less conspicuous arrangements. For

² E.g.: “The JVC may not hold the portion of net cash that exceeds 25% of the JVC’s total assets for more than three consecutive quarters.”

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example, if the joint venture is incorporated as a limited liability company, statutory³ voting and consent requirements demand the vote of seventy five per cent of the capital to amend the operating agreement or two-thirds of the capital to elect a company officer.

Shareholder deadlock can be dealt in a shareholder agreement through a buy-out arrangement. Typically, buy-out mechanisms follow the “divide and choose” (a.k.a. “I cut, you choose”) envy-free allocation protocol:

***Either Party (the "Offeror") may offer**, by sending written notice (the “Buy/Sell Offer Notice”) to the other Party (the "Offeree"), **to purchase all, but not less than all, of the Offeree’s membership units** in the Company **at a cash price per unit set forth in the Buy/Sell Offer Notice** (the "Proposed Value"), while undertaking, in the Buy/Sell Offer Notice, to sell all, but not less than all, of the Offeror’s membership units to Offeree for the Proposed Value in cash.*

***The Offeree shall have a period** of sixty (60) days from the date of receipt of the Buy/Sell Offer Notice **to (i) accept to sell all**, but not less than all, of the Offeree’s membership units in the Company **for the Proposed Value**, or to (ii) purchase all, but not less than all, of the Offeror’s membership units in the Company **for the Proposed Value**, by sending the Offeror a written notice of such election (the "Offeree’s Notice”).*

***If, within the period set forth in the above subsection, the Offeree (i) fails to send the Offeree’s Notice to the Offeror or (ii) delivers the Offeree’s Notice to the Offeror stating Offeree’s acceptance to sell its membership units in the Company, Offeree shall be obliged to sell all**, but not less than all, of the Offeree’s membership units **for the Proposed Value** to the Offeror, and the Offeror shall be obliged to purchase said units from the Offeree for the Proposed Value.*

Here, one of the venturers can be bought out, thus preserving the JVC as a going concern and assuring a fair price to the exiting venturer.

- Share transfer restriction

Share transfer restrictions are intrinsic to a joint venture. As noted, venturers get together in light of certain specific competences and affinities. Therefore it is fitting that the transfer of JVC shares to outsiders be restricted.

Typically, such transfer restrictions are set out by means of one or more option provisions. The cross-option provision requires that the shareholder must offer the shares to the other venturer(s) before transferring them to an outsider.

Call or put options provide for a binding buy-sell agreement between the venturers, exercisable upon a specified event.

³ Brazilian Civil Code.

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The above options are sometimes complemented with tag along and drag along rights. The tag along right⁴ aims to protect a minority venturer against a new unfamiliar controlling shareholder. The drag along right⁵ on the other hand aims to make easier the sale of the controlling interest in a JVC to an outsider.

When is it recommendable to use a shareholder agreement?

Whenever you enter into a fifty-fifty or closely similar joint venture arrangement. Specifically in Brazil if the JVC is incorporated as a limited liability company (see the second paragraph in “Provisions against Shareholder Deadlock” above).

Shareholder agreement may also be advisable in a JVC where there is an even-numbered board, veto provisions or a greater-than-normal quorum/voting requirements.

Validity and Enforcement of a Shareholder Agreement

In Brazil the Business Corporation Law⁶ (“LSA”) expressly permits shareholder agreements dealing with the exercise of shareholder voting and option rights and the control of the corporation. The statute provides that the chairperson of the meeting of shareholders shall not compute any vote casted in violation of the provisions of a shareholder agreement.

There are no statutory provisions dealing with a shareholder agreement in a limited liability company. Therefore in order to ensure that a shareholder agreement between the members of a LLC is enforceable and valid the LLC’s articles of organization must incorporate the provisions of the LSA by reference⁷.

Various judgments by (among others) the Supreme Court of the State of Rio de Janeiro⁸ and the Federal High Court of Appeals⁹ have affirmed the validity and binding authority of shareholder agreements.

Arbitration

⁴ If the majority shareholder sells his or her stake, then the minority shareholder has the right to join the transaction and sell his or her minority stake in the company.

⁵ A right that enables a majority shareholder to force a minority shareholder to join in the sale of a company. The majority owner doing the dragging must give the minority shareholder the same price, terms, and conditions as any other seller.

⁶ *Lei das Sociedades por Ações (Lei nº 6404/76)*.

⁷ Such incorporation is restricted to those matters (such as the shareholder agreement) not covered already by the company law provisions in the Civil Code.

⁸ *Tribunal de Justiça do Estado do Rio de Janeiro (TJ-RJ)*.

⁹ *Superior Tribunal de Justiça (STJ)*.

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Without prejudice to the fact that in Brazil shareholder agreements are enforceable in a court of law, in most cases it is recommendable to insert a provision for arbitration of future controversies among the shareholders. Reasons for this are: (i) faster resolution procedure (court actions on the other hand are usually long-drawn-out proceedings), (ii) the possibility of submitting the disagreement to an arbitration court specialized in company law disputes (there are various arbitration institutions in Brazil with company law specialist arbitrators).

Rio de Janeiro, September 9, 2009.

Doubts, clarification or just more information?

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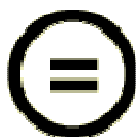
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