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## LEGAL MEMORANDA

### EDITOR'S NOTE

*"Legal Memoranda" is a regular section of the Review devoted to reports from corresponding law firms throughout the Hemisphere. The reports are compiled by the Review, but their accuracy is represented by the corresponding firms, to which all inquiries should be directed.*

*We appreciate the contributions of the corresponding law firms and invite other firms interested in participating in this section to contact us.*

## BRAZIL

### ASSET SECURITIZATION

#### I. INTRODUCTION

Securitization could be defined as the conversion of cash generation assets into securities which can be marketed to institutional investors. In general terms, through securitization a company may use highly liquid assets to raise funds in the capital market at a lower cost than if the company would have raised funds directly. The assets to be used by a company wishing to carry out securitization transactions are basically assets with a stable cash flow. These assets typically represent rights to payments at future dates and are usually referred to as "receivables." As long as the company that wants to carry out a securitization, or the "originator company," can reasonably predict the aggregate rate of default, it can securitize even those assets that present some risk of uncollectibility. After identifying

the assets to be securitized, the receivables will generally be transferred to a special purpose vehicle in order to separate the risks associated with the originator company. The special purpose company will then issue securities abroad to obtain the necessary funding.

### A. *The International Experience*

Based on international experience, virtually any type of asset may be securitized. The country where the vast majority of securitization operations have been carried out is the United States. In the last ten years, securitization has become a major investment alternative for pension funds and other investors, and a vast multitude of assets have been securitized. Due in large part to the support of three quasi-governmental housing credit agencies (FNMA, FHLMC, GNMA, also known as Fanny Mae, Freddie Mac, and Ginnie Mae), securities backed by residential mortgage loans dominate the securitization market. There is over \$1.3 trillion in these residential mortgage-backed securities outstanding. Securities backed by other kinds of assets have emerged as an alternative for pension funds and other institutions. The most common of these relate to auto loans, credit card receivables, home equity loans and other credit lines. Others are tied to trade receivables, manufactured housing loans, aircraft leasing contracts and project related receivables, such as toll road revenues, and increasingly, revenue producing real properties, such as office buildings, strip shopping centers and fast food restaurants and other franchise or multiple outlet business operations.

One of the factors that explains the success of securitization transactions world wide is that it enables the borrower to match maturities of assets and liabilities, and to borrow at lower rates. Securitization is most valuable when the cost of funds, reflected in the interest rate that is necessary to entice investors to purchase the securities issued, is less than the cost of the originator's other direct source of funds. The goal of securitization therefore is to obtain low cost capital market funding by separating all or a portion of an originator's receivables from the risks associated with the originator. Additionally, there may be from time to time an undersupply of medium-term and long-term financing in the capital markets. In some securitization structures, the assets are kept abroad, thus reducing the so-

called "country risk" factor. In export securitization transactions, the credit risk is concentrated in the importer and the performance risk in the exporter.

The main disadvantage of securitization is the potential complexity of these operations and the costs that may be involved in structuring them. Complexity of the operation entails costs, and most transactions demand rather complicated and unique solutions. Another problem, especially evident in export securitization transactions, is the disclosure of the pertinent export agreement when necessary. These agreements normally contain confidentiality clauses, and the prior authorization of the buyer is necessary before these clauses may be disclosed. Competitors of the buyer (in export securitization, the importer) may have access to valuable information as a result of the disclosure. Additionally, due to the costs involved, only operations involving significant amounts are worth securitizing.

Before we analyze securitization transactions in Brazil, it might be useful, based on the U.S. experience, to divide such transactions into three basic types. The first type would be the *collateralized debt* type, where the owner of the receivables borrows funds through a loan and pledges these receivables so as to guarantee the loan. In this structure, the owner of the receivables and the issuer are one and the same. The most common method to assure effectiveness of a guarantee is through "overcollateralization," i.e., the pledge of receivables is greater than the face value of the debt. The second type would be the *pass through obligations* type, where a company assigns participation in receivables to the general public. It differs from the collateralized debt due to the existence of a trust as an intermediary to the operation. The beneficiary assigns the receivables to the trust, and the trust issues securities to investors, who will be entitled to their share when the trust receives principal and interest. It is essential that the principal obligation is passed through to the investors. Brazilian law generally does not contemplate the figure of a "trust," except as relates to the *fideicomissio* and the *comissão mercantil*. Accordingly, this type would probably not be very effective in a domestic securitization, which would probably be structured as the third type, which we could refer to as the *pay through obligations* type. This type of operation involves the intermediation of a special purpose company, and the receivables are effectively assigned (effectively in terms of Brazilian law because, as opposed to the structure in-

volving a trust, the SPC will have full ownership of the receivables, and not "beneficial ownership," which is a concept of difficult application in Brazil) to the SPC. The SPC will issue securities (with the guarantee of the receivables), but the investors will not be owners of the receivables themselves, but of securities collateralized by such assets/receivables. Another advantage of such a structure is that the source of funds to pay the securities debt is in the assets rather than the originator company's general funds (therefore credit-worthiness of the originator will not be a factor to determine rating of the transaction).

### *B. Brazil*

The Brazilian experience with securitization has been more limited with respect to the types of assets that have been securitized. The securitization of the Brazilian assets themselves has mostly taken place abroad, which reflects generally that the cheaper sources of funds exist outside Brazil. Securitization of export receivables are by far the most common transactions to have taken place in the country.

Generally securitization of exports can be done in two ways: (a) through the securitization of the export credits or the receivables themselves, where the Brazilian exporter sells the receivables (for a long-term export contract to a foreign trust, and this trust, in turn, issues bonds and sells them) to investors, thus raising money (when export contracts fall due, the trust receives funds from the importer, which will be used to pay back the investors); or (b) through the use of receivables to guarantee financing. The receivables are deposited by the exporter in an offshore account, and these monies are then used to contract financing for the exporter or for the exporter to issue securities. The Central Bank will supervise and inspect the offshore account and request information therefrom regularly, as will be explained later.

The entry of the proceeds arising from these "international" securitization operations into the country are treated as either foreign loans or as financed imports, depending on their nature, and are subject to the rules applicable thereto. The Central Bank of Brazil is responsible for enacting the rules regulating the flow of funds into the country. Accordingly, these international securitization transactions fall into the scope of the Cen-

tral Bank's power to regulate. Legislation enacted specifically regarding securitization deals generally with export securitization.

In addition to export receivables, other local receivables have been the object of international securitization. These are most commonly linked to credit instruments for payment of projects, such as promissory notes.

The only domestic securitization operation we are familiar with involves a local retail store, Mesbla. It must be noted that securities to be issued in the domestic market must be provided for by Brazilian law, which generally limits the issues of these securities to debentures and "commercial paper" type instruments (please refer to item 3 below). In an issue of debentures, the role of the fiduciary agent for the debenture holders is a potentially attractive feature in terms of securitization, as the investors will be offered greater protection of their interests in case of default by the originator. The duties of the fiduciary agent are listed in the Corporation Law (Law 6404, arts. 61, 62, 68).

Generally, as is the case abroad, any fund-producing asset may be securitized in Brazil. As an example, a transaction involving the securitization abroad of aircraft lease payments made by a Brazilian lessee has recently occurred. Most of the structuring of the operation as a securitization was carried out abroad, and in Brazilian terms, the relevant lease agreement and other documents had to be adapted to reflect the special purpose company created abroad as the new lessor and the creation of a mortgage lien over the aircraft in favor of the bank acting as trustee for the investors abroad. The rating agencies involved were especially concerned with the forms of the legal opinions issued by Brazilian counsel, as these had to be adapted to reflect investors' concerns.

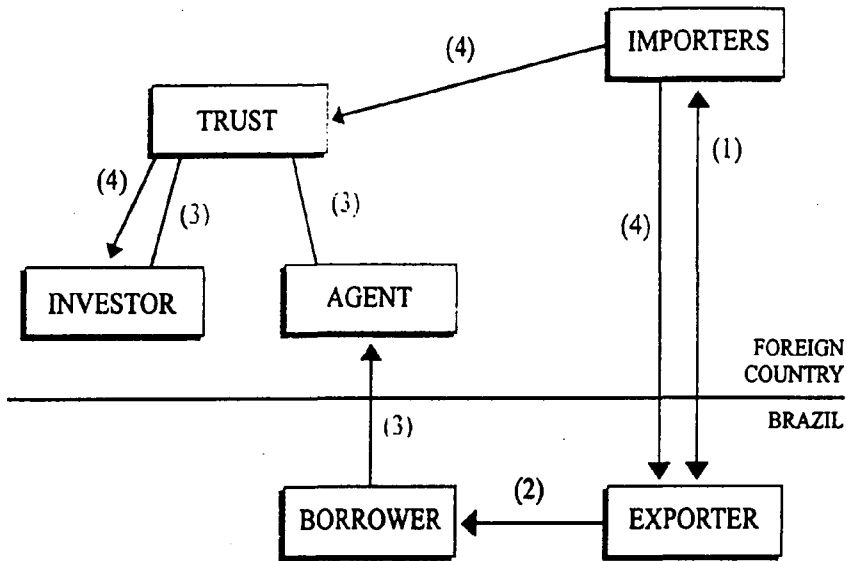
## II. SECURITIZATION OF EXPORT RECEIVABLES

### A. *Typical Structures*

As has been briefly outlined, securitization of export receivables or export credits allows the company receiving the funds to link its credit transactions to the income from its exports. Brazilian law extends this concept to exports from its controlling

company, or those of a controlled company or company under common control. The transaction is guaranteed with foreign currency funds to be paid by importers overseas, diminishing the country risk. The term "securitization of exports" involves the securitization of the export credits themselves or the use of the receivables to guarantee the financing.

A typical securitization operation involving securitization of export receivables could be structured basically as follows:

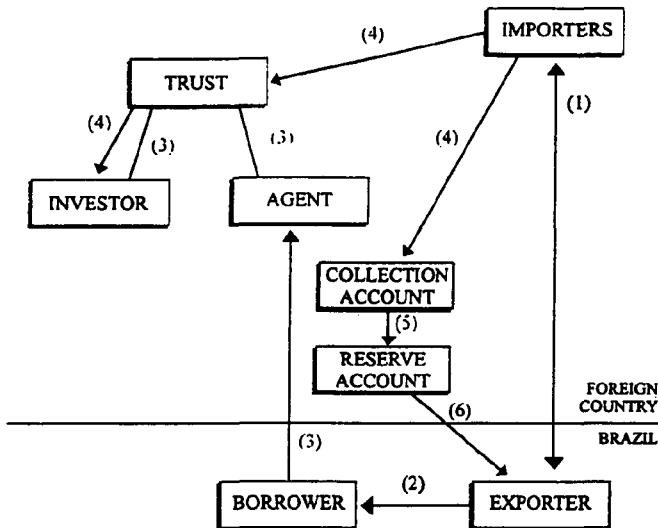


- (1) Export transaction between the Brazilian exporter and the importer. The exporter will receive payments from the export transaction ("receivables" or "export credits").
- (2) The exporter assigns the export credit to the borrower. The exporter and the borrower could be the same party. (Structures to strengthen the collateral may be developed, such as guarantee by "aval" or "fianca" by another company related to the borrower/exporter.
- (3) The borrower issues securities abroad to raise funds. Payments due to the purchaser of these securities (investors represented by the trustee) are secured by the export credits. The documents connected to such issue abroad are those normally required for foreign issues, such as an offering circular/memorandum, and the agreements which normally accompany these. If the placement abroad is private, nor-

mally an issuing and paying agency agreement will be entered into.

- (4) When export credits are repaid, the trust receives the funds from the importer, which repays the investors; excess amounts are returned to the exporter.

Another typical export securitization transaction could be structured basically as follows:



- (1) Export transaction between the Brazilian exporter and the importer. The exporter will receive payments from the export transaction ("receivables" or "export credits").
- (2) The exporter assigns the export credit to the borrower. The exporter and the borrower could be the same party.
- (3) The borrower issues securities abroad to raise funds. Payments due to the purchaser of these securities (investors represented by the trustee) are secured by the export credits.
- (4) As export credits mature, they are received in a collection account maintained by the Brazilian exporter with the trustee.
- (5) Part of the payment is transferred to a reserve account,



corresponding to the payments of principal, interest and other amounts due in each interest amortization period of issue of securities transaction. Evidently the mechanism described in (4) and (5) is automatically carried out by the depository bank.

- (6) The balance of the amounts received (collection account-reserve account) is remitted to the Brazilian exporter. In a structure where the reserve account is not collateral, but represents the mechanism actual payments are made through, this balance could be remitted to the borrower.

Evidently these structures are basic and may be added to or modified depending on the characteristics of the operation.

### *B. Legal Texts*

The first and most important legal text to regulate export securitization was Central Bank Resolution 1834, dated June 26, 1991 (Resolution 1834). The other legal texts basically regulated its terms. Resolution 1834 essentially established the possibility of using export related revenue to obtain funds in the foreign capital markets; this possibility was created for the borrower, and extended for a controlling or controlled company within the definition used in Brazilian corporate law (Article 133 of the Corporation Law). The Resolution already mentioned a special treatment for foreign currency denominated accounts abroad to be linked to receipt of the export receivables.

On the day following the Resolution, the Central Bank issued Circular 1979 (June 27, 1991, "Circular 1979"). Circular 1979 basically established that the export transactions which could be used to obtain funds through securitization would have to be medium or long term export transactions (i.e., more than 360 days). As already mentioned in Resolution 1834, the beneficiaries of the resulting funds could be the controlled or controlling companies of the exporter or companies under common control. Circular 1979 also provided for the need to enter into foreign exchange contracts, even if purely symbolic, to reflect the entire operation and established a special mechanism for these contracts. The Circular further permitted the creation of escrow accounts abroad in connection with such securitization transactions, the balance of these deposits being closely controlled by

the Central Bank. Funds in these accounts should be deposited at the relevant periods under the original export transaction, and these deposits may be made in the name of the borrower or another entity abroad indicated to centralize them. It was established that the total amount of the deposits existing in each reference period should correspond to the amount of commitments due at the end of the same period, with the Foreign Capital Control Department of the Central Bank — FIRCE — establishing the maximum amount of surplus deposits permitted in relation to the commitments relating to each reference period (the “overcollateralization” concept). Circular 1979 expressly indicates that these deposits are subject to the monitoring and control of the FIRCE, which, from time to time, may require that a specific audit report be prepared by a specialized company, with the borrower being liable in any event for the misuse of the funds while they are being held abroad. Payment periods may not be for less than 361 days.

On July 15, 1991, the Central Bank issued Circular Letter 2185, establishing the need to obtain prior approval from the Central Bank for securitization transactions and treating the funds arising therefrom as either foreign loans or import financing, depending on the nature of the transaction. In the event it is impossible to determine under which of the two types the transaction can be classified, the Central Bank is empowered to make such classification. Circular Letter 2185 also listed the documents that have to be presented for purposes of obtaining the approval from the Central Bank and established that, after granting of the prior approval, the borrower must, within ninety days thereof, submit an application for prior authorization for purposes of closing the foreign exchange contracts at the date the funds “enter” the country. The borrower must also submit a request for the issuance of the relevant certificate of registration by the Central Bank which will allow the borrower to make the repayments under the intended transaction. Circular Letter 2185 also provided that the escrow account abroad cannot have balances of principal in excess of fifty percent of the amounts of the financial commitments in the relevant reference period under the securitization operation. Any exceptions to this rule must be subject to prior Central Bank approval, especially in cases of default by the borrower and/or exporter. Funds to be obtained under the securitization operations must be “fresh funds,” unrelated to Brazilian foreign debt rescheduling.

Central Bank Circular Letter 2191 of August 1, 1991 (Circular Letter 2191) describes the procedure for the closing of foreign exchange contracts in securitization operations as per section D below.

*C. Tentative Timetable*

Based on the above legal texts and especially on the terms of Circular Letter 2185, a typical export securitization transaction would probably have the following schedule:

- (a) the entering into of the export contract, which will give rise to the export receivables;
- (b) subsequently, a formal application by the exporter or related company to the FIRCE department of the Central Bank in Brasilia would be submitted, describing the transaction and its purpose in detail and stating the name of the financial institution where the interest-bearing deposit account will be held;
- (c) along with this application, FIRCE will need to receive a statement from the agents confirming the transaction and structure of the deal, as well as its term. The agents must also agree to semi-annually send FIRCE an excerpt from the deposit account abroad (if actually effected), and the report from the special audit made on the account operations;
- (d) another requirement is the preparation of the statement signed by the agents regarding nonassessment of any other charges in domestic and foreign currency, in accordance with Circular Letter No. 1443 of July 16, 1986;
- (e) additionally, an instrument of commitment to be signed by the borrower of the funds must be presented to the FIRCE to the effect that: (i) the deposit account is intended exclusively for operation of the amounts of the exports in question, as well as for releases intended to comply with the obligations regarding fund raising transactions and entries into Brazil; (ii) all income obtained from the deposit account will come into Brazil immediately after payment of the obligations of the fund raising transaction for each reference period; and (iii) the parties will arrange in the event of losses due to misuse of the funds of the deposit account for the appro-

priate exchange set-off at the Central Bank, as may be defined by the Central Bank;

- (f) should the exporter not be the borrower itself: (i) a statement of consent for the exporter must be prepared earmarking its exports for fund raising activities, indicating the products whose export will be earmarked and the average monthly value thereof in the last twelve months; and (ii) evidence showing that the borrower satisfies the condition of controlling, controlled company or company with the same controller as the exporter must also be presented;
- (g) after the transaction has been approved by FIRCE, the borrower has ninety days to: (i) request preliminary authorization for entry of the funds as a loan, in accordance with FIRCE Communiqué 10; or (ii) request issue of a certificate of authorization or registration, in the form of a financing as provided for in FIRCE Communiqué 25 and Circular Letter No. 2173 of May 31, 1993; and
- (h) the drafting of a letter to the Federal Revenue Service, explaining the transaction and applying for the tax benefits, will also be necessary in the cases under Decree-Law 1215 of July 4, 1972 (please refer to part F below).

#### *D. Foreign Exchange Contracts*

Foreign exchange contracts for exports securitization transaction follow the rules established in Circular Letter 2191 (Aug. 1, 1991). Pursuant to the exchange rules prevailing in Brazil, exporters are not allowed to receive directly the foreign currency relating to exports. Such foreign currency must be negotiated for Brazilian currency with a bank authorized to deal with foreign exchange in Brazil, by means of an exchange contract.

In export securitization transactions, the following exchange procedure shall apply: first, the exporter shall enter into export exchange contracts with a Brazilian bank, with either future or at sight liquidation, for the sale of the foreign currency derived from the export. Concurrently, the exporter shall enter into another exchange contract maturing on the same date of the first one, for the purchase from that bank of the same amount of

foreign currency, that shall be credited to the trust. These linked exchange contract transactions are of a special kind, both liquidated without actual transfer of funds.

Upon credit of the export payments to the collection account, the trust and/or the depository financial institution shall give written notice to the Brazilian bank, indicating the amount so received and the amount that will be retained in the reserve account. Such notice shall cause the exchange contracts to be liquidated by the Brazilian bank simultaneously. As already mentioned, this is a symbolic liquidation, without the actual transfer of funds.

Immediately thereafter, the exporter shall enter into another exchange contract with the Brazilian bank, in order to sell the foreign currency corresponding to payments not deposited in the reserve account, as well as any earnings obtained therefrom periodically.

Payment of interest and principal due under the foreign placement are remitted by the issuer to the Trust through ordinary financial exchange contract transactions, using the relevant certificate of registration/authorization.

Provided no event of default under the foreign fund raising transaction has occurred, the amounts deposited in the reserve account are remitted to Brazil at the maturity of the foreign transaction.

#### *E. Export Advances: ACCs and ACEs*

One of the most attractive mechanisms available for Brazilian exporters is the possibility of obtaining advances under export transactions, the so-called ACCs (*adiantamentos sobre contratos de câmbio*) and ACEs (*adiantamentos sobre cambias entregues*). Through these advances, exporters may rely on immediate receipt in Brazilian currency of future export credits. In export securitizations, the exporter benefits from a receipt at sight of future export receivables, as a result of the sale of such receivables to a special purpose company or to the issue of securities by the exporter or such special purpose company. Accordingly, one of the questions posed by exporters was whether they could still benefit from export advances generally available in regular export transactions in export transactions being securitized. The question was posed to the Central Bank, which

responded that it did not oppose the concession of such advances.

In a standard export advance, the bank granting the advance to the exporter will use pre-export funding lines to obtain the necessary Brazilian currency by selling foreign currency. The liquidation of such lines is in the future, coinciding with the receipt of the foreign currency from the importer under the export transaction.

In export securitization transactions, the importer will normally pay a collection account or the trust abroad and not the exporter. If all such amounts are transferred to the reserve account or retained abroad, the foreign currency resulting from repayment by the importer will not enter Brazil but remain abroad. Accordingly, export advances will probably not be possible because the bank will not have foreign currency amounts to repay its pre-export lines commitments. Further, as a general rule, export advances will normally be possible for amounts which are not deposited in the reserve account or retained abroad but returned to the exporter. Therefore, in the event the exporter wants to benefit from export advances, a careful planning of terms and amounts of the securitization transaction will have to be made.

#### *F. Brazilian Withholding Tax Issues*

The general rule under Brazilian tax law is that income credited or paid to foreign residents is subject to withholding tax. This withholding tax will be generally assessed at the rate of twenty-five percent, unless the provisions of a double-taxation treaty apply. In this case, the rate will be reduced to fifteen percent except in the case of Japan, in which case the applicable rate is twelve and a half percent.

Accordingly, payment of interest, fees, commissions and amounts other than principal, made to creditors resident and domiciled in countries having a double-taxation treaty with Brazil, will generally be subject to withholding tax, as indicated above.

Brazilian law contemplates the possibility of exemption or reduction of the applicable withholding tax rate for certain external credit transactions, provided they meet the applicable legal requirements. The rules on exemption or reduction may be

basically divided into three groups. The first group is that under Decree Law No. 815 of September 4, 1969, as reworded by article 1 of Decree Law No. 1139 of December 21, 1970 and article 87 of Law No. 7450 of December 23, 1985, which grants exemption to payments of interest and fees relating to credits obtained abroad to finance Brazilian exports. The exemption will automatically apply in this case, i.e., it is not necessary that approval of Brazilian authorities be obtained for the benefit to attach. As an example of an operation under this group, the interest paid on the amounts entering Brazil as anticipated payment of exports could be mentioned.

The second group of benefits fall under Decree Law 1411 dated August 1, 1975, which delegates authority to the National Monetary Council to establish the conditions under which certain foreign currency financial transactions may enjoy the benefit of reduced withholding tax rates. Through Resolution 644 dated October 24, 1980, the Central Bank granted the benefit of reduction to zero of the withholding income tax rate in commercial paper transactions. The benefit was later extended to the issue of bonds, notes and certificates of bank deposits, by means of Central Bank's Resolution 1853 dated August 2, 1991.

This benefit will automatically apply to the transactions which meet the minimum average term of eight years (as established by Circular 2546 dated March 9, 1995 of the Central Bank) and which are approved by the Central Bank. Accordingly, bond, notes and certificates of bank deposit issue transactions which have received Central Bank's preliminary authorization and which are made for an average minimum term of eight years will automatically benefit from this rate reduction to zero.

Finally, the third group of benefits fall under Decree Law 1215, of July 4, 1972. The Decree Law generally contemplates exemption, reduction or restitution of withholding tax paid on remittances of interest, fees and expenses relating to loans and financing which fulfill three conditions: (a) they meet the minimum term established by Brazilian authorities (which presently is an average minimum period of eight years); (b) it will in fact imply the reduction of the financial cost to the borrower; and (c) the transaction, for its characteristics, may be considered as being of national interest.

The benefit in this case will not be granted automatically, but depends on an application to be made to the Ministry of

Finance. Usually, after the preliminary contacts with the Central Bank, the Brazilian borrower will make the application. The certificate of registration of the Central Bank will make reference to the benefit obtained.

The above basically refers to exemption or reduction, but one should not forget restitution, which may be requested after the withholding tax payments are made.

### III. SECURITIZATION OF BRAZILIAN RECEIVABLES

The major source of funds in the 1990's lies with the investors which acquire securities in the local or international markets. These investors are seeking good financial conditions, of course, but they also wish to be in a position to easily buy and sell their securities.

Securitization in the domestic market is still being developed. The applicable legislation is very strict as to the securities that may be issued by Brazilian companies in a public or private placement.

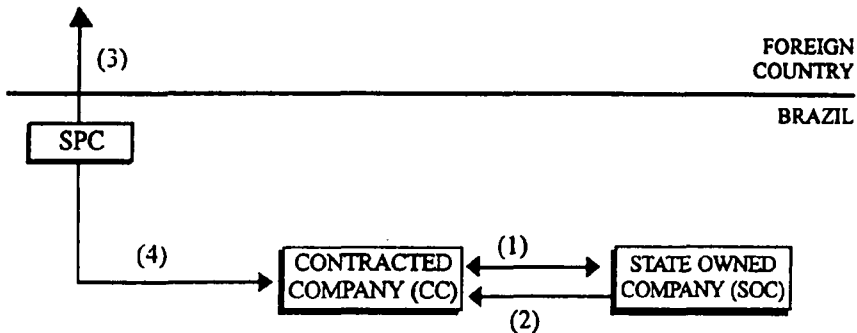
Basically, the securities that may be used to raise funds from local investors are debentures and promissory notes (commercial papers). Only *sociedades anonimas* are allowed to issue debentures. The issue of the domestic commercial papers has in practice become impossible since Central Bank's Resolution No. 2.156 (Apr. 27, 1995), which prohibited any form of participation of financial institutions in these papers. This measure was taken by the Central Bank to reduce the sources of funds to finance sales to consumers, as the number of domestic commercial paper issues has increased substantially in the last months.

A very well known domestic securitization was made by the Mesbla group. Mesbla is a department store with its own credit card. The securitization was very simple in its concept: a special purpose company issued debentures to raise money in the domestic market and used it to acquire the credits from Mesbla. As these credits matured in a short period of time, the amounts received were used to acquire new credits, on a revolving basis. Apparently, this was a successful transaction and other securitization basically following this structure is being developed.

Another possibility for securitization of domestic credits is to resort to the international market. We at Pinheiro Neto — Advogados have participated in some transactions involving



state-owned companies which basically follow this procedure and which were successfully launched in the international market in the last quarter of 1994.



- (1) SOC has contracted a project with the CC.
- (2) As payment for the equipment acquired, the SOC will issue promissory notes.
- (3) SPC issues securities abroad which match the conditions of the promissory notes;
- (4) SPC acquires the promissory from CC.

The important elements of this structure are as follows:

- (a) a state-owned company makes a bid for the acquisition of equipment, for instance. The bid notice (edital) states that this company will only pay for the equipment within, for example, five years. However, this company will assume the cost of the financing raised by the supplier to finance this sale. If the funds are raised outside Brazil, this company will also pay the foreign exchange variation;
- (b) the financing is more detailed in the supply contract between the supplier and the state-owned company. Usually a clause stating that such financing may either be contracted directly by the supplier or may be made by a special purpose company;
- (c) the supplier forms the special purpose company which

issues bonds or notes outside Brazil, thus raising the funds needed;

- (d) the funds are used by the special purpose company to acquire the credits held by the supplier against the state-owned company.

The details concerning a transaction like this are very important. Initially, it must be taken into consideration that certain time mismatches may occur. The supplier will only be entitled to credit against the state-owned company after the equipment is delivered and accepted by such state-owned company, which will then issue a document recognizing the debt and issuing promissory notes.

On the other hand, the special purpose company will immediately raise the funds, and the investors wish either a joint guarantee from the supplier for the debts of the SPC or they wish to have the immediate acquisition of the credits.

In one of the cases we worked on, the parent company of the supplier, outside Brazil, granted a joint guarantee. In this case, then, the funds raised were kept with the SPC and invested in the local market, until acquisition of the credits. Special attention was given to this credit administration in terms of hedge.

In the other case, the state-owned company agreed to immediately issue the promissory notes as a form of payment to the supplier. This was possible due to the characteristics of the specific bid and supply contract. In order to cover any possible delivery problem, the supplier put up an insurance called an "advance payment bond," so in the event of delay in performance by the contracted company or any problem relating to the financing, the state-owned company would be in a position to claim indemnification directly from the supplier, without affecting the promissory notes.

The assumption of the financial terms and conditions of the financing contracted by the supplier falls under Decree Law 857, article 2, item V (Sept. 11, 1969), which permits that an obligation between two Brazilian residents be indexed in foreign currency, as an exception to the general rule that, usually, an obligation between two Brazilian residents shall be denominated and paid in local currency.

This is a very important element which permits matching of

the payments made by the state-owned company to the SPC and the payments due by the SPC to the noteholders. Otherwise, there would be an exchange variation risk, which could not be entirely covered by a hedge mechanism as the transaction is usually made for a long period of time. To our knowledge, hedges of *reis* against U.S. dollars, for instance, are presently available for short-term periods only. We are aware that, in certain cases, the structure discussed herein is slightly different, as the secured credits would refer to other types of credit.

We understand that this transaction would also be feasible, but special attention should be dedicated to the following aspects:

- (a) the documentation supporting the transaction (bid notice and contract with the state-owned company) should permit payment of exchange variation and the cost of the foreign financing by the state-owned company; and
- (b) the credits acquired by the SPC shall be due on the same date and in the same amounts as the foreign currency amounts due to the noteholders, so that the SPC will not run the risk of exchange variation.

Finally, as to the SPC, we note that the SPC would be a very simple company, usually a *sociedade civil por quotas de responsabilidade limitada*, which will be liquidated after the payment of all amounts due to the noteholders. The Articles of Association of the SPC will not allow it to enter into any transaction or incur any debt other than as necessary for the specific transaction for which it was formed. It is possible to adopt the "golden share" structure, i.e., a representative of the noteholders holds a participation in the SPC and he will have veto power over certain matters, such as change of the SPC's Articles of Association. Additionally, the tax aspects involving the SPC in the transaction have to be carefully reviewed so that the cost of the operation may be adequately ascertained.

#### IV. EFFECT OF THE BANKRUPTCY OF THE BRAZILIAN BORROWER OR OF THE BRAZILIAN EXPORTER

*Concordata* is a general reorganization of a company's unsecured debts, which the company has two years to repay. Credits secured by pledge of export receivables would not be subject to

the effects of the *concordata*, i.e., they should not in any way suffer consequences of the *concordata*, as they are considered secured credits.

It is important to note that the Brazilian company continues to operate normally under a *concordata* and should be able to fulfill its obligations to export. The transaction should subsist without further problems.

Bankruptcy represents the failure of the Brazilian company to maintain its activities. One immediate effect of the bankruptcy is that the credits in foreign currency will be converted into local currency on the date the judge decrees the bankruptcy of the Brazilian company.

The escrow account is a guarantee in rem under Brazilian law. In the case of bankruptcy of the Brazilian company, the amounts relating to this escrow shall be used to satisfy the credit it guarantees, unless the other free assets of the bankrupt company are not sufficient to pay for tax and labor debts.

The SPC in the structure to securitize domestic credits, as discussed above, is not expected to undergo financial troubles. The structuring of the transaction is made in such a way that the credits acquired shall be sufficient to meet all its monetary requirements.

On the other hand, the state-owned companies are not generally subject to bankruptcy or *concordata*, as a matter of law. In the event that they are not in a position to meet their debts, the controlling shareholder will be subsidiarily liable for their obligations. These companies may delay payments, which could cause a default by the SPC under the note issue transaction.

Because the only assets of the SPC are the credits against the state-owned company, the issue documents must contain detailed information on the state-owned company which is the debtor, as such company in fact is the risk assumed by the noteholder.

## V. CONCLUSION

Securitization of credits will permit access to international capital markets to fund the big projects that Brazil is implementing. This alternative represents a cheaper source of funds.

Securitization transactions are, however, very complex, in

that they involve many aspects that must be carefully and properly considered in their structuring. As a consequence, these transactions involve a longer period of time to be implemented and many different parties, as well as a higher cost. This is more than adequately compensated by the cost of the funds raised.

Securitization is the best form to raise cheaper funds to finance those projects relating to infrastructure which are dealt with in the new Brazilian Concession Law. This legislation permits use of "emerging rights" (future revenues) of concessionaires as guarantee/collateral in transactions. This should permit concessionaires to issue securities based on "emerging rights" to fund projects in areas such as telecommunications and electric energy supply.

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## THE LOOSENING OF THE BRAZILIAN PETROLEUM MONOPOLY — HEAVEN OR HELL?

John D. Rockefeller once said that the best business in the world is a well managed oil company, and the second best, a badly managed oil company.<sup>1</sup> His statement can be applied to what is presently going on in Brazil with regard to ownership in the oil business. The discussion taking place at the moment is related to who should run the oil business — well or poorly managed — the government or the private sector?

In some countries, like Brazil, the oil industry is still controlled by the State. In other parts of the world, the private sector solely manages it. There is also a mixed system, where the State and private oil companies co-exist. What system is the best? It is very hard to say, if not impossible. The answer would depend on a number of factors, such as the characteristics, purpose, intention, and predominant ideology of each country.

In Brazil, the petroleum law<sup>2</sup> dates back to 1941 and states that all deposits of petroleum and natural gas existing in the nation are the property of the government. The Petrobrás law<sup>3</sup> of 1953 made all the Brazilian petroleum industry — excluding marketing — a government monopoly under Petrobrás and its policy-making supervisory agency, the National Petroleum Council.<sup>4</sup>

In the 1970's, Petrobrás sought private participation in the exploration of oil by means of risk contracts. However, with the enactment of the Federal Constitution of 1988, the federal government was forbidden to assign or grant any kind of participation, either in kind or in legal tender, in the development of oil or natural gas deposits.<sup>5</sup>

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1. See G. Coronel, *State Oil Companies In Latin America: Performance and Outlook*, NRF 12 (1988) 4, at 378.

2. Decree Law 3236/41.

3. Law 2001/53 (establishing *Petróleo Brasileiro S.A. (Petrobrás)* and the *Conselho Nacional do Petróleo (CNP)*).

4. Presently named National Department of Fuels.

5. BRAZ. CONST., art. 177 (1988).

The new government, which took office in January 1995, has submitted a bill to Congress which, if approved, will allow the federal government to contract with private companies, either national or foreign, for the following activities:

- (i) prospecting and exploitation of deposits of oil and natural gas and of other fluid hydrocarbons;
- (ii) refining of national or foreign oil;
- (iii) import and export of the products and basic by-products resulting from the activities set forth in the preceding items; and
- (iv) ocean transportation of crude oil of national origin or of basic oil by-products produced in Brazil, as well as pipeline transportation of crude oil, its by-products and natural gas of any origin.

This bill has been approved by the Lower House of Congress. It will now be submitted to the Senate for two rounds of voting. Even if approved by Congress, the contracts with private companies for the performance of the activities listed above will still depend on the issuance of regulations.

Other constitutional changes, such as the extinguishment of the telecommunications monopoly and the dropping of restrictions on foreign capital participation in mining, have been recently approved by Congress. They were easily passed in the Senate, where the government holds an overwhelming majority.

The same is expected to happen with the proposal to loosen the petroleum monopoly. Nevertheless, this topic is more polemic and is generating a lot of debate in the country.

State participation is considered by many as mortal sin — synonymous with inefficiency and misuse of national revenue. The so-called neo-liberals announce deregulation and privatization as true redeemers. On the other hand, many advocate that state participation is the real answer to prayers, for it is legitimate and can indeed result in greater development and social justice. For some, mortal sinners are the privatization enthusiasts. We are yet to see who goes to heaven and who goes to hell.

Exaggerations apart, it is clear that the neo-liberal proposal does not mean salvation. Excessive state participation and national oil company monopolies are not likely to be the best ap-

proaches either.<sup>6</sup>

It can be argued that state participation and the creation of national oil companies contributed very much to the economic development of the major Latin American oil producing countries, among them Brazil. They played a very important role in ensuring national sovereignty and achievement. Pemex and Petrobrás are good examples of technology development capability.<sup>7</sup>

Notwithstanding, the world today is very from the one of the 1960's and 1970's. Most of the reasons for the state monopoly in the oil industries do not exist anymore. Insisting on monopolies or quasi-monopolies is likely to result in under-exploration and under-development of oil reserves.<sup>8</sup>

There are other means by which countries can develop their oil industry. The private sector can certainly participate; allowing countries to preserve their sovereignty and security by controlling the industry and guaranteeing their share of mineral rent.

Participation of private capital in the oil industry of Brazil can probably result in a healthy competitive environment. Privatization of the national oil company is not essential. Apparently, Petrobrás is capable of adapting itself to confront competition. A more efficient and competitive company is likely to emerge from the co-existence of national and private oil companies.

The issue of state sovereignty over natural resources does not have the same appeal it had in the past. The globalization of the world economy seems to evidence that the threats of the past do not exist anymore. The argument that the development of the oil industry by international oil companies is a threat to national sovereignty or security is no longer an item in the agenda. Government ownership of the oil deposits and strong state control of the oil industry can in most cases be good enough to preserve national sovereignty and national security.<sup>9</sup>

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6. See K. Khan, *Some Legal Considerations on the role and Structure of State Oil Companies: A Comparative View*, 34 INT'L & COMP. L.Q. 584 (1985).

7. See G. PHILIP, *OIL AND POLITICS IN LATIN AMERICA* (1982).

8. See Coronel, *supra* note 1, at 375.

9. See R. Sims, *Government Ownership Versus Regulation of Mining Enterprises in Less-developed Countries*, NRF 9 (1985) 1, at 265.



The most important question, however, apparently has not been asked. What is most interesting is who benefits from the development of a country's natural resources. The answer has to be closely connected with economic development and, more important, with social development. State participation in the economy has led Brazil in the past to remarkable economical achievements. Yet, the country is still lagging behind in social development.

Brazil must envisage the role of the State in the economy as a means to foment the development of its natural resources, with the benefits accruing both economically and socially. The private sector can surely play an important part in it. The present government seems to be aware of this point. It has taken the first step to achieve what is being referred to in Brazil as the "flexibilization" of the petroleum monopoly.

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## LETTER OF SEPTEMBER 1995

WAIVER OF APPEAL BY THE ADMINISTRATION IN JUDICIAL  
PROCEEDINGS

In Brazil, public defenders representing the Administration's interests in legal proceedings act strictly in compliance with the provisions of applicable law. Although this seems logical, it does not leave any leeway for personal decision, criteria or even common sense.

In order to protect the Administration's interests and avoid defeats or improper action by its defenders, the pertinent regulations determine that adverse decisions issued by competent courts *must* appeal to and be reviewed by a higher court.

In recent years, due to certain mistakes in the drafting and to the unclear wording of the laws and regulations (especially with regard to tax matters), a nonstop flood of suits — filed by private parties against the Administration — has inundated the Judiciary Branch.

Some of these suits have reached the Supreme Court, which in turn has found against the Administration. Other similar proceedings, however, have to be appealed by public defenders until a final decision from the Supreme Court is reached (even knowing that such decision will be contrary to the Administration).

In order to do away with such problems, on August 23, 1995, President Fernando Henrique Cardoso issued Decree No. 1601, permitting the Government Attorney's Office of the Federal Treasury to waive appeals in suits that deal exclusively with the matters specified in such decree that were previously found against the Administration by a final Supreme Court decision.

This will appreciably diminish the volume of suits before the courts, and allow the public defenders to decide what suits should and should not be appealed (DOU-I, August 28, 1995).

## ANTI-DUMPING MEASURES

On August 23, 1995, President Cardoso issued Decree No. 1602, setting forth the rules regarding administrative proceedings on use of anti-dumping measures set forth in Provisional Measure No. 616 of September 14, 1994, approved by Congress and now in effect as Law No. 9019 of March 30, 1995 (see item 6 of our Letter of September 1994).

Under Decree 1602/95, *dumping* is defined as the entry of a product onto the domestic market (including under drawback) at an export price inferior to its normal price. A *normal price*, in turn, is defined as the price actually charged for a similar product in regular commercial use/consumption in the exporting country.

The difference between the export price and the normal price will be considered the dumping margin. If the export is found to constitute a threat to the domestic market (after proper administrative proceedings before the Foreign Trade Office), then anti-dumping measures will be instated. This means that the price of such export will be increased by an amount that cannot exceed the margin determined.

During an administrative proceeding, provisional anti-dumping measures can be imposed. The provisional or definitive anti-dumping measures can be suspended if a price settlement is reached with the exporter or with the nation of origin of such exported item.

Decree 1602/95 sets forth in detail the procedures for (i) proof of dumping, (ii) administrative investigation requirements, (iii) provisional anti-dumping measures, and (iv) definitive anti-dumping measures and price settlements (DOU-I, Aug. 28, 1995).

## LOSS OF BRAZILIAN CITIZENSHIP

On June 7, 1994, Congress approved Constitutional Review Amendment No. 3, altering specific provisions of Article 12 of the Brazilian Constitution that deal with naturalization conditions and loss of Brazilian nationality (see item 1 of our Letter

of June 1994).

On August 4, 1995, the Ministry of Justice approved the opinion from the Justice Office regarding nationality. Based on Constitutional Review Amendment 3/94, Brazilian citizens that acquire another nationality due to an imposition by the law of a foreign country (in order to permit such citizen to stay or have rights in that foreign country) will not lose their Brazilian citizenship (DOU-I, Aug. 7, 1995).

#### FOREIGN CAPITAL INVESTMENT VEHICLES

On August 10, 1995, the Central Bank of Brazil issued Resolution No. 2188, changing specific rules for investment of any funds remaining in the foreign capital investment vehicles set forth in annexes to Resolution No. 1289 of March 20, 1987 [(i.e., Investment Companies (Annex I), Investment Funds (Annex II), Managed Securities Portfolios (Annex III), and Institutional Investor Portfolios (Annex IV))]. Basically, resolution 2188/95 determines that the funds remaining in each fund should be invested as follows:

(a) Annex I:

- (i) shares of listed companies;
- (ii) Rural Debt Bonds (TDA), Brazilian Development Fund Bonds (OFND), Debentures issued by Siderurgia Brasileira S.A. (SIDERBRÁS); and
- (iii) other investments expressly approved by either the Central Bank of Brazil or the Brazilian Securities Commission (CVM);

(b) Annexes II and III:

- (i) other securities of listed companies;
- (ii) the same as (a) (ii) above; and
- (iii) the same as (a) (iii) above.

(c) Annex IV:

- (i) the same as (a) (ii) above; and
- (ii) the same as (a) (iii) above (DOU-I, Aug. 11, 1995).

## CONSTITUTIONAL AMENDMENTS

On August 15, 1995, Congress approved Constitutional Amendments Nos. 5, 6, 7 and 8, thereby permitting the participation by concession of Brazilian and foreign private capital in services that were traditionally restricted to the Administration and its agencies, or to companies organized under Brazilian law but held directly and indirectly by Brazilian partners on an exclusive basis:

- (i) Constitutional Amendment 5/95 altered article 25, paragraph 2 of the Constitution permitting the participation of private capital through concession of local piped gas services.
- (ii) Constitutional Amendment 6/95 altered article 170, item IX of the Constitution, eliminating the concepts of *Brazilian companies with domestic capital* and *Brazilian companies with foreign capital* contained in the Constitution. In the past, certain services (such as prospecting for minerals and mining) could only be rendered by Brazilian companies with domestic capital authorized by the Administration. This meant that companies organized in Brazil but with direct or indirect foreign participation were forbidden to render such services.

Under Constitutional Amendment 6/95, any and all companies organized under Brazilian law (regardless of any foreign interests) have the same rights.

Constitutional Amendment 6/95 also altered constitutional article 176, paragraph 1, permitting the participation (by means of government concession) of companies organized *under Brazilian law* in prospecting for and working of mineral resources within Brazil.

- (iii) Constitutional Amendment 7/95 altered article 178 of the Constitution, permitting the participation of foreign vessels in coastal shipping of merchandise and inland navigation. previously, such services could only be rendered by Brazilian vessels.
- (iv) Constitutional Amendment 8/95 altered article 21, items XI and XII "a" of the Constitution, permitting the

operation directly by the Administration or through third parties under government authorization, concession or permission of: (1) telecommunications services, (2) radio broadcasting services, and (3) sound and image broadcasting services.

These measures represent an important step towards the modernization of Brazil, permitting the participation of private parties (including foreigners) in services in need of massive infrastructure investments (DOU-I, Aug. 16, 1995).

#### DEBT REFINANCING

On August 23, 1995, the Minister of Finance issued Ordinance No. 208, determining the conditions for refinancing of the principal of debts paid to international banks by entities directly and indirectly controlled by the federal government, states, and municipalities by means of a debt swap for United States-dollar-denominated government bonds in accordance with the provisions of the Brazilian Investment Bond Exchange Agreement.

On August 24, 1995, the Minister of Finance also issued Ordinance No. 211, determining the conditions for refinancing of interest due from July 1989 through December 1990 and paid to international banks by entities directly or indirectly controlled by the federal government, states and municipalities by means of debt swaps for United States-dollar-denominated government bonds in accordance with the provisions of the Bond Exchange Agreement (DOU-I, Aug. 25, 1995).

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