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LEGAL SOLUTIONS FOR DOING BUSINESS IN A HYPERINFLATIONARY JURISDICTION: BRAZIL 1989

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This article will discuss the effects of Brazilian inflation on the legal practice at Baker & McKenzie and other law firms that deal with foreign correspondents in Brazil. Most comments apply to cases already seen in Argentina and other Latin American countries.

The best example of the effects of inflation is this article. While preparing this article, the inflation in Brazil was approximately twenty-five percent per month. When the article was completed exactly thirty days later, inflation was already thirty percent per month. By mid-January 1989, when the inflation rate was at sixty percent per month, or an average of two percent per day, the Brazilian Government implemented an anti-inflation plan aiming at zero inflation and froze wages and prices for an indefinite period. Due to these attempts to wipe out inflation, some of the contents of this article had to be changed, not because inflation is not coming back, but rather because, in my opinion, inflation will return. In order to analyze the contingency of inflation disappearing overnight, the new Brazilian anti-inflation plan, which is something for which lawyers must prepare themselves and their clients when drafting contracts, will be addressed.

Four factors are important when analyzing inflation in countries like Brazil. The first factor is the legal practitioner's understanding of inflation. Americans know what inflation is because they have experienced it at a rate of four to ten percent per year for many years now. In Brazil, in contrast, inflation rises one percent or more per day, which results in a sharp decrease in purchasing power. The real threat is, however, leaving cash unprotected against daily inflation increases and, perhaps, losing it altogether.

During January 1989, before the anti-inflation plan was enacted, Brazilians raised their prices because there were rumors of

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an anti-inflation plan. The anti-inflation plan became effective on January 16, 1989. Temporarily, the word inflation was erased from the Portuguese vocabulary until the end of February 1989. As of March 1989, there was to be an index factor in place that would bring inflation rates up gradually. However, this was an impossible dream because one cannot suddenly cut inflation when it is impossible to cut public spending. Furthermore, it is not possible to keep wage and price freezes forever, as the United States realized in the early days of the Nixon Administration.

The second factor in dealing with Latin American inflation is indexation. In Brazil, indexation has existed for more than twenty years. To use an apt metaphor, indexation is like a drug taken to combat a deadly disease. The drug may not cure the disease, but it can help in coping with it. After a certain time, dependency on that drug may be such that one cannot live without it unless something radical happens. With inflation, the "shock treatment" is an anti-inflation plan with zero inflation and consequent recession as done in Israel.

In Brazil, the mechanics of indexation are simple. Using country-wide research, the government measures the evolution of wages and prices of certain basic items. The government then publishes this index which becomes the index for the month or more recently, for the day. This index may be ten percent, thirty percent or whatever is warranted. When prices are not controlled by industrial and commercial business, a higher index is sometimes used to catch up with profit margins and prices. Everyone involved with the drafting or negotiations of commercial contracts and the purchase and sale of real estate will use this index.

In Brazil, the government index was published through government bonds or the *Obrigações do Tesouro Nacional* ("OTNs"). The OTNs, however, bore no interest. The OTNs did not really cover inflation, because OTNs were sometimes manipulated for economic or political reasons. The inflation index is set as high as possible during the months of higher tax collections and set at the lowest levels during the months when the government must fix the rates of the periodic salary increases.

Drafting contracts in a hyperinflationary jurisdiction would be easier if the parties could protect the stability of their payment rights and obligations using a foreign currency as denominator.

However, in addition to inflation and indexation (with indexa-

tion fueling inflation), Brazil has strict exchange controls similar to exchange controls in other Latin American countries. Because there is no free exchange market in Brazil, one cannot go into a bank and buy hard currency as freely as one can in the United States. In Brazil, in order to buy hard currency, one needs a special authorization from the Central Bank, the exchange control authority. The Central Bank generally disallows purchases of foreign currency because the country needs foreign currency to pay for its external indebtedness, *i.e.*, imports and other obligations. Therefore, if products or services were not previously imported into Brazil or if an investment in foreign currency was not previously made in Brazil, the Central Bank will not allow a remittance of foreign currency. Thus, exchanging local currency for foreign currency is significantly restricted.

The third factor to consider is that Brazilian residents cannot contractually subject their obligations to any currency other than the local currency. Consequently, two residents of Brazil (including branches or subsidiaries of foreign entities or individuals) cannot buy and sell in installments and adjust their obligations according to the U.S. dollar. This reality accounted for the Brazilians' use of the OTN, the government bond, as an index of the obligation.

Selling foreign currency in Brazil is very easy. In January 1989, the government enacted a tourism exchange which allows any unidentified person to go into a bank and sell any amount of currency.

Today there are three exchange rates. One is the official Brazilian exchange rate which is presently one U.S. dollar to one *cruzado*. A second rate is a tourism exchange which is similar to a special rate for other transactions in foreign currency. The tourism exchange is approximately one U.S. dollar to one and one-half *cruzados*. The third rate is the parallel exchange or the black market rate. Although the parallel exchange market is illegal, its use is widespread, with rates generally close to the tourism exchange rates. Today, 1.45 *cruzados* equal one U.S. dollar. While this market may offer interesting devices for maximizing the purchasing power of a holder of foreign currency, one must be careful in specifying the money's origin and the intended future use to avoid a case of tax evasion.

The fourth factor, in addition to inflation, indexation, and exchange control, is the limitation on interest. It would be easy to protect cash if one could lend money subject to interest rates that

were close to the prime rate or LIBOR. However, there is a rule in the new Brazilian Constitution, enacted in October 1988, that establishes a ceiling on interest at twelve percent per year, lending at higher rates constitutes usury subject to criminal sanctions. This rule is contested among financial institutions and banks on the grounds that banks take money at higher rates in the market and, therefore, must lend at twenty-five or thirty percent or more. With individuals, private entities, and non-banking institutions, there is no doubt that a non-banking institution which charges interest in excess of twelve percent is violating the usury laws. Thus, in an intercompany loan, the lender will charge interest of one percent per month over monetary correction of the period. If, for example, monetary correction was thirty percent for that month, in lending on a plus one percent interest basis, liability in one month will be 31.3 percent higher than it was thirty days before.

How does hyperinflation affect our areas of practice? While hyperinflation remains undefined, time is of the essence in hyperinflation, more than it is in times of economic stability. For instance, if, as in Brazil, a credit card company is generally paid by its cardholders up to forty days after the purchases without any interest or monetary correction, the effect of one percent per day inflation may bankrupt the credit card company in a matter of months if the credit card company pays the establishment or store where the card was used within ten or fifteen days of presentation of the charge slip. In order to protect itself, the credit card company should extend the period within which it pays the store and reduce the period within which the cardholder pays the charges. Otherwise the discount charged to the store (generally between three and ten percent of the purchases) will not be enough to maintain the credit card company's operations. For the store the situation is the reverse: the sooner it receives from the credit card company, the better. For this reason, many establishments or stores increase their prices and give a discount (*e.g.*, ten percent) if the customer pays cash instead of using a credit card.

Another good example is a contract for transfer of technology between a U.S. licensor and a Brazilian licensee. Generally, the licensor in the United States would settle its fees or royalties on a quarterly basis. The fees are usually charged on net sales which sales are, obviously, made in Brazilian currency. Thus, every three months, licensor and licensee would review the sales over the prior three month period and determine what fee is owed the licensor. It

is deadly, however, to wait for three months when: a) sales are being made by the licensee in local and soft currency; b) only after reviewing their accounts will the parties agree to a certain fee or royalty; and c) the licensee will then go to the Central Bank, request authorization to remit the funds, and wire transfer the funds to the U.S. licensor. By the time the fees are in the licensor's bank, the amount received is sometimes thirty or forty percent of what the foreign licensor expected to be paid at the time of the agreement's execution. No one, however, can claim that the licensee is in default because the licensee is complying with what the agreement provides; rather, the fault lies with the lawyer who drafted the agreement.

Another area of interest to U.S. lawyers is client cost advance. Although private practitioners in the United States have a problem with client cost advance, Brazilian attorneys suffer more even when they wait only for thirty days for clients to reimburse costs the attorneys have advanced. One should not be surprised, therefore, if a Latin American correspondent asks for an advance to cover costs.

Attorneys can avoid all of these problems, in one way or another, by drafting careful contract provisions. The key is in drafting those provisions where inflation has a major impact, namely, in price computation, payment terms, price adjustments, penalties for violations, damages, and cost determinations. For instance, in Brazil, a promissory note may look more attractive than a mortgage because the note can be enforced by executory proceedings in which the debtor must either pay or deposit the equivalent amount of the note in court within twenty-four hours of the filing of the complaint. However, it may take years of litigation before there can be collection on a mortgage. In commercial litigation, the crucial element is time. More than ever clients understand the old saying that a bad settlement is usually better than a good case.

Corporate lawyers are increasingly likely to feel the effects of hyperinflation. Hyperinflation is likely the result of clients requesting lawyers to create corporate devices, such as mergers and spin-offs, purely for tax and financial reasons. However, there is a risk in having form prevail over substance. Even though Brazil has no clear set of rules, such as disregarding the corporate personality, there are several revenue rulings which try to prevent this kind of abuse.

As far as minority shareholders are concerned, the payment of

minimum dividends is a requirement under Brazilian corporate law. The minimum dividend is payable at twenty-five percent of the yearly profit and is only ascertained upon the annual shareholders meeting, which is four months after the closing of the fiscal year. If the fiscal year ends on December 31, then by April 30, the shareholders will meet and decide to pay the minimum dividend. The minimum dividend is paid in installments thereafter. Therefore, a minority shareholder might start receiving dividends six months after December 31 based on December 31 figures which are sometimes 400 percent outdated. In this type of case, a good shareholder's agreement makes sense.

Tax planning is probably the area where attorneys can deal most with hyperinflation. While the Treasury can also use inflation to increase the tax rate because it naturally augments the effect of taxes, taxpayers can also use inflation to reduce tax liability. In Brazil, there is the so-called inflationary profit which is profit resulting from monetary correction or indexation. At year's end, one compares the balance sheet to the financial statement and applies the index of monetary correction for the year (for example, 1,000 percent) to fixed assets and equity. If the result is fixed assets monetarily corrected in excess of equity, then that it is positive monetary correction which is taxable income for the company. If the result is that monetary correction over equity is higher than monetary correction over fixed assets, however, then it is a deductible expense. Therefore, in playing with assets and equity, one can either save money in taxes or can generate profits artificially resulting from inflation. Profits out of inflation accepted by the exchange control authority are payable to foreign shareholders or equitable shareholders, which means that a subsidiary can remit from Brazil purely out of inflation.

In Brazil, tax litigation is another area which has recently grown substantially. Because of the government's need for cash, taxes and tax devices were sometimes created which were not strictly within constitutional boundaries. Questioning these tax changes has become a major area of tax savings. In 1987, some clients saved one to three million dollars in taxes just by raising a constitutional issue in court. Today with the zero inflation plan, taxes in arrears are collected with only a ten percent penalty and no monetary correction. No one goes to jail for paying taxes in arrears in Brazil, provided the taxes are paid before the marshal takes action. Today, interestingly enough, everyone attempts to

pay taxes in arrears because short-term investments earn up to twenty-five percent per month. If the tax is paid thirty days later with only a ten percent penalty, this means a net savings of fifteen percent.

Cash protection, in addition to timing, is the real game in hyperinflation. Cash protection is possible through several schemes. Intercompany lending is permissible in Brazil and between affiliates. It is not necessary to charge correction or interest provided the lender recognizes for tax purposes only the monetary correction not charged. Therefore, lending can be free between two affiliated companies. Of course, it becomes very simple to have a cash-rich company lending to a cash-poor company minimizing taxation of both, especially when the borrower can repay by the historical amount (deteriorated through time). Currency swaps are also common. As an affiliate can lend to another subsidiary-affiliated resident, the subsidiary can also lend to its foreign parent company in turn, without any interest or monetary correction. The parent company can subsequently swap these interest- and monetary correction-free funds with another non-resident. This practice is very popular today and warranted, provided the transaction takes place between two non-residents (*i.e.*, two non-Brazilian parties) and that lending is not abused.

Sale and leaseback transactions are also permissible. As in the United States, sale and leaseback of machinery will generate cash and reduce assets, thereby creating passive monetary correction or a deductible expense when compared to equity. Currently with a twenty-five percent earning rate on short-term investments, one should try to keep as much cash as possible available for this purpose.

The new anti-inflation plan is very similar to the former plan enacted three years ago. Each time an anti-inflation plan is created, lawyers must be prepared to analyze it as if it was really new, and not simply a remnant from the past. One of the major concerns when an anti-inflation plan is proposed is to have a client protected in terms of prices, especially if your client sells on an installment basis. Sellers using installment contracts will have prices deflated as of the day the anti-inflation plan is enacted or even retroactively applied. "Deflated" means that if the anticipated inflation reflected in an installment price was, for example, thirty percent, the government requires a reduction of prices by thirty percent and a price freeze for the duration of the plan. The

length of the existence of the plan varies and cannot be predicted.

One interesting idea that many clients implemented in 1986 was selling for cash with immediate payment terms, but using the seller's bank to finance the customers. In doing so, by the time the anti-inflation plan came into force, the seller was not really selling on installment, but rather for immediate payment which made them not subject to deflate its prices.

Before concluding, one must remember that dealing with inflation is very much like fishing in troubled waters. If one knows how to deal with the market and the fast economic changes the gain can be substantial. If one does not know how to protect oneself and identify the opportunities, one can waste a great deal of money and time. Those entities that have a presence in Brazil, continue to do business wisely in Brazil and continue to invest. To deal in a hyperinflationary jurisdiction, a basic requirement is good financial and tax planning which requires attorneys to advise intelligently clients doing business in such jurisdictions. Overall, one must bear in mind that Latin American countries, such as Brazil, Argentina, and Mexico, are unique societies that cannot be treated as a block. These countries also contain unique economies. In the case of Brazil, its economy is very dynamic. Although the Brazilian economy is said to be the eighth largest in the world, the actual extent of the Brazilian economy cannot be accurately measured because of the existence of a high parallel underground economy. One must have a good relationship with foreign advisors, auditors, lawyers, and business consultants in order to respond to the repeated and fast changes that take place in hyperinflation. When one deals with a foreign correspondent in a country like Brazil, one must understand what is going on and not underestimate a correspondent simply because the environment is extremely different from the business environment in the United States.

Lastly, one should not allow a foreign correspondent to answer questions vaguely or incompletely. It may take some time and may be difficult to understand the answers due to cultural and regional differences, but there is always a good explanation for each issue discussed with a foreign correspondent.