/ REGULATION OF SEED - FUNDING IN BRAZIL

Comments and perspectives regarding supplementary act no. 155/2016

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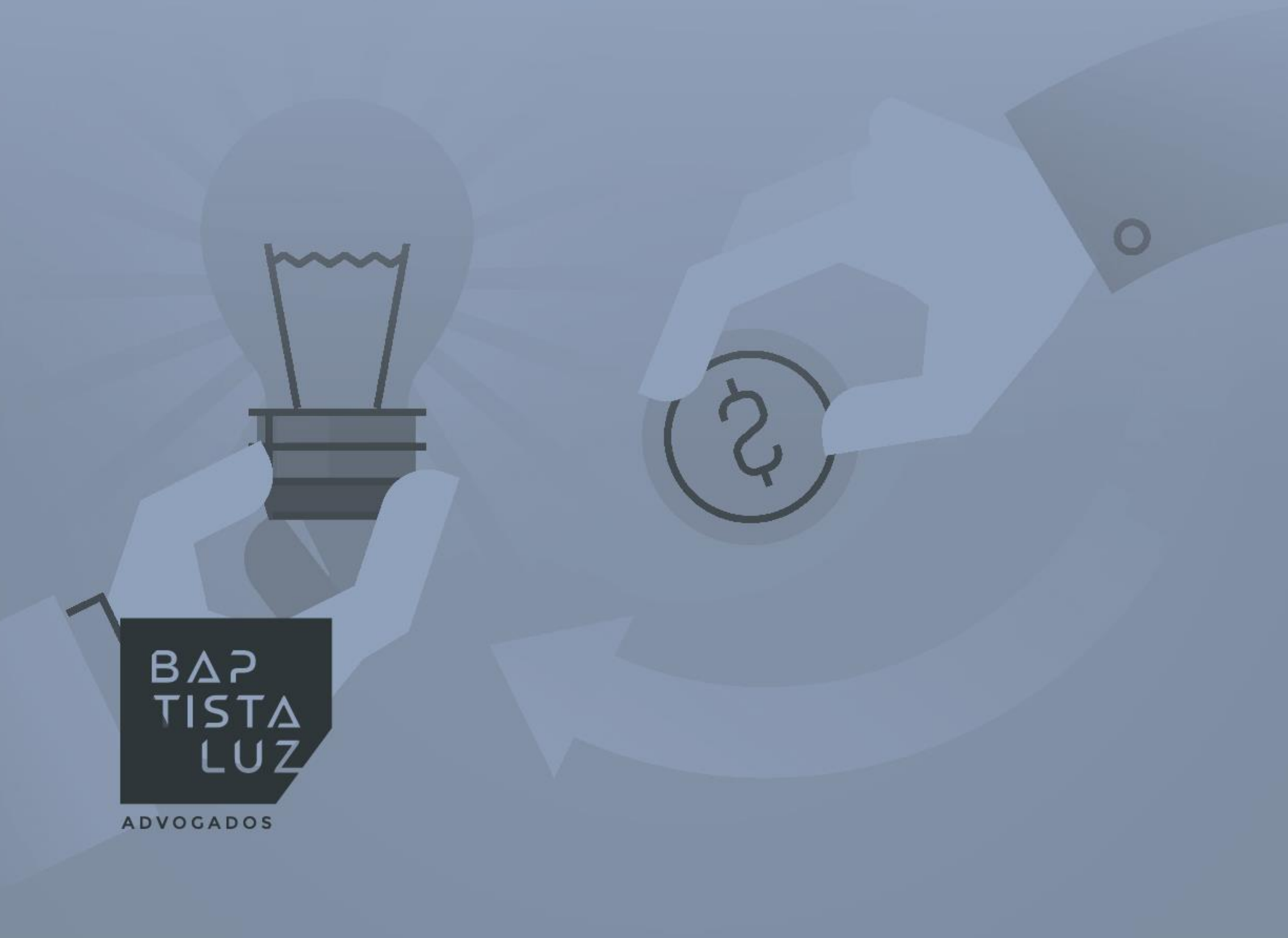

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REGULATION OF SEED FUNDING IN BRAZIL

COMMENTS AND PERSPECTIVES REGARDING SUPPLEMENTARY ACT No. 155/2016

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Supplementary Act no. 155, sanctioned on October 27, 2016, amends provisions of Supplementary Act no. 123 (the "National Statute of Micro and Small Companies" or, merely, "the SIMPLES Act"). Among the primary innovations of LC 155 we will point out the inclusion of articles 61-A through 61-D into the SIMPLES Act, which govern what is known as *seed funding*.

Seed funding is a type of funding for early-stage companies which have exponentially grown over their latest years. The term "seed" first appeared in the early twentieth century to refer to individuals who funded theater productions in Broadway, just like *patrons* and *benefactors* supported artists in the previous centuries.

Lately, the term has been used for individuals who fund innovative ventures by means of contributions to seed capital, i.e. financial contribution for the primary purpose of funding the early steps of a company. As compensation *seed investors* expect to receive financial yield from the company in the future either through dividends or by capital gain.

The seed funding activity in Brazil has grown, due especially to groups of seed investors and associations, such as Anjos do

Brasil, focused on encouraging this type of funding in the country. Obviously, popularization of such a pattern has been culturally, economically and legally challenged. On the last topic, the Brazilian regulations have so far implemented little legal security for seed investors to fund micro and small companies.

The Brazilian caselaw about the disregard of legal entity in case of “public interest”, e.g. labor, consumer and tax matters, is notably strong in the case limited companies, such aspect bringing risks to investors due to exposure of their private assets in a venture which is risky in nature. Aimed at overcoming such challenge, the market practice has sought creative ways, importing instruments used in other jurisdictions, such as the convertible bonds, but which also come with disadvantages, e.g. the Judicial branch not being familiar with this type of funding and thus creating excessive burdens on investees.

Upon introduction of articles 61-A through 61-D into the Act of SIMPLES, LC 155 purported to determine the regulatory landmarks of a *Brazilian pattern* of seed funding. By using concepts previously existing in the Brazilian Civil Code and carrying out some legislative innovations LC 155 brought major changes to the legal environment, which shall be effective as of January 2017.

Below is the result of our detailed analysis of the innovations brought by LC 155 and at the end of the article our recommendations for law regulators and enforcers which shall manage the challenges posed by the law.

ANALYSIS—ARTICLES 61-A THROUGH 61-D OF SUPPLEMENTARY ACT No. 123 (INTRODUCED UNDER LC 155)

Art. 61-A. Aimed at encouraging innovation activities and productive investments, companies classified as micro or small companies, under this Supplementary Act, will be authorized to *admit the contribution to capital, which shall not comprise the company's capital stock*

The first relevant article on the matter defines some major characteristics:

(i) **purpose of seed funding**: supporting innovation activities and productive investment;

(ii) **who/what is to be seed funded?** Micro and small companies which, according to art. 3 of the Act of SIMPLES, are corporations, companies, limited-liability companies and entrepreneurs, and which:

a. in case of a micro venture, make each calendar year a gross revenue equal to or lower than BRL 360,000.00; and

b. in case of a small venture, make each calendar year a gross revenue over BRL 360,000.00 and equal to or lower than three million and six hundred thousand Brazilian Reais (BRL 3,600,000.00) and, as of January 1, 2018, and equal to or lower than BRL 4,800,000.00.

In addition to the prior provisions, the primary contribution of the header of article 61-A is the clear indication that the contribution to capital of the seed investor shall not comprise the company's capital stock — which is discussed in further detail in the following paragraphs.

§ 1. The purpose of funding innovation and productive investment shall be contained in the equity interest agreement, the effectiveness of which shall not exceed seven years.

This paragraph makes the first reference to an *equity interest agreement*, i.e. the seed funding agreement governing the accomplishment of the contribution as provided for in the header of the article. Although such type of agreement is unusual in relation to those listed in the Brazilian Civil Code, it seems to us that LC 155 brought, especially in this article 61-A, a series of formal requirements approaching such equity interest agreement as a typical agreement, i.e. with its template prescribed in law.

That does not mean that the seed investor equity interest agreements cannot come with new provisions. The main discussion nowadays is whether the agreement could provide for the possible conversion of the nature of the special contribution made by the seed investor in a company's capital stock. In the seed funding rationale, the primary expectation of the contribution is that there shall be an extraordinary financial return: unlike investment in fixed-income securities or investment in consolidated companies, the primary goal of the seed investor is to join extremely high-risk ventures (startups in the innovation industry) which, due to their disruptive nature, carry a much higher possibility of return than the general market expectations.

In view of such elementary feature of seed funding and considering that there is no provision conflicting with such nature, at first, we do not see that the seed funding equity interest agreements providing for the possible conversion of the special contribution into company's capital stock would be a hindrance. Such possibility has characteristics directly related to liability: while seed investors own special contributions, they are protected by the disclaimer as determined in §4 below, but their financial return, upon redemption of the invested sum, is limited to the adjusted invested sum, under §7. As of conversion, it seems that the broad disclaimer in §4 would no longer be applicable but, on the other hand, the limited return in §7 shall not apply either. That is a trade-off between a disclaimer and a cap for a financial return.

A different circumstance would be if a certain agreement innovated in conflict with some of the requirements provided for in LC 155 (e.g. the 7-year term provided for in the article). In this case, the agreement could lose its typical characteristic, which would lead to the loss of some benefits granted by the law, notably the disclaimer as determined in §4.

After defining these critical characteristics on the nature of the agreement, we shall now point out some contractual requirements brought by LC 155 for the seed investor equity interest agreements. By reading this §1 two requirements are initially brought up:

(i) the agreement subject matter shall provide for the contribution to be made for the purpose of financing innovation and productive investment; and
(ii) the agreement shall be effective for a maximum of 7 years.

Limitation of the agreement subject matter is relevant and seems to be one of the key warranties that the funding shall not be used for purposes considered fraudulent or that are not comprised by the protection to the seed funding granted by LC 155. In such regard, it seems that the founding partners can themselves be personally held liable if diverting from the purpose of the contribution, in this case, article 50 of the Brazilian Civil Code being applied on them.

As regards the maximum term of 7 years, it is convenient to comment that, at first sight, such term seems to carry no losses to the practice currently exercised by the Brazilian seed investors; in fact, this is a long term, when the market is seen as working with terms lower than that for convertible bonds, for instance, with expiration terms usually varying from 2 to 3 years.

§2. The contribution to capital may be made by individuals or legal entities known as seed investors.

This paragraph has a critical provision: by defining that the seed investor may be a corporation, there is warranty that the groups of seed investors may meet to discuss around investment vehicles to make special contributions or that individual investors will be authorized to arrange their investment strategy by means of legal entities (either national or foreign), supporting legal models of capital planning.

§3. The activity constituting the corporate purpose is solely exercised by regular partners, on their individual behalf and under their sole liability.

§4. The seed investor:
I—shall neither be considered a partner nor be entitled to management or to vote in the company's administration;
II—shall not be liable for any company's debts, including court reorganization, not applying it to art. 50 of Act No. 10.406, dated January 10, 2002—Brazilian Civil Code;
III—shall be compensated for their contributions under the equity interest agreement for the maximum term of five years.

§3, §4 and their respective following items carry part of the rationale of the seed funding regulation. Items I through III of §4 establish not only critical characteristics of the equity interest agreement, but also *benefits* granted by the standard as of the time when the seed funding agreement completes all legal requirements determined by law, to wit:

(i) the benefit of not being considered as a partner—which, on the other hand, deprives them from the right to management or vote in the company's administration, which is under the sole liability of the regular partners, pursuant to §3;

(ii) the disclaimer, being quite broad and an intense right, especially in reference to article 50 of the Brazilian Civil Code; and

(iii) the possibility of compensation by the contributions, but for a maximum term of 5 years.

Out of the previous topics, item I deserves special attention. In agreements for bonds convertible into equity interest (so usual in the seed funding universe in Brazil), establishing what was covenanted as "*rights to veto*," became common, although such term is improper within the scope of a loan agreement. That is the case because, in convertible bonds, the investor's vetoes exist within the scope of the respective credit rights, i.e. the only sanction the investor is allowed to impose upon the founding partners if these ignore or violate the investor's right to veto is to advance the early bond due date (with an occasional increase of a penalty). However, the investor cannot effectively prevent certain decisions from being taken and certain acts from being practiced by the founding partners, because, as a general rule, there is no specific enforcement for these rights (the investor is only entitled to exercise their credit rights).

The restriction imposed by LC 155 as to management or vote in the company is aimed at preventing a founding partner from being "vested" with the character of a seed investor, taking part of the company's management, but at the same time being protected by the disclaimer provided for in law. It means that provided that the equity interest agreement shall not entitle the seed investor to corporate rights, at first sight, there seems to be no legal hindrance to the creation of early due date clauses (abiding by the minimum term of two years of paragraph 7) in the event of decision-making or practice of acts opposite to the interests of the seed investor.

Paragraphs 3 and 4 also bring another core discussion: by establishing a typical agreement character, did the equity interest seed funding agreement *kill* the convertible bond? In other words, will seed funding in Brazil only be permitted, from now on, by means of written equity interest agreements in strict compliance with LC 155?

Such discussion is raised from concerns that arise out of determination of LC 155. The primary concern may come from judicial interpretations that the investors using instruments other than the equity interest agreement as defined in LC 155 shall not be legally considered seed investors, which could be detrimental to the disclaimer of such investors. Such interpretation does not seem to be suitable to thrive.

A convertible bond is actually an unusual agreement, not expressly determined in the Brazilian law, but that does not mean it is illegal, especially considering that article 425 of the Brazilian Civil Code enables the parties to freely determine unusual agreements, provided that the subject matter is possible, legal, the qualified parties and remaining principles of the Brazilian private law are complied with.

It means the correct legal view of the issue is, in our opinion, that creation of a new typical agreement benefits the legal security, but it does not render illegal other patterns previously adopted by the market.

In such regard, the equity interest agreement is a new legal creation, with a hybrid nature: enabling the exercise of some rights typically deriving from equity interest (profit sharing, preemptive right, tag along) but, at the same time, it expressly excludes any and all liabilities of the investor for company's debts. Without LC 155, the creation of a principle with such characteristics would be impossible; it could be argued that the convertible bond carried similar characteristics, but its alien characteristic before the Brazilian law, although legal, did not provide clear legal security to its contracting parties. In summary, it seems that LC 155 created something new, interesting, and challenging, but it did not destroy what was previously practiced in the market.

Finally, another discussion raised in paragraph 4 is the possible inconsistency between its item III and the term outlined in the above-mentioned paragraph 1. While this provides for a maximum term of seven years for the equity interest agreement, §4, III, provides for a maximum term of five years during which the seed investor can be compensated for its contribution.

At first sight, one could consider there is a direct connection between these provisions and §7, determining the minimum two-year term for redemption. However, while §7 deals with *redemption*, §4, III deals with *compensation for the contributions*, which is explained in detail in §6. Considering the maximum term of 7 years for the equity interest agreement and the maximum 5-year term for compensation of the contributions, the law seems to have also explicitly created a *lock-up period* to initiate the compensation of the seed investor for the contributions; however, there would be no prevention for compensation for the contributions from beginning right after the equity interest agreement is signed, provided that the maximum 5-year term is abided by.

§5. For the purpose of classifying the company as a micro or small venture, the amounts of contributed capital are not considered company's revenue.

By establishing that the special contribution shall not be considered company's revenue, it seems clear that the law excludes from calculation of the company's revenues for the purpose of classifying it as a micro or small venture. From the accounting perspective, considering that the special contribution shall be accounted for as company's liabilities, under a special category, it seems relevant.

§6. By the end of each period, the seed investor shall be entitled to the compensation corresponding to the shared profit, according to the equity interest agreement, not exceeding fifty percent (50%) of the company's profits which is classified as a micro or small venture.

§6 introduces the possibility of compensating the seed investor's special contribution by receiving a part of the net profit earned by the company, as determined in the equity interest agreement, but in a sum not to exceed 50% of the profit to be shared.

Three topics call attention on the matter. The first is, if the companies are comprised by the law of the micro and small companies, which are released from the annual accounting bookkeeping, our understanding is that the profits which the seed investor may share are the same profits that can be shared among the partners and shall not be confused with accounting net profit or dividends. Since the reference system used by LC 123 is that of the companies with the SIMPLES, it must be clarified that this is one of the topics the regulations of the Treasury Department shall probably handle, aimed at averting abusive interpretations.

Another critical topic is the definition of the "period" mentioned in law. There seems to be contractual freedom to broadly define the compensation based on the shared profit, which may be monthly, every two months or annually, as defined by the parties, since LC 155 created no limitation in such regard.

The third topic is the 50% limitation, which ends up creating another formal requirement for the funding to be actually considered as a seed funding, which makes sense even if we construe that the market practice is that seed investors are minority shareholders in the startups, and rarely control their capital stock.

Finally, the reason for which such sums shall be received by the seed investor is not so clear and, accordingly, the taxation to which these would be subject. Except that the Treasury Department will be able to regulate this topic, we see the rationale of this §6 as bringing one of the most prominent aspects of LC 155: possibility for the seed investor to share the company's profits, *as if they were a partner, but not being a partner*. For compliance with the legal principles, such compensation is required not to be subject to taxation, as the case of the partners (sharing of such profits to partners represents exempted, non-taxable yield). If such compensation is subject to any taxation, in our opinion, one of the cornerstones of the magnificence of the new institution shall be put down.

§7. The seed investor shall only be able to exercise the right of redemption after two years, as a minimum, have elapsed as of the contribution to capital, or any longer period as determined in the equity interest agreement, and its assets shall be paid under art. 1.031 of Act No. 10.406, dated January 10, 2002 — Brazilian Civil Code, not being allowed to exceed the duly adjusted invested sum.

§7 determines the *right* of the seed investor for redemption after, at least, two years of the contribution to capital, with the amount being equivalent to the lesser among (i) a sum corresponding to a percentage of the company's book value, as defined in the equity interest agreement, to be calculated based on a balance sheet especially drafted until the redemption date, pursuant to article 1.031 of the Brazilian Civil Code and (ii) a maximum sum corresponding to the full sum of the special contribution, duly adjusted until the redemption date (the law does not determine any specific indexes, and the parties shall opt for the index of their convenience, such as IGP-M/FGV or IPCA/IBGE).

Companies are granted protection as established herein, by a cap to the amount to be redeemed by the seed investor. Accepting convertible bonds as funding instrument was common for companies concerned with being subject to the return of the full bond value in the event of non-conversion, and the return of such sum could be burdensome under a company's sensitive financial situation. With §7, companies are assured that the full amount of the special contribution will not be permitted to be charged in cases where the company's book value is low. In such case, the amount due is calculated in accordance with the partial dissolution standards provided for in the Brazilian Civil Code.

§8. The provisions of §7 hereof shall not prevent ownership of the contribution from being transferred to third parties.
§9. The contribution ownership assignment to third parties not any part of the company shall depend upon the partners' consent, unless otherwise expressly determined in an agreement.

The provision of paragraphs 8 and 9 seems interesting. By allowing for the contribution ownership assignment without requiring any consent by the partners (as expressly determined in agreement), there arises the possibility that the seed investor equity interest agreements will have a circulation characteristic, i.e. holder of the rights defined in the equity interest agreement (the seed investor) can assign these rights to third parties, including under consideration.

Such characteristic does not include the equity interest agreements among those under the regulatory protection of the Brazilian Securities and Exchange Commission — CVM (agency regulating the capitals market in Brazil) under Act no. 6.385/76, unless otherwise publicly offered (e.g. by means of investment-based crowdfunding platforms).

§ 10. *The Treasury Department will be authorized to regulate taxation upon withdrawal of the invested capital.*

This paragraph had an inaccurate text, but it seems clear that reference is made to redemption of the invested capital, as determined in article § 7. Regulation of the executive branch must be directed towards compliance with one or more of the following assignments:

(i) **simplifying enforcement of the act**—such assignment involves developing prescriptions capable of settling interpretation doubts, providing means to promote the application of the act with reduced regulatory costs and as much legal security as possible;

(ii) **specifying it in a viable manner**—the aim here is to specify cases which the act, either on purpose or not, left pending, requiring specification for strict enforcement; and

(iii) **accommodating the administrative apparatus, for strict compliance**—to inspect and apply the act, it is often necessary for the Executive Branch to develop or adjust procedures and agencies for the purpose of enforcing the act as effectively as possible.

It seems that the reference to the Treasury Department regulation is especially aimed at simplifying enforcement and adapting the administrative apparatus to inspect the taxation on the withdrawal of the invested capital, especially by means of the Brazilian Receita Federal.

In such regard, the reference to "withdrawal of the invested capital" seems to be considered only as "redemption of the contribution". Thus, the regulation would be restricted to a single circumstance: redemption of the adjusted amount contributed.

The amount contributed (main), obviously cannot be taxed. The point is how to tax the adjustment, since the equity interest agreement is, as repeatedly explained, a hybrid institution, not being a loan, not being an actual equity interest either.

For loans, adjustment would be taxed as interest; for equity interests, the positive difference between the amount contributed and amount redeemed would be capital gain; i.e. the Treasury Department intervention in this point makes sense, which is aimed at standardizing the fiscal interpretation for a new institution. In our view, the nature of the equity interest agreement has such risk and such unforeseeable return, not only for the credit risk, but also for the limitation imposed by paragraph 7 of article 61-A, that eventual gain obtained by the seed investor, either upon redemption, or by assignment to third parties, is much more aligned with the concept of capital gain than to that of interest in loan agreements.

Art. 61-B. Issuance and ownership of special contributions shall not prevent the execution of the National Simples.

The focus of the lawmaker when drafting article 61-B was to clarify that the special contributions received by the micro or small venture under LC 155 shall not result into the company being removed from the SIMPLES. Considering that the special contributions shall not be considered company's revenues, it would actually make no sense for us to think that a relevant contribution could be added to the company's revenues for the purpose of classifying as SIMPLES; likewise, the law clarified that signing an equity interest agreement of a seed investor executing the document by a legal entity shall not be considered as a case for removal from the SIMPLES.

Art. 61-C. If the partners decide to sell the company, the seed investor shall hold a preemptive right in its acquisition, as well as a tag-along agreement of the ownership to the contribution to capital under the same terms and conditions as those offered to regular partners.

Art. 61-C assigns to the seed investor two well-known privileges in the Corporate Law: preemptive right and tag-along. Upon preemptive right, the partners wishing to dispose of their shares in the company shall first offer them to the remaining partners and to the seed investor, being authorized to offer them to third parties only if the other partners and the seed investor do not wish to acquire them. The tag-along, in its turn, grants the seed investor the right to cause its special contribution to be included into the disposal of the company's shares to third parties, so that such third parties shall have to acquire such contribution along with the shares of the company disposed of by the partners, under the same terms and conditions. It should also be noted that there is no legal provision assigning tag-along to the partners of limited-liability companies, but art. 61-C renders it mandatory in the benefit of the seed investor.

The preemptive right and tag-along are both assigned to the seed investor generally and not so technically, leaving some legal gaps required to be analyzed in detail in the equity interest agreement. Accordingly, we should highlight (i) the provisions, in the agreement, for the operating means of such rights and (ii) how to apply equal terms and conditions when acquiring the special contribution in relation to acquisition of the company shares.

In respect of the operating means for tag-along, for example, we point out the required provisions which oblige the company and its partners to advise the seed investor of an existing proposal of third-party stakeholder, while the partners and the company shall fully advise such third-party stakeholder of the equity interest agreements in effect with the company since the special contributions shall comprise the operation.

In respect of application of equal terms and conditions when acquiring the special contribution in relation to acquisition of the company shares, the most natural thing seems to be the application of the equity interest percentage held by the seed investor over the total amount of a third-party offer or, also, as expressly determined in the equity interest agreement, determine the prior conversion of the special contributions into company capital stock, by issuing new shares in the benefit of the seed investors, which shall comprise the operation with the third-party stakeholder.

Art. 61-D. Investment funds will be authorized to contribute capital as seed investors in micro and small companies.

As of 08/30/2016, CVM Instruction 578 ("ICVM 578") was issued, providing for constitution, operation and management of the Investment Funds in Equity Interest—FIPs. In its Chapter III, Section I, the new FIP—Seed Capital class is introduced, intended to invest in small and mid-sized companies or limited-liability companies (art. 15, ICVM 578). In our analysis, however, there is no alignment between the provisions of such standard and the institutions introduced by LC 155 into LC 123.

For the FIP to be compliant with the terms of ICVM 578, at least 90% of their shareholders' equity is required to be maintained invested in certain securities (art. 11, ICVM 578), to wit, bonds and securities representing equity interest in limited-liability companies, but these must grant to FIP power to participate in the invested company's decision-making, with effective influence in defining its strategic policy and in its management (art. 5, ICVM 578). Since the special contribution cannot grant to the seed investor any right to management or vote in the company's administration (art. 61-A, § 4, I, LC 123), there is a prohibition of FIP investment by means of equity interest agreement in relation to, at least, 90% of its shareholders' equity.

After excluding the sum intended to pay the FIP operating costs, there would be freedom to invest the remaining 10%, but art. 43 of ICVM 578 has prohibitions for certain acts of the fund administrator and manager, to wit, application of funds when acquiring credit rights (art. 43, VI, b, ICVM 578). As explained above, funding by means of the special contributions contains elements of a credit operation, such that it seems that seed funding by means of FIP has no room in ICVM 578.

Thus, we see the necessity of a specific regulation by CVM regarding the possible seed funding by FIP, aimed at providing such entities' administrators and managers with the required security. As soon as the regulatory authorization matter for the funding is solved, such provision may bring one of the most important regulatory news of LC 155.

Prior to LC 155, FIPs could not make funding by convertible bonds, required to invest using debentures, which often rendered the low-value investments unfeasible. Furthermore, acquisition of shares (possible after ICVM 578) belonging to limited-liability companies by funds automatically implied that such companies would be removed from the SIMPLES. Now, the funds are allowed to conduct the seed funding without such problems, which may create a whole new market for fundraising by startups.

CONCLUSIONS

Approval of the LC 155 was important for the innovation industry, after introduction of standards for seed funding within the context of the micro and small companies, especially considering its main goal: simplifying the access by startups to funding and credit.

Therefore, a hybrid way to invest was created, mixing credit operation characteristics and corporate institutions, with the highlight to the merits of the initiative and the many possibilities inaugurated by the new provision. On the other hand, a topic to be pointed out is the absence of any legal provision to handle fraud within the context of the businesses between, the seed investor on the one side and, on the other, the company and its partners.

The general character of the legal provisions means, in our opinion, a possibility for the parties to more freely adapting their interests to the equity interest agreement; a comfortable room for the parties to be free tends to be embraced as it produces good results in the market.

As to fraud management, at first sight, there seems to be little room for such occurrence by the seed investor against the company, but much room for fraud by the company and its partners against the seed investor. Thus, the seed investors shall seek the respective protection of their interests by means of the equity interest agreement and, in our view, there is no deterrent for the founding partners to be jointly and severally liable for losing the invested capital in the event of diversion of the purpose of the contributions received and fraud of any nature.

Finally, we point out that the equity interest agreement created by LC 155 may be a feasible alternative for investment-based crowdfunding types, and the possible regulation, which is currently under public enquiry before CVM. This aspect could be considered in the regulation of such Commission, especially due to the many possibilities provided by the law for protection of seed investors.