



**PRIVATE EQUITY DEVELOPMENTS
IN BRAZIL, COLOMBIA AND MEXICO**

Committee on Inter-American Affairs

JULY 2010

NEW YORK CITY BAR ASSOCIATION
42 WEST 44TH STREET, NEW YORK, NY 10036

PRIVATE EQUITY DEVELOPMENTS IN BRAZIL, COLOMBIA AND MEXICO

Latin America has historically suffered a number of financial crises spurred by a dependence on commodity exports, high levels of external debt, hyperinflation, local currency devaluations, political turmoil and other causes. Since the early 1990's, a handful of Latin American countries have overcome or tamed these dependencies and enjoyed greater economic and political stability coupled with relatively high levels of economic growth, foreign direct investment and exports of manufactured products. However, the region as a whole has not been able to match the growth rates of emerging markets in China, India or much of the rest of Asia or Eastern Europe. Latin American governments have generally been less willing than in prior periods to use public funds to finance private sector economic growth, while most foreign-based multinational companies and financial institutions have concentrated more on Asian opportunities than those in Latin America. Furthermore, local capital markets have not yet matured enough to provide a sufficiently stable and liquid marketplace to satisfy the capital needs of new and emerging businesses.

For these and other reasons, governments and investors have increasingly come to believe or hope that private equity, which has become a powerful factor in the economies of the developed world, could play a similar role in Latin America. A growing number of private equity funds based outside of the region have been formed to explore opportunities for investment in Latin America, including some which have offices in the region. There is also a growing number of locally-organized private equity funds.

The Committee on Inter-American Affairs of the Association of the Bar of the City of New York has published this report in an effort to identify some of the key legal factors that may have an impact on the growth of private equity investment in Brazil, Colombia and Mexico.¹ These factors include (i) corporate governance regimes, (ii) preferred stock provisions, (iii) anti-dilution rights, (iv) board membership and liability, (v) minority shareholders' rights, (vi) exit strategies and the related issues of tag along, drag along and registration rights, (vii) regulatory issues regarding fund formation and operation, and restrictions on foreign investment, (viii) tax issues, and (ix) dispute resolution.² The Committee has elected to study these factors in three Latin American countries, Brazil, Colombia and Mexico, which should serve to highlight the challenges faced by private equity investors throughout Latin America.³

¹ The members of the Committee gratefully acknowledge contributions to and comments on the report which they have received from attorneys at the firms Machado Meyer Sendacz Opice (Brazil), Posse Herrera & Ruiz, Prieto & Carrizosa, and Brigard & Urrutia (Colombia), and Forastieri Abogados and SAI Abogados (Mexico).

² There may be other factors not addressed in this report that also play a role in the development of private equity investment, such as the relative strength of a country's antitrust laws.

³ Please note that terms defined in one country's portion of one of the chapters below are used, as so defined, in such country's portions of the subsequent chapters. References to "boards", "directors" and "managers" are intended to refer to boards of directors, members of such boards, and officers or individual administrators, respectively.

I. CORPORATE GOVERNANCE REGIMES

Private equity investors often take a minority stake in a company, with the intention of either adopting a passive role in management or otherwise relying on the experience and/or skills of existing management. Even investors starting with or taking on a controlling stake may later wish to sell all or part of their shares, either through a negotiated sale or through an initial public offering (“IPO”) of shares, to other investors who will expect a corporate structure that need not be changed significantly to effect the transaction and that provide appropriate incentives for the company to be managed without undue bias in favor of the interests of the controlling shareholders. A well-structured corporate governance regime signals to prospective investors how minority shareholders’ interests will be protected, whether the board will have some independence and perspective, and whether its independent members will play a role in decisions about compensation of senior management, the development of company policies on key issues, and adequate auditing of the company’s financial condition and operations. Depending on the type of company involved, the more stringent corporate governance regimes may be mandatory under applicable law and/or may be obtained through the insertion of appropriate provisions in the company’s by-laws and/or the relevant shareholders’ agreement.

Brazil

Several weaknesses in Brazilian corporate governance laws have been identified. Some of them are due to the concentration of voting control within a few shareholders and the issuance of preferred or non-voting shares on public securities markets to enable issuers to retain family-controlled ownership structures. Other problems include the generally poor functioning of boards, a disregard of minority shareholders' rights, and a lack of adequate legal protection for investors under the Brazilian Companies Law (*Lei das Sociedades por Ações* or “LSA”).

However, Brazil has gradually begun to improve its corporate governance laws. The LSA, the Securities Market Law (*Lei que disciplina o Mercado de Capitais e Cria a CVM*), and the Brazilian Civil Code are the main bodies of law that govern Brazilian companies. The Brazilian securities regulator, the *Comissão de Valores Mobiliários* (“CVM”), also issues various securities market regulations that affect corporate governance practices. The LSA provides the general framework for the operation and governance of all publicly-traded and privately-held Brazilian companies. In 2001, the LSA was amended to strengthen minority shareholder rights, improve disclosure standards and implement improvements in tag along rights, de-listing, non-voting shares, election of board members by minority shareholders, and private arbitration. In 2002, the CVM published voluntary, non-binding corporate governance standards on a "comply-or-explain" basis similar to those implemented in various other countries, i.e., the company may either comply with the prescribed corporate governance codes or diverge from them, but if it diverges, it must disclose and explain the divergence.

Other than the CVM’s Recommendations on Corporate Governance, the voluntary codes or models that address corporate governance matters are the Code of Self-Regulation for Primary and Secondary Offerings, launched by the National Association of Investment Banks (ANBID), and the Brazilian Code on Corporate Governance, launched by the Brazilian Institute on Corporate Governance (IBGC).

Perhaps most importantly, the Brazilian Stock Exchange (BM&F Bovespa or “Bovespa”), has created three new classifications for publicly-traded companies, each with progressively stricter corporate governance requirements. These include the Special Corporate Governance Level 1 and Level 2, and the *Novo Mercado* level, with the *Novo Mercado* having the most stringent requirements. Although companies listed within these segments constitute less than half of the total number of companies listed on Bovespa, and the large majority of companies originally listed within the traditional segment have not migrated even to Level 1 or Level 2, voluntary adherence to one of these special listing segments has now become standard practice in IPOs taking place on Bovespa, and the market capitalization of such companies as of the beginning of 2010 totaled over 65% of the exchange’s total capitalization.⁴

The Level 1 (*Nível 1*) Listing Rules provide that to become a Level 1 company, in addition to the obligations imposed by the LSA, an issuer must agree to (a) ensure that shares representing 25% of its total capital are effectively available for trading; (b) adopt offering procedures that favor widespread ownership of shares whenever making a public offering; (c) comply with minimum quarterly disclosure standards, including disclosure of quarterly cash flow statements; (d) follow stricter disclosure policies with respect to transactions made by controlling shareholders, directors and officers involving securities issued by the issuer; (e) submit any existing shareholders’ agreements and stock option plans to the Bovespa; and (f) prepare and disclose an annual calendar announcing scheduled corporate events.

The Level 2 (*Nível 2*) Listing Rules provide that to become a Level 2 company, in addition to the obligations imposed by the LSA, an issuer must agree to (a) comply with all of the listing requirements for Level 1 companies, (b) grant tag-along rights for all shareholders in connection with a transfer of the company’s control, offering the same price paid per share for controlling block common shares and 80% of the price paid per share for controlling block preferred shares; (c) grant voting rights to holders of preferred shares in connection with certain corporate restructurings and related party transactions, (d) have a board of directors comprised of at least five members, of which at least 20% shall be “independent,” as defined by Bovespa, with a term limited to two years; (e) if it elects to delist from the Level 2 segment, carry out a tender offer by the company’s controlling shareholder(s), with the minimum price of the offered shares to be determined by an appraisal process and, for the same purposes, in the case of companies with no majority controlling block, to comply with complementary rules to be issued by Bovespa; (f) disclose both quarterly and annual financial statements in English prepared in accordance with U.S. GAAP or International Financial Reporting Standards (IFRS); and (g) adhere exclusively to the rules of Bovespa’s Arbitration Chamber for resolution of disputes involving the controlling shareholders, the managers and the members of the fiscal council.

To be listed in the *Novo Mercado*, an issuer must meet all of the requirements described above and (a) ensure that the company’s capital sock will be composed exclusively of common shares; and (b) grant tag-along rights for all shareholders in connection with a transfer of the

⁴ See Hansmann, Henry; Gilson, Ronald J.; and Pargendler, Mariana, "Regulatory Dualism as a Development Strategy: Corporate Reform in Brazil, the U.S., and the EU" (2010), Faculty Scholarship Series, Paper 28, at 27 (2010), available at http://digitalcommons.law.yale.edu/cgi/viewcontent.cgi?article=1027&context=fss_papers.

company's control, offering the same price paid per share for the common shares held by the controlling shareholders(s).

Although the corporate governance standards contained in the CVM regulations and recommendations are voluntary for other companies, the by-laws of these companies may nevertheless be structured so that they comply with such standards.

Finally, it is possible (at least since amendments to the LSA were enacted in 2001) to structure corporate by-laws so that disputes are subject to arbitration within or outside of Brazil. However, domestic arbitration in Brazil of such disputes is mandatory in the case of companies wishing to be listed on the Novo Mercado.

From the standpoint of prospective private equity investors in Brazilian companies, the absence of mandatory governance standards means that they must pay detailed attention to, and often strenuously negotiate, the provisions of a company's by-laws in order to achieve the level of corporate governance that they would deem to be adequate. The goals of such standards can also be achieved by incorporating them into a shareholders' agreement, to the extent that any of the parties wish to have recourse thereunder for any failure to comply with the applicable standards, but the need for detailed attention to and extensive negotiation of the needed provisions will apply in this context as well. In any case, a shareholders' agreement may also be useful for other purposes not easily accommodated by the by-laws, such as requiring the shareholders to vote in favor of certain corporate actions, requiring the company to undertake obligations to the shareholders, or imposing on the shareholders various obligations to each other. On the use of shareholders' agreements to protect minority shareholders, see Chapter V below.

Colombia

In Colombia, there have been numerous efforts to improve corporate governance since 1995. These efforts have focused on the management and operation of both privately held and publicly-traded companies, and have gradually expanded in scope and in the types of companies and business entities to which they apply. Several corporate governance codes have been developed, some of which are tailored to deal with the particular needs of different kinds of companies, including family-owned and close corporations, simplified stock companies, companies with securities traded on exchanges, private equity funds and companies in which pension funds are allowed to invest.

The earliest corporate governance standards, as set forth in the Colombian Code of Commerce, dealt with all companies generally. In 1995 the passage of Law 222 modified the Code of Commerce to include regulations covering the election of boards, shareholder agreements, rights of withdrawal and obligations and liabilities for executive officers and directors. Also in 1995, Resolution 400 and Resolution 1200, issued by the former Securities Superintendency, which is now the Financial Superintendency of Colombia (the *Superintendencia Financiera de Colombia* or "SFC"), established certain obligations for issuers of securities registered with the SFC ("Issuers") and thereby permitted to trade on exchanges such as the Colombian Stock Exchange (the *Bolsa de Valores de Colombia*). These obligations included a requirement to disclose to the public material or relevant information (*información relevante*) as well as restrictions on insider trading.

Subsequent corporate governance standards were tailored to the type of entity involved, initially focusing on those entering the markets for publicly traded securities. The Securities Market Law enacted in 2005 (Law 964) created a more complete set of corporate governance rules for Issuers, including not only Issuers that are companies but also other types of Issuers such as special-purpose entities created for the purpose of securitizing certain types of assets. For all Issuers, Law 964 established certain corporate governance requirements which include, among others, (i) minimum and maximum limits as to the number of board members (a minimum of 5 and a maximum of 10), (ii) a phased-in minimum number of independent board members which must ultimately be at least 25% of the total number of board members, (iii) creation of an audit committee of at least 3 members, which must include all of the independent board members, and (iv) systems that ensure timely disclosure to the market of both interim and year-end financial information.

Law 964 also established additional mandatory corporate governance standards focused primarily on Issuers that are companies with equity securities (i.e. shares or bonds convertible into shares) registered in the National Registry of Securities and Issuers (such companies being called “Registered Companies”). The additional requirements applicable to Registered Companies include (i) protections for initiatives proposed by minority shareholders (provided that any such initiative is proposed by at least two shareholders representing at least 5% of all shares), (ii) special share issuance and placement rules, (iii) special stock repurchase procedures, and (iv) disclosure of shareholder agreements. In 2001, Resolution 275 was promulgated by the Securities Superintendency, now the SFC, providing that in order for any securities issued by an Issuer to be eligible for investment by a Colombian pension fund, the Issuer had to disclose its corporate governance practices in some detail and implement mechanisms to protect and guarantee equal treatment of shareholders.

In 2007, the SFC revoked Resolution 275 and promulgated a new voluntary and more detailed model code of corporate governance for Issuers, the *Código País* (the “Country Code”), which reflects a modified version of the “comply-or-explain” approach, whereby the Issuer must annually report on the portions of the Country Code with which they are in compliance, but are not required to report on their non-compliance with any of the provisions of the Country Code. Results of a 2007 survey on the Country Code indicated that its promulgation was a response to concerns that: (i) shareholders lacked sufficient information at general shareholders’ meetings, (ii) the meetings lacked written functioning rules, (iii) shareholders did not receive enough information regarding their rights and duties at meetings, (iv) boards tended to lack functioning rules and did not rely on committees to support the work of the board (although the boards are usually of adequate size, hold meetings frequently, and have members that are well qualified and increasingly independent), and (v) although the requirements regarding statutory auditors (*revisores fiscales*), board membership and dispute resolution seemed to be adequately developed, information disclosure mechanisms still needed to be strengthened.

The Country Code contains provisions covering 41 subjects, including: participation by minority shareholders in shareholders’ meetings; rights and equal treatment for all shareholders; professional, experienced and informed directors; additional committees to support the board (i.e., corporate governance and compensation committees); additional disclosure of financial and non-financial information; independence of financial auditors; conflict resolution mechanisms; and related-party transactions. Although adoption of a code of corporate governance is not

mandatory, it appears that all Issuers have adopted codes that are consistent with the Country Code.

Perhaps as a result of the various improvements in corporate governance outlined above, Colombia has recently been recognized as being relatively protective of investors' rights; the World Bank study referred to in Chapter IX.A below indicates that Colombia ranks 5th best, out of 181 countries surveyed, in protecting investors' rights.

Special corporate governance rules were prescribed by Decree 2175 enacted in 2007 for Colombian private equity funds (*Fondos de Capital Privado* or "FCPs") in order for them to receive investments from Colombian pension funds; for more detail on such rules, see Chapter VII below.

An innovation in the form of business entities was approved by the Colombian Congress in December 2008. Law 1258 authorizes the formation of a "simplified stock company" (*sociedad por acciones simplificada*) ("SAS"), which is a privately-held company whose corporate governance structure can be individually tailored to meet the unique needs of the company, with considerable freedom of contract similar to limited partnership agreements in the United States. The by-laws of an SAS can be structured so that they are subject to arbitration before an arbitration tribunal within or outside of Colombia. There are no corporate governance standards for an SAS, so investors must negotiate and agree upon the corporate governance standards for such entities.

However, in November 2009 the *Superintendencia de Sociedades* (Companies Superintendency) of Colombia issued a Corporate Governance Guide for Closely Held and Family Companies, which is an effort to create a complete set of recommendations on governance for small companies that are not Issuers or listed on exchanges. Although compliance with this guidance is optional, it is designed to improve and/or correct common corporate governance problems relating to closely-held corporations, including management policies, rules for shareholders' meetings (or their equivalent), powers and limitations for managers, disclosure, and the creation of a "family council" as a consulting body for family companies.

Disputes with respect to corporate governance provisions of a company's by-laws can generally be resolved through arbitration. The scope for arbitration is greatest in the case of an SAS, as to which arbitration may be conducted either within or outside of Colombia. With other types of companies, arbitration outside of Colombia is subject to Law 315 of 1996, which requires that one of several conditions be satisfied, such as a condition that at least one of the parties be domiciled outside of Colombia. Regulation 28, promulgated by the SFC in 2007, strongly encourages the shareholders of Issuers to agree to settle disputes through an alternative dispute resolution procedure. Additional discussion on dispute resolution appears in Chapter IX.

In summary, as in the case of Brazil, the corporate governance requirements that have been promulgated in Colombia are not mandatory, except to the limited extent prescribed in the Code of Commerce or – in the case of Issuers – Law 964. However, due to the influence of the Country Code and other voluntary rules as well as the effect of the limited mandatory rules, publicly-traded companies all appear to have complied with corporate governance standards. On the other hand, information about the level of compliance by privately-held companies with the

new standards is not yet known, and prospective private equity investors in Colombian companies are advised to include in the relevant company's by-laws and/or shareholders' agreement such provisions as they may feel are necessary to achieve an adequate level of corporate governance protection. Model provisions in this respect may be found in the Country Code and other voluntary rules.

Mexico

Mexico has historically had many of the same corporate governance challenges as those which have been faced in Brazil and Colombia, due in part to a rather antiquated companies law, the General Law of Business Entities (*Ley General de Sociedades Mercantiles* or "LGSM"), which generally lacked the more advanced corporate governance concepts recently embraced in other countries. However, in recent years Mexico has made great strides in the development of a comprehensive body of corporate governance laws. The Securities Market Law (*Ley del Mercado de Valores* or "LMV") of 2005 made a number of improvements to corporate governance standards for publicly-traded companies, including the introduction of a minimum percentage of independent directors, strengthening minority rights, and limiting the amount of restricted stock that may be issued.

The LMV amendments also introduced three types of corporate structures to complement the existing structure of a *Sociedad Anónima* ("SA") (corporation), which is governed by the LGSM. Each of the following structures has progressively more stringent corporate governance requirements: the *Sociedad Anónima Promotora de Inversión* ("SAPI") (venture capital company), the *Sociedad Anónima Promotora de Inversión Bursátil* ("SAPIB") (pre-IPO venture capital company), and the *Sociedad Anónima Bursátil* ("SAB") (public company). Such entities are also governed by the LGSM, except to the extent that the provisions of the LMV are inconsistent. Prior to the 2005 amendments to the LMV, publicly-traded companies had been subject to a regime comparable to the "comply-or-explain" approach used in Brazil under the 2002 CVM standards and (in a somewhat different form) in the Country Code adopted in Colombia in 2007, but this approach no longer applies in Mexico.

Governance standards provided for in the LMV are voluntary for SAs but mandatory for SAPIs, SAPIBs and SABs. The SAPI to SAB process allows for gradual conditioning of company management and shareholders to corporate governance concepts as a company transitions from a privately-held SAPI to a publicly-traded SAB. A company that registers as a SAPI can avoid some of the requirements of the conventional publicly-traded corporation in return for adopting a "Corporate Governance Best Practices" code and conceding more power to minority shareholders. The SAPI form obviates the need to deal with many of these governance issues in shareholders' agreements in order to ensure enforceability. It should be noted that not all of the corporate governance provisions applicable to SAPIs are mandatory; some of them are voluntary. Mandatory provisions relate primarily to the protection of minority shareholders and the structure of the board, and those that are optional relate primarily to committees of the board, certain kinds of stock and drag along and tag along rights. Thus, even within the universe of SAPIs, some have corporate governance rules that are closer to those of a publicly-held SAB than others.

Independently of the governance standards specified in the LMV, several types of financial services companies are subject to special corporate governance standards. Currently credit institutions (banks), brokerage firms (*casas de bolsa*) and fund managers (*sociedades operadoras de sociedades de inversion*), among other financial services entities, are required under regulations issued by the National Banking and Securities Commission (the *Comisión Nacional Bancaria y de Valores* or “CNBV”) and the Ministry of Finance and Public Credit (the *Secretaría de Hacienda y Crédito Público* or “SHCP”) to establish committees of the board to address internal control, risk management and prevention of money laundering and activities linked to international terrorism. Most such committees must contain a significant number of independent members of the board, and the duties of committee members are spelled out in the regulations issued by the CNBV and the SHCP. Also, corporate governance requirements are applicable in connection with the recent introduction of CKDs, instruments designed to attract investment by pension funds and other types of investors in infrastructure projects and private equity offerings, which are further described in Chapter VII.

It is possible for a SAPI or SAPIB to have its by-laws (*estatutos*) subject to arbitration, even before a foreign arbitration tribunal, but it is not known whether disputes over the corporate governance provisions of any such by-laws have ever been resolved through arbitration. As for disputes relating to shareholders’ agreements, the parties to such agreements often agree to resolve them through binding arbitration, whether within or outside of Mexico, and the resulting arbitral awards are normally enforceable in the Mexican courts. This issue is discussed more broadly in Chapter IX.

Most private equity investors in Mexican companies, apart from companies in the financial services industry, currently insist on using SAPIs to ensure a high level of corporate governance standards prior to the company going public. It is possible for standards of equal or greater stringency to be established for an SA in its by-laws and/or pursuant to a shareholders’ agreement or other type of investment agreement, but other advantages of using the SAPI structure (described below) would not be achieved. Notwithstanding the foregoing improvements, there are lingering concerns about weak corporate oversight and reporting requirements (firms must report annually on non-compliance but there are no penalties for not doing so), and the prevalence of family and other ties that dilute minority shareholder rights.

Summary Comparison

Of the three countries, Mexico seems to have the corporate governance regime with the most mandatory application, although the mandatory rules only apply to the SAPI, SAPIB and SAB (and in some respects to financial services companies) and do not reach the most stringent level until a company becomes publicly-traded as a SAB. There has been little experience to date in judicial enforcement of the standards adopted by any SAPI, SAPIB or SAB. Most private equity investors in Mexico currently insist on using SAPIs, principally because of their extensive mandatory corporate governance protections and the other advantages discussed below. Colombia’s corporate governance provisions established under Law 964 are mandatory only for publicly-traded companies, but investors are free to structure corporate governance rules in a stringent manner through provisions in the company’s by-laws, through a shareholders’ agreement or by structuring the company as an SAS, in each case by adopting the voluntary measures established in the Country Code and other similar model corporate governance codes

developed for privately held companies. Brazil's corporate governance regime suffers from not being mandatory for either publicly-traded or privately-held companies, except for those publicly-traded companies that elect to be listed on the *Novo Mercado* or, to a lesser extent, at Level 1 or Level 2. However, Brazilian companies may conform their respective by-laws to the standards contained in the voluntary codes or stricter standards if the shareholders so desire.

In each country it is possible to structure the by-laws of a company so that (i) stringent corporate governance standards are required, and (ii) at least until the company becomes publicly-traded, the by-laws are subject to arbitration within or outside of the country of formation. Except for the mandatory governance standards that apply in the case of a Mexican SAPI, private equity investors will generally not enjoy the protection of minimum corporate governance standards unless those standards are documented in a company's by-laws.

II. PREFERRED STOCK PROVISIONS

One way of attracting investors that are primarily interested in an economic return and potential growth of a company, rather than a controlling position, is to offer to such investors some form of preferred stock which provides for a fixed return and ranks ahead of common stock in distributions and in liquidation. This may involve a trade-off, whereby the preferred shareholder has limited voting rights in shareholders' meetings.

Brazil

Legislation in Brazil provides for the issuance of preferred non-voting shares up to a maximum of 50% of all outstanding shares, provided that the preferred non-voting shares entitle their holders to receive financial benefits on a priority basis in the distribution of fixed or minimum dividends and/or priority in the reimbursement of capital, with or without premium. Cumulative preferred stock is also permissible, with fixed cumulative dividends; if no dividends are paid for three consecutive years, the holders of such stock become entitled to voting rights.

Preferred stock provisions are not favored under the corporate governance regimes that apply to Brazilian companies that have issued publicly-traded shares, and as a consequence companies that have recently elected to issue shares to the public have avoided issuing preferred shares.

Colombia

In Colombia, companies may issue three types of stock: (i) ordinary shares, (ii) privileged shares with certain voting rights, and (iii) preferred non-voting shares with preferential dividend. The preferred non-voting shares with preferential dividend are intended to receive dividend payments with priority over any other shareholders and also convey certain economic preferences, including receipt of minimum dividend amounts on a priority basis and preferential reimbursement of capital in case of liquidation or winding-up of the company. The amount of preferred shares cannot exceed 50% of the total issued and outstanding shares of the company.

Law 1258 allows the by-laws of an SAS to be structured to provide for any type of shares, including privileged shares, shares with preferential dividend and no voting rights, shares with a

fixed annual dividend, and “payment shares” which may be issued by an SAS to its employees or executive officers as compensation and valued in accordance with Colombian labor laws. An SAS may issue shares that have privileges greater than those attributable to preferred shares (including cumulative preferred rights to dividends), and may represent such percentage of the total shares as specified by the by-laws, provided that such shares are not called preferred shares. This is due to a July 2009 opinion issued by the Superintendency of Companies, which requires that shares of types that existed prior to the enactment of Law 1258 will continue to be subject to the restrictions that previously applied to them, even if they are issued by an SAS created under such Law.

Mexico

Although the laws of Mexico establish that all shares will have the same rights and value, the by-laws of any company may permit the issuance of different classes of shares conferring different rights, including shares with limited voting rights and a preferred dividend of up to 5% of the purchase price. Preferred shares can be convertible into ordinary shares. In the event of the issuance of convertible preferred shares, the shares must be accompanied by the issuance of a sufficient amount of treasury stock to be delivered to the shareholder upon conversion. While the LGSM does not allow the shareholders of an SA to waive their rights to participate in the profits of the company, this prohibition does not prevent an SA from issuing preferred stock that has liquidation and dividend rights that might require the company, upon liquidation, to pay the preferred shareholder before common shareholders. Under the LMV, SAPIs and SAPIBs are permitted to issue different types of shares (including cumulative preferred shares) with no or limited voting rights or with limited economic rights.

Summary comparison

In summary, preferred shares may be issued in all three countries, normally in exchange for limitations on voting rights, and the holders of preferred shares may have priority over common shareholders in the event of liquidation. Preferred shareholders in Brazil and Colombia can also obtain priority in the payment of dividends without limitation as to amount (except that preferred shares cannot exceed 50% of the total outstanding shares, even when the company is an SAS, although an SAS can have other kinds of privileged shares in excess of such limitation), but in Mexico the amount of the dividend priority is limited to 5% of the purchase price, except in the case of a SAPI or SAPIB. Subject to such limitations, cumulative preferred stock is permitted in all three countries.

III. ANTI-DILUTION RIGHTS

A shareholder of a private company can be protected against the dilution of its percentage ownership of the company’s shares through (i) preemptive rights, which entitle the shareholder to purchase a percentage of any new shares issued by the company in proportion to the shareholder’s share ownership prior to the issuance, and (ii) a right of first refusal, which in the event of any shareholder proposing to sell its shares to another person, entitles each of the other shareholders to purchase such shares at a price equivalent to that proposed to be paid by the other person.

Brazil

In Brazil, preemptive rights are a statutory requirement under Law 6404 and rights of first refusal are contemplated by Article 171 of the LSA. A Brazilian company's by-laws may provide for first refusal rights with respect to any transfer of shares to a third party.

Colombia

In Colombia, Article 388 of the Colombian Code of Commerce mandates a preemptive right with respect to the issuance of new shares unless such right is waived in a shareholders' meeting or by means of a written consent or waiver delivered to the company upon approval at the shareholders' meeting of the dilutive issuance. Article 407 of such Code permits a right of first refusal to be included in the by-laws of any company other than an Issuer or Registered Company.

It is common for companies to include both types of rights in their by-laws. In addition, Law 1258 permits an SAS to restrict the transfer of its shares for a period of up to ten years, extendible for an additional ten years. There are no special statutory anti-dilution rights (whether preemptive or first refusal) applicable to FCPs.

Mexico

In Mexico, the LGSM clearly grants statutory preemptive rights to all shareholders of an SA. Consequently, if the SA issues any shares, each shareholder will have a preemptive right to subscribe and pay for such shares *pro rata* in accordance with their respective ownership percentage in the equity of the company immediately prior to the issuance of the new shares. Such preemptive right cannot be waived in advance, thus limiting the ability of the SA to issue stock options and warrants, or grant price protection through anti-dilution and registration rights. However, the issuance of options or warrants may be accomplished through the issuance of shares held as treasury shares as to which the shareholders waive their preemptive rights. The requirements relating to preemptive rights also apply to SAPIs and SAPIBs. In addition, any SA (pursuant to the LGSM) or SAPI or SAPIB (pursuant to the LMV) may grant to its shareholders a right of first refusal on transfers of shares.

Summary comparison

In summary, preemptive rights are mandatory in all three countries. First refusal rights do not appear to be mandatory in any of the three countries, but they all permit the by-laws of a company to provide for such rights.

IV. LIABILITY OF MANAGERS, DIRECTORS AND SHAREHOLDERS; BOARD MEMBERSHIP

Corporate laws in Brazil, Colombia and Mexico – to different degrees – all provide for duties of care, loyalty and diligence, allowing managers and directors to be held liable for any damages or losses caused to the company and the shareholders thereof due to a breach of their fiduciary duties of loyalty and care, and similar duties and liability apply to fund managers.

There are a few circumstances in which shareholders can be held liable for the actions or omissions of a company. In some cases, there are special requirements and restrictions applicable to the members of a board, including requirements that certain minimum percentages of the board members be independent of management, and restrictions on foreigners serving on a board.

Brazil

Although directors of *sociedades anonimas* and *sociedades limitadas* are generally not liable for actions or obligations undertaken in the ordinary course of business, directors are required to act with care, diligence and loyalty on behalf of the company, respecting confidentiality and disclosure rules. Liability for damages can arise from fault (negligence, recklessness or malpractice), deceit, malice, bad faith, violation of the law or violation of the organizational documents of the company. Directors that fail to file for bankruptcy when necessary can be held personally liable for any resulting loss to the company. Directors can also incur liability for labor, social security and environmental laws and regulations. Article 135 of the Brazilian Tax Code establishes special liability provisions for “obligations arising out of acts performed in abuse of power or in violation of the law” or the company’s organizational documents.

The managers of mutual funds (*Fundos de investimento em participacoes* or “FIPs”) have duties of care, diligence and loyalty similar to those of *sociedades anonimas* and *sociedades limitadas*, and managers may be held liable for any damages or losses caused as a result of a failure to comply with such duties as established by law or by the company’s constitutive documents.

As for board membership requirements, in the case of public companies listed on the *Novo Mercado* or as Level 2 Special Corporate Governance Companies, as noted in Chapter I above, boards must have at least five members and at least twenty percent of the members must be independent; for other companies with publicly traded shares, whether Level 1 companies or companies with shares traded in the general segment of Bovespa, at least ten percent of the members must be independent. There are no independent-director requirements for privately-held companies. Each board member must own at least one share of the relevant company (unless it is a *sociedade limitada*), but they do not have to be Brazilian citizens.

“Piercing the corporate veil” of a company, i.e. taking action to hold a shareholder liable for the company’s acts or omissions, is possible where the shareholder is considered controlling. There are specific rules of the CVM indicating when the degree of control would justify the imposition of such liability in the case of public or listed companies, and the CVM would determine whether the corporate veil should be pierced in the case of such companies. In the case of other companies, the Civil Code would mandate that such determination be made by a court. If the obligations are of a tax, labor or social security nature, there is a greater risk of shareholders being held liable than in the case of debt obligations. In the case of labor and social security obligations of a company, a shareholder may be found by a Regional Labor Office or the Brazilian Social Security Institute, respectively, to be jointly and severally liable for the company’s respective obligations.

Colombia

Commercial law in Colombia imposes fiduciary duties on board members and officers as well as professional managers hired by the company that require them to act in good faith and in the company's best interest. Pursuant to Colombia's Code of Commerce, board members and managers are jointly and severally liable for any damages caused to the company, its shareholders or any third parties as a consequence of their negligence or willful misconduct. Negligence is presumed if the board members act beyond their powers. Fund managers also have fiduciary duties and must act in the investors' best interest; they have duties of care, diligence, loyalty and confidentiality, among others, and must not participate in any transaction involving a conflict of interest. Such persons may be held liable for damages caused by failure to comply with fund agreements and applicable law.

Under the Colombian Code of Commerce the main limitations on board membership in the case of privately-held corporations are that (i) a majority of the board members may not be persons related by blood or marriage (up to specified degrees), and (ii) the same individual may not be a member of the boards of more than five companies. There are no prohibitions on foreigners serving as board members in Colombia, and since meetings may be held by written consent rather than by holding a physical meeting, foreign board members may easily participate in such meetings without having to attend a physical meeting in Colombia.

However, as mentioned in Chapter I above, Law 964 provides that the board of an Issuer must have between five and ten members, and at least 25% of them must be independent, but does not contain requirements as to nationality. In the case of SSCs, Law 1258 does not require them to have a board and, even in those cases where a board is required by the by-laws, there is no need to appoint alternates (which appointments are mandatory for all other types of companies).

According to Articles 54 to 60 of Decree 2175, the general rules of the Code of Commerce are applicable to private equity funds, if organized as FCPs (as defined in Chapter VII below) and their managers.

With respect to shareholders' liability, depending on the nature of the company, such liability may be limited. Members or shareholders of limited liability companies and corporations are only liable to the extent of their capital contributions to the company – except for labor and tax obligations of a limited liability company and fraudulent actions of a corporation, in which cases the corporate veil may be pierced. The corporate veil can also be pierced upon the occurrence of any of the events specified in Articles 31 and 71 of Law 222 and in Articles 49-8, 61, 82 and 83 of Law 1116 of 2006 regulating reorganization proceedings, if required by specific decision of a competent authority. In such events, the authorities may declare the company's existence as a separate entity null and void or otherwise disregard the corporate entity and thereby make the partners or shareholders of the company (including any SSC) personally liable. In addition there are specific provisions in connection with liability for any act performed with the existence of a conflict of interest.

Mexico

Mexico's civil and commercial law provides for a general standard of diligence applicable to any SA, SRL or SIC. Such standard requires board members to act in good faith and in the best interest of the company. The LMV regulates the liability of board members and managers of SAPIs, SAPIBs and SABs, imposing on them duties of diligence and loyalty. Pursuant to the LMV, the duty of diligence requires directors to act in good faith and in the best interest of the company and the duty of loyalty creates an obligation on the part of directors to maintain the confidentiality of all information not available to the public and requires directors to abstain from voting on matters that represent a conflict of interest. It may be more difficult to sue directors of SAPIs for violation of duties established solely under the LMV than for a violation of duties applicable to all companies as established under the LGSM.

Board members' and managers' liability requires them to indemnify the company for any damages or losses caused by failure to comply with their fiduciary duties of diligence and loyalty. Shareholders have the right under both the LMV and commercial law, to make managers accountable for their actions or omissions.

Shareholders' liability in SAs and SRLs is limited to their capital contributions to the company and there are no precedents of piercing the corporate veil, except in the case of labor, social security and tax liabilities, as to which officers and directors are also more likely to be held liable if it can be shown that they were aware of the company's failure to satisfy such liabilities. Piercing the corporate veil, and holding officers and directors liable, is less likely in the case of environmental liabilities than with labor, social security and tax liabilities.

The LMV requires that at least 25% of the members of the board of a SAPIB or SAB be independent, and a former auditor of the company may not be a member of the board. The LMV contemplates independent members of the boards of SAPIs and SAPIBs, but does not make their participation mandatory. Neither the LMV nor the LGSM imposes any nationality requirement on board members.

Summary comparison

Board members in all three countries are subject to standards of conduct (of care, diligence and loyalty in Brazil, and of good faith and the company's best interest in Colombia and Mexico), that may give rise to liability if they fail to comply with the applicable standards. In Mexico, heightened standards apply to companies formed under the LMV (SAPIs, SAPIBs and SABs), including more explicit confidentiality requirements and statutory indemnification of the company for violations of the standards. While Colombia and Mexico require that independent directors make up at least 25% of the boards of public companies (and, in the case of Mexico, SAPIBs), the minimum percentage in Brazil is only 20%, and this percentage is only applicable to companies listed on the *Novo Mercado* or at Special Corporate Governance Level 2. There are no mandatory minimum percentages for independent directors of privately-held companies (except for SAPIBs in Mexico). In each country, however, private company shareholders may voluntarily agree to establish such minimum percentages. None of the countries restrict the right of foreigners to be board members. Colombia restricts the number of

companies on whose boards any individual may be a member (the maximum is five), and prohibits a majority of the members of any board from being related by blood or marriage.

V. MINORITY SHAREHOLDERS' RIGHTS

In each of the three countries, there are certain statutory protections of minority shareholders. To further enhance such protections, shareholders' agreements and voting covenants have been commonly used in Brazil, Colombia and Mexico during the last two decades in private equity transactions and other structures involving private investment groups. The enforceability of shareholders' agreements and minority shareholders' rights has been questioned in certain jurisdictions, leading to legal reforms that recognize the validity of such arrangements, subject to certain requirements or exclusively for specific types of companies.

Brazil

The LSA provides for minority shareholders' rights, such as (i) the right to appoint board members and, under certain circumstances, officers of the company, (ii) a veto right for certain matters at the board and shareholder levels, and (iii) rights of first refusal as to the transfer of shares to third parties. Statutory rights of minority shareholders vary significantly depending on whether the invested company is a closely held or public company. In general, shareholders have certain rights that cannot be eliminated by majority vote, such as the right to share in the profits of the company and in distributions of assets upon its liquidation, the preemptive right to subscribe to new share offerings and the right to withdraw in the event of certain fundamental changes in the company. In addition, any holder or holders of at least 5% of the company's shares may, among other things, (i) obtain a court order compelling disclosure of the corporate books, (ii) file a shareholders' derivative suit claiming management irregularities, (iii) require the audit committee to report on matters for which it is responsible, (iv) request a winding-up of the company upon proof that it is not achieving its corporate objectives, (v) sue for damages caused by any controlling shareholder or shareholders on the basis of a claim of abuse of the control position, (vi) call a shareholders' meeting, and (vii) if the shareholder has dissented from a decision taken at a general shareholders' meeting, obtain payment of a "refund" for its shares under Article 45 of the LSA, which allows the dissenting shareholder to sell its shares to the company for an amount equal to not less than 80% of the value of such shares as determined under such Article.

Minority shareholders holding a higher percentage are entitled to additional rights. For example, shareholders owning at least 10% of the voting shares have the right to (i) request the adoption of cumulative voting for members of the board, (ii) call a meeting of the audit committee (this can also be done with 5% of the non-voting shares), (iii) elect one member of such audit committee, and (iv) elect one member of the board. Holders of at least 15% of the shares are entitled to elect two members of the board.

In Brazil, shareholders' agreements are common, recognized and enforceable, can be used to provide more stringent protection of minority shareholders' rights than the statutory provisions specified above, and may provide for resolution of disputes through arbitration either within or outside of Brazil. A shareholders' agreement can state that it is governed by the law of a jurisdiction other than Brazil, but any agreement to be performed in Brazil must be governed by

Brazilian law, which as a practical matter means that such agreements are normally stated to be governed by Brazilian law.

Colombia

Statutory minority rights in Colombia include the following: (i) shareholders holding at least 20% of the voting and outstanding shares of a company may request the Superintendency of Companies to call an extraordinary shareholders' meeting, (ii) no more than 50% of the company's net profits may be distributed unless shareholders holding at least 78% of the outstanding shares of the company approve the distribution, (iii) the issuance of stock disregarding the preemptive rights provided in the company's by-laws must be approved by at least 70% of the outstanding shares, (iv) the distribution of shares as dividends must be approved by at least 80% of the outstanding shares, (v) shareholders have a right of withdrawal (*derecho de retiro*) if, as a result of the company's transformation into a different corporate entity, or a merger or spin-off, the shareholders' liability will increase or their economic rights will be adversely affected, (vi) dissident shareholders may challenge the resolutions adopted at the shareholders' meeting when such resolutions contravene the company's by-laws or applicable law, and (vii) repurchased stock does not entitle the company to any representation or voting rights. In the case of an SAS, the provisions protecting minority shareholders can be made more stringent than the statutory requirements. For example, the minimum voting percentages can be higher than those required by law.

Minority shareholders have a "withdrawal right" (*derecho de retiro*) that is similar to an appraisal right, and arises in the case of a merger, spinoff or transformation. Article 12 of Law 222 of 1995 provides that if any such transaction would increase the shareholders' liability or adversely affect their economic rights, the withdrawal right would entitle them to withdraw from the company and obtain reimbursement from the company in an amount equal to the value of the shares they return to the company. If the parties cannot reach an agreement as to such value, it must be determined by means of an appraisal carried out by an expert pursuant to Article 16 of Law 222. A procedure providing for a right similar to an appraisal right also applies in the context of certain types of public tender offers.

The Code of Commerce expressly permits shareholders' agreements regarding voting requirements, board election, transfer of shares (including tag along and drag along rights) and other issues related to minority shareholders' rights. Any such agreement will be treated as valid and enforceable against the parties, provided that the agreement is filed at the main business office of the company. However, shareholders' agreements are only valid for up to ten years, extendible for a second period of ten years with the unanimous consent of all shareholders party to the agreement.

For Registered Companies, additional requirements for the validity and enforceability of shareholders' agreements are that they must be disclosed to the market, that a copy of the agreement be delivered to a legal representative of the company, and that compliance with the agreement must not contravene the securities market rules. The filing and disclosure requirements do not apply to an agreement between the shareholders to which the company is not a party, even if the company is a Registered Company (i.e., it can be enforceable against the shareholder parties even if it is not enforceable against the company).

Provisions protective of minority shareholders can be included not only in shareholders' agreements but also in the company's by-laws, and as indicated above, dispute settlement provisions can provide for arbitration either within or, subject to some limitations, outside of Colombia. A shareholders' agreement that is to be performed in Colombia must be governed by Colombian law, except that it can be governed by foreign law when (i) there are international aspects of the agreement, such as where any foreign shareholder is a party thereto, and (ii) the parties have agreed that the agreement is subject to international arbitration. However, since enforcement may involve application of aspects of Colombian corporate or commercial law, as a practical matter such agreements are often governed by Colombian law.

Mexico

The LGSM provides for certain rights of minority shareholders, and the LMV provides for additional rights applicable to shareholders of SAPIs and SAPIBs: (i) shareholders holding 10% of the voting shares of the company may appoint one member of the board, (ii) shareholders holding 10% of the voting shares of the company may appoint a statutory examiner (*Comisario*), (iii) shareholders holding 15% of the voting shares may bring actions against directors of the company, without the need for a resolution adopted by the shareholders at a general shareholders' meeting, and (iv) shareholders holding 20% of the voting shares may sue to block implementation of resolutions adopted by the shareholders. Shareholders of a SAPI or SAPIB may also agree on non-compete provisions, tag along and drag along rights, put and call options, first refusal rights on the transfer of shares, voting agreements and registration and public offering rights. There are no statutory appraisal rights in favor of minority shareholders of a privately-held company dissenting from a merger or other transaction in which a controlling block of shares would be transferred. If the shares of the company are publicly traded, the LMV provides for protection of dissenting shareholders by ensuring that in any buyout of shares they receive a price per share equivalent to that which is paid to the controlling shareholder(s) and that the price per share be approved by the corporate practices committee of the company's board.

Even before the adoption of the LMV provisions relative to SAPIs and SAPIBs, shareholders' agreements were common in Mexico. However, such agreements had not been enforceable as to provisions that restrict or limit voting rights. As of 2006, the LMV expressly provides for the enforceability of shareholders' agreements for SAPIs and SAPIBs even as to provisions restricting or limiting voting rights.

As in Brazil and Colombia, provisions protective of minority shareholders in Mexico can be included not only in shareholders' agreements but also in the company's by-laws, and as indicated above dispute settlement provisions can provide for arbitration either within or, subject to some limitations, outside of Mexico. A shareholders' agreement can be governed by the law of a jurisdiction other than Mexico, but any agreement to be performed in Mexico must be governed by Mexican law, which as a practical matter means that such agreements are normally governed by Mexican law.

Summary Comparison

In all three countries, minority shareholders have certain rights prescribed by statute. Further protection may be obtain through shareholders' agreements with provisions for the

protection of minority shareholders' rights, which are generally enforceable in Brazil and Colombia for both publicly-listed and private companies. In Mexico, shareholders' agreements relating to SAs are not clearly enforceable as to voting restrictions, except in the case of SAPIs and SAPIBs. Provisions protective of minority shareholders can be included not only in shareholders' agreements but also in the company's by-laws, and as indicated above dispute settlement provisions can provide for arbitration either within or, subject to some limitations, outside of a company's country of incorporation. A shareholders' agreement can be governed by the law of a jurisdiction other than the country of incorporation (although in Colombia this works only when there is an international aspect, such as the presence of one or more foreign shareholders and the parties have agreed to international arbitration), and for practical reasons such agreements are often governed by the law of the country of incorporation.

VI. EXIT STRATEGIES AND IMPLEMENTATION, VIA TAG ALONG, DRAG ALONG AND REGISTRATION RIGHTS

Private equity investors normally seek to maintain their investments for relatively short periods, usually no more than 5 or 6 years, and thus tend to insist on protections of their ability to exit from the portfolio company at the end of the projected period of investment or beforehand if appropriate. Exits may be through an IPO, a sale to a strategic buyer, a sale back to the company or a sale to existing management. To protect their ability to carry out such exits, investors often seek provisions in shareholders' agreements that will enable them to register their shares in a public offering, participate in sales by other shareholders to third parties ("tag along" rights) and require other shareholders to sell their shares to a third party identified by the initiating seller ("drag along" rights). Each of the three countries permits these means to enable a shareholder to carry out its exit strategy, but the usefulness of such methods will of course depend on whether there is an adequate market (in the case of registration rights) or available interested buyers (in the case of tag along and drag along rights).

Brazil

In Brazil, under the LSA, minority shareholders are entitled to tag along rights in a public offering of shares and in the case of a merger. The *Novo Mercado* requires that each listed company have at least one class of shares with tag along rights for all minorities. Rights of first refusal, tag along and drag along rights and preemptive rights may be established contractually in shareholders' agreements and are theoretically enforceable in court, but judicial precedents have so far been insignificant.

Brazilian companies generally have limited access to traditional sources of financing, such as bank financing or debt markets, and capital costs in Brazil are high. CVM regulations make it difficult to effect a leveraged buy-out (a listed company may not be liable for the debt incurred to finance the transaction) and a listed company may only delist if a tender offer is made at a price that may ultimately be set by minority shareholders. Bovespa does not have the size or depth to support a robust market for IPOs, although the *Novo Mercado* has been attracting investors and may be close to becoming a real exit possibility for private equity or venture capital funds. In addition, venture capital funds are subject to higher, non-standardized administrative taxes, and often do not have the necessary size and structure to serve as an exit. In some circumstances, companies may be better able to do an IPO outside of Brazil, as indicated in the

section on Mexico below. Where an exit is not possible through a leveraged buyout or IPO, investors must focus on the possibility of either a strategic sale (such as a sale to another company in the same industry) or a sale to the other shareholder or shareholders.

Colombia

Tag along rights, although sometimes used in Colombia (especially when foreign investors are involved), are not generally mandatory for any type of company, but can be implemented through shareholders' agreements (subject to the limitations referred to in Chapter V above). Shareholders agreements and by-laws can also include put options, drag along rights and registration rights, and these provisions are recognized by the SFC and enforceable in the courts. As for Registered Companies, tag along rights are only mandatory in certain cases, such as in the context of some types of public tender offers (*oferta pública de adquisición* or "OPA") or an auction sale (*martillo*). There is no requirement that a Registered Company have at least one class of shares with tag along rights for all minorities. For shareholders of Registered Companies, tag along rights structured through shareholders' agreements are recognized and enforceable among the parties, but only if such rights are structured in compliance with securities market laws and regulations, including registration and disclosure, as indicated in Chapter V above.

The lack of legal rules governing the inclusion of tag along or drag along provisions allow the parties to freely regulate these issues within the law's general framework, but this freedom may lead to deadlocks or enforcement difficulties. Since there is no quick and specifically established mechanism for the enforcement of these provisions, the resolution of disputes or penalties for default are subject to judicial or arbitral proceedings, as applicable. Furthermore, practical implementation of such structures is not well developed, and there are few published judicial or arbitral decisions construing the application thereof.

There are a variety of exit alternatives available. Foreign investment requirements are limited to requiring that the investment be registered and that the registered information be updated on a yearly basis, and do not limit the divestment strategies. The exit strategies generally used by fund managers to exit investments include (i) listing the portfolio company on the stock exchange and carrying out an IPO or creating a secondary market (there are no piggy-back rights in Colombia), although the requirements can be cumbersome, (ii) selling the fund's equity investment to the remaining or initial shareholders or to management in a management buy-out, using put and call rights, and (iii) selling the fund's equity investment to third parties (strategic or non-strategic investors), using tag along and drag along rights. Exchange regulations, however, make it difficult to effect a leveraged buy-out. In addition, debt push-down structures are also difficult to implement. In some circumstances, companies may be better able to do an IPO outside of Colombia, as indicated in the section on Mexico below.

Mexico

Tag along rights are generally recognized but not mandatory in Mexico. By-law provisions as to such rights are likely to be enforceable when they involve SAPIs and SAPIBs, but such enforceability is considerably more difficult in the case of other types of entities, such as

SAs and SRLs. Registration rights are common, although judicial enforcement of such provisions may be complicated.

The common exit options for private equity investments in Mexico are a sale to a third party, a sale to other shareholders, or an IPO, but for practical reasons the most common exit strategy is to sell the assets or stock of the company to a third party in a private sale, sometimes through the exercise of drag along and tag along rights. The LMV allows shareholders of SAPIs and SAPIBs to agree on buy/sell mechanisms that will allow them to sell their interests in the event of a deadlock at the board or shareholder level. Except in the case of SAPIs and SAPIBs, Mexican law specifically prohibits private Mexican companies from redeeming shareholders' stock unless redemption is judicially ordered for the purpose of satisfying debt obligations. An SAB may sell its stock to the general public by listing its shares directly on the Mexican stock exchange (*Bolsa Mexicana de Valores*, or "BMV") in an IPO. However, public stock markets in Mexico remain small by U.S. standards and can be illiquid. An SAB may also sell its stock directly or by listing American Depositary Receipts on a U.S. stock exchange, on NASDAQ, or in the over-the-counter or "pink sheet" markets. Mexican companies can also pursue a private placement in the United States under Section 4(2) of the Securities Act (most commonly via Regulation D).

Summary Comparison

Because local markets lack sufficient size or depth to support IPOs, exit strategies in all three countries tend to rely more on the possibilities of transferring shares to other shareholders or to third parties (including strategic buyers) in negotiated sales, which can depend on the effectiveness of tag along and drag along rights as well as puts and calls. In all three countries, shareholders can seek the protection of such rights through negotiating for inclusion of appropriate provisions in the company's by-laws and/or in shareholders' agreements, but such provisions are not mandatory except for tag along rights in the case of publicly-traded companies in Brazil.

VII. REGULATORY ISSUES: FUND FORMATION/FUND OPERATION AND RESTRICTIONS ON FOREIGN INVESTMENT IN FUNDS

To a growing degree, investment in Latin America by private equity funds based in the United States and Europe is being supplemented by investment through locally-based private equity funds. This is particularly true in Brazil and Colombia, where local sources of capital are being directed to investments in local companies, but not so prevalent in Mexico (although the recent introduction of CKDs described below may change this situation). Local funds often have the advantage of being more familiar with local companies, and may be less complicated for local investors from a tax perspective.

Brazil

Brazil has a regulatory regime that is relatively friendly to private equity investment, which has helped to significantly increase private equity activity in recent years. As described below, however, a number of issues still exist.

The two most commonly used vehicles for private equity investments in Brazil are *Fundos de Investimento em Participação* (“FIPs”) and *sociedades limitadas*. While both have made investing in private equity funds more accessible, FIPs in particular have become the preferred form.

FIPs are closed-end investment funds permitted to invest in public or private corporations. They benefit investors by allowing investments in private entities to be exempt from both capital gains and distribution taxes. Additionally, they permit the netting of gains and losses among investments in the same fund. FIPs are generally not constrained as to the size of their target companies and have the ability to control targets through majority ownership or contractual agreements. FIPs may not make direct investments outside of Brazil or invest in real estate. *Sociedades limitadas* provide their shareholders with limited liability to the extent of subscribed and paid-up capital and are not required to publish their financial statements. Any *sociedade limitada* must be comprised of at least two equity shareholders, which may be individuals or legal entities (domestic or foreign). Non-resident equity holders need to appoint a Brazilian resident individual to represent them locally. Furthermore, *sociedades limitadas* have no minimum capital requirement.

FIPs (but not *sociedades limitadas*) must register with the CVM, and this registration process can be cumbersome. FIPs are only accessible to qualified investors, which include financial institutions, insurance companies, investment funds, portfolio administrators, and securities consultants, as well as individuals or legal entities that hold financial investments in an amount exceeding a specified threshold. No simple online registration process exists for FIPs. Additionally, the central bank in Brazil requires the registration of all of the investments made by foreign investors, whether through FIPs or *sociedades limitadas*. While Brazil has made great strides in enabling equity investments, the somewhat difficult registration process as well as problems associated with processing foreign exchange flows make investing logistically difficult, especially for foreign investors.

Negotiations between private investors and various funds are severely hindered in Brazil due to the lack of valuation guidelines needed to create a framework for valuing investments and so provide consistency within the private equity industry. Intellectual property rights present an additional issue because a lack of transfer rules makes registration and enforcement quite difficult.

Both insurance companies and pension funds are major sources of private equity funding in Brazil, but these institutional investors are under certain restrictions which limit their ability to participate. Such restrictions include Brazil’s variable income rules, which specify that no more than 50% of a pension fund may be allocated to variable income. Pension funds are also limited to investing no more than 20% of the entirety of their respective funds under investment (“reserves”) in private equity and cannot invest in any private equity funds domiciled outside of Brazil. Open pension funds may invest up to 60% of their reserves in stocks while insurance companies may invest up to 50% of their reserves in stocks and other variable income instruments. Pension funds generally participate in Brazilian private equity investments more often than insurance companies. Many pension funds investing in private equity also insist on participating on the investment committees of the funds in which they have invested.

Foreign investors also face obstacles. All foreign investments in Brazilian companies must be registered with the Central Bank Electronic Registration System. Without proper registration, the investor's ability to repatriate funds and receive dividends will be severely hindered. While investors must pay the increased transaction costs associated with this registration, there is no requirement that they maintain a permanent establishment in Brazil in order to invest in a Brazilian company. Additionally, there are no restrictions on the amount of the foreign investment, except for certain regulated industries such as nuclear energy, health services, postal services, airlines and media. Compared to other Latin American countries, such as Argentina and Mexico, Brazil has fewer restrictions on foreign investments in private equity funds. However, foreign investors will likely face increased transaction costs due to the registration requirements associated with these types of investments.

Colombia

In Colombia, regulation of private equity funds is focused on those which are formed as *Fondos de Capital Privado* ("FCPs"), which are closed pooled funds (*carteras colectivas cerradas* or "Pooled Funds") in which 2/3 of the contributions are invested in assets or economic rights other than publicly traded securities registered with the National Registry of Securities and Issuers (*Registro Nacional de Valores y Emisores*).

The formation and management of FCPs are subject to Decree 2175. FCPs are also subject to administrative regulations issued by the Central Bank with respect to currency and foreign exchange matters, as well as administrative and technical regulations issued by specific supervisory governmental agencies. SFC regulations address more specific issues for FCPs, such as fund formation monitoring, fund portfolio and individual share valuation methodologies and reporting standards, management and compliance issues and profitability disclosure rules. The SFC also cooperates with the *Autorregulador del Mercado de Valores* ("AMV"), a self-regulating organization which acts to maintain stability and integrity in the markets and to protect investor interests.

Decree 2175 classifies categories of Pooled Funds based in part on requirements for the redemption of shares. For example, it provides for (i) open Pooled Funds without restrictions on redemption, (ii) open Pooled Funds with penalties for early redemption, (iii) staggered Pooled Funds (*cartera colectiva escalonada*) in which shares may only be redeemed once a specified maturity has been reached, and (iv) closed Pooled Funds where shares may only be redeemed upon expiration of the fund's term unless partial and advanced redemptions are (a) required by law, or (b) required to distribute the appreciated value of shares. It also classifies categories of Pooled Funds with regard to the underlying asset and transactions managed by such funds, for example, (i) real estate, (ii) margin (only brokers and trust companies are authorized to manage such funds), (iii) speculative (with minimum investment size restrictions), (iv) index funds, and (v) FCPs. Decree 2175 does not, however, preclude the establishment of funds structured with other characteristics (i.e., funds of funds), if authorized by the SFC.

An FCP must be formed as a special purpose vehicle that does not have legal personality and that is administered by a trust company (*Sociedad Fiduciaria*), a broker (*Sociedad Comisionista de Bolsa*) or an investment company (*Sociedad Administradora de Inversión*), such companies being collectively called "Authorized Companies". FCPs are not eligible investments

for pension funds. As closed Pooled Funds, FCPs' participation units may only be redeemed upon expiration of the fund's term unless (a) the redemption is partial and in advance, or (b) there has been an appreciation in the value of the units of participation.

FCPs must be managed by either a manager designated by the Authorized Company or by a professional manager (*Gestor Profesional* or "GP") hired by the Authorized Company. Decree 2175 requires that the GP be an expert in the management of investment portfolios or the type of assets in which the fund invests. Authorized Companies that manage FCPs through a manager who they designate directly can only designate managers who are registered with the *Registro Nacional de Profesionales del Mercado de Valores* (RNPMV) and who maintain certifications with AMV. In order for the FCP to receive investments from pension or severance funds, it must designate a GP who has had at least 5 years of experience in managing (i) private equity funds, or (ii) assets of the class targeted by the fund within or outside of Colombia. If the GP is a legal entity, such requirement can be satisfied by its legal representative or by its parent company, as applicable.

As noted in Chapter IV, Articles 54 to 60 of Decree 2175 provide that provisions of the Code of Commerce applicable to *sociedades anónimas* apply to FCPs as well. As a result, participation units in FCPs, directors and investment committee members are subject to a regime similar to that applicable to shareholders and directors of companies. Also, the rules on managers' liabilities, board membership and shareholder rights that are contained in Law 222 also apply to FCPs. Although this law refers specifically to managers' liabilities in the context of the different forms of "companies" existing in Colombia, they are also applicable to FCPs, as specifically set forth in Decree 2175.

In general, the formation of an FCP in Colombia is relatively simple. Once the Authorized Company and the manager or GP have been appointed, the Authorized Company must file the proposed Placement Rules (*Reglamento*) of the FCP with the SFC for informational purposes. Even though the SFC's prior approval is not an operational requirement, it is advisable that the FCP organizers take into account any comments the SFC and potential institutional investors may make regarding the proposed Placement Rules or other aspects of the FCP. The FCP can commence operations within ten days after the filing of its Placement Rules with the SFC. Thereafter, the Authorized Company will be required to comply with certain obligations such as periodic disclosure of information to investors and to the SFC, delivery of periodic valuation and profitability reports, and responding to any requests by the SFC for additional information.

Decree 2080, adopted in 2000, requires that foreign private capital invested from abroad in Colombia must be channeled through the foreign exchange market, as foreign direct investment or as portfolio investment. Investment by a foreign investor, whether or not it is a foreign private equity fund, in an FCP in Colombia is deemed to be foreign direct investment, as is investment by a foreign fund directly in a Colombian company, and in each case such investment must be routed through a foreign exchange intermediary to the corresponding FCP or company. Article 6 of Decree 2080 provides that foreign investment is permitted in most sectors of the Colombian economy. The main exceptions are: (i) the sectors in which foreign investment is prohibited, namely defense and national security activities and the processing, transportation and disposal of toxic, hazardous or radioactive waste originating outside of Colombia; (ii) a few sectors where

there are percentage limitations, notably telecommunications; and (iv) a few sectors where prior government authorizations are required, notably financial services.

For a Colombian pension fund to invest in a private equity fund formed outside of Colombia (a *Fondo de Capital Privado Constituido en el Exterior* or “FCPE”), the FCPE must satisfy the following additional restrictions imposed by the SFC: (i) at least one of the following entities must be incorporated in an investment grade jurisdiction: (a) the special purpose entity through which the FCPE was formed, (b) the FCPE’s manager, parent company or affiliates, or (c) the FCPE’s professional manager, (ii) the FCPE or its manager (or affiliates) or general partner (or general partner’s affiliates) must have invested or managed qualified assets of at least US\$1 billion; (iii) the FCPE’s manager, whether an individual or entity, must have at least 5 years of experience in the management of FCPs or FCPEs or in the management of the underlying assets of FCPs or FCPEs (if the FCPE’s manager is an entity, the 5 year experience requirement can be satisfied by any legal representative thereof); and (iv) the FCPE’s private placement memorandum must identify the fund’s investment targets, investment policies, risk management and internal corporate governance controls.

Mexico

Mexico has not been an attractive jurisdiction in which to create or form private equity funds, partly due to a lack of appropriate vehicles and mechanisms and partly due to a lack of tax incentives. Mexico has not yet developed a strong or compelling regulatory structure that would allow the private equity industry to fully develop, and investors do not consider the available vehicles to be appealing or trustworthy.

During the 1990’s, new legislation permitted the formation of a new type of capital investment entity called the *Sociedad de Inversión de Capital (SINCA)*, an open-end private equity fund regulated by the CNBV. Unfortunately, SINCA’s have not prospered due to excessive regulation which restricts the scope of their investments as well as their funding and management.

More recent legislation has introduced additional types of investment vehicles. In 2005, Banco de México (Mexico’s Central Bank) promulgated rules permitting the creation of vehicles called Private Equity Investment Trusts (*Fideicomisos de Inversión de Capital Privado (FICAP)*) regulated by the Income Tax Law. The FICAP was designed as an open trust, which may continuously raise funds and close multiple deals. From a corporate and tax perspective, FICAPs are structured like a U.S. limited partnership. However, FICAPs are still problematic for investors because of (i) restrictions on the investment period of the trust (80% of its funds must be invested one year after closing), and (ii) restrictions on the reinvestment of funds (the trust must distribute its income immediately after selling any portion of its portfolio).

In July 2009, the CNBV issued new regulations permitting the issuance of Development Capital Bonds (*Certificados de Capital de Desarrollo* or “CKDs”), which may be listed on the Mexican Stock Exchange for the purpose of attracting investments in infrastructure, communications, energy, commercial harbors and certain private real estate projects, among others. CKDs are a new vehicle that can provide financing and investing in infrastructure projects and private equity investments in specific sectors. The new regulations set forth

corporate governance rules applicable to issuers of CKDs that are similar to those applicable to SABs. Mexican pension funds are permitted to invest in CKDs. They are not permitted to invest in other private equity fund structures, whether organized in Mexico or in a foreign jurisdiction.

Recently, Mexico's largest development banks - National Financiera S.N.C. (Nafin), Banco Nacional de Obras y Servicios Públicos, S.N.C. (Banobras) and Banco Nacional de Comercio Exterior, S.N.C. (Bancomext) - and FOCIR (a Federal government trust fund) launched a fund of funds (informally called the "*Fondo de Fondos*") which aims, among other things, to provide long-term financial resources via private equity and venture capital funds to Mexican companies, promote a venture capital culture and contribute to establishing the conditions necessary to develop the market by increasing the amount of resources available. The Fondo de Fondos has already funded several private equity funds in Mexico as part of an economic support and development plan. The Fondo de Fondos' investment policies include investing in private equity funds which have a minimum target capital of US\$12 million and to hold a minority share of up to 35% and a maximum of US\$30 million of the fund's capital.

Apart from the funds formed in Mexico, there are a number of foreign-based funds, mainly investment management firms managed in the United States and in other countries, that have made investments in Mexican companies. Some of these funds are created as specialized funds limited to Mexico, and the portfolio companies are managed locally. Some sectors of the Mexican economy are subject to restrictions on foreign investment, such as telecommunications, air transport, navigation in coastal waters (cabotage) and the oil and gas industry.

Summary Comparison

Of the three countries, Brazil and Colombia have more investor-friendly regulatory schemes with regard to private equity investments. While some hurdles do exist in Brazil, such as cumbersome registration processes and higher costs for foreign investors, the creation of FIPs and *sociedades limitadas* have made investment opportunities in Brazilian private equity funds much more accessible. Colombia's regulations are perhaps broader and more flexible, and allow for the establishment of a wide variety of FCPs, and FCP formation is relatively simple and rapid, but investors must comply with various SFC requirements as to the qualifications of fund managers, and as well as additional SFC restrictions placed on foreign private capital invested through FCPEs, including requirements that investments originate from an investment grade jurisdiction. To complicate matters, certain aspects of Pooled Fund regulation in Colombia have not been clarified by the SFC. Mexico has implemented the least investor-friendly regulatory scheme, characterized by a lack of both investment vehicles and tax incentives. Most attempts to create investment entities in Mexico have failed due to excessive regulation.

Pension funds in Brazil and Colombia are permitted to invest in certain types of private equity funds, including, in the case of Colombian FCPEs, funds based outside of the country. In Mexico, pension funds are permitted to invest in CKDs but in no other type of private equity structure, whether based within or outside of Mexico.

VIII. TAX ISSUES

There are a variety of tax issues that private equity investors must address before deciding to make an investment in a particular company or fund, including: (i) tax rates on corporate profits in the relevant jurisdictions, (ii) the applicable rate at which capital gains are taxed, (iii) the presence or absence of tax incentives, and (iv) whether there is any treaty in force between the home country of a foreign investor and the country where the relevant company or fund is formed that would minimize double taxation on dividends and distributions payable to such investors, as well as on capital gains. Brazil, Colombia and Mexico have taken different approaches to these issues.

Brazil

Brazil has taken steps to encourage investment in private equity and venture capital through codification of certain tax incentives. Favorable measures include a lower rate of taxation applicable to private equity investments, tax incentives for foreign direct investment, and tax benefits made available to public entities that invest in private sector research and development. Further, dividends from Brazilian companies are not subject to tax or withholding tax regardless of the residence of the investor.

In recent years, Brazil has lowered certain tax rates. As of January 2005, Brazil reduced the rate of income and capital gains tax on domestic investment in regulated private equity and venture capital funds from 20% to 15%, with a lobby working towards a further reduction to a 10% rate. These rates are attractive, especially as compared to the 34% effective rate on corporate income.

In addition, Brazil's tax incentives for foreign investment in private equity and venture capital funds reduce, and can sometimes eliminate, any related taxes for foreign investors. Foreign investment in regulated private equity and venture capital funds is generally exempt from income and capital gains tax if (i) the investment does not come from entities registered in tax havens, (ii) the investor does not hold more than 40% of the investment funds, and (iii) each fund in which the foreign investment is made does not hold more than 5% of its equity in bonds other than Brazilian public bonds.

Nevertheless, while Brazil has moved towards a more investor-friendly tax regime, there are still some issues of which an investor should be aware. For instance, double taxation is more easily avoided by foreigners, but domestic investors must carefully structure transactions in order to take advantage of tax benefits discussed above. In addition, Brazil changes its rules on tax domiciles often and sometimes unpredictably. These changes can make the rate of taxation or the existence of an exemption difficult to determine. As a result, an investor may unwittingly find itself in a locally classified tax haven where capital gains are not exempt and have instead been increased from a 15% to a 20% rate.

Colombia

Colombia has also enacted a number of tax rules to encourage investment in private equity and hedge funds. Under Colombian law, foreign investment funds themselves are not

taxpayers. In addition, private equity funds organized as FCPs are generally disregarded for tax purposes, and are therefore not themselves subject to income or capital gains tax. As a result, FCPs may be considered tax-transparent or pass-through vehicles. Investors in FCPs are taxed on the income of the FCP as if they had received the income directly. For such purposes, capital gains are generally assessed at the normal corporate income tax rate of 33%, except for certain special situations in which capital gains tax treatment is different, notably: (i) with the sale in any fiscal year of less than 10% of a company's shares listed on the Colombian Stock Exchange, in which case no capital gains tax is payable, and (ii) with the sale of real property in specified cities (including Bogotá), in which the book value for purposes of the capital gains tax is deemed to be the self-appraised value for real estate municipal tax purposes. On the other hand, no tax deduction can be claimed for losses from the sale of any kind of corporate shares. A new equity tax on companies was recently approved and will become effective as of January 1, 2011, but as in the case of other taxes, FCPs are disregarded for purposes of such tax.

Colombia is also party to various agreements that enable foreign investors from certain countries (currently Perú, Ecuador, Bolivia, Chile and Spain) to avoid double taxation on income accruing from investments in Colombia, and is negotiating or in the process of approving similar agreements with additional countries, including Switzerland, Mexico, Canada and South Korea. Finally, under a special incentive, investment (whether made by foreign or domestic investors) in real productive assets generates a tax deduction (equivalent to 30% - recently reduced from 40% - of the initial investment, after taking into account normal depreciation of the related assets). Commercial profits generated by this tax benefit can be distributed abroad without applying any tax in Colombia. Moreover, tax losses may be deducted and carried forward without any time limitation.

FCPs may invest in companies located in any type of Free Trade Zone in Colombia, either as an industrial user or as an operator, and in such cases the companies' profits distributed to the FCPs as dividends will be subject to a corporate income tax rate of 15% instead of the otherwise applicable rate of 33%. However, the 30% special tax deduction mentioned in the preceding paragraph cannot be utilized in such cases.

Interest paid by a Colombian entity or FCP to foreign creditors is generally deemed to be foreign (non-Colombian) source income and thus is not subject to income tax withholding in Colombia. There is no longer any remittance tax imposed on the transfer of Colombian-source income to investors located abroad.

Mexico

Mexico has also taken some steps to encourage investment in private equity and venture capital. Principally, dividends paid to both residents and non-residents are generally not subject to withholding tax, and are not otherwise subject to tax if the dividend is paid from profits on which the Mexican company has paid its own income tax. On the other hand, under rules of the SHCP, pass-through treatment for Mexican income tax purposes is not possible unless the foreign shareholder is not only tax transparent but also treated as having no legal personality. In this regard, a limited partnership formed under the law of certain Canadian provinces can satisfy the latter requirement because it may be deemed to lack legal personality under the laws of such provinces, but it does not appear that a limited partnership organized under the laws of any state

of the United States could do so. The SHCP seems determined to continue this rule, which means that foreign private equity investment in Mexico has been largely flowing through Canadian limited partnerships.

Mexican-sourced interest paid to a foreign investor is subject to withholding tax. The withholding tax rate on interest generally can be as high as 30%, but depends on a number of factors. In addition, the applicable withholding tax rate on interest may be reduced for certain categories of interest. For example, interest paid to a foreign financial institution registered with the SHCP is taxed at the rate of 4.9%. In certain circumstances, interest paid to residents of tax havens that are not financial institutions is subject to withholding at the rate of 40% (but SHCP rules and a recent Supreme Court decision tend to limit the 40% withholding to transactions between related parties).

The taxation of capital gains in Mexico may be a deterrent to investors, as capital gains from the sale of stock in a Mexican company are generally subject to tax at 25%. The rate of tax can be 40% if the selling foreign investor is a resident of a low-tax jurisdiction, subject to the limitation referred to in the preceding paragraph. These rates apply to any sale of equity in a Mexican entity, whether it is an SRL, SA, SAPI, or SAPIB, but not to a sale of publicly traded shares in an SAB on a recognized stock market, which sales are generally exempt from tax. Capital gains tax rates are either based on the price paid for the equity interest or on the actual capital gain as determined through a certified public accountant's tax report prepared in accordance with certain specific requirements. The impact of capital gains taxation with respect to foreign investors may be mitigated by double-taxation conventions between Mexico and the investors' home countries (Mexico has signed such conventions with around 40 countries to date).

Mexico has also enacted special incentives for tax-exempt foreign pension and benefit funds. Such funds may be eligible for an exemption from Mexican withholding taxes on interest, capital gains and rent, if they are tax exempt in their home jurisdiction and make appropriate registrations with the Mexican government. Tax incentives have also been put in place for equity or debt investments in venture capital funds (*Fideicomisos de Capital de Riesgo*) but the attractiveness of such funds is limited by what are viewed to be the insufficient benefits thereof and the rigid rules established for the operation of such funds.

Summary Comparison

Brazil, Colombia, and Mexico have all taken steps to encourage investments in private equity and other funds through the use of various tax incentives. The common incentives in all three countries include lowering tax rates and eliminating taxes for specific types of investments. Investors in all three countries must also be aware of potential tax problems and how to avoid them. While Brazil has lowered rates and made certain exemptions for foreign investors, investments must be carefully structured to avoid unfavorable results, such as double taxation and unpredictable tax domiciles. In Colombia, the development of FCPs successfully promote foreign investments but investors need to keep in mind that FCP income is directly taxable. Mexico has taken steps by eliminating withholding taxes on dividends paid to residents and non-residents, but investors must adhere to the SHCP rules in order to take advantage of pass-through

tax treatment. Investors should obtain the advice of qualified counsel in order to avoid these problems.

IX. DISPUTE RESOLUTION

Litigation is a fact of business life; market forces alone do not entirely govern private equity/venture capital transactions such as fund formation, asset acquisition, manager compensation, and exits. Arbitration is sometimes chosen as an alternative to litigation because of concerns over the efficacy of the applicable judicial systems in resolving disputes. This Chapter first looks at investor perceptions of dispute resolution in Brazil, Colombia and Mexico in the context of overall concerns about how well investor interests are protected in such countries, and then considers the use of local and international arbitration with respect to private equity disputes affecting the three countries, including how arbitration may apply to fund manager and investor relations, fund relations with portfolio sellers, portfolio company operations, and bankruptcy.

A. Perceptions of Latin American Dispute Resolution: Brazil, Colombia, and Mexico

In considering the private equity “gap” that affects Latin American markets, it is important to know how market perceptions of dispute resolution play a role. The Latin America Venture Capital Association (“LAVCA”) releases an annual scorecard ranking Latin American countries with respect to various factors that can affect private equity investment decisions. On its most recent scorecard, Brazil, Colombia and Mexico are ranked 3 on a scale of 4 (4 being the highest ranking) as to “protection of minority shareholders” and “corporate governance requirements.” Each country ranked 2 on a scale of 4 with respect to the “strength of the judicial system.” When it comes to bankruptcy procedures, LAVCA ranks Brazil 3 on a scale of 4, and Colombia and Mexico 2 on a scale of 4. Each of the three countries in our study faces very negative worldwide perceptions about corruption in their legal systems, scoring 1 on a scale of 4.⁵

A broader comparison of these issues is found in The World Bank’s “Doing Business 2010” report. Among the factors it measures are “protecting investors” (liability for self-dealing, shareholders’ ability to sue officers and directors for misconduct), “enforcing contracts” (time, cost, and number of procedures involved from the moment a plaintiff files a hypothetical collections lawsuit until actual payment), and “closing a business” (time and cost required to resolve bankruptcies).

In the World Bank report’s overall ranking, Mexico (no. 49) outranks Colombia (no. 63) but not by as much as both outrank Brazil (no. 101). Brazil has low marks across the board, ranking 73rd worldwide for protecting investors, 100th for enforcing contracts, and 131st for closing a business. Colombia surprises with a stunning 5th for protecting investors, and a quite

⁵ LAVCA says Brazil’s strengths include favorable laws relating to fund formation and operation, and quality accounting standards, while overcoming perceived corruption and achieving enforcement of intellectual property rights continue to be challenging. Colombia’s strengths include improved minority shareholders rights and corporate governance, while its perceived corruption and the weakness of the local judicial system still pose a problem. Mexico’s strengths are corporate governance and protection of minority investors’ rights, while it still faces challenges pertaining to control of the drug trade and laws for fund activity and bankruptcy procedures.

respectable 32nd for closing a business, but 152nd for enforcing contracts. Mexico ranks 41st for protecting investors, 81st for enforcing contracts, and a very strong 24th for closing businesses (which seems to conflict with its very low LAVCA ranking in this regard). The World Bank's methodology does not include "enforcing contracts" by the use of commercial arbitration, which has effectively replaced the courts for many commercial matters.

B. Arbitration

Surveys such as those mentioned above reveal perceptions that there are significant difficulties in enforcing contracts in the courts of Brazil, Colombia and Mexico. These perceptions lead many private equity fund managers and investors to choose international arbitration for the resolution of disputes, or to create offshore structures. Arbitration provides several advantages over local legal systems. Arbitration is usually faster, arbitrators are often better decision-makers, with more time and attention available to understand the complex issues and to apply commercial standards, and arbitration is usually confidential. On the other hand, arbitration is increasingly adopting processes similar to those used in litigation, and the absence of an appeal right and relaxed expectations of adherence to precedent generally make arbitration more unpredictable. Arbitration may be more appropriate in some cases (such as in striking compromises, approximating damages) but less advisable in others (such as the strict enforcement of written obligations). Even in the most advanced economies, arbitration is superior to litigation where the alternative is a poorly-rated court system, or where confidentiality is of key importance.

Arbitration may not be available for some important types of disputes. In the private equity context, the arbitration of provisions of the shareholders' agreement or investment agreement may be limited by legislation that requires disputes over by-laws to be litigated in courts rather than through the arbitration process. Under Brazilian and Colombian law, however, if all parties to a dispute have executed an arbitration agreement and the bylaw dispute falls within the language of the arbitration agreement, the dispute is almost always permitted to be resolved through binding arbitration. Under Mexican law, the by-laws of a SAPI or SAPIB can generally be subject to arbitration but other corporate entities would be subject to constraints based on Civil Code restrictions on the ability of shareholders to agree in advance as to how their votes will be cast at shareholders' meetings. Otherwise, a shareholders' agreement can be subject to arbitration regardless of the type of entity which is involved.

Arbitration may be domestic or international. All three countries permit enforcement of foreign arbitral awards, though they vary in restricting foreign arbitration of certain types of disputes. Foreign and domestic arbitration awards alike must be presented to a court where the relevant assets are located in order to reach those assets. Thus, the location of the assets backing a contractual obligation is the forum whose laws matter most to the enforcement process. These may not be in the country where the portfolio company is domiciled.

Arbitration is a limited option when an injunction or specific enforcement of a contractual provision is required, such as to enforce drag along/tag along rights, or to block a sale or other corporate action requiring investor approval that management fails to gain. Arbitrators may adopt interim measures (claim registrations and seizures) in disputes regarding property rights, but in Colombia they may not issue preliminary awards or interim relief. This is clearly a

deficiency that should be remedied so that local legal systems, widely perceived to be slow, expensive, uncertain, and perhaps corrupt, are not the only way to secure provisional remedies.

A variety of interim awards and relief can be obtained in both Brazil and Mexico, including orders to compel the production of financial statements and other documents.

C. Offshore Structures

Where there are insurmountable concerns about local legal systems or enforcement of arbitral awards, funds respond by structuring investments through offshore entities, choosing jurisdictions whose courts or arbitral forums are accepted by all parties and relevant to the execution of the ultimate award. The offshore entity is usually structured to own all or substantially all of the equity in the local company, in order that judgments *or* arbitral awards can be enforced – in most respects – in disputes among managers, general partners, and limited partners outside of the local country. Offshore entities may also offer some advantages with respect to particular concerns of corporate governance, protection of minority investors and other protections familiar to the global investment community, though in each of these categories, Brazil, Colombia, and Mexico receive relatively high marks demonstrating significant improvement (*see* Section A above).

Offshore entities can create tax complications. Examples include those resulting from local investors having to invest abroad or when managers extend equity to sellers of local portfolio companies as part of the consideration for an offshore purchase. Similarly, the offshore structure is less useful where local general or limited partners, or managers, that contribute to the fund's attractiveness and performance, cannot agree to them. And, offshore equity entities provide no remedy with respect to acquisition/disposition or operations disputes.

D. Fund relations with portfolio sellers

Portfolio company sellers (or buyers) may act strategically or tactically in ways that breach covenants, representations and warranties, or other market norms. Actions against them must usually be swift and will therefore often be brought before domestic courts or arbitral tribunals. If a local player is perceived to have some advantage in domestic courts or arbitral tribunals, any such advantage can be offset by selecting foreign judicial or arbitral forums. Parties may, where appropriate, enter into arbitration agreements in advance of consummation of an acquisition and may also provide for arbitration in the acquisition agreement. Because enforcement of the award would ordinarily require execution on assets through local courts, most acquisitions and dispositions have indemnification reserves subject to disposition by the arbitrators.

E. Portfolio company operations

Fund profitability is affected by operations, which are in turn affected by the expense and reliability of the local legal systems. Operations of portfolio companies are no less subject to employee or commercial litigation simply because the company happens to be in a private equity portfolio. Customs and tax disputes, employment matters, environmental regulation, and the like have significant impacts on the attractiveness of the acquisition to foreign investors, which means

that it is quite important for international investors to understand the operation of domestic dispute resolution systems. Funds can compensate for some “foreign-owner” disadvantages through reliance upon local participants such as co-managers or through reliance upon local arbitration to the extent available.

F. Bankruptcy And Restructuring

As the recent worldwide recession demonstrates, unforeseen market circumstances can drive parties into unanticipated disputes and dispute resolution processes, and financial restructuring or liquidation cannot be systematically avoided. Portfolio companies may have to restructure, investors may file for protection from creditors, and even funds may seek restructurings. As discussed more fully in Section A above, the LAVCA scorecard rankings on business-termination and bankruptcy processes suggest that there have been significant improvements in restructuring law and systems in each of the three countries studied, demonstrating that these systems should not pose substantial hurdles to international private equity investors.

CONCLUSIONS

Brazil, Colombia and Mexico have all made great strides in the last few years to improve the legal environment affecting private equity investment in most of the areas reviewed above. In all three countries, however, further improvements will be needed in order for private equity to reach its maximum effectiveness as a driver of economic growth.

All three countries have placed substantial emphasis on improving corporate governance standards, although such standards are generally still voluntary and investors should ensure that the corporate by-laws and/or shareholders’ agreements establish the standards they deem important. Some types of entities are more attractive and flexible in this regard, such as the SAS in Colombia and the SAPI in Mexico, than are the more traditional corporate forms. The newer types of entities are also more capable of providing for the most attractive forms of preferred stock and for protection of minority shareholders’ rights. Some types of anti-dilution protection are mandatory, through statutory preemptive rights, while others, such as first refusal rights, must be provided for in optional provisions of the by-laws and the shareholders’ agreement. In general, while some protections are mandatory, most must be negotiated by the parties through specific provisions of the by-laws and or the applicable shareholders’ agreement.

Tax and regulatory regimes have become more favorable to investors but significant challenges remain in this area, particularly in Mexico, which has not kept pace with the changes in the other countries. Foreign investors in general are faced with a few special hurdles not applicable to local investors (except in the dwindling number of sectors subject to foreign investment restrictions, where in some areas foreign investment is prohibited entirely).

Investors’ main concerns appear to focus on the reliability of the legal and judicial systems in the three countries. For this reason, they have turned to arbitration as the preferred method for resolving disputes. They have also utilized offshore investment vehicles whose management and operations are not subject to local law and enforcement. This leads to corporate structures that are often overly complex in relation to the size of a projected investment, which

increases transaction costs and discourages smaller investments that in the aggregate could represent a substantial contributor to economic growth. In the long run, what will be needed to ensure broad-based and sustained growth - not only in the private equity area but also with other forms of private investment - will be stronger and more efficient judicial systems, more transparent legal processes and a substantial reduction in corruption at all levels.

The Committee on Inter-American Affairs

Steven M. Kahaner, *Chair**

Philip Tisne, *Secretary*

José A. Aquino

Carlos Arevalo

Craig A. Bowman

Janine Burman Nicolau*

Hunter T. Carter*

Eduardo Crosa

Annette De La Torre

Stuart K. Fleischmann

Richard R. Fogarty

Albert Garrofé-Pujol

Daniel A. Goldberger

Fabián Guevara

Maria Krasnikow Harris

Antonio Herrera

Evan M. Koster

Clara Krivoy

Rafael Llano-Oddone

Renate J. Lunn

Emilio Mena

Juan Francisco Méndez

Alexandria C. Nichols*

Leonora Olmedo

Neil A. Quartaro

John E. Rogers†

Marc M. Rossell

Xavier Ruiz

Mark S. Tibberts*

José Ramón Villar

Michael D. Young

†Editor-in-chief of the report.

*Co-author of the report.

The Committee on Inter-American Affairs thanks former Committee member Clayton Steele, also a co-author, for her help in writing the report.