BRICS DUE DILIGENCE:
WHAT YOU NEED TO KNOW
(Updated as of March 2019)

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When it comes to due diligence in emerging markets, cross-border investors and their lawyers know that one size does not fit all. Investigating a target to make an informed investment decision and identify legal or commercial issues that may affect the execution of the transaction poses very different challenges when the assets are in Belo Horizonte rather than in Suzhou. For this reason, the process of assessing the risk profile of a target and the execution risk of a deal in a BRIC country should start with an assessment of what is to be expected of companies operating in the relevant market.

Because what's normal in each BRIC country is different (and differs from what's normal in the United States or Europe), cross-border investors face a steep learning curve when they enter an offshore market for the first time. With this in mind, we have prepared brief surveys of some of the most significant due diligence issues that we have encountered in carrying out transactions in Brazil, Russia, India and China. These observations are by no means intended to provide an exhaustive compendium of the issues that investors may face. Rather, the purpose of these short briefs on due diligence in Brazil, Russia, China and India is to begin to adjust the expectations of investors and their counsels. Doing deals in BRIC countries presents unique challenges. Here are some pointers for each country.

~~~CHINA ~~~

I. Due Diligence Process

- Lack of familiarity with due diligence process and requirements: "Due diligence" is a relatively new concept in China; Chinese companies, in particular the small and medium-sized ones and their personnel, often do not appreciate its relevance and importance. Moreover, Chinese companies traditionally are reluctant to share information with outsiders.

- Poor internal organization: Chinese companies are relatively weak on internal organization. Many Chinese companies do not have a legal department or even any in-house counsel. Decentralization of information and knowledge is a common issue. Another issue is the lack of standardized documentation—material information or events may not have been properly documented; some important documents may be missing or contain errors. Many Chinese companies have a highly centralized management structure and it is likely that only the chairman and a few very senior officials have knowledge of any serious problems.

- Limited public search resources: Some of the public search resources that are widely consulted in the due diligence process in Western countries, such as searchable litigation, bankruptcy or real property records, are not yet well developed in China. In the past few years, the Chinese government has been trying to establish more transparency and public search resources. Online company searches are now available, although the database may not always be comprehensive enough for a foreign investor to obtain certain basic corporate information. Online search of court judgments are also available, but the searchable database does not contain all the judgments that have been made and the courts generally do not upload new judgments in a prompt manner.

- Chinese language capacity: Because most personnel of Chinese companies are still not capable of or comfortable with communicating in English and almost all the due diligence documents will be in Chinese, it is very important to engage advisor teams fluent in Chinese. Good bilingual advisors can facilitate tremendously the due diligence process.

- Background investigations: It has become common for foreign investors to engage specialized investigation firms to conduct background due diligence on key management members of Chinese target companies and their business partners. But given the number of information privacy laws that were promulgated and enforced in recent years, foreign investors may now encounter difficulties in engaging investigation firms and uncovering background information. In particular, the widely reported conviction of Peter Humphrey and his wife, Yu Yingzeng, who co-owned an investigation firm in China, for illegally obtaining the personal information of Chinese citizens, illustrates the new operating environment for such firms and makes it much harder for foreign investors to undertake the same level of due diligence they could have before. Foreign investors should ensure they obtain adequate assurances of compliance with Chinese law from investigation firms before engaging them.

- Online news search: Foreign investors should conduct both Chinese-language and English-language Internet searches on Chinese target companies and their senior management at the earliest stage of a potential transaction. This type of search cannot substitute for the full-scale due diligence and background investigations, but it sometimes provides enough information on the potential Chinese counterparties for foreign investors to decide whether or not to proceed with committing significant time and resources to pursue a deal.

- <u>On-site due diligence</u>: In recent years, the Chinese government has increased its focus on protecting "state secrets" which are broadly defined under the PRC law as "matters that have a vital bearing on state security and national interests". The vague "state secrets" definition grants Chinese authorities broad discretion in classifying information as a "state secret" and penalizing the disclosing party and the recipient. Therefore, some Chinese companies, especially the state-owned enterprises, have become reluctant to upload all the due diligence documents to virtual data rooms whose servers are usually maintained outside of China. Instead, they will request the foreign investors to do on-site review of certain documents that they believe are sensitive. On-site visits, review of documents and interviews with management can frequently furnish substantial additional information.

II. Business Due Diligence

- <u>FCPA and UK Bribery Act</u>: China is a "high-risk" country in so far as bribery is concerned. Chinese officials tend to seek free meals, gifts, entertainment, travel and other business-related opportunities that may be deemed to be "kickbacks". Since many large companies in China are state-owned or controlled, their directors and employees are deemed to be "government officials" under the FCPA, and these companies may also be subject to the UK Bribery Act.

- China's anti-corruption campaign: While China continues to be an important source of FCPA investigations, the past few years have been dominated by China's domestic anti-corruption crackdown, which has resulted in charges against hundreds of Chinese officials, including many connected to former politburo officials. Major state-owned enterprises and multinationals have also been targeted. This anti-corruption campaign is expected to continue and broaden in the next few years. Therefore, foreign investors need to ask adequate questions during their due diligence about possible investigations by Chinese government agencies, interaction with government officials and compliance with Chinese anti-corruption laws.

- Labor and employment: It is not uncommon to find that Chinese companies fail to make overtime compensation in accordance with applicable law, enroll employees in China's mandatory social insurance and housing fund systems or sign written employment contracts with all full-time employees. These violations can sometimes lead to significant fines or labor unrest. In addition, Chinese companies generally neglect to ensure safe and healthy working conditions. China does not yet have sophisticated occupational safety/health laws and regulations, and any enforcement of safety standards is weak and difficult. A foreign investor may face reputation risk if the company in which it invests, or with which it does business, has serious occupational safety/health issues. For instance, Apple suffered a blow to its image and reputation in China when over 100 employees working at a factory of a main supplier to Apple were seriously injured in 2010 by exposure to a toxic chemical used to clean the iPhone's touch screen.

- Environmental protection: Despite increasing governmental efforts to enforce environmental protection regulations in recent years, many Chinese companies do not conduct their business in compliance with environmental laws, partly because statutory penalties for environmental violations usually consist only of a modest fine which can be substantially lower than the compliance cost (mandatory remedial action is rare). Foreign investors should consider conduct an environmental audit in connection with any transaction involving a potentially polluting industry. Independent environmental consultants are increasingly becoming a standard part of the due diligence exercise.

- Insurance: Many Chinese companies do not purchase insurance policies covering property loss/damage, third party liability, product liability, etc. Even if a company has purchased insurance policies, the scope or amount of coverage may be inadequate in view of the type/nature of the business conducted by such company. In addition, missed premium payments are quite common in China.

- Land use rights: In China, land is owned by the state (or, in the case of farmland, collectively by village residents). Land use rights can be transferred only after statutory premiums, which can sometimes amount to a large sum, have been paid to the state.

III. Legal Due Diligence

- Regulatory environment: The Chinese legal system is based on written statutes. Compared to common law jurisdictions, prior court decisions have limited precedential authority or value in China. Chinese laws and regulations have undergone substantial development over the past decade and are still evolving rapidly. Many laws and regulations are relatively new and contain broad and sometimes ambiguous provisions. As a result, government authorities and courts have much discretion in interpreting and enforcing Chinese laws and regulations.

- Foreign investment approvals: All foreign direct investments into Chinese industries that are within the "sectors subject to special administration measures for entry (also known as the "Negative List")" are subject to governmental approvals, while investments into other industries generally only need to be filed a notice with the relevant authorities. However, Chinese authorities have enormous discretion to convert a notification filing into a *de facto* approval process, or find other means to approve or block an investment; they are also often free to dictate the approval process (timing, application documents) and there are many exceptions and "unwritten rules". Therefore it is very important to communicate with the regulators early. Foreign investors should also bear in mind that except for the few standard approvals that are required to be issued in writing, Chinese authorities are generally reluctant to communicate or confirm anything in writing—for instance, no-action or no-objection letters do not exist in China.

- Foreign investment restrictions: Foreign investments are generally categorized under Chinese law into four categories—encouraged, permitted, restricted and prohibited. In particular, investments in "prohibited" industries (e.g., operations of news agencies and radio/television networks) are off-limits for foreign investment. On top of the classification described above, Chinese regulators may impose additional foreign investment restrictions with respect to specific industries (e.g., value added telecommunication services and life insurance).

- Acquisition of state-owned assets: China has numerous regulations and rules concerning the administration of state-owned assets. In particular, the acquisition of state-owned assets is subject to special appraisal and approval procedures which will materially affect the price and timing of a proposed transaction. Therefore, it is critical to evaluate at the beginning of the due diligence process whether the proposed transaction involves any state-owned assets. Even if the target company is not a state-owned enterprise, it is still possible that certain assets held by such target are state-owned assets subject to such special regulations and rules.

IV. Financial Due Diligence

- Accounting records: Accounting books and financial records of Chinese companies are less transparent than those of U.S. companies. Furthermore, some Chinese companies deliberately keep two sets of accounting records, one for the statutory reporting purpose and the other for internal use. The latter reflects a company's actual financial condition and results, whereas the former set of records tend to reflect less revenue and/or more expenditures with a view to reducing the company's tax liability.

- Financial Audit: Compared to the "big four" accounting firms, Chinese local accounting firms may be less credible and impartial in performing audits, as they tend to react to pressures from the company under audit due to their eagerness to win engagements or maintain relationships.

- Related-party transactions: Chinese companies tend to have extensive, and sometimes messy, related-party transactions or arrangements, and are almost always reluctant to fully disclose such transactions/arrangements to foreign investors, third parties or government authorities.

- Accounting standards: Chinese companies are required by law to prepare audited financial statements under Chinese GAAP. Following multiple rounds of revisions, the current version of Chinese GAAP is believed to be substantially in line with the IFRS, although differences still exist between the two standards.

- Forensic accounting diligence: Following the negative publicity surrounding allegations of fraud at Sino-Forest Corporation and its subsequent bankruptcy in 2012, foreign investors have been increasingly engaging advisors to conduct forensic accounting diligence to verify revenue and cash flow of target Chinese companies. The nature and scope of forensic accounting diligence activities varies depending on the industry of the target company and its operations, although this will often include a review of selected transactional data such as purchase orders, receipts and corresponding bank records in order to identify any irregularities.

~~~RUSSIA~~~

I. Due Diligence Process

- Familiarity with due diligence process and requirements: Russian companies' familiarity with the due diligence process and the relevant requirements is considerably dependent on the size, type and location of any particular company. While most public companies in Russia are well aware of the due diligence process and its importance to investors, on occasion management may nonetheless be reluctant to share information with outsiders for confidentiality reasons or concerns relating to the impact of a transaction on management's own future or the business as a whole. Private companies are generally even more skittish about sharing information and may need a fair degree of prodding before they will do so. Certain restrictions on disclosure of certain types of information (*inter alia*, introduced by insider trading and personal data protection legislation as well as required by industry specific laws (e.g., on banking and insurance activities)) should also be kept in mind.

- Internal organization: The strength of the internal controls and organization of Russian companies varies greatly, with public companies that are subject to more extensive disclosure requirements and independent audits of their financial statements obviously being better situated than private companies. Most companies have legal departments and in-house counsel; however, decentralization of information and knowledge is a common issue. For example, even public companies may lack a comprehensive uniform internal list or register of licenses and contracts, and documents may be held by various different departments. There is also often a lack of efficient communication between departments and/or affiliates. Another impediment is the lack of standardized documentation and good corporate housekeeping, e.g., minutes of shareholders meetings or board meetings are often not properly maintained.

- Russian inside information law: Russian public companies may treat some of the due diligence documents as "inside information", in which case they would add the recipients to the insiders list. In addition to general restrictions on insider trading and on transfer of inside information, the insiders list may subject the recipients to a number of procedural requirements under the Russian Inside Information Law. For example, each legal entity on the insiders list must maintain its own list of insiders, appoint an officer responsible for compliance with Russian inside information rules and adopt certain internal control rules.

II. Business Due Diligence

- Sanctions: Since March 2014 the United States and EU (and certain other countries, in particular, Canada and Japan) have imposed several sets of Ukraine-related sanctions (i) against certain Russian companies and individuals (Russian defense companies, certain Russian government officials, persons engaged in or supporting separatist activities), (ii) in respect of certain sectors of the Russian economy (finance, defense and energy (oil and gas)), and (iii) restricting operations in Crimea. The sanctions regime is quite complicated – the sanctions vary from the most restricting "blocking" sanctions to limited "sectoral" sanctions. Even if a company is not directly targeted by sanctions, its transactions (or even a facilitation of other parties' transactions) with sanctioned persons may lead to imposition of U.S. sanctions based on the "secondary" sanctions regime.

- Environmental compliance and enforcement: Levels of compliance by Russian companies with environmental laws, and the extent of enforcement, varies depending on the region and the size of a company's operations. Russian environmental regulations generally establish a "pay-to-pollute" regime administered by federal and regional authorities. Payment obligations may also arise under the laws and regulations applicable to water use, air protection, and the handling of waste. If the operations of a company violate environmental laws or otherwise cause harm to the environment or any individual or legal entity, a court action may be brought to limit, suspend or ban such operations and require the company to remedy the effects of the violation. The payment of fines by an entity involved in business or other operations for adversely impacting the environment does not exempt it from the application of environmental protection measures or compensation for damage caused to the environment.

- Occupational health and safety: Russia has rather extensive occupational health and safety laws and regulations, and companies and their employees that fail to comply with such laws and regulations are subject to fines and other sanctions. However, the extent of enforcement of these laws and regulations also varies depending on the region and industry sector.

- Insurance: Many Russian companies do not purchase insurance policies covering such matters as property loss/damage, product liability and third-party liability, other than if explicitly required to be maintained by law (for example, where a company operates hazardous facilities). Therefore, the scope and amount of insurance policies held by a company may well be inadequate in view of the nature of the business conducted by such company.

- FCPA: Russia is still considered a “high-risk” country from an anti-bribery perspective. The FCPA risk is, not surprisingly, higher in business sectors that operate under governmental concessions and authorizations. In addition, it should be noted that many large companies in Russia are state-owned or controlled, therefore, directors and employees of such companies are deemed to be “government officials” under the FCPA with the result that payments made to them could run afoul of anti-bribery laws.

- Land use issues: Russian law recognizes private and state land ownership, as well as other categories of land rights and encumbrances. State ownership is divided into property of the Russian Federation (federal property), property of the various Russian regions and property of municipal entities (municipal property), but for various reasons it is not always clear which governmental body or official has the right to lease or otherwise regulate the use of real property. Additionally, Russian companies occasionally use land without proper title. To make matters worse, although title to real property in Russia is subject to state registration, in certain cases land rights are considered valid without such registration. Therefore, it is often difficult to determine with certainty the validity and enforceability of title to real property and the extent to which it is encumbered.

III. Legal Due Diligence

- Regulatory environment: Russia's legal system is primarily based on statutes. Compared to common law jurisdictions, prior court decisions have limited precedential authority in Russia. Many Russian laws and regulations are relatively new and may contain broad and sometimes ambiguous provisions. As a result, government authorities and courts end up having broad interpretive and enforcement discretion leading to sometimes unpredictable results.

- Foreign investment approvals and restrictions: Russian law establishes different regimes for foreign investment in various sectors, such as prohibitions or restrictions in respect of transactions involving foreign investors. For example, starting from January 1, 2016 foreign investors are prohibited from foundation of and participation in Russian mass media; foreign investors may not acquire more than 20% of the voting shares in companies owning regional gas supply systems or gas distribution systems. In addition to direct prohibitions, Russian law also establishes restrictions on foreign investments in companies operating in certain sectors. Such restrictions generally take two forms: either a quota is put in place for foreign investments in a certain market (e.g., there is a quota for foreign investment in the Russian insurance sector) or there is a requirement that transactions involving foreign investment in companies of strategic importance for national defense and national security (*i.e.*, operating in certain "strategic" areas) must be cleared by the state. Under the Strategic Investments Law, such areas of strategic importance include, *inter alia*, certain types of activities relating to transport, aviation and aerospace; operations of natural monopolies; use of subsoil plots of federal importance. According to the recent amendments, the Chairman of the Governmental Commission for Control over Foreign Investments has a broad discretion to refer any acquisition of a Russian company by a foreign investor (even in the sections that are not directly mentioned in the Strategic Investments Law) for consideration and preliminary approval by the Commission.

- Foreign exchange control: Most of the currency control restrictions applicable to currency transactions between Russian residents and non-residents ceased to apply in 2007. However, there is still a general prohibition on foreign currency transactions between Russian residents and a requirement to repatriate export-related earnings back into Russia, which in practice may, for example, prohibit cross-border offset or assignment of receivables. Although largely viewed as outdated, these restrictions, if breached, may lead to large fines (up to 100% of the relevant transaction value) or even criminal prosecution.

- Labor litigation: Russian laws grant employees extensive social security and labor rights and employee benefits, the costs of which are mostly borne by the employer. Additional rights and benefits may also be established by collective bargaining agreements between labor unions and employers, although unions have recently become less common.

IV. Financial Due Diligence

- Accounting records: Accounting books and financial records of Russian companies are generally less transparent than those of U.S. companies. Russia is currently implementing an electronic filing system aiming to improve the level of monitoring by Russian tax authorities and the transparency of accounting records generally.

- Financial Audit: Most large Russian companies, whether public or private, are audited by the "big four" auditing firms or a reliable Russian accounting firm. However, that there are a number of local accounting firms in Russia that are less credible and not always impartial in performing audits.

- Accounting standards: As a general rule, Russian companies are required to prepare audited financial statements under Russian Accounting Standards which significantly differ from IFRS or U.S. GAAP. However, financial institutions, insurance companies, listed companies and certain other companies are also required to prepare consolidated financial statements in compliance with IFRS.

- Related-party transactions: Private companies in Russia tend to have extensive and sometimes messy related-party arrangements, or interested-party transactions, as they are often called. Failure to approve a transaction as an interested-party transaction may in certain cases lead to invalidation of the transaction if challenged in court by shareholders of the company or the company itself. Even a transaction governed by foreign law and containing an arbitration clause (e.g., a related-party transaction or a so-called major transaction) in certain cases may be found invalid in Russian courts under Russian law.

~~~BRAZIL ~~~

I. Due Diligence Process

- <u>Familiarity with due diligence process and requirements</u>: Although most companies in Brazil are familiar with the due diligence process and are aware of its importance, on occasion, management can be reluctant to share information with outsiders out of a cultural sense of invasiveness and likely some concern for the impact on its own future. In-house counsel, for example, may regard even ordinary requests and questions in connection with due diligence as personal attacks against their work and may respond negatively. As in all of the BRICs (and elsewhere), building trust with management is critically important to the success of the process.

- <u>Internal organization</u>: The strength of the internal organization of Brazilian companies varies greatly. While many companies in Brazil, including all public companies, are subject to mandatory audits, many others are not; companies subject to independent audits of their financial statements are generally better organized than those that are not subject to audits. Most companies have legal departments and in-house counsel; however, decentralization of information and knowledge is a common issue, especially at privately held companies. There is a lack of standardized documentation practices generally in the country, and corporate records, such as minutes of the meetings of shareholders or the board and the registry of share ownership and transfers, may not have been properly documented or registered with the competent authorities. On the other hand, corporate law in Brazil is primarily federal law, which may reduce inconsistencies in documents and records of companies located in different Brazilian states.

- <u>Availability of public search resources</u>: The Brazilian government has made substantial investments in public search resources, and a wide range of matters such as federal court litigation, trademarks, patents and domain, tax registrations, as well as certain tax debts can be searched through the Internet. In most states, it is also possible to carry out public Internet searches for labor and state court litigation and corporate records. As a general rule, if a public search cannot be made through the Internet, it can be made at the public authority charged with keeping records of the particular information being sought. However, Brazil still has a convoluted and expensive real estate registration system and disputes concerning land rights are not infrequent, especially in rural properties located in sparsely-populated areas. Note that Brazilian publicly held companies are required to file several reports, corporate documents and financial statements with the Brazilian Securities Exchange Commission (CVM), as well as publish communications and material fact notices related to certain corporate events. These documents are available to the public on the CVM's website (http://www.cvm.gov.br/).

- Assistance of local counsel: The Brazilian legal system can be inefficient and is complex, with civil, criminal and administrative procedures often overlapping and taking years, if not decades, to be resolved. Against this backdrop, local counsel may be essential to assist foreign investors and foreign law firms in assessing the real risks associated with a legal proceeding and navigating the Brazilian bureaucracy.

II. Business Due Diligence

- Anti-Corruption (including Brazil's CCA and U.S.'s FCPA): Brazil is a "high-risk" jurisdiction in the anti-corruption area. Business sectors that operate under governmental concessions or authorizations, participate in public tenders, or rely on government financing are more likely subject to heightened enforcement scrutiny. Anti-corruption due diligence therefore has become a major focus of investors in the country, especially in connection with targets that contract extensively with the Brazilian government (at any level) or with government-owned or government-controlled enterprises such as the *sociedades de economia mista*. The ongoing “Operation Car Wash” (*Operação Lava Jato*), a widespread investigation into corruption and cartel practices involving Brazil’s state-controlled energy giant (Petrobras), dominated the political and business news in the past few years, implicating an ever-growing number of businesspeople, politicians, and government officials, including in 2018 the arrest of one of the country’s former Presidents. In addition to U.S. authorities’ vigorous enforcement of the Foreign Corrupt Practices Act, including with respect to conduct in Brazil, Brazilian authorities likewise are enforcing actively relevant local laws such as the so-called Clean Company Act (the “Act”), which was adopted in 2013 and took effect in 2014. The Act imposes strict civil and administrative liability on corporate entities doing business in Brazil for corruption and bribery of Brazilian or foreign public officials, and for fraud in connection with public tenders and government contracts. Offending entities may face steep monetary fines ranging from 0.1% to 20.0% of annual gross revenues, in addition to other penalties such as debarment. The Act also provides for successor liability in the case of mergers, acquisitions, or spin-offs, and provides that liability may extend to affiliates. In 2015, Brazil issued a decree regulating certain aspects of the Act, including calculating fines, analyzing compliance programs, and negotiating leniency agreements. As the anti-corruption enforcement landscape continues to evolve in Brazil and beyond, investors in Brazil are encouraged to focus their due diligence efforts on assessing a target’s potential anti-corruption risk and determining the adequacy of its anti-corruption policies, procedures and controls. Such risk-based due diligence – including through targeted diligence requests and interviews of management – is critical, particularly when the target interacts regularly with government officials.

- Occupational safety and health: Unlike China, for instance, Brazil has extensive occupational safety/health laws and regulations, and employers that fail to comply with such laws and regulations are subject to fines and other sanctions. Like in China, however, the enforcement of occupational safety/health laws and regulations may vary depending on the region and the business sector. Also, from time to time, the Brazilian government and NGOs have denounced companies, especially those in the agricultural and clothing sectors, for subjecting workers to inhumane conditions that amounted to slave labor. Foreign investors may face reputational risk if the company in which they invest or with which they do business has serious occupational safety/health issues.

- Environmental compliance and enforcement: In Brazil, federal, state and municipal governments have the power to regulate environmental matters. Although these matters are usually regulated by federal laws, states and municipalities have the power to (and not infrequently do) implement additional requirements and proceedings for environmental compliance. As a result, compliance with environmental laws can be challenging, particularly for companies operating in multiple areas within Brazil. The enforcement and levels of compliance with environmental laws may also vary depending on the region and the size of a company's operation. While large corporations are closely monitored by environmental authorities, NGOs and smaller businesses, especially those operating in certain regions, are less likely to be closely monitored and are, therefore, less likely to be in strict compliance with environmental laws. Note that Brazil has its own "Superfund"–like laws providing that under certain circumstances, a new owner of a contaminated area may be held jointly and severally liable with the previous owners for damages and remediation measures, regardless of whether the new owner caused or even contributed to the environmental degradation. In addition, Brazilian environmental legislation provides that directors and officers may be criminally liable for acts of the company against the environment. Brazilian environmental legislation also provides for the possibility of piercing the corporate veil for purposes of payment of damages. Environmental litigation in Brazil is lengthy and amounts actually due by the defendant may be considerably lower than the amounts initially claimed by public prosecutors. Environmental risk is even higher for infrastructure projects.

- Foreign investment restrictions: On its face, Brazilian law restricts foreign investments in certain areas and activities, such as nuclear energy, certain healthcare services (although a January 2015 law significantly reduced these restrictions), post office and telegraph services, certain aerospace activities, newspaper and magazine publications and television and radio networks. Only in 2018, the Brazilian government enacted a decree authorizing 100% of ownership of domestic airline services by foreign investors. Foreign investments in financial institutions, rural properties and in properties implicating national security continue to be restricted. While most of these restrictions can be waived by the government, or otherwise avoided by obtaining the prior authorization of the government or through other similar processes, this is not always the case. Since 2010, for example, a new interpretation of a 1971 law in an opinion issued by the Federal Attorney's General Office concluded for certain limitations on foreign investor's ownership of rural properties in Brazil. In the past, the Brazilian Congress has passed amendments to the constitution to remove or ease certain of these restrictions, as was the case during the privatization process of the late 1990's, and it is currently discussing a bill that would address the issue of foreign ownership of rural properties. Because interpretation of these restrictions and related registration requirements has varied among the registries in charge of recording rural land transfers, certain past transfers may be challenged in court and ultimately declared void.

III. Legal Due Diligence

- Regulatory environment: Brazil's legal system is based on written statutes. Compared to common law jurisdictions, prior court decisions have for long had limited precedential authority in Brazil. With the introduction of the stare decisis principle for Supreme Court precedents through an Constitutional amendment in the first decade of the 2000s and the new code of civil procedure in 2016, precedents of higher courts for matters that are widely disputed in the judiciary, particularly with respect to taxes, now may bound lower courts. Even so, many laws and regulations are relatively new and contain broad and sometimes ambiguous provisions and, until a higher court recognizes its widely disputed nature, lower courts may decide the matter as they see fit. It is not unusual for there to be contradictory rulings of similar matters in different parts of the country. As a result, as with all the BRICs, there is significant uncertainty as to one's legal rights and obligations, and government authorities and courts have wide discretion in interpreting and enforcing Brazilian laws and regulations. The new code of civil procedure aimed at increasing predictability of judicial decisions and reducing the number of years for a final decision to be rendered in civil litigation. Under the new code, other than the requirement that judges and lower courts must follow precedents decided by higher courts, the number of available interim appeals is more limited and courts will refrain from hearing contractual claims if the parties have elected a foreign forum.

- Foreign exchange control: Foreign investments in Brazil must be registered with the Central Bank. Non-compliance with Brazilian registration requirements may jeopardize a foreign investor's ability to remit dividends or other distributions payable to its investors outside of Brazil and may require the repatriation of the investment. Registrations are made electronically by the company receiving the investment through the electronic declaration registry of the Central Bank information system, but they are not subject to prior examination or verification by the Central Bank. New rules enacted in 2014 requiring further regulation by the Securities and Exchange Commission of Brazil have changed certain requirements with respect to foreign investments registered through "portfolio accounts". The executive branch has discretionary power to raise or lower the tax on financial transactions ("IOF"), and often does so as a tool of macroeconomic policy.

- Regulated industries: Some industries are regulated by the government, and the granting of concessions or permissions to operate, the transfer of such concessions or permissions, and the acquisition of any participations in the regulated companies are subject to the approval of the federal, state or municipal authority, as the case may be. While, subject to the foreign investment restrictions described above, there are no legal restrictions on the participation by foreign investors in most regulated industries, foreign investors must comply with the same requirements imposed on Brazilian investors.

- Tax: The Brazilian tax compliance system is considered one of the most complex in the world. As a result, business entities in Brazil are frequently involved in many lawsuits and administrative proceedings that challenge the interpretation and application of the tax framework. Frequently, entities within the same industrial sector are involved in lawsuits and administrative proceedings challenging the same taxes and on the same grounds. In an attempt to encourage settlement of tax litigation, the Brazilian federal government launched an amnesty program (*REFIS*) in 2017 allowing companies to use otherwise unavailable tax losses to partially offset their disputed tax liabilities. Companies could opt into the program until Octobr 31, 2017, and the consequences for opt-in companies should be a focus for tax due diligence. Matters likely to be contentious in the near future include (i) a temporary income tax hike imposed on financial institutions and tax benefits generated from goodwill in corporate reorganizations and stock option plans or similar equity-based employee compensation structures and (ii) the consequences of terminations or amendments of tax amnesty programs by certain Brazilian states experiencing financial difficulties.

- Labor litigation: Brazilian laws grant employees extensive social security and labor rights and benefits, the costs of which are mostly borne by the employer. Additional rights and benefits may also be established by collective bargaining agreements between labor unions and employers. Until 2017. employees in Brazil frequently filed suits against their former employers claiming unpaid rights and benefits, as well as damages; however, upon settlement of the disputes, the amounts actually due by employers tended to be considerably lower than the amounts claimed by the employees. Calculations of a company's exposure to labor liabilities often included considerations of the average amount claimed in lawsuits of the same nature and the company's historical rates of loss. In 2017, the government implemented a wide and controversial labor reform to increase the country's labor market efficiency and tackle rising rates of unemployment. The reform provided more flexibility and certainty to a number of employment related matters: vacation regime, agreements between employee and employers, hours, time spent to go to work, etc. Notably, before the reform, a plaintiff-employee did not have many downsides or risk of payment of the employer legal fees in the event he or she was unsuccessful in the suit. Such a structure created a perverse incentive for employees and labor lawyers and it aggravated the amount of requests made before labor courts. Following the reform, employees became subject to legal fees and court expenses to the extent they claim more rights than those the court ultimately recognizes. The expectation is that the measure will drastically reduce the number of labor lawsuits affecting companies operating in Brazil. Still, courts may also determine that shareholders and directors and officers be jointly and severally liable, or that piercing of the corporate veil is necessary, if it is established that the legal entity is not capable of paying a monetary obligation established by the court in benefit of the plaintiff, and order seizure of bank accounts held by the legal entity, its controlling shareholders and members of management. As mentioned above, although most companies have a significant number of labor claims, these claims need to be analyzed to determine whether they are ordinary course or whether they represent a significant exposure, e.g., litigation resulting from retaining employees as service providers or through SPVs.

IV. Financial Due Diligence

- Accounting records: Electronic platforms for accounting and tax compliance are progressively being implemented in Brazil with the purpose of improving the level of monitoring by Brazilian tax authorities and the transparency of accounting records, and may ultimately replace certain bookkeeping and tax reporting obligations in the near future. A significant example of this trend is the SPED Project currently being implemented by the Brazilian Federal Tax Authorities. Digital accounting bookkeeping, digital tax bookkeeping and electronic invoicing systems are already in place and have increasingly became common, if not the rule, for most mid-sized and large businesses.

- Financial Audit: Independent audits of financial statements are mandatory only for public companies, financial institutions, investment and private equity funds, insurance companies and large companies (as defined in Brazilian legislation); however, creditors commonly require independent audits of other companies as well. Many other Brazilian companies with significant operations and income, whether public or private, are audited by the "big four" auditing firms or a reliable Brazilian accounting firm. Multinational corporation operating in the country also require regular audits even when the local legal entity is closely-held. Some local accounting firms in Brazil may be less credible and impartial in performing audits, as they may feel pressured to win engagements or maintain relationships with the companies for whom they are providing the audits.

- Accounting standards: Brazilian publicly held companies and large companies (as defined in Brazilian legislation) are required by law to prepare audited financial statements in compliance with IFRS. Financial institutions and insurance companies, however, are generally required for regulatory purposes to prepare their financial statements under Brazilian GAAP. Financial institutions and insurance companies that are publicly held or that are considered large companies must prepare their financial statements in both IFRS and Brazilian GAAP. Following multiple rounds of revisions and interpretation pronunciations from the Accounting Standards Committee, the February 2016 version of the Brazilian GAAP is substantially in line with the IFRS, although a few differences still exist between the two standards.

- Related-party transactions: Private companies in Brazil tend to have extensive, and sometimes disorganized, related-party transactions or arrangements, and may be sensitive to sharing this type of information. These transactions generally result in tax and labor liabilities to the companies involved. Public companies, on the other hand, are required to disclose related party transactions periodically pursuant to the CVM rules.

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I. Due Diligence Process

- <u>Familiarity with due diligence process and requirements</u>: While there is no statutory definition of "due diligence" in India, contracting parties are expected to exercise diligence while entering into a contract, and the law does not enable a party to avoid a contract on account of a fraudulent misrepresentation if the aggrieved party had the means of discovering the truth with "ordinary diligence". Public companies in India are familiar with the due diligence process since Indian securities laws require them to disclose certain information to the Securities Exchange Board of India. Private companies need much more guidance and are less willing to share information with outsiders. In fact, it is not uncommon for private companies to stage the availability of documentation, such that the most sensitive materials (whether related-party transaction documentation or otherwise) are provided only at the end of the process, and sometimes in a very limited format. This access might consist solely of having materials shown for a fixed period of time to local counsel only, without the ability to make copies or even to take notes!

- <u>Internal organization</u>: Indian businesses are mostly promoter led and family-controlled and usually have their in-house legal, compliance and accounting-related work being handled by a single department. Information and knowledge regarding company matters is generally centralized (since the owners retain tight control), but it can still take companies some time to gather such information. Companies also routinely rely on chartered accountants to take care of corporate formalities. This can create issues with corporate records, such as board or shareholders' meeting minutes, as well as the registry of share ownership and transfers.

With a view to improving corporate transparency and protecting the financial system against money laundering and terrorist financing, in 2018, the government issued rules for significant beneficial ownership ("SBO") disclosures, aligning India's laws (to some extent) with recommendations of the Financial Action Task Force. The SBO shareholding threshold is pegged at 10% and applies to all types of companies in India. Companies must now maintain SBO registers and make them accessible to their shareholders.

- <u>Availability of public search resources</u>: Database searches, such as litigation and lien searches, that are widely consulted in the due diligence process in Western countries are not comprehensive in India. Coupled with the broad geographical span of the country, the various levels and hierarchy of courts and tribunals, the overlapping, but limited, jurisdiction of various courts makes it an uphill battle to track such information online. The higher courts in India, being the Supreme Court and the various state high courts, make their decisions available online and a large number of lower courts have also moved in this direction. Also, there are initiatives to make land records available on the Internet but these efforts are in a nascent stage and do not currently ensure that the information is accurate or comprehensive.

II. Business Due Diligence

- <u>Foreign investment restrictions</u>: FDI into India is governed by, among other things, the FDI policy of the Government of India, and the inflow and outflow of foreign capital is regulated by the Foreign Exchange Management Act, 1999. While foreign investors are permitted to own 100% of businesses in most sectors and can invest via the "automatic route" which does not require prior approval by either the Government of India or the Reserve Bank of India ("RBI"), certain critical sectors (such as defense, insurance, certain types of retail ventures, etc.) are subject to foreign ownership caps and restrictions and prior approval from the Government of India for foreign investment above prescribed thresholds. In addition, wholly owned Indian domestic subsidiaries of non-resident entities are treated as foreign companies for FDI purposes.

There are also pricing restrictions, both at the time of entry and exit, which are applicable to foreign investors investing in India. In addition, deferred consideration structures, either as holdbacks or escrows (including for indemnity claims), are permitted only up to 25% of the total consideration to be paid by the foreign purchaser and for a maximum period of 18 months from the date of the transfer agreement (any structure outside of this scope will require an approval from the RBI).

- <u>Licenses and approvals</u>: Companies operating in India must navigate a complex bureaucracy and a regulatory system with seemingly ambiguous and imprecise rules. Each sector has its own list of licenses and approvals that are required from both the central and state governments. Usually, a financially stable company that has been in business for a while will have its licenses and approvals in order, but there are many companies that do not. The Government of India and various state governments have been aggressively trying to reduce the licensing backlog by creating "single window clearances" for setting up businesses in various non-critical sectors. These initiatives to more streamlined approvals should be particularly helpful to companies operating in the infrastructure sector, where development permits take more time than expected to obtain, if they can be obtained at all. Further, the government has strongly emphasized its commitment to improving the ease of doing business in India by introducing various reforms such as streamlining and expediting the process of setting up legal entities in India, introducing online applications for industrial licenses, introducing online registrations for tax identification numbers, commercial courts and a new bankruptcy code, etc.

As a result, in the World Bank "ease of doing business" rankings, India has moved up significantly from 130th position in 2017 to 77th position in 2019, out of a total of 190 world economies. This is one of the most significant jumps for any large economy and the World Bank report recognizes the concerted efforts made by India and states a number of fronts where the country has embarked on a fast-paced reforms path.

- FCPA: Corruption remains a challenge of investing and doing business in India. The risk is higher in business sectors that operate under governmental concessions or authorization (sectors such as real estate, infrastructure, telecom, mining and power). It should be noted that many large companies in India are state-owned or controlled, and therefore directors and employees of such companies are deemed to be "government officials" under the Foreign Corrupt Practices Act and the UK Bribery Act, with the result that payments made to them fall within the laws' restrictions. However, India enacted the Lokpal and Lokayuktas Act, 2013, which brings into existence an independent anti-corruption ombudsman to investigate and try corruption charges against government officials.

  In 2018, India amended the Prevention of Corruption Act, 1988 ("PCA"), India's main anti-graft law, to bring it in line with international legislation, including the UK Bribery Act. The amendments are aimed at tightening the existing provisions of the PCA and expanding the coverage of the offences to also include the giving of a bribe (not just receiving). Further, commercial organizations operating in India can now be held vicariously liable for any bribes provided to public servants by persons associated with such organizations. The amended PCA also imposes personal liability on directors, managers, secretaries and other officers of a commercial organization found to have "consented or acted in connivance of the commercial organization's corrupt conduct". If found guilty, managerial personnel can face imprisonment and/or fines.

- Corporate governance: The Companies Act, 2013, along with the requirements prescribed by the Securities and Exchange Board of India ("SEBI") for listed companies, have brought about significant reforms in the corporate governance standards in India. Public companies are now mandatorily required to have independent directors on their boards, with public listed companies required to have at least one-third independent directors. Such directors may not be given any stock options and their time in office cannot exceed two five-year terms. In addition, nominee directors will not be regarded as independent. These provisions are significant, as the lack of independent directors and/or their true independent character has always been perceived as a central reason for most corporate frauds. Indian companies are generally promoter controlled, and historically, there was no tradition of independent directors challenging the decisions of the promoter.

  However, as these norms are still relatively new, it remains to be seen whether independent directors do, in fact, start playing the type of proactive role that has become more common in the United States and the United Kingdom, and whether they present conflicting viewpoints from those favored by the promoters. Also, the standards for private companies are less stringent.

III. Legal Due Diligence

- Litigation: India has the world's largest backlog of cases, with nearly 30 million proceedings pending before the courts. It is estimated that an average lawsuit takes 15 years to get resolved in India. In a move to ease this undue pressure on the judiciary, the Indian parliament enacted the Commercial Courts, Commercial Division and Commercial Appellate Division of High Courts Act, 2015 (the "Commercial Courts Act"). The Commercial Courts Act establishes commercial courts at the high court as well as the district court levels across India to deal exclusively with 'commercial disputes'. Together with the changes brought by the Bankruptcy Code (as discussed below), this seems to signal an overall shift towards a faster and more efficient dispute resolution regime in India. Given that cases pending before Indian courts for indefinite periods tend to create significant contingent liability assessments during the due diligence process, these changes should help reduce pending cases within a more reasonable timeframe.

When investigating pending litigation of the target company, however, foreign investors should keep in mind the potential delays and the costs of such delays (litigation-related legal costs are relatively high when compared to other countries, including even the United States), as well as the unpredictability of court decisions. It is worth noting, however, that India is a party to the New York Convention on the enforcement of foreign arbitral awards and has a good arbitration law, which is drafted along the lines of the UNCITRAL Model Law. Arbitration clauses are a regular feature in business agreements.

In order to reform and modernize its arbitration regime, in 2015, India extensively amended its arbitration law, the Arbitration and Conciliation Act, 1996 ("Arbitration Act"). The aim of this amendment was to make arbitration the preferred mode for the settlement of commercial disputes in India by making it more transparent, user-friendly, cost effective and expeditious.

In order to reduce the scope for challenge of foreign arbitral awards in the Indian courts, the new law narrowly defines the term "Public Policy of India". Until now, the Indian courts broadly interpreted the "Public Policy of India", enabling parties abusively to delay the enforcement of foreign arbitral awards in India. The rules on interim measures have also been changed. The new law recognizes the jurisdiction of the Indian courts to grant interim awards in support of arbitration proceedings seated outside of India as long as the seat of the arbitration is in a country recognized by India as a "reciprocating country" (note that, among others, the United Kingdom, Hong Kong and Singapore are reciprocating countries while the United States is not).

More recently, in 2018, India's lower house of parliament passed further amendments to the Arbitration Act with a view to strengthening institutional arbitration and clarifying certain provisions that were part of the 2015 amendments. The new amendments include: (i) setting up of "The Arbitration Council of India" - an independent body to develop guidelines for arbitrations, to establish a repository of arbitral awards, and generally to promote the use of arbitration in India, (ii) imposing a duty of confidentiality on all aspects of an arbitration (except for the electronic repository of all awards to be maintained by the Council), and (iii) removing the controversial twelve month time-limit for arbitral tribunals to render awards in international arbitrations that was introduced by the 2015 amendment. These amendments are pending approval by India's upper house of parliament.

In addition, India has recently amended its specific relief law to make specific performance the default remedy for contractual and other disputes. This replaces the traditional common law rule of first having to prove that monetary damages would be inadequate. This, coupled with the amendments to the arbitration law discussed above and a continuation of the pro-arbitration attitude of the Indian courts, are all steps towards the creation of a more business-friendly legal environment.

- Labor laws: There are over 50 laws at the national level and several more at the state level that govern and regulate the Indian labor market. These laws and regulations are quite dated and very protective of employees. The Industrial Disputes Act, 1947, for example, makes it difficult for companies employing more than 100 workers to conduct layoffs. It is also common to find workers organized into unions that prove to be very successful in negotiating pay increases and securing benefits for their members. Foreign investors ought to get a clear understanding of these issues, especially if they plan on restructuring the target's business in any way.

- Land title issues: Land registration in India does not involve a registration of title, but a registration of deed, i.e., it is simply an acknowledgment that a transaction has taken place between the parties. Additionally, there is no system of issuing title certificates for land, which makes it necessary for a buyer to establish a "chain of title" that involves searching relevant land records for the preceding 30 years. Since land records are not computerized and can be in the local languages of the states, the process can be very time-consuming and expensive and there is no title insurance currently available. It is also notable that although there is a statutory requirement to register all sales of land, the reality in India is that due to the high cost of registration (in the form of stamp duty that varies from state to state); some realty transactions are never registered. There is no mandatory registration of land acquisitions, court decrees, land orders, partitions, mortgages, agreements to sell, etc., under state legislation. Foreign investors accustomed to deriving comfort from clear records of title are, therefore, often surprised at the complexity of, and lack of assurances provided by, a title search in India.

- Tax-related issues: The fiscal regime in India is extremely complex and poses numerous challenges. Each year's budget brings with it new levies and taxes. Business entities in India are frequently involved in extensive litigation and administrative proceedings that challenge the interpretation and application of the tax framework. However, anyone planning to establish or invest in a business in India should conduct a thorough review of the transaction by local consultants so that the potential tax risks are appreciated. India is currently facing a number of investment treaty claims brought by large international corporations alleging losses suffered as a result of the unfair, arbitrary and/or discriminatory application of

India’s tax laws against them and their investments. Adding to the uncertainty and complexity are some recent court decisions and the lack of clarity around the retrospective application of certain tax laws by the Indian government.

India has Double Taxation Avoidance Agreements with various countries, and most foreign investors prefer entering India through these jurisdictions. However, in 2016, the Indian government signed protocols to amend its tax treaties with Mauritius and Singapore, countries through which a significant portion of foreign investment into India was then routed. As a result of these amendments, India taxes capital gains arising from the sale of shares acquired on or after April 1, 2017 on a company resident in India. In recent years, The Netherlands has emerged as an alternate jurisdiction for investments into India.

In line with these changes, from April 1, 2017, India also implemented its General Anti-avoidance Rule (“GAAR”), which empowers tax authorities to tax ‘impermissible tax arrangements’ and grants a wide range of powers to scrutinize arrangements and deny tax benefits. The application of these tax changes has made it imperative for investors to conduct a more in-depth due diligence exercise from a tax perspective in order to effectively structure transactions and to assess the potential tax implications.

On July 1, 2017, the government implemented the new Goods and Services Tax (“GST”) regime to simplify the then existing complex indirect tax regime in India. GST is a comprehensive tax levy on the manufacture, sale and consumption of goods and services at a national level, replacing the complicated system of federal and state division that was then in force. Through a tax credit mechanism, this tax is collected on value-added goods and services at each stage of sale or purchase in the supply chain. In parallel, the government also began making efforts in 2009 to consolidate and simplify the country's direct tax laws by proposing a draft Direct Tax Code, which included proposals to change the existing direct tax regime for both domestic and foreign companies. However, although the GAAR, an offshoot of the draft Direct Tax Code, has been implemented, the status of the draft Direct Tax Code still remains uncertain.

- Intellectual property: As a signatory to the Agreement on Trade-Related Aspects of Intellectual Property Rights, India has enacted all mandated intellectual property laws. However, even though sufficient laws are in place, intellectual property enforcement remains problematic, a big issue in this country, especially in the area of copyright.

- Bankruptcy Code: If a target entity is a creditor or is otherwise involved in a bankruptcy proceeding, from a risk-assessment and due diligence perspective, the recent enactment of the Insolvency and Bankruptcy Code, 2016 (the "Bankruptcy Code") will be relevant. The Bankruptcy Code is an effort to consolidate the wide gamut of existing insolvency laws in India into a single comprehensive legislation with a view to streamlining the insolvency related process and reducing the large pendency of such cases. The Bankruptcy Code provides for a time-bound insolvency process and creates dedicated new regulatory and adjudicatory authorities to oversee and resolve insolvency cases. Significantly, the Bankruptcy Code now permits debtors and creditors, whether domestic or foreign, to commence the insolvency process and imposes a moratorium period similar to that under Chapter 11 in the United States. The new regime is expected to encourage foreign investments in distressed assets in India and has helped raise India's standing in the World Bank rankings for resolving insolvency. However, like any new legislation of this scale, the Bankruptcy Code has faced certain teething issues, including judicial challenges to its validity and process. The Supreme Court of India has attempted to deal with these swiftly and has upheld the constitutional validity of the Bankruptcy Code.

IV. Financial Due Diligence

- Accounting records: The accounting books and records of Indian companies are sometimes less transparent and reliable than those of U.S. companies. In fact, some Indian companies deliberately keep two sets of accounting records, one for the statutory reporting purpose and the other for internal use. The latter reflects a company's actual financial condition and results, whereas the former set of records tends to book less revenue and/or more expenditures with a view to reducing the company's tax liability.

- Financial auditing terms: India does not permit FDI in accounting and auditing services businesses. However, the "big four" accounting firms have established offices in India and offer consultancy services through tie-ups and other arrangements with local partners. It should be noted that many local accounting firms in India may be less credible and impartial in performing audits, as they are more susceptible to pressures from the company as a result of eagerness to win engagements or maintain existing relationships.

- Accounting standards: Indian companies are required to prepare audited financial statements in accordance with Indian GAAP. The Government of India has proposals pending that would require certain entities, including listed companies, banks, insurance companies and other large entities, to comply with IFRS. However, these proposals have yet to be enacted.

- Related-party transactions: Since many businesses in India are still structured as family-owned conglomerates with a great deal of interdependence, there can be extensive related-party transactions that must be identified and examined. The Companies Act, 2013 and the rules prescribed by SEBI for public listed companies have made an attempt to significantly increase disclosure and compliance requirements around related-party transactions in an attempt to bring greater transparency.