Due Diligence and the New Legal Climate in Brazil

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Brazil is one of the hottest markets in Latin America, offering some of the highest returns on investment in the region. But those rewards do not come without political, economic, and legal risks. While stable compared to other countries in the region, Brazil is undergoing significant structural and cultural change in its business world. Preconceived notions regarding corruption, taxes, and labor laws are being pitted against a government and an international business community clamoring for transparency. The result has dangerous consequences for companies looking to invest in Brazil. On the one hand, corruption and unethical business practices are still widespread, but on the other, tougher enforcement and prosecution are exposing and penalizing illicit activities more than ever. In today's Brazil, due diligence is particularly needed to avoid the perils of a rapidly changing business environment.

Brazil is ranked 72 on Transparency International's 2007 corruption perception index, just below Senegal and sharing the spot with Mexico, India, and China. The current government of Luiz Inácio da Silva (Lula) has taken the fight against corruption seriously, and enforcement against such crimes as tax evasion and money laundering is on the rise. However, the shift to more transparency is uprooting some long-established business norms. Small bribes and creative accounting, once a normal part of any business day, are increasingly being scrutinized. Even the most reputable firms are having difficulties with the new tone in the country. Consequently, it has become more necessary than ever to conduct thorough due diligence before engaging in any business-related venture in Brazil.

The Brazilian tax code is extensive and esoteric. Therefore, it comes as no surprise that companies have found many ways to avoid paying taxes. In fact, in 2007, the Brazilian Federal Revenue Attorney General's Office (Procuradoria Geral da Fazenda Nacional) reported approximately US$285 billion in taxes under judicial review, 90 percent of which had been in court proceedings for more than five years. The statistic is quite revealing. Not only is the amount of outstanding tax liability enormous, but much of it dates back before Lula took office, indicating that the current administration has implemented a more aggressive collections policy. For investors, it is imperative to have all the information regarding any past tax liabilities accrued by a Brazilian firm as the government is looking to close these cases out in its favor.

Another danger to investors is the availability of tax havens from which Brazilian firms can choose to park their capital. Accounts in destinations such as the Cayman Islands and the Bahamas can easily be used to launder funds or avoid taxes. More importantly, international transfers are being closely examined by the Central Bank, making firms more vulnerable to audits or other legal actions. Many financial firms became targets of investigations by the Brazilian government after the 1999 devaluation of the real. According to media reports, many companies sought refuge outside the country before and during the crisis. The government accused a number of these firms of "crimes against the economy." One congressional inquiry involving the sale of U.S. dollars at below-market price by the Central Bank to Marka and Fonte Cindam Banks also led to the investigation of 10 other banks, including Citibank and BankBoston. While only Marka and Fonte Cindam were charged, the resulting negative publicity did nothing to enhance the image of some of Brazil's leading financial institutions.

Proper due diligence is also required because of the systemic corruption in business affairs. A 2005 survey released by PricewaterhouseCoopers showed that 45 percent of companies in Brazil had experienced some kind of fraud over the past two years. In a 2003 report conducted by Transparency International, 74 percent of domestic companies reported corruption to be a "very important" obstacle to private sector development. Furthermore, it has been estimated that 95 percent of all domestic firms have spent at least 3 percent of total revenue on bribes. Such figures highlight just how crucial it is to investigate the reputation of a firm and its principals. A comprehensive review of Portuguese media and Brazilian government regulatory databases can offer insight into a firm's or principal's overall reputation. Past incidents involving corruption that have been publicized are almost always the tip of the iceberg and serve as red flags for potential issues.

Despite the current administration's resolve to stamp out corruption, the problem is most rampant when it involves government officials, especially at the local level where federal controls are weaker. Investors should be wary of any company/industry that engages heavily in public bidding, imports foreign products, or requires extensive licensing to do business, as all these areas require extensive contact with various government bureaucracies. Construction companies are particularly prone to graft, as was demonstrated by the 2007 case regarding Gautama, which engaged in fraud and bribery to win government construction contracts. Even the reputable Brazilian construction giant Odebrecht was shaken by a bribery scandal in the early 1990s. In such cases, substantial due diligence would be needed to investigate business practices.

The location of a firm or individual can also serve as a warning sign. Certain states in Brazil are known to be more corrupt than others or have specific problems. The northern and west-central regions of Brazil, made up by the Amazonas, Para, Acre, Mato Grosso, and Mato Grosso do Sul, are particularly lawless because of their low population density. Illegal logging and drug running are common in these areas of the country. While most investment opportunities are centered in Sao Paulo and Rio de Janeiro, mining and logging companies will often have interests in these regions. Some industry is also centered around small towns in these states. Because of the lack of law enforcement, companies are more likely to violate the law, and corporate controls are minimal. One of the largest problems concerns labor violations, which can range from withholding pay to outright enslavement. In 2007, the Brazilian Labor Ministry freed some 1,100 slaves at a sugarcane plantation in Para. Slavery issues in the north have even led to a temporary embargo by the United States against Brazilian pig iron, one of the country's major exports.

The state of Sao Paulo (outside the city) has its own unique risks as it grows some 60 percent of the country's sugar. Sugar is a labor-intensive industry, and as a result, is prone to labor violations. The Brazilian government has been particularly aggressive in prosecuting labor-related infractions committed by sugarcane growers and ethanol distilleries. While ethanol is a hot investment these days, it is essential to understand how a particular distillery has managed its labor force.

Brazil will continue to be one of Latin America's fastest growing markets, but the risks are many. As the government continues to strive for greater transparency, businesses can expect to see greater enforcement and prosecution under the law. Proper due diligence is essential in Brazil to avoid the ever-increasing legal risks that are reshaping the country's business culture.

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