

**Brazil approves legal framework on angel investing**

Complementary Law No. 155, of October 27, 2016, amends the so-called Small Business Act (Complementary Law No. 123, of December 14, 2006) to put in place project “Crescer sem Medo” (“Growing without Fear”, in a free translation). The project reforms the simplified tax system known as “Simples Nacional” and provides for a new regime for investments in Brazilian startups to be carried out by angel investors, which will enter into effect on January 1<sup>st</sup>, 2017.

According to the new regime, startup companies may receive capital contributions (“special contributions”) from individuals, companies and investment funds by means of a “participation agreement”, which shall specify the purpose of the contribution and have a maximum term of seven years. The law sets forth that said special contribution shall not be considered (i) income of the startup for the purpose of qualifying for the Simples Nacional<sup>1</sup>; nor (ii) part of startup’s capital stock. It is not clear whether the special contribution should be considered liability or net equity in the startup’s balance sheet. Also, taking into consideration the company’s obligations to pay a portion of its profits to the angel investor as well as to redeem his contribution, as further explained hereto, we understand that the special contribution shall not be considered taxable income.

The law establishes that angel investors shall not be regarded equity holders and will not be liable for any debts of the startup, even in case of judicial reorganization or disregard of the legal entity. On the other hand, angel investors cannot hold any political rights or any rights to take part in the management of the startup.

Distribution of profits to the angel investor is limited to a 5-year term from the contribution date and shall not exceed 50% of startup’s profit in each fiscal year.

Angel investors may redeem their contribution after a minimum term of two years following the contribution date (parties may increase this term). The cash redemption value shall be based on a balance sheet specially drawn up for that purpose and the amount will be limited to the contribution value adjusted for inflation.

The special contributions may be assigned by the original angel investors to third parties. If the assignee is not a shareholder, the assignment requires the prior approval of company’s shareholders<sup>2</sup>, unless stated otherwise in the participation agreement. If the assignee is also a shareholder of the invested company, no prior approval of the other shareholders will be required.

An important aspect of the new regulation is that the angel investors will have a right of first refusal (“ROFR”) in case the shareholders decide to sell the company.

Alongside with the ROFR, the new regime also grants angel investors tag-along rights (“TAR”) to be triggered by the sale of the company. In this case, the angel investor would have the right to join the deal and sell his special contribution at the same terms and conditions offered to the shareholders.

The law fails to indicate the percentage of the sale of shares that will trigger the ROFR and/or the TAR. It also leads to the conclusion that the ROFR and/or the TAR apply not only when shares are acquired by third parties, but also by current shareholders. At least with respect to the percentage required to trigger the ROFR and/or TAR, the mention to “sale of the enterprise” leads to the conclusion that a sale of a controlling interest has to take place in order to trigger such rights. In our opinion, the key element is the transfer of the effective control, regardless if the controlling shareholder owns the majority of the shares.

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<sup>1</sup> In broad terms, companies the annual gross income of which does not exceed R\$4.8 million can adopt the Simples Nacional regime.

<sup>2</sup> The law does not mention the quorum for such resolution. We understand that it can be taken by simple majority, unless stated otherwise in the startup’s corporate documents.

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Although the new law does not mention any corporate approval required for companies willing to enter into participation agreements with angel investors, we believe that the execution should be subject to prior approval of the shareholders because (i) the participation agreement would limit their own return on investment; and (ii) ROFR and TAR would affect their rights to sell their shares.

Furthermore, the new law does not indicate if the existence of the participation agreement should be mentioned in company's articles of association. This measure should be adopted in the future, since it is important so as to make public to third parties that a ROFR and a TAR are effective.

Other negative aspect of the new regime is that it does not state shareholders' and managers' fiduciary duties to the angel investors, such as disclosing business information and financial data to angel investors so that they can monitor how the special contribution resources are being employed. Angel investors are not equity holders and thus should have a proper regime able to protect their interests in the startups. In the absence of specific rules in this regard, the general rules on controlling shareholders' and managers' liabilities before third parties shall apply. In any case, the participation agreement should provide for detailed mechanisms in order to avoid any doubts.

Finally, the law is uncertain whether the results of each fiscal year distributed to angel investors are included or not in the tax exemption applicable to dividends paid by companies<sup>3</sup>.

The regulation of angel investing in startups shall be well received by the market, but there are aspects of the new legal framework to be clarified by Brazilian courts or by amendments to the law. In the meantime, parties shall seek efficient legal assistance so as to overcome the legal loopholes with adequate provisions in the participation agreement.

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<sup>3</sup> Dividends paid by companies are exempted from income tax according to article 10 of Law No. 9,249, as of December 26, 1995.