Ten Years of the Brazilian Bankruptcy Law: Some Lessons Learned and Some Wishes for Improvement

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The Brazilian Bankruptcy Law—Law No. 11,101 of 2005 ("BBL")—has just celebrated its 10th anniversary.[2] It replaced the outdated bankruptcy law that had been in force since 1945. The BBL promoted a major overhaul of the Brazilian corporate insolvency system. It ultimately shifted from a liquidation-oriented and outdated legislation to embrace modern principles of corporate restructuring designed to rescue distressed but viable businesses.

Indeed, the BBL has provided distressed companies with the opportunities and tools to restructure their obligations and operations and continue as a going concern through the use of rehabilitation and reorganization procedures, which include (a) in-court, or judicial reorganization (*recuperação judicial)*; or (b) out-of-court reorganization/prepackaged reorganization (*recuperação extrajudicial*). If restructuring and rehabilitation is not feasible, then the business is promptly and efficiently discontinued through a bankruptcy liquidation process (*falência*).

The judicial reorganization ("Judicial Reorganization") is a court-supervised procedure somewhat inspired by and analogous to a Chapter 11 case under the U.S. Bankruptcy Code. It is a tool essentially designed to promote effective restructuring and reorganization of viable companies in financial distress.

In short, while protected against enforcement and other actions for a certain period (i.e., a stay period), the debtor is entitled to submit, negotiate and eventually have a plan of reorganization ("Plan of Reorganization") approved by its creditors,[3] through which it can generally adjust its operations and reprofile its debt (and perhaps its equity structure).[4]

Upon approval and confirmation of the Plan of Reorganization, pre-petition claims[5] are generally discharged and the debtor can thus enjoy a fresh start. As a rule, the debtor itself and related management remains at the helm of the debtor's activities during the life of the Judicial Reorganization proceeding (*debtor in possession*). A court-appointed trustee is designated to supervise the process, without any management powers.

The out-of-court reorganization or prepackaged reorganization ("Extrajudicial Reorganization") is also a court-supervised procedure designed to promote corporate restructuring. Similar to prepackaged arrangements in other jurisdictions, the main goal of the prepackaged reorganization is to obtain expedited confirmation of a plan of reorganization ("Prepackaged Plan") that has been previously negotiated and accepted by requisite majorities involving certain classes or groups of creditors that are impaired by the Prepackaged Plan and which will share in similar payment conditions under the Prepackaged Plan.

When compared to a full-blown Judicial Reorganization proceeding, the Extrajudicial Reorganization is a fast-track

procedure that tends to be more effective because it minimizes transaction costs and time spent in court, and also reduces uncertainty when a Prepackaged Plan has been previously negotiated and approved. In practice, however, it is used far less than Judicial Reorganization.

Finally, the bankruptcy liquidation ("Bankruptcy Liquidation") of a corporate debtor, whether filed for by third parties (involuntary bankruptcy) or by the debtor itself (voluntary bankruptcy), is usually prompted by an acknowledgment that the debtor's business is no longer viable.

Under this proceeding, all of a debtor's assets are scheduled by a court-appointed trustee. Assets are liquidated and the proceeds serve to repay the existing liabilities pursuant to a certain ranking of priorities. Upon decree of bankruptcy liquidation, the management is removed and the liquidation process is conducted by the court-appointed trustee.

After payment of (a) statutory priority liquidation labor claims; (b) claims for restitution; and (c) administrative expenses (bankruptcy estate expenses and post-petition claims, if applicable), the proceeds from sale of the debtor's assets are distributed to pre-petition creditors in the following priority-distribution order: (i) labor related claims (capped at 150 minimum wages per employee) and claims originating from occupational accidents; (ii) secured claims up to the value of the collateral; (iii) tax liabilities; (iv) special privilege claims; (v) general privilege claims; (vi) unsecured claims; (vii) contractual fines and penalties; and (viii) subordinated claims.

Some Lessons Learned

The BBL represents an undisputed step ahead when compared to the previous bankruptcy legislation. Indeed, the current tools have allowed many debtors to successfully restructure their obligations and continue as a going concern, while preserving creditors' interests and fostering investments and asset sales (free and clear of prior liens).

Notwithstanding the notable improvements, the 10 years of practice have revealed some of the BBL's challenges and weaknesses in promoting effective corporate restructuring. For example, equity continues to play a critical part and drive the restructuring process even when there is no equity value. Often in conflict with the best interests of the debtor, there are various cases where equity will use the restructuring proceedings to force haircuts on disorganized creditors and retain equity value for no or unfair consideration.

Moreover, the lack of specific rules governing substantive consolidation has also created distorted outcomes in complex cases involving various companies in the same economic group.[6] In some of these cases, structural seniority was disregarded and claims and liabilities were mingled, to the detriment of senior creditors. Further, the BBL is silent in respect of the use of the absolute priority rule in reorganization proceedings, which has also created distorted outcomes in some instances.

Practice also reveals that the typical Brazilian debtor tends to seek restructuring proceedings very late, when its liquidity position is already very dire. Additionally, while the BBL contemplates rules governing DIP financing and the sale of assets free and clear of debtors' liabilities, it is clear from experience that the BBL requires some improvements to facilitate and expand the use of these transactions and techniques, which are needed by most companies in reorganization to minimally stabilize working capital to levels that would permit the continuation of its business.

Some Wishes for Improvement

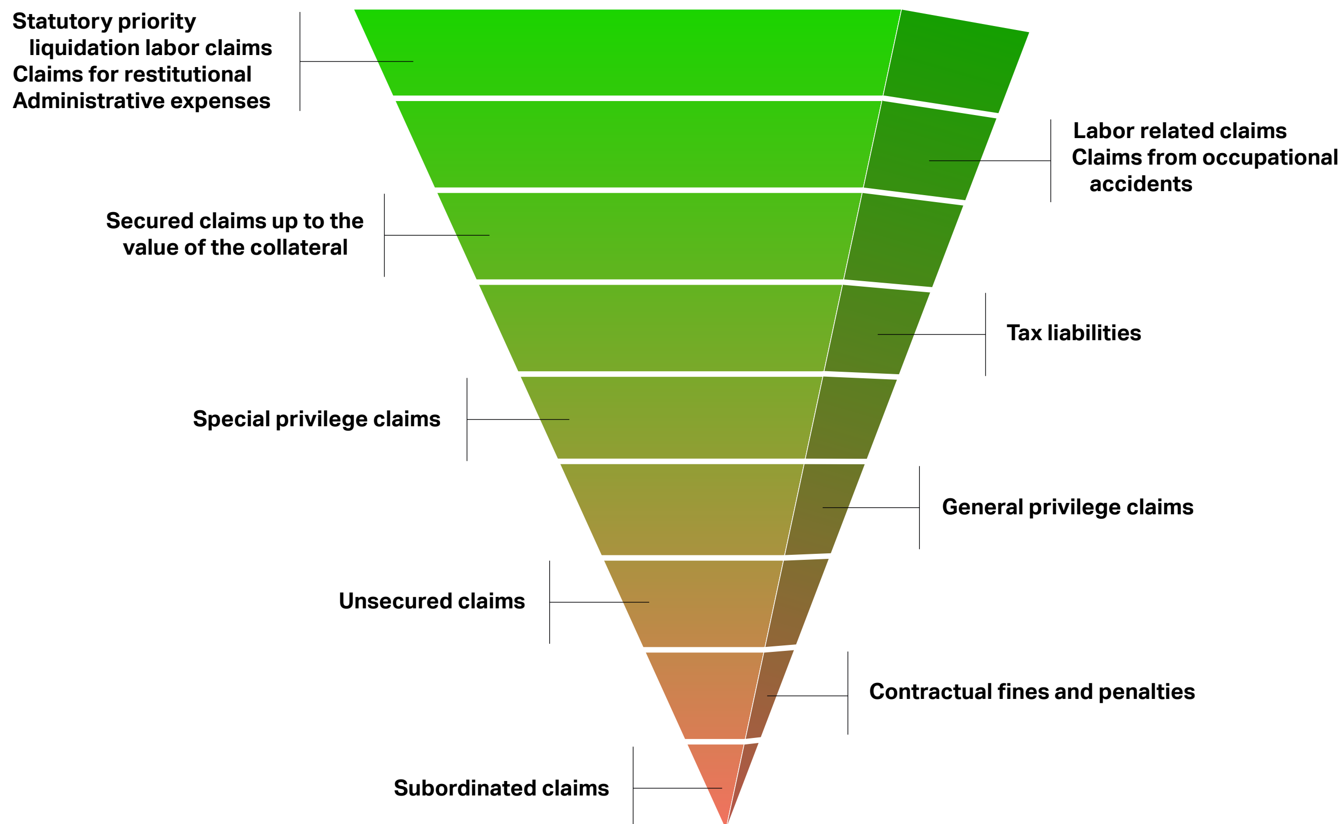
Accordingly, as with any other bankruptcy legislation, there are certain aspects calling for change. Some reforms are critical to make the whole process more effective and balanced among the stakeholders involved, thus setting a higher standard in legal certainty for debtors, creditors, distressed investors and financiers alike. Below we briefly outline some wishes for improvement of the BBL in certain key areas we consider important in achieving more fair, balanced, transparent and efficient restructuring proceedings.[7]

Balance of forces in Judicial Reorganization—Alternative-Competing Plan of Reorganization

The BBL does not envisage an involuntary filing for Judicial Reorganization. Indeed, a going-concern reorganization can take place only on the debtor's initiative. Moreover, once under Judicial Reorganization, a debtor's management and equity retain control of the company. More specifically, it is generally established that a Plan of Reorganization is put to vote only with the debtor's consent. As a result, the debtor and its respective shareholders play a very central role in a reorganization process, notably where creditors are still very concerned and unclear about the real prospects for credit recovery in Bankruptcy Liquidation proceedings.

Indeed, while rejection of the Plan of Reorganization typically leads to conversion of the Judicial Reorganization into Bankruptcy Liquidation, with the consequent detrimental effects for the debtor and its shareholders,[8] the general feeling among creditors is that there is limited or no recovery value

Brazil — Recovery Waterfall

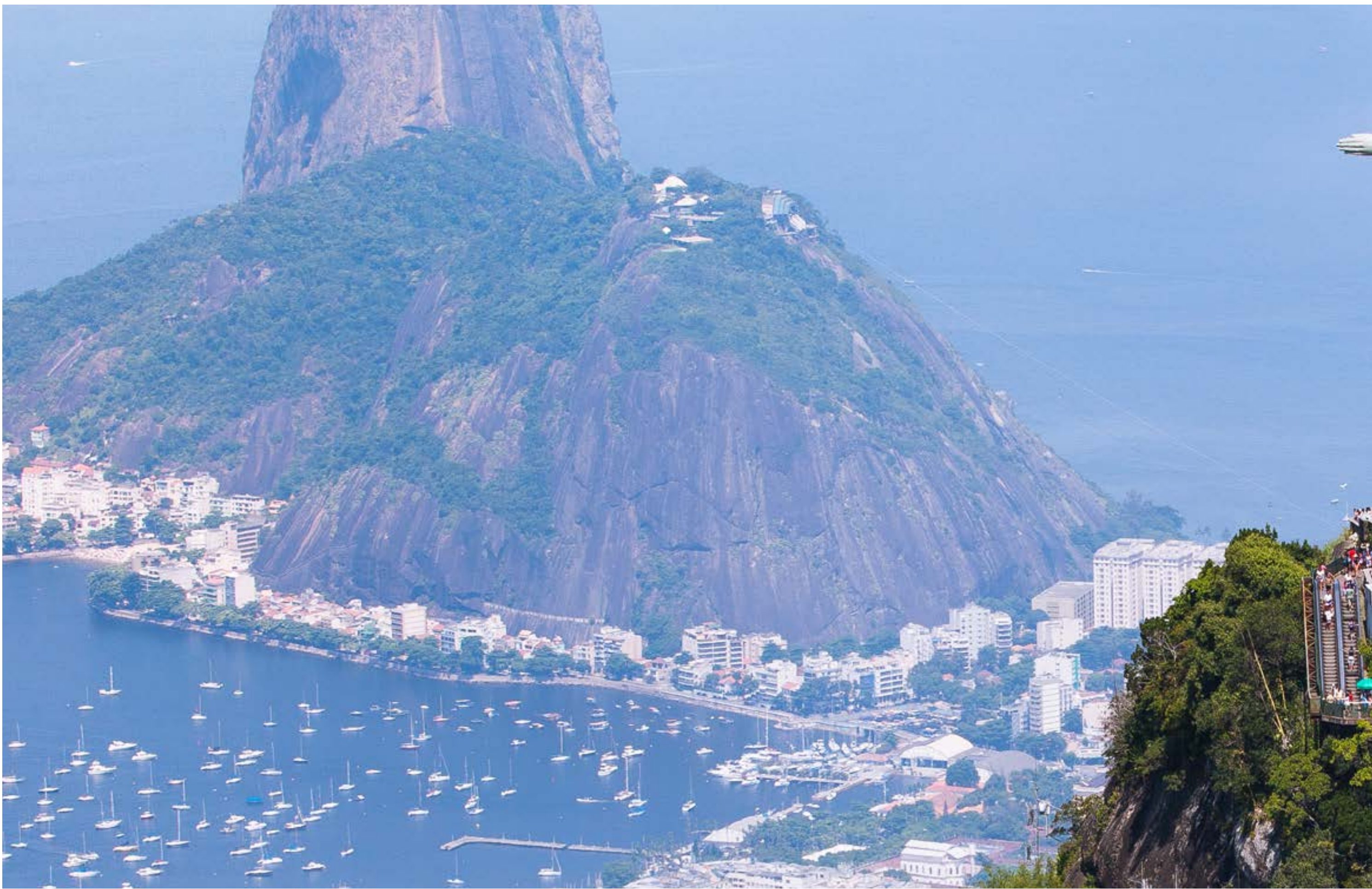


under a potentially time-consuming, costly and bureaucratic Bankruptcy Liquidation process. Therefore, in practice, creditors tend to approve a questionable and sub-optimal Plan of Reorganization rather than vote for its rejection which would relegate them to coping with the downsides of Bankruptcy Liquidation.

Aware of those circumstances, is not uncommon for debtors to be uncooperative and restrict as much as possible creditors' access to minimum information necessary to assess whether the proposed restructuring is effectively the best and most equitable alternative. In addition, the BBL lacks effective instruments to compel debtors to provide creditors with timely and useful information on its business plan, liquidity and other strategic data to appropriately evaluate a proposed Plan of Reorganization.

The scenario is thus devoid of decent options for creditors to fight for purportedly better restructuring conditions. This could be sorted out by giving the majority of creditors (or alternatively a super-majority) additional rights and instruments to impose their will on the debtor in circumstances where the debtor fails to timely file and/or approve a Plan of Reorganization that is fair and equitable. To that end, the possibility of an alternative-competing plan proposed and submitted by creditors regardless of a debtor's consent—as in other jurisdictions—would be instrumental, including in minimizing the abuses of equity holders in effectively controlling the restructuring process. This alternative-competing plan would be binding on the debtor and shareholders, regardless of their will and consent, once it was approved by its respective creditors.

This should ultimately further a balance of forces under Judicial Reorganization. Besides, it would also encourage the debtor's entities to share their internal information in a more efficient and constructive manner with creditors and other stakeholders and submit a Plan of Reorganization that is much closer to the best alternative that can be offered by the debtor in order to keep control of the process, thus making Judicial Reorganization an even more transparent and likely effective process.



DIP Financing—An absolute senior administrative expense priority in case of Bankruptcy Liquidation
DIP financings are generally regarded as post-petition obligations of the debtor for being disbursed in the debtor's benefit after the filing for Judicial Reorganization. Therefore, DIP financing enjoys senior treatment in case of Bankruptcy Liquidation. Such credit facilities should precede any pre-petition obligation of the debtor in the waterfall priority of payments.

However, DIP loans may still rank junior to certain of a debtor's other obligations. More specifically, pre-petition creditors holding collateral in the form of a fiduciary lien may liquidate their claims prior to repayment of the DIP loans. Upon occurrence of a default (even post-petition), a creditor secured by a fiduciary lien is generally authorized to foreclose on the respective encumbered asset.

In particular, in a Bankruptcy Liquidation scenario such creditor is entitled to seek restitution of the respective assets and amortize its claim with the proceeds from the sale of its collateral (the asset encumbered to the respective creditor).[9] In this scenario, a pre-petition creditor could recover on its claims before a DIP lender, as the respective asset would not be scheduled and consequently not available to satisfy existing obligations of the bankrupt debtor's estate. Further, the DIP loan is also junior to some other statutory administrative post-petition obligations of the Debtor, including fees of court-appointed trustees and ordinary expenses for running the estate.

The DIP lender is often the creditor that runs the greatest risk, financing the distressed debtor when the situation is most uncertain. Securing new money is key to successful restructurings, ideally on an unsecured basis from the debtor's perspective.

Therefore, the BBL should clearly provide for super-seniority and priority of DIP loans, even on an unsecured basis, notably in the case of Bankruptcy Liquidation of the financed debtor. In some circumstances, the BBL should also empower the Bankruptcy Court to prime liens for the benefit of the DIP lender. This would be a useful measure to foster and facilitate the financing of distressed companies, an essential tool for successful restructurings.

Asset Sale – Free and Clear - Further flexibility
The sale of assets under the prior insolvency regime[10] was risky and challenging. It was relatively common to see the acquirer of an asset being later liable for the debtor's obligations. Naturally, almost no sale transactions were implemented.

Fortunately, the BBL has changed this scenario by establishing that the acquirer of a debtor's *Isolated Business Unit* ("IBU") would not be held liable for any of the seller's existing liabilities. This new legal framework, which has been consistently confirmed by court precedents, has fostered numerous successful transactions during the last decade under Judicial Reorganization cases.[11] Notwithstanding the success over the last 10 years, practice has shown that a few improvements are still necessary to make the process even more efficient and effective.

First, the BBL failed to define the actual extent of an IBU. This stirred up discussions on whether an IBU should (or should not) encompass all or a substantial part of debtor's assets and whether remaining in operation with a residual business would be crucial to qualifying as an IBU. In addition, the IBU concept in the BBL is also unclear about the kind of assets that could make up an IBU. Naturally, this brings a certain degree of uncertainty when considering that, if assets are found not to comprise an IBU, the acquirer may be accountable for the debtor's existing obligations.

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Accordingly, many of these discussions and uncertainties would be eliminated if the BBL would state that an IBU may consist of any subset of the debtor's assets and even comprise all or a substantial portion of the debtor's business. The size of an IBU vis-à-vis the debtor's activities (and whether such debtor remains in business) should not prevent a deal from being considered free and clear, given the underlying principle of the BBL to preserve the going-concern and operations of certain assets, even in the hands of other investors or shareholders.

Second, a strict reading of the BBL may lead to the interpretation that the sale of an IBU—and respective competitive process—should be contemplated in the respective Plan of Reorganization. In other words, a transaction analogous to a 363 sale under the U.S. Bankruptcy Code—i.e., consummated prior to the filing or approval and confirmation of a Plan of Reorganization—would not qualify to be free and clear. While we strongly disagree with such strict view and interpretation, it is beyond doubt that most companies that file for Judicial Reorganization crave cash (or will soon after filing). Experience shows that time is of the essence when dealing with liquidity shortages.

As a Plan of Reorganization is usually approved only around six months after the filing for Judicial Reorganization, to avoid any sort of academic discussions and uncertainties that could compromise (as it has been the case) strategic deals from happening, it would be a welcome adjustment in the BBL to clearly stipulate that an IBU may be sold free and clear of a debtor's obligations at any time during the life of the Judicial Reorganization, even before deliberation on the Plan of Reorganization. Of course, this sale transaction should also involve a competitive, court-supervised process that includes creditors' participation.

Conclusion

During the past 10 years, the BBL has proved to be an effective instrument for distressed companies to overcome their financial crises. The BBL is also praiseworthy for its other mechanisms that allow creditors to preserve their rights in an insolvency scenario, while also enabling investors to participate in and implement successful transactions within the reorganization process. But a few changes are still necessary.

It is likely that the next few years in Brazil will be marked by a credit shortage and limited access to capital markets for local companies. The consequences of the present political and economic crisis are still unknown, but several local companies will certainly have to look to existing insolvency regimes and tools for protection. The BBL and its characteristics will be put to test again. All things considered, the time is ripe for improvements to make the legal framework even more balanced, effective and predictable to cope with the challenges ahead. ■

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2. The BBL was enacted in February, 2005. Generally, the Plan of Reorganization is considered approved by the favorable vote of a majority of claims (i.e., dollar amount) and/or creditors (i.e., head count) present at a general meeting of creditors (a "GMC") called and convened to deliberate and vote on the plan, and the plan must be approved by each impaired class of creditors (i.e., labor, secured, small companies or unsecured/general class). Under the labor and small companies' classes, the plan is generally approved by the favorable vote of the majority of creditors in attendance of the GMC, and need not also be approved by the majority of claims. The BBL also provides for cram down rules to confirm a contested Plan of Reorganization, provided that certain requirements are met.
3. As a rule, the Plan of Reorganization must contemplate all means that will be employed by the debtor to reorganize and restructure its business. The BBL provides enough flexibility to accommodate any deal the parties in interest might find suits their needs (including the sale of part of the business to third-party investors free and clear). Normally, the Plan of Reorganization stipulates a scale-down of the pre-petition debt load with the consent of requisite majorities of creditors.
4. Generally, all claims against the debtor on the date of filing for judicial reorganization, even if not due, are governed by the Judicial Reorganization procedure. The BBL, however, provides some safe harbors for certain claims, including those secured by fiduciary lien and those originated from a forward foreign currency agreement (ACC).
5. An example of such distorted outcomes is Rede Energia S.A.'s (and affiliates') Judicial Reorganization (Case No. 0035245-15.2013.8.26.0100, underway before the 2nd Bankruptcy Court of São Paulo).
6. This paper does not intend to be exhaustive of all points the authors would consider to merit the reform of the BBL.
7. Upon decree of Bankruptcy Liquidation, the debtor and its shareholders are no longer entitled to remain in control. Indeed, the management will be removed, shareholders will have limited rights, and a court-appointed trustee will manage the company's activities (if it continues to do business) and take control over existing assets.
8. Naturally, a DIP loan may also contemplate collateral in the form of a fiduciary lien. In this case, the DIP lender would also be entitled to take over the encumbered asset and not be affected by Bankruptcy Liquidation.
9. Decree-Law 7,661 of 1945.
10. In fact, such provision of BBL has also been challenged before the Federal Supreme Court which has ultimately affirmed its constitutionality (Direct Unconstitutionality Action # 3.934). Moreover, Varig S.A. (case records # 2005.001.072887-7; 1st Business Lower Court of Rio de Janeiro), Supermecado Gimenes S.A. (case records # 597.01.2008.014658-6; 3rd Civil Lower Court of Sertãozinho) and Lácteos Brasil S.A. (case records # 0015595-79.2013.8.26.0100; 1st Bankruptcy Lower Court of São Paulo), among others, are examples of successful transactions involving the sale of IBUs.

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