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The Fight for Bondholder Suffrage in Brazilian Restructurings

By Francisco L. Cestero and Daniel J. Soltman*

The authors of this article discuss potential reforms to Brazilian insolvency laws and the difficulties faced by certain bondholders to vote on plans of reorganizations in recuperação judicial proceedings.

In 2005, the Brazilian government made significant reforms to Brazilian insolvency laws (the "Brazilian Bankruptcy Reforms").[1] Among other things, the Brazilian Bankruptcy Reforms provided for recuperação judicial (judicial reorganization), an in-court restructuring analogous to Chapter 11 of the United States Bankruptcy Code (the "U.S. Bankruptcy Code"),[2] designed to allow a company to restructure its debt and emerge as a stronger and more viable business. Similar to Chapter 11, recuperação judicial provides for a creditor vote on a proposed plan of reorganization and for consensual approval of the plan by means of affirmative votes by a majority in number of creditors and amount of debt[3] in each voting class present at a general meeting of creditors.[4] However, for a bondholder that beneficially holds a New York or English law governed bond through a central depositary outside Brazil (such as DTC, Euroclear or Clearstream) (a "Bondholder"), voting on a plan of reorganization in a recuperação judicial proceeding is no small feat. In a Chapter 11 proceeding, a Bondholder has a clear path to voting its individual holdings; procedures are well-established, rights are provided for in the U.S.

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[1] Lei No. 11.101 de 9 de Fevereiro de 2005, Diário Oficial da União [D.O.U.] de 9.2.2005 (Braz.).

[2] *See* 11 U.S.C. § 101-1532.

[3] With certain exceptions, recuperação judicial provides for three types of creditor classes: secured, unsecured and labor. While the secured and unsecured classes must approve a plan of reorganization by a majority in amount of debt and in number of creditors, the labor class need only approve the plan by a majority in number.

[4] Lei No. 11.101, Art. 45. Note that as under the U.S. Bankruptcy Code, recuperação judicial also has a path available for a "cram-down" confirmation over a dissenting voting class.

Bankruptcy Code, and any objection to a Bondholder's right to vote individually on a plan of reorganization is so far-fetched that no litigant is likely to make such an argument. In contrast, to vote in a recuperação judicial proceeding, a Bondholder faces a much more difficult task; despite the Brazilian Bankruptcy Reforms, voting procedures are still not well-established.

UNITED STATES AND BRAZILIAN PRACTICE

Under the U.S. Bankruptcy Code, the right to vote on a plan of reorganization rests squarely with the "holder of a claim or interest."[5] Further, United States courts have recognized unequivocally that it is the beneficial holder of a claim, rather than an agent or trustee, who is entitled to vote on the plan of reorganization.[6] The right to vote is a fundamental right of creditors; as such, individual Bondholders commonly vote in a Chapter 11 proceeding, and a trustee does not.[7] In part because a Bondholder's right to vote is so well established under United States law, the model New York law indenture (the "N.Y. Law Model Indenture")[8] gives no specific authority for a trustee to vote on behalf of individual Bondholders in a judicial reorganization proceeding.[9]

In Brazil, however, the path to voting is less clear. There is no well-established procedure for individual Bondholder voting in a recuperação judicial, legislatively[10] or otherwise. In the case of Brazilian law governed debentures, the

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[5] 11 U.S.C. § 1126(a).

[6] *In re Pioneer Fin. Corp.*, 246 B.R. 626, 633 (Bankr. D. Nev. 2000) ("Pursuant to § 1126(a), it is only the 'holder of a claim or interest' who is entitled to vote on a plan. Under the [United States Bankruptcy] Code, a holder of a 'claim' is one who has a 'right to payment.' 11 U.S.C. § 101(5)(A). Plainly, it is the beneficial holder, not a holder of record, who has the 'claim' and the 'right to payment.'").

[7] *See, e.g.*, *In re Indianapolis Downs, LLC*, 486 B.R. 286, 296 (Bankr. D. Del. 2013) ("Courts have consistently held that the right of creditors to vote on a plan is critical feature of Chapter 11[reorganization proceedings] . . . ."); *In re Adelphia Communs. Corp.*, 359 B.R. 54, 61 (Bankr. S.D.N.Y. 2006) ("A right to vote on a plan is a fundamental right of creditors under chapter 11.").

[8] American Bar Foundation Corporate Debt Financing Project: Commentaries on Model Debenture Indenture Provisions 1965 (Am. Bar Found. ed., 1971).

[9] The N.Y. Law Model Indenture provides that a trustee may file proofs of claim, but does not provide voting authorization for a trustee. N.Y. Law Model Indenture § 5-4 ("Trustee May File Proofs of Claim"). Further, the N.Y. Law Model Indenture explicitly states that the trustee is not required to take any action or risk any of its own funds without adequate indemnity or security, effectively discouraging the trustee from taking any action without explicit authorization. N.Y. Law Model Indenture § 6-3(e) ("Certain Rights of Trustee").

[10] While no legislation has been enacted to address the issue, in March 2015, the 2nd

trustee votes on behalf of all debenture holders upon a majority direction from the debenture holders. However, the law does not contemplate that a trustee could split the vote among debenture holders in accordance with the individual instructions, but instead must cast one vote affirmatively or negatively on behalf of all the debentures. As noted above, this is wholly inconsistent with a Chapter 11 restructuring. The N.Y. Law Model Indenture, on which most of the New York law governed indentures used by Brazilian issuers is based, is not tailored to address the unique circumstances in Brazilian markets, neither providing explicit authorization for the trustee to vote on behalf of the bonds nor contemplating the right or procedures for the Bondholders to vote individually. As such, with no well-established path to individualized voting and no specific authority for a trustee to vote, a Bondholder risks total disenfranchisement in a recuperação judicial.

RECENT EXPERIENCE

In recuperação judicial proceedings, trustees have generally been hesitant to vote on behalf of Bondholders given the ambiguities regarding their authority. At a minimum, as they are permitted to do under most New York law governed indentures, they have required an indemnity and instruction from the majority Bondholders.[11] In some cases, Brazilian courts have given individual Bondholders the right to vote, but the practice is not uniform and Bondholders have had to comply with, or receive specific exemptions from, "individualization" procedures for documenting and verifying claims prescribed by the law for all creditors that are burdensome to comply with for bonds held through central depositaries and clearinghouses outside Brazil. Further, a Bondholder that has individualized its claim must attend the general meeting of creditors, in person or by proxy or counsel, in order to submit a vote, adding expense and complexity to the process.[12]

The *Rede Energia* decision in Brazil further complicated the discussion. The Brazilian court held that a trustee of a New York law governed bond is not allowed to vote in a recuperação judicial proceeding without the explicit

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Commercial Law Journey of the Federal Justice (II Jornada de Direito Comercial—Conselho da Justiça Federal), in an exercise analogous to the American Bankruptcy Institute's report on Chapter 11 reform, took the view that fiduciary agents or trustees should vote in recuperação judicial proceedings in accordance with the relevant documentation, without prejudice to the right of Bondholders to vote individually after seeking and obtaining specific court approval.

[11] N.Y. Law Model Indenture, § 6-3(e) ("Certain Rights of Trustee").

[12] By contrast, in a Chapter 11 proceeding, voting is not costly at all, since beneficial owners are permitted to vote simply by returning the ballot they receive from the record holder.

consent of 100 percent of Bondholders to the extent the plan of reorganization contemplates a fundamental change to the underlying securities. The court relied on a provision typical in New York law indentures that prohibits amendments regarding certain reserved matters without the consent of all holders,[13] holding that a trustee could not vote without the consent of 100 percent of Bondholders, because such a vote by the trustee would impermissibly consent to a change in the principal or interest on the securities.[14] As a practical matter, obtaining 100 percent consent is next to impossible, and judicial restructurings often result in changes to terms that would otherwise require the consent of 100 percent of Bondholders under New York law indentures.[15] While practitioners would not generally consider this provision as applicable to votes cast in judicial proceedings, this precedent, combined with the inability of trustees in Brazilian judicial proceedings to cast votes in accordance with individual holder instructions, have heightened the risk and concerns of trustees.

Post-*Rede Energia*, litigants have re-examined the right of Bondholders to vote in recuperação judicial proceedings. During the restructuring of Óleo e Gás Participações S.A.—Em Recuperação Judicial, *et al.* ("OGX"), with these challenges to Bondholder voting in mind, the 4th Lower Commercial Court in Rio de Janeiro approved a specific procedure by which Bondholders could elect to individualize their claims to vote on the plan of reorganization at the general meeting of creditors (the "Individualization Procedure"), designed to accom-

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[13] "However, without the consent of the Holder of each outstanding Security affected thereby, an amendment or waiver may not: (1) change the date upon which the principal of or the interest on any Security is due and payable; (2) reduce the principal amount of any Security; (3) reduce the rate of interest on any Security (including Additional Amounts) or any premium payable upon the redemption thereof . . ." Rede Energia Indenture § 9.02 ("With Consent of Holders").

[14] Note that in *Rede*, approximately 37 percent of Bondholders individualized their claims and voted at the general meeting of creditors. However, the remainder did not, perhaps due to the costs they would have incurred during the individualization process and the uncertainty surrounding the validity of an individual Bondholder's vote. *See* Fact Stip., *In re Rede Energia*, Case No. 14-10078 (SCC) (Bankr. S.D.N.Y. May 2, 2014), ECF No. 26, ¶¶ 96–98.

[15] In a decision granting Chapter 15 recognition and relief to the Rede debtors, the United States Bankruptcy Court for the Southern District of New York, in holding that Bondholders' due process rights were not violated in the Brazilian proceedings, noted that "the [objecting bondholders do] not contend that [disallowing the trustee's vote] was wrong as a matter of U.S. law; it is well-accepted that indenture trustees do *not* vote on chapter 11 plans." *In re Rede Energia*, Case No. 14-10078 (SCC) (Bankr. S.D.N.Y. Aug. 27, 2014). However, as noted, this is somewhat of a non-sequitur, because there is no need for the trustee to vote in a Chapter 11 proceeding, since well-established procedures already exist to protect Bondholder voting rights.

modate the realities of holding securities through foreign central depositaries and clearing houses.[16] Only days before the general meeting of creditors, two non-Bondholder creditors filed an objection to the Individualization Procedure, arguing in substance that § 6.06 ("Limitation on Suits")[17] of the indentures governing the OGX-issued bonds (the "OGX Indentures") prevented individual Bondholder voting in this case, as (1) the trustee had the authority and priority to vote, and (2) before Bondholders could be allowed to vote individually, they were required to first instruct the trustee to vote and the trustee fail to follow such instruction.[18]

The 14th Civil Chamber Appellate Court in Rio de Janeiro granted an injunction on Bondholder voting at the general meeting of creditors.[19] The appeal likely would have been denied on the merits for a number of reasons, including that (1) the stated purpose for provisions like OGX Indentures § 6.06, as stated by the American Bar Foundation, is to "deter individual debenture-holders from bringing independent law suits for unworthy or unjustifiable reasons, causing expense to the Company and diminishing its assets,"[20] essentially the opposite of what occurs by voting for a plan of reorganization, and (2) in the OGX restructuring, the trustee had repeatedly informed Bondholders of its intentions not to vote at the general meeting of creditors, nullifying any requirement of trustee refusal prior to individual

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[16] 4th Lower Commercial Court Order Approving Voting Individualization Procedures Motion, April 11, 2014. The Brazilian court overseeing the recuperação judicial of OAS S.A., et al. also recently approved procedures for individual bondholder voting.

[17] Section 6.06 of the OGX Indentures is based on N.Y. Model Indenture § 5-7 and reads in relevant part: "A Holder may not institute any proceeding, judicial or otherwise, with respect to this Indenture or the Securities, or for the appointment of a receiver or trustee, or for any other remedy under this Indenture or the Securities, unless: (1) the Holder has given to the Trustee written notice of a continuing Event of Default; (2) Holders of at least 25% in aggregate principal amount of outstanding Securities have made written request to the Trustee to institute proceedings in respect of the Event of Default in its own name as Trustee under this Indenture; (3) Holders have offered to the Trustee indemnity or security satisfactory to the Trustee against any costs, liabilities or expenses to be incurred in compliance with such request; (4) the Trustee within 60 days after its receipt of such notice, request and offer of indemnity has failed to institute any such proceeding; and (5) during such 60-day period, the Holders of a majority in aggregate principal amount of the Outstanding Securities have not given the Trustee a written direction that is inconsistent with such written request . . ."

[18] The appellants argued that the trustee was required to vote, notwithstanding the fact that the OGX Indentures contained a provision almost identical to the one that the *Rede Energia* court found prohibited a trustee from voting. OGX Indentures § 9.02 ("With Consent of Holders").

[19] 14th Civil Chamber Appellate Court Injunctive Order May 23, 2014.

[20] American Bar Foundation Corporate Debt Financing Project 232.

Bondholder action.

However, both appeals were withdrawn before the creditors' vote, and as such, there is no court opinion adjudicating the issue. Had the appeals proceeded successfully, the risk of Bondholder disenfranchisement would have been high, as the trustee would have been forced to choose between refusing to vote or voting the totality of the bonds pursuant to majority instructions and thus risking challenges from minority Bondholders. Even if the trustee voted on behalf of all Bondholders with only a majority instruction, the outcome would not have been ideal, as the minority Bondholders would have argued that their vote had been silenced altogether.

CONCLUSION

The outcome in the OGX case was ultimately correct—individual Bondholders were able to attend and vote, personally or by proxy, at the general meeting of creditors. The risk of disenfranchisement, however, remains. A different judge, debtor or venue could have resulted in another outcome. To decrease the risk of disenfranchisement, some combination of the following reforms should be considered:

(1) companies and Bondholders can solve the problem contractually, clarifying the rights of the trustee and Bondholders in the indenture itself, providing that absent clear authority by a court permitting individual Bondholder voting, the trustee shall be allowed to vote the totality of the bonds in a reorganization proceeding pursuant to instructions from a majority of Bondholders;

(2) Brazilian bankruptcy law could clearly establish standardized procedures for individualizing claims by Bondholders, thus eliminating any remaining ambiguity;[21] and

(3) Brazilian bankruptcy law could allow a trustee to vote on behalf of any instructing Bondholders in proportion to their holdings, effectively allowing the trustee to vote pro-rata on behalf of the Bond-

[21] In implementing these suggested reforms, the Brazilian legislature could look to recent reforms in Mexico. The Mexican reforms automatically provide the trustee with the right to vote, but also provide mechanisms for bondholders to individualize their claims and vote separately; the weight of the trustee's vote is then reduced pro-rata by the amount of Bondholders that individualize their claims. *See* Ley de Concursos Mercantiles, *as amended*, art. 122, Diario Oficial de la Federación [DO], 12 de Mayo de 2000 (Mex.). However, the Mexican system does not contemplate that a trustee can split its own vote pro-rata in the event of conflicting instructions.

holders.[22]

Unquestionably, the best outcome would be for Brazilian bankruptcy law to clearly recognize individualized voting by Bondholders pursuant to cost-efficient and effective procedures or pro-rata voting by trustees on their behalf. However, while we wait for legislative changes, practitioners would be well advised to consider changes to indentures that would at least clearly allow the trustee to vote in Brazilian reorganization proceedings and thus minimize the risk of disenfranchisement.[23]

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[22] With respect to non-instructing, non-individualizing Bondholders, the legislature could provide either that they are deemed to not vote or that they are deemed to have voted pro-rata in proportion to the other Bondholder instructions received.

[23] Ideally, such language in the indenture itself would grant authority for the trustee to vote pursuant to an instruction from the majority Bondholders, but would also (a) explicitly state that such authority is without prejudice to a Bondholder's right to vote separately if the applicable court allows it to do so and (b) provide that if a Bondholder votes separately, the trustee's vote shall be reduced by the amount of the Bondholder's claim so that no bonds are counted as voting twice.