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Odebrecht Oil & Gas and the Use of Brazilian Extrajudicial Reorganization in Cross-Border Restructurings

By Richard J. Cooper, Francisco L. Cestero, and Jonathan Mendes de Oliveira*

The largest ever Brazilian extrajudicial reorganization was successfully concluded in late 2017. The authors of this article discuss the reorganization, which illustrates how the extrajudicial reorganization, a rarely used proceeding available in the Brazilian bankruptcy law, can be an effective and expedited instrument for cross-border restructurings of Brazilian entities, with minimal disruption to the debtors' activities.

In December 2017, Odebrecht Óleo e Gás S.A. ("OOG")[1] successfully concluded a debt restructuring of approximately US$5 billion, the largest ever Brazilian extrajudicial reorganization (*recuperação extrajudicial*). This deal illustrates how the extrajudicial reorganization, a rarely used proceeding available in the Brazilian bankruptcy law, can be an effective and expedited instrument for cross-border restructurings of Brazilian entities, with minimal disruption to the debtors' activities.[2]

OOG RESTRUCTURING

OOG is the oil and gas arm of the Brazilian conglomerate Odebrecht. From 2006 through 2015, OOG, directly or through special purpose vehicles or joint ventures, obtained a number of long-term contracts with the Brazilian state-owned oil company, Petrobras, including seven drilling contracts, two production contracts and other specialized services contracts.

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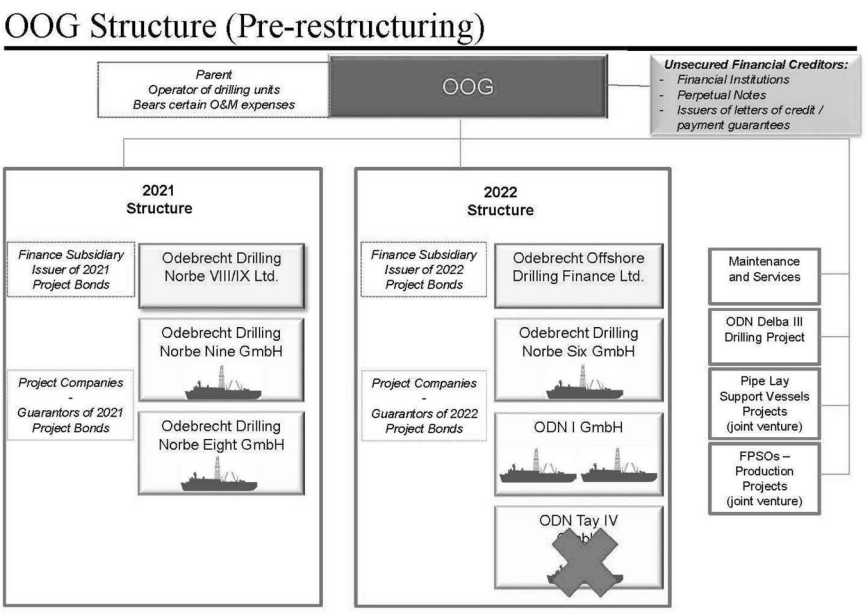
1 After completion of its debt restructuring, OOG was rebranded and is now named Ocyan S.A.

2 Cleary Gottlieb represented the ad-hoc group of holders of the two series of project bonds that negotiated with the debtors the terms and conditions for the restructuring of such project bonds, prior to the filing for extrajudicial reorganization.



These ventures were funded on a project finance basis, with syndicated loans and two series of project bonds. The project bonds were issued to finance six drilling units (each drilling unit is a drillship or a drilling rig): the 2021 notes[3] financed two drilling units (Norbe VIII and Norbe IX drillships) and the 2022 notes[4] financed four drilling units (ODN I and ODN II drillships, and Norbe VI and Tay IV drilling rigs). For each drilling project, a project company (an offshore special purposed vehicle controlled by OOG) acquired or contracted the construction of a drilling unit and chartered it to Petrobras pursuant to a charter agreement, while OOG operated the drilling unit pursuant to a separate services agreement with Petrobras. Each series of project bonds was issued by a finance subsidiary, guaranteed by the applicable project companies and secured by substantially all assets of the project companies, including mortgages on the relevant drilling units. The project bonds were not guaranteed by OOG or other companies in the Odebrecht group.

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[3] 6.35 percent senior secured notes due 2021, issued by Odebrecht Drilling Norbe VIII/IX Ltd. and guaranteed by Odebrecht Drilling Norbe Eight GmbH and Odebrecht Drilling Norbe Nine GmbH.

[4] 6.75 percent and 6.625 percent senior secured notes due 2022, issued by Odebrecht Offshore Drilling Finance Ltd. and guaranteed by ODN I GmbH, Odebrecht Drilling Norbe Six GmbH and ODN Tay IV GmbH.

OOG Situation

The first signs of distress appeared in the second half of 2015, when Petrobras terminated the contracts for the Tay IV drilling rig, which served as collateral for the 2022 notes, due purportedly to operational issues. This termination occurred at a time of declining oil prices, which made the redeployment of the asset virtually impossible.

The termination of Tay IV agreements constituted an event of default under the 2022 notes, but it was soon evident that the problems were not limited to the 2022 notes. Although OOG did not guarantee the project bonds, OOG undertook to bear all the operating and maintenance ("O&M") expenses for each drilling unit in excess of certain caps established in the financing documents. Also, the cap structure was established in U.S. dollars, and the agreements provided that, for purposes of calculating OOG's obligations to pay O&M expenses, certain O&M expenses incurred in Brazilian *reais* were to be converted into U.S. dollar at a fixed exchange rate of two Brazilian *reais* for one U.S. dollar. As a result of this feature, the continuous depreciation experienced by the Brazilian currency following the date of issuance of the project bonds had the practical effect of significantly increasing the cash contributions required from OOG.

This credit support, initially established to secure investment grade rating to the project bonds, ended up strangling OOG, as the projects' actual O&M expenditures proved to be significantly higher than the caps contemplated in the agreements, particularly in the projects financed by the 2021 notes. To finance these expenses and other obligations, OOG had to incur a significant amount of debt (more than US$1.1 billion), including bilateral loans with Brazilian banks and perpetual bonds, in addition to the debt incurred at the projects' level. At the same time, the Odebrecht group became involved in operation Car Wash (*Lava Jato*), the massive investigation into corruption and money laundering in Brazil, which closed access to credit for certain Odebrecht group companies, and caused Petrobras, the sole customer of OOG, to temporarily prevent the awarding of new contracts to OOG.

In May 2017, when OOG filed for extrajudicial reorganization, it had defaulted under the perpetual notes and other unsecured debt at the OOG level. For over a year, the majority of the holders of the 2021 notes and the 2022 notes granted temporary and limited waivers under the bond documentation to permit the payment of O&M expenditures above the caps with cash generated from the charter agreements, relieving OOG from its funding obligations. These waivers provided liquidity and permitted OOG to continue performing its obligations under the ongoing services agreements with Petrobras, while negotiations over a comprehensive restructuring ensued. Although the issuers of

the project bonds were current with their principal and interest payments under the 2021 and 2022 notes until the date of filing, a payment default under the project bonds was inevitable.

The Deal

After a long negotiation with different creditor groups, OOG reached an agreement with more than 60 percent of its unsecured financial creditors at the OOG level (financial institutions, perpetual bondholders and banks and insurance companies that issued certain letters of credit and payment guarantees to support the 2021 notes and the 2022 notes) and of the holders of each series of project bonds (2021 and 2022 notes). Upon confirmation of the plan by the Brazilian court, the deal became binding and enforceable against all creditors within these categories. Other stakeholders, in particular customers, suppliers, service providers, employees, joint venture partners and creditors of other projects were left unimpaired by the restructuring.

KEY RESTRUCTURING TERMS

- **Financial claims exchanged for participating titles.** The unsecured financial claims at the OOG level were exchanged for participating titles, a hybrid security that provides creditors with a participation in the equity value and distributions of OOG.
- **No haircut under the project bonds; dual tranche structure to adjust the repayment profile to the revenues of existing and future contracts.** Each series of project bonds was exchanged for two new series of bonds (tranche 1 and tranche 2), both secured by the same collateral package as the original notes. Tranche 1 was modeled to be repaid from revenues deriving from the existing contracts, while tranche 2 is expected to be repaid with the revenues from new contracts to be obtained upon completion of the existing ones.
- **Preservation of the operator.** A successful restructuring of OOG was key to an effective restructuring of the project bonds, as OOG was the operator of all the drilling units, and a collapse of the operator would have likely resulted in further contract terminations and operational issues. To ensure the financial soundness of the operator of the drilling units, the project bondholders released OOG from its obligations to fund operating and capital expenditures (in exchange for such release, the project bondholders received participating titles). Also, to provide the appropriate incentives for the operation of the drilling units, the project companies were required to pay, subject to the terms of accounts waterfall in the project bonds, a quarterly management fee and an annual incentive fee to OOG. The management fee is subject to deductions based on the operational performance of the operator and the incentive fee is subject to the achievement of certain performance targets, based on a pre-approved annual budget for each drilling unit.

- **Collective action and creditor representative.** One of the key challenges in financing long-term infrastructure projects with bonds is obtaining waivers and consents from creditors, when flexibility is required. The indentures for the new project bonds provided for a creditor representative, an individual jointly appointed by the bondholders and OOG, who will be in charge of, among other things, approving, on behalf of the bondholders, new charter and services agreements, upon expiration or termination of the existing ones, and the annual budget for each project.

TERMS	TRANCHE 1 NOTES	TRANCHE 2 NOTES
Maturity	• Same year as original bonds (i.e. 2021 or 2022).	• 2026.
Interest Payments	• Mandatory interest payments in cash.	• Until the full repayment of the tranche 1 notes: payment of interest in cash, if available, or in kind.
		• After full repayment of tranche 1 notes: mandatory payments of interest in cash.
Amortization	• Mandatory amortization pursuant to a schedule set forth in the documentation; plus	• No amortization until full repayment of tranche 1 notes.
	• 100 percent of quarterly excess cash flow.	• After the full repayment of tranche 1 notes: (i) 100 percent of quarterly excess cash flow to amortize tranche notes until all drilling units are redeployed and (ii) 90 percent of quarterly excess cash flow to amortize tranche 2 notes after all drilling units are redeployed.
Collateral	• Same as original bonds	
Ranking	• Senior secured notes.	• Senior secured notes, but contractually subordinated to tranche 1 notes; holders of the tranche 1 notes have control over the collateral until full repayment of the tranche 1 notes.

EXTRAJUDICIAL REORGANIZATION PROCESS

The restructuring deal was implemented through an extrajudicial reorgani-

zation, filed on May 23, 2017, and confirmed by the fourth commercial court in the city of Rio de Janeiro on October 19, 2017. On December 12, 2017, in a Chapter 15 proceeding, the U.S. Bankruptcy Court for the Southern District of New York recognized and granted comity to the confirmation order issued by the Brazilian court.

The extrajudicial reorganization is a simple and relatively quick bankruptcy proceeding, especially when compared to judicial reorganization, the main restructuring instrument under Brazilian bankruptcy law. In an extrajudicial reorganization, a restructuring plan must be validly executed and delivered, prior to a court filing, by the debtors and creditors representing at least 60 percent (the statutory threshold) of the total amount of each category of claims being restructured. Other categories of claims cannot be impaired by the restructuring.[5] As such, subject to public disclosure obligations and cleansing obligations under confidentiality agreements with creditors, negotiations with creditors can be structured to minimize ongoing disclosure that can harm the relationship with customers, suppliers and employees.

Brazilian law does not provide for an automatic stay of the claims against the debtors upon filing for extrajudicial reorganization, but such relief can be requested by debtors. Upon filing, the court grants 30 days for creditors to challenge the plan and five days for the debtors to respond to any challenge. The court must decide on any challenges and on the confirmation on the plan. The grounds for challenges and judicial review are limited to compliance with applicable law and other limited matters specified in the Brazilian bankruptcy law. Upon confirmation by the court, dissenting creditors are crammed down, and the plan becomes binding on all the creditors of the category of claims being restructured. Creditors within the same category must be treated equally, and the plan cannot offer terms that are more favorable to the creditors that expressly supported the plan. Dissenting parties may appeal the confirmation decision, but such appeal does not typically stay the effectiveness of the plan. There is no appointment of judicial administrator to oversee the debtors' management. The failure to obtain confirmation of an extrajudicial reorganization plan does not result in the liquidation of the debtors, which may be the case in a judicial reorganization.

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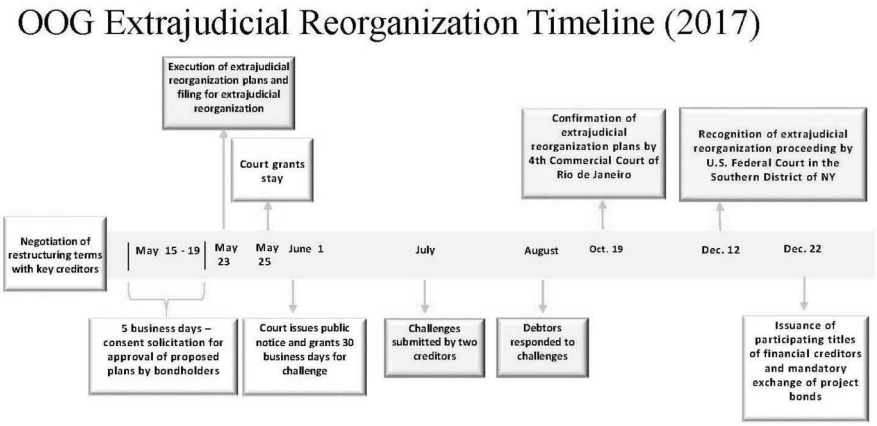
[5] Consistent with a judicial reorganization, tax claims, claims involving fiduciary ownership or fiduciary liens, advances for export agreements (*adiantamento de contrato de câmbio*) and other similar claims referred to in the Brazilian bankruptcy law are not subject to extrajudicial reorganization. In contrast with a judicial reorganization, labor claims cannot be restructured in an extrajudicial reorganization.



EXTRAJUDICIAL REORGANIZATION AS A TOOL TO MINIMIZE DISRUPTIONS TO THE DEBTORS' ACTIVITIES

The use of the extrajudicial reorganization was a determinant factor for the successful restructuring of OOG. One of the key considerations in this deal was the need to preserve the existing contracts and to permit the debtors to continue performing their obligations and generating revenues under these contracts. Any further contract cancellation by the sole customer, or other issues stemming from the restructuring that could significantly impact OOG's performance on the ongoing projects (such as strikes, suspension of operations or other operational issues) could have impaired creditors' recovery prospects and OOG's existence a going concern.

In an extrajudicial reorganization, the law provides flexibility in the establishment and delimitation of the categories of claims being restructured,[6] and the statutory majority of 60% of each of these categories must approve the plan. In OOG's restructuring, the three categories of claims were: 2021 notes, 2022 notes and unsecured financial claims at the OOG level. This was an important tool to avoid disruption to the debtors' activities. A filing for judicial reorganization would have unnecessarily brought multiple other stakeholders to the negotiation table and raised concerns with the sole customer, suppliers, service providers, joint venture partners and project financing creditors in other OOG projects.

[6] An extrajudicial reorganization plan may follow the broad categories under the judicial reorganization rules (secured, unsecured, small claims), or may follow different criteria, such as suppliers, bank lenders, bondholders, etc.

EXTRAJUDICIAL REORGANIZATION AS AN EFFECTIVE MECHANISM TO RESTRUCTURE INTERNATIONAL BONDS

The extrajudicial reorganization can be an effective mechanism to overcome the unanimous or supra-majority requirements for amending bonds governed by New York law. U.S. bankruptcy courts have consistently recognized that Brazilian insolvency proceedings (judicial reorganizations and extrajudicial reorganizations) are not contrary to U.S. public policy, as they provide the required minimum due process protections and do not otherwise violate basic U.S. law public policy principles. Therefore, plans validly approved pursuant to Brazilian restructuring proceedings are typically recognized and deemed enforceable in the United States.

In OOG's restructuring, despite the preservation of the principal and interest rate on the 2021 and 2022 notes, the extrajudicial reorganization plans provided for a mandatory exchange of the project bonds for new notes with different amortization schedules and interest payment terms. These changes, among others contemplated in the plans, were subject to unanimous bondholder approval pursuant to the terms of the bond indentures, which were governed by New York law.[7] As part of the extrajudicial reorganization, each series of project bonds was deemed a separate category of claims, and these changes were approved by at least 60 percent of the holders of each series and confirmed by Brazilian court.

This was not the first time that an extrajudicial reorganization was used as means to restructure international bonds. In 2016, USJ Açúcar e Álcool S.A., a Brazilian sugar and ethanol producer, sought to restructure its unsecured bonds, issued under an indenture governed by New York law. The debtor proposed to exchange its unsecured bonds for newly issued secured bonds, in the face amount of 75 percent of the unsecured bonds, conditioned upon acceptance of 90 percent of the bondholders. However, if the exchange offer did not obtain a participation of 90 percent in the exchange offer, but obtained more than 60 percent, the debtor would file for extrajudicial reorganization and seek confirmation from the court, cramming down the dissenting bondholders. So, as a condition for a valid tender of the bonds in the exchange offer, bondholders were required to sign the documentation approving an extrajudi-

[7] The U.S. Trust Indenture Act of 1939 ("TIA") does not permit amendments of certain key payment and related terms in a bond indenture qualified under the TIA without unanimous approval of the bondholders. A similar rule is typically reproduced in New York-law governed indentures that are not qualified under the TIA, as it was the case of the indenture for the project bonds.

cial reorganization plan attached to the exchange offer memorandum. Eventually, the debtor obtained the necessary participation and successfully concluded the exchange offer, and the filing for extrajudicial reorganization was not necessary.[8]

In 2014, Lupatech obtained approval by 85 percent of the holders of its 9.875 percent unsecured perpetual bonds and implemented the exchange for new notes in the face value of 15 percent of the restructured notes and the right to subscribe for American depositary receipts representing one common share of the company. Although the transaction was successful from a legal perspective, the debtor failed to make payments on the restructured bonds and eventually filed for judicial reorganization in 2015.

OTHER LESSONS LEARNED FROM OOG

OOG's restructuring clarified other important aspects of the extrajudicial reorganization process, and brought important lessons for future restructurings:

- **Brazilian courts recognize jurisdiction over foreign subsidiaries of a Brazilian debtor in the context of an extrajudicial reorganization.** The court accepted jurisdiction over ten offshore entities controlled by OOG, applying to an extrajudicial reorganization the same center of main interest (COMI) principle previously recognized by Brazilian courts in connection with judicial reorganizations.
- **There may be stay, but it is not automatic.** In contrast with a filing for judicial reorganization, the filing for an extrajudicial reorganization (or the acceptance of such filing by the court) does not result in an automatic stay of the claims against the debtors. In OOG's case, the court confirmed the understanding that, upon request of the debtors, the court can grant a stay of the claims of the categories being restructured, after a compliant plan has been filed with the courts.
- **Narrow grounds for challenges and judicial revision.** Dissenting creditors have narrow grounds to challenge an extrajudicial reorganization plan. The decision that confirmed OOG's extrajudicial reorganization plans mentioned that the economic terms of the plans are irrelevant for purposes of court approval, and that the judicial review is limited to the legality of the plans. Under Brazilian bankruptcy law, the grounds for challenging an extrajudicial reorganization plan are: (i) failure to obtain approval by the statutory majority, (ii) certain concerted actions to defraud creditors, (iii) breach of law, or (iv) other actions that under Brazilian law could authorize creditors to file for involuntary bankruptcy of the debtors.

[8] Cleary Gottlieb represented the dealer managers in connection with USJ's exchange offer and consent solicitation for extrajudicial reorganization.

- **Simple approval process.** An extrajudicial reorganization plan at its inception has a contractual nature, and must be validly executed and delivered by creditors representing the 60 percent statutory majority before filing. This may be challenging in cases were creditors are widespread international bondholders; Brazilian law is generally formalistic, particularly when foreign parties are involved, and an overcomplicated process not in line with international practices could jeopardize the approval by the 60 percent statutory majority. In OOG's case, the mechanism for approval by the bondholders was simple and straightforward, successfully avoiding the long and painful process of individualization of claims typically followed in connection with Brazilian judicial reorganizations. The record holder of the bonds, Cede & Co., the nominee of DTC, issued an omnibus proxy to the DTC participants, who in turn received approval instructions from the beneficial owners of the notes. Each DTC participant gave a formal voting instruction and power of attorney to an information agent, who validly executed and delivered the extrajudicial reorganization plans on behalf of holders representing more than 60 percent of each series of bonds. This approval process was accepted by the Brazilian court.
- **No suspensory effect of appeals.** The decision that confirms an extrajudicial reorganization plan is subject to appeal to the state court of appeals (in OOG's case, the court of appeals of the state of Rio de Janeiro). This type of appeal does not automatically have suspensory effect to stay the effectiveness of the plan, and therefore does not prevent implementation. The court of appeals may, however, grant suspensory effect, subject to the satisfaction of the grounds for such injunctive relief under Brazilian law. In OOG, the court of appeals of Rio de Janeiro rejected a request for suspensory effect in connection the appeals filed by two creditors, confirming that the grant of such suspensory effect is an exceptional measure. This mitigates the risks of the interminable appeals in the Brazilian legal system.
- **Chapter 15 confirmation**. The U.S. federal bankruptcy court for the Southern District of New York recognized the Brazilian extrajudicial reorganization as the foreign main proceeding for OOG and all other debtors. This decision confirms a trend of recognition of Brazilian proceedings and the understanding that plans duly approved by Brazilian courts are not manifestly contrary to U.S. public policy.[9] The U.S. court gave full force and effect to the Brazilian proceeding and granted the appropriate relief for implementation and enforcement of the plans in the United States.

[9] U.S. bankruptcy courts have granted recognition to a number of Brazilian proceedings in Chapter 15. Most cases were uncontested, but in connection with the restructuring of Grupo Rede, OAS and Oi S.A., U.S. bankruptcy courts addressed specific challenges of dissatisfied creditor groups and confirmed that the plans were not manifestly contrary to U.S. public policy and that substantive matters must be discussed before Brazilian courts.

CONCLUSION

Extrajudicial reorganization can be an effective and expedited restructuring tool for cross-border debt restructurings of Brazilian entities or entities whose center of main interest is Brazil. The proceeding provides fewer opportunities for litigious creditors and can be used to bind minority dissenting creditors. It may not be used to restructure all types of claims, or where a stay of litigation is necessary during negotiations, but under the right conditions, the extrajudicial reorganization can be an elegant and efficient instrument that allows for the restructuring of bonds governed by New York law, without the need for a long and complex judicial proceeding in Brazil that oftentimes destroys value for all constituents and disrupt the debtor's activities.