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The Brazilian Insolvency Regime: Some Modest Suggestions—Part I

By Richard J. Cooper, Francisco L. Cestero, Jesse W. Mosier, and Daniel J. Soltman*

This two-part article is loosely organized chronologically according to the typical life of a Brazilian restructuring. The first part of this article focuses on (i) the need to improve the recuperação extrajudicial process and ensure specialized knowledge of courts overseeing recuperação judicial proceedings, (ii) the need to expand the reach of the courts to approve and facilitate debtor-in-possession financing, and (iii) a debtor's relationship with its vendors and its need to have the ability to (A) prefer critical vendors over other creditors in order to ensure continued service and operations and (B) extract itself from overly burdensome contracts. The second part of this article, which will appear in an upcoming issue of Pratt's Journal of Bankruptcy Law, *focuses on the plan of reorganization, where the authors recommend (i) creditor-focused standards for substantive consolidation, (ii) allowing creditors to propose a plan of reorganization, (iii) simplifying the process for bondholder voting on a plan, and (iv) scaling back the restrictions against repeated reorganization filings.*

At the time it entered into force in 2005, Brazil's new insolvency regime (the "Brazilian Insolvency Regime") was being hailed as the most modern insolvency regime in Latin America, indeed perhaps throughout the emerging markets. It included broad reforms providing for a restructuring either through in-court restructuring (*recuperação judicial*) or out-of-court restructuring (*recuperação extrajudicial*); it contemplated debtor-in possession financing; it permitted Section 363 type sales free and clear of adverse liens and encumbrances; and it contained look back and anti-fraud protections against questionable transactions and misbehavior by debtors and shareholders alike. And, by almost any measure, the Brazilian Insolvency Regime has been a marked improvement over

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its predecessor regime. For example, under the old regime, the average creditor recovery rate was 0.2 percent[1] and reorganizations took, on average, 10 years.[2] As of June 2014, the average creditor recovery rate was up to 25.8 percent and the average time of reorganization was down to four years.[3] While these are unquestionably positive developments, there is still progress to be made. For example, as of June 2014, the average creditor recovery rate among all Latin American and Caribbean jurisdictions was 36.0 percent and the average time spent in reorganization was 2.9 years.[4] Of course, creditor recovery rate and time spent under reorganization are by no means the only metrics by which to evaluate the Brazilian Insolvency Regime or to compare it to other insolvency regimes. Nevertheless, they are a useful place to start an analysis of Brazil's current insolvency regime and are helpful in identifying areas for improvement.

With that in mind, this article examines certain aspects of the Brazilian Insolvency Regime and identifies seven areas for potential improvement. Although there is undoubtedly a broader collection of improvements one could suggest, we have specifically identified areas where we think relatively modest reforms could produce a much more efficient, effective and predictable process for debtors and creditors alike, ultimately increasing confidence in the system and resulting in more successful restructurings.

This two-part article is loosely organized chronologically according to the typical life of a restructuring. The first part of the article focuses on (i) the need to improve the *recuperação extrajudicial* process and ensure specialized knowledge of courts overseeing *recuperação judicial* proceedings, (ii) the need to expand the reach of the courts to approve and facilitate debtor-in-possession ("DIP") financing, and (iii) a debtor's relationship with its vendors and its need to have the ability to (A) prefer critical vendors over other creditors in order to ensure continued service and operations and (B) extract itself from overly burdensome contracts. The second part of the article focuses on the plan of reorganization, where we recommend (i) creditor-focused standards for substantive consolidation, (ii) allowing creditors to propose a plan of reorganization, (iii) simplifying the process for bondholder voting on a plan, and (iv)

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[1] Jeffrey M. Anapolsky, & Jessica F. Woods, *Pitfalls in Brazilian Bankruptcy Law for International Bond Investors*, 8 J. Bus. & Tech. L. 397 (2013).

[2] Aloisio Araujo, Banco Central do Brazil, Bankruptcy law, bank liquidations and the case of Brazil, http://www.bcb.gov.br/secre/apres/Aloisio_Araujo-Bacen.pdf.

[3] World Bank, Doing Business, http://www.doingbusiness.org/data/exploretopics/resolving-insolvency.

[4] World Bank, Doing Business, http://www.doingbusiness.org/data/exploretopics/resolving-insolvency.

scaling back the restrictions against repeated reorganization filings.

EXTRAJUDICIAL REORGANIZATION / SPECIALIZED COURTS

The timing and predictability of reorganization proceedings can dramatically impact the value of the process for both debtors and creditors. Proceedings that drag on for years longer than expected, or that take unanticipated turns, mean that business plans and financial models are guesswork at best, thereby defeating one of the primary purposes of reorganization proceedings. As mentioned, while the average time for a reorganization in Brazil has decreased, it still remains higher than other Latin American and Caribbean jurisdictions. Even more important than the length of time necessary to exit reorganization, is the predictability of when the exit will occur. This is particularly a problem in Brazil where protracted and sometimes groundless appeals can follow a nearly unanimous vote approving a plan at a general meeting of creditors. In addition, in recent years, a number of Brazilian *recuperação judicial* proceedings have resulted in wholly unexpected and unpredictable results for certain groups of creditors. Both of these situations have impacted the credibility of the Brazilian Insolvency Regime and undermined the confidence of creditors in the process.

There are two obvious, although not necessarily simple, ways to improve the timing and predictability of Brazilian reorganization proceedings. The first, and arguably more straight-forward way, would be to improve the *recuperação extrajudicial* process, so that both creditors and debtors consider it as a serious alternative to *recuperação judicial*. The second, and potentially more complicated way, is to create specialized bankruptcy courts, or to specifically designate certain existing courts as the exclusive venues for all bankruptcy and insolvency proceedings, so that jurists have the opportunity to develop relevant expertise and establish precedent, ultimately leading to a more predictable and transparent insolvency regime.

The first option, improving the *recuperação extrajudicial* process, would provide debtors and creditors alike with better opportunities to negotiate a prepackaged reorganization plan prior to submitting anything to a court. In a perfect world, once a prepackaged and creditor-approved plan is submitted to a court, its jurisdiction would be limited to analyzing the legality and viability of the plan, thereby providing for a much swifter and potentially less contentious exit from reorganization proceedings. Unfortunately, and in contrast to several other Latin American jurisdictions, a number of features of the *recuperação extrajudicial* process in Brazil make it relatively less desirable than its in-court analog.

As one of the authors here has described elsewhere,[5] *recuperação extrajudicial* is problematic because the thresholds for creditor approval are higher in a *recuperação extrajudicial*, requiring 60 percent approval of creditors for each category of claim, as compared to a simple majority of each class in a *recuperação judicial*. Further, unlike the *recuperação judicial*, labor claims are excluded from *recuperação extrajudicial* proceedings, which makes it difficult for debtors to address both operational and balance sheet concerns. As is the case in prepackaged restructurings in most other jurisdictions, there is no automatic stay applicable during the negotiation of the reorganization plan, and so initiating negotiations opens the debtor up to remedial actions by creditors that might not otherwise have been taken. This problem is particularly acute in Brazil, because, as described below, vendors and financial creditors regularly file *protestos* and other suits against defaulting debtors, pushing them prematurely into a judicial filing.

Another problematic aspect of the *recuperação extrajudicial* process is that, while there is no explicit prohibition on DIP financing, there are also no provisions in the law allowing for it. Therefore, even in circumstances where it would be helpful, there is no established procedure or clear authority for courts to grant collateral to secure DIP financing or give priority to DIP financing in a subsequent liquidation proceeding. In the absence of collateral or priority, it is very unlikely that any lender would be willing to provide DIP financing. This makes it difficult for debtors to continue operating in the face of liquidity crises, which can become more severe once reorganization negotiations commence or vendors begin to file *protestos* in an attempt to pressure the debtor and beat their fellow creditors to the courthouse.[6] In addition, unlike in the *recuperação judicial* context, where there is favorable precedent, there is some doubt as to whether, in a *recuperação extrajudicial* proceeding, creditors can be forced to become equity holders as part of the reorganization plan. Finally, even though prepackaged deals are in theory subject only to minimal court review, for many of the reasons described below in the *recuperação judicial* context, timely and final approval by the courts is far from guaranteed.

Contrasting the Brazilian experience with the extrajudicial reorganization processes in other Latin American jurisdictions, the room for Brazil's improvement becomes even more apparent. The Mexican *concurso con plan de reestructura previo*, adopted in 2007, is widely considered to be the most

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[5] Richard J. Cooper, Adam Brenneman & Jessica E. McBride, *A New World for LatAm Creditors: Insolvency Reform in Latin America*, 11 Pratt's Journal of Bankruptcy Law 190 (2015).

[6] As discussed later, availability of DIP financing is also a problem in *recuperação judicial* proceedings, albeit for different reasons.

efficient extrajudicial reorganization procedure in Latin America, and a number of high-profile reorganizations have been completed in recent years.[7] A prepackaged deal may be submitted to the court based solely on the debtor's representation that the creditors supporting the plan represent a majority of the voting unsecured debt. Similarly, the Argentine *acuerdo preventivo extrajudicial* ("APE") is utilized more frequently in international insolvencies than the in-court restructuring option, and unlike the Brazilian *recuperação extrajudicial*, the APE requires the same thresholds for creditor approval as the Argentine in court restructuring option. In Peru, while there is no automatic stay in a prepackaged reorganization proceeding, a debtor may apply for, and the insolvency commission generally grants, a discretionary stay as a matter of course. The stay can be granted prior to entering into negotiations with creditors, and lasts until the plan is approved at a creditors' meeting.

While improving Brazil's *recuperação extrajudicial* process would mitigate problems associated with the *recuperação judicial* process by steering troubled companies away from court-supervised reorganizations, some debtors will inevitably end up in court. In addition, as mentioned, even prepackaged *recuperação extrajudicial* plans require court approval. As such, reforms to ensure the predictability of, and depth of judicial knowledge in, Brazilian courts dealing with complex restructurings are essential.

As mentioned above, recent cases have resulted in wholly unexpected and unpredictable results for certain groups of creditors, which have undermined the regime's credibility, particularly among foreign creditors. This is partly due to a lack of uniformity and experience among Brazil's courts—unlike the United States and a number of other jurisdictions, restructuring proceedings in Brazil are not handled by specialized courts, but rather by whichever local court has jurisdiction in the debtor's principal place of business (*local do principal estabelecimento*).[8] As one might expect, the concept of principal place of business is ambiguous, and a lack of appropriate precedent leaves the debtor with much discretion as to where to initially file for *recuperação judicial*. The result is that creditors are exposed to potential abuse and both debtors and creditors face unpredictable outcomes. This issue is compounded by the fact

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[7] *See, e.g.*, Controladora Comercial Mexicana, Sanluis Interco, Metrofinanciera, Iusacell and the various homebuilder cases (Corporación Geo S.A.B., Desarrolladora Homex, S.A.B. de C.V.and Urbi Desarrollos Urbanos S.A.B.) now in or recently out of concurso in Mexico.

[8] We are aware that certain jurisdictions in Brazil have some form of specialized commercial chambers that provide a certain degree of specialization on bankruptcy matters (such as the *Varas Empresariais* in the Rio de Janeiro State Court), though their jurisdiction is not limited to bankruptcy matters.

that only debtors may initiate *recuperação judicial* proceedings—no involuntary petitions by creditors are possible.

Of course, the use of non-specialized courts does not necessarily result in nefarious actions by debtors or inappropriate decisions by judges. Nevertheless, and particularly in complicated international restructurings, advisors for creditors and debtors often have to spend significant time and resources working with judges as they encounter international insolvency issues, many of them for the first time.

The lack of expertise and experience for local courts and judges is compounded by the fact that important aspects of a debtor's operations are outside the jurisdiction of *recuperação judicial* proceedings. For example, tax issues are not subsumed by *recuperação judicial* proceedings, and therefore tax claims, which are often substantial in Brazil, cannot be resolved in bankruptcy. Corporate law issues are also not explicitly subsumed by *recuperação judicial* proceedings. One effect of this lack of exclusive jurisdiction is that the implementation of reorganization plans can be delayed, complicated or, in theory, even impeded because of corporate authorizations, steps or even seemingly unrelated tax rules. Another effect is that if creditors (or debtors) are not satisfied with a particular outcome in the bankruptcy court, it is possible, indeed likely, for them to pursue injunctions or other remedies in other courts for certain matters, further complicating and delaying the process.

In the United States, bankruptcy proceedings are handled by specialized federal bankruptcy courts, and reorganization plans do not have to comply with, for example, normal securities laws rules. The benefits to this approach in terms of predictability, expertise and transparency are obvious. The drawbacks include the costs associated with establishing an entirely new system of courts, and the efforts that would be required by Brazilian bankruptcy practitioners to familiarize themselves with the new system. Recent reforms to the Mexican and Chilean systems represent a cost-effective middle ground that could be emulated by Brazil.

In Chile, while independent bankruptcy courts were not created by its 2014 reforms, the law provided that certain courts would develop a specialty in bankruptcy issues and become the preferred courts for overseeing bankruptcy cases. Also, in addition to court proceedings, it is now possible for a Chilean debtor's bankruptcy proceedings to be submitted to arbitration, with the broad power to adjudicate all matters under the proceedings. Bankruptcy arbitration, as it does in many other contexts, allows for the appointment of arbitrators with particular subject matter expertise. In Mexico, a federal entity (the Federal Institute of Specialists in Mercantile Insolvency and Bankruptcy Procedures, or IFECOM) supervises all aspects of insolvency proceedings, and courts rely

heavily on its expertise and resources. Even in the United States, mediation is a popular tool used by bankruptcy judges to push parties to resolve their disputes and avoid costly and unnecessary litigation.

The goals of improving the *recuperação extrajudicial* procedure and providing for some sort of specialization of the courts supervising *recuperação judicial* proceedings are designed to target similar problems. Specifically, reforms in both areas would likely lead to improvements in the timing of exiting reorganization proceedings and predictability of results. Regardless of whether formal legal reforms in this area are considered, significant benefits for reorganization participants could be obtained by increasing training for judges in the courts most frequently used for reorganization proceedings. Ideally, this training would cover not just aspects related to local Brazilian insolvency law, but also to international aspects and consequences of Brazilian insolvency cases.

DIP FINANCING

One of the most important areas for improvement to the Brazilian Insolvency Regime is with respect to the availability of DIP financing. Most companies enter *recuperação judicial* following a period of strained liquidity, and at a time when they desperately need financing. DIP financings are done in Brazil, but they have not been common. At least part of the reason is likely that while the Brazilian Insolvency Regime recognizes and validates DIP financings in the *recuperação judicial* context, the court's power to facilitate and approve DIP financing is still too limited, and should be expanded to make DIP financing a more attractive option for potential lenders.

Specifically, while the Brazilian Insolvency Regime provides that a court may grant a superpriority lien on unencumbered assets to DIP lenders in a *recuperação judicial* proceeding—a feature that proved crucial in the restructuring of Óleo e Gás Participações S.A., *et al.* ("OGX"), where creditors provided over $250 million in DIP financing to ensure that OGX could continue operating while the restructuring was ongoing—the Brazilian Insolvency Regime has no mechanism by which a court may (i) grant a senior lien to a DIP lender on already encumbered property or (ii) approve a roll-up of prepetition debt into a DIP loan.[9]

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[9] We also note that there are non-bankruptcy impediments to companies procuring DIP financing, including that a bank wishing to lend to a company in *recuperação judicial* must keep 100 percent reserves. While this is not an entirely unreasonable fiscal policy in the wake of the financial crisis, it makes it difficult for local banks to act as DIP lenders. And for anyone that has worked on a DIP financing in Brazil, the myriad of corporate and tax issues that often accompany such a financing can be equally daunting to overcome, particularly for non-Brazilian institutional

Providing a court with the ability to grant a senior lien on already encumbered property, as is possible in other insolvency regimes, such as the United States,[10] would be an important step in improving the chances for a company in *recuperação judicial* to emerge as a stronger, more viable enterprise. As the law stands today, without such ability, a company in *recuperação judicial* without any unencumbered property on the date of its *recuperação judicial* filing may be unable to secure DIP financing at a time when it is most needed, because DIP lenders are unlikely to lend to a financially distressed entity on a junior or unsecured basis. Of course, allowing a court to grant these sorts of priming liens to DIP lenders would also require some form of adequate protection[11] for the original lienholder, by which the lienholder is compensated for the increased risk of nonpayment.

Providing a court with the ability to "roll-up"[12] prepetition debt into post-petition DIP financing would also be an important improvement to the Brazilian Insolvency Regime for two reasons. *First*, a "roll-up" provides debtors with important flexibility in structuring their plans, effectively allowing them to afford the prepetition debt of the DIP lenders the same priority status as the DIP loan itself. *Second*, allowing "roll-ups" would also incentivize prepetition creditors to make DIP loans, which is helpful because prepetition creditors are (i) particularly incentivized to see the debtor succeed and (ii) already familiar with the debtor's operations. Given the potential impact on other creditors when prepetition debt is "rolled-up" into a post-petition priority claim, it would be most appropriate, as is the case in the United States, for courts to grant such roll-ups only when (i) financing cannot be reasonably secured on better terms and (ii) such an arrangement is in the best interest of both debtors and creditors, among other criteria.

Each of these suggested additions to the Brazilian Insolvency Regime would significantly improve a debtor's chances of securing DIP financing while in *recuperação judicial*, thereby paving the way to emergence as a more successful company, a result that would benefit all creditors.

TREATMENT OF CRITICAL VENDORS AND EXECUTORY CONTRACTS

Another key area for improvement is with respect to the debtor's critical

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investors that are not set up to "lend" money in Brazil on an ongoing basis.

[10] *See* 11 U.S.C. § 364(d).

[11] *See* 11 U.S.C. § 361.

[12] A "roll-up" is a term of art used to describe the situation where DIP lenders' prepetition claims are elevated in priority through the terms of the DIP financing.

vendors and counterparties on executory contracts. The Brazilian Insolvency Regime leaves debtors with no challenge-free mechanism through which they can treat critical vendors better than other creditors and impedes debtors' ability to rid themselves of burdensome executory contracts.

While companies in *recuperação judicial* are generally able to continue conducting ordinary course of business transactions, prepetition claims of a debtor's critical vendors are treated in *recuperação judicial* no better than any other claim. As a result, and as mentioned above, vendors often vigorously file *protestos* and other suits against defaulting counterparties. The result is that companies are sometimes pushed into judicial restructuring proceedings when a full *recuperação judicial* is not obviously necessary. In many such cases, a voluntary restructuring of certain financial and/or business contracts might have been sufficient to prevent a lengthy and costly reorganization proceeding. In other cases, an in progress negotiation for a *recuperação extrajudicial* might have to be abandoned because of a lack of stay during such negotiations. In any case, vendors should not be blamed for taking actions to protect themselves. Instead, focus should be placed on the Brazilian Insolvency Regime, which does not provide critical vendors with sufficient protections.

When a company enters a liquidity crisis, its vendors are often the first to miss out on payments. Unfortunately, in Brazil, vendors are incentivized to file *protestos* against their counterparties at the first sign of trouble, in order to preserve the value of their claims. The lodging of a formal *protesto* by a creditor (vendor or otherwise) occurs prior to any insolvency filing, and allows the creditor a speedier, one-time attempt to recover an overdue amount from a debtor. Any amounts not recovered via *protesto* would become general claims in any insolvency proceeding, with a creditor likely to receive a far smaller percentage of its initial claim.

The result of this rush to file *protestos* is that companies that were possibly experiencing only minor financial strain can suddenly find themselves facing a barrage of claims, and in an attempt to avoid the threat of an involuntary liquidation proceeding or mounting legal costs, decide to file for *recuperação judicial*. The conflicts that can arise between debtors and suppliers during the early stages of financial difficulties, as a result of the lack of special protection for critical vendors' prepetition claims, can exacerbate supply problems for debtors precisely at the time when they most need to ensure stability in their supplies (and costs). In addition, the inability to treat critical vendors' prepetition claims differently hinders the debtor's ability to prioritize necessary services from the vendor after the filing of the plan of reorganization. Although some debtors have built in provisions in their plans to deal with critical vendors, the absence of legal protections under the Brazilian Insolvency Regime adds

challenges and implementation risks to a plan. The *recuperação judicial* process is intended to preserve businesses as going concerns, and incentivizing vendors to be trigger happy with their claims does not contribute to that result.

Contrast this situation with the newly reformed Chilean insolvency regime, which has taken specific steps to add protections for trade creditors. In Chile, prepetition debt of certain vendors, as well as international trade creditors, can receive preferential status in the reorganization, as long as such counterparties continue providing services to the debtor during the proceedings. The new Chilean regime was also the first Latin American jurisdiction to adopt a U.S. style prohibition on the termination and acceleration of a debtor's contract on the grounds of insolvency.

On the other side of the coin, under the Brazilian Insolvency Regime, debtor companies have a difficult time rejecting executory contracts. As a result, debtors often continue to be saddled with burdensome prepetition contracts that no longer make sense from an operational perspective. Indeed, claims related to rental and lease arrangements (*arrendamento mercantil*) are explicitly excluded from reorganization proceedings. More generally, debtors have no specific right to terminate or reject contracts as a result of being in insolvency proceedings, but rather only those rights normally available under contract law. If a debtor terminates an executory contract during a *recuperação judicial* proceeding, in breach of its obligations thereunder, the counterparty's claim for damages does not become part of the reorganization plan, but rather must be dealt with outside of the plan.

The United States and several Latin American jurisdictions take different approaches to executory contracts. In each of the United States, Argentina and Mexico, executory contracts can be either assumed or rejected during a judicial reorganization proceeding. In the United States, a debtor may decide to assume, assume and assign to a third party or reject an executory contract, provided that, if it assumes or assumes and assigns, it (or the assignee, where applicable) must cure any defaults and provide adequate assurance of future performance. Rejecting a contract is considered a breach, but assuming the debtor rejects the contract immediately upon filing, the breach is deemed to have occurred immediately before the restructuring petition. Therefore, any claim arising from the contract would usually be treated as a prepetition unsecured claim, and not entitled to any priority. Moreover, damages would be determined under standard contract law, which generally require the non-breaching party to take measures to mitigate damages.

In Argentina, a debtor can assume or reject contracts entered into prior to the proceedings pursuant to which both parties have reciprocal binding obligations, though such rejections are subject to approval by the bankruptcy court.

Similarly, in Mexico, executory contracts can be rejected, but only at the decision of a court appointed mediator (*conciliador*). Otherwise, Mexican debtors may generally only terminate contracts if expressly provided for in the relevant agreement.

In both of the above areas, special treatment for critical vendors and relief from executory contracts, the Brazilian Insolvency Regime should be reformed in such a way that focuses on preserving the debtor as a going concern by instituting more practical approaches towards relationships with non-financial contractual counterparties.

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The second part of this article will appear in an upcoming issue of *Pratt's Journal of Bankruptcy Law*.