SALES OF BUSINESSES IN INTERNATIONAL CASES: CLEAR OR NOT-SO-CLEAR TITLE?

Recent Developments under Brazil's New Bankruptcy and Restructuring Law

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Brazil's New Bankruptcy Law (BNBL) which took effect on June 9, 2005 represents a great advance in respect to the anachronistic retired statute of 1945. Aligned with the modernisation wave of the insolvency statutes carried out by most developed countries, modelled upon the fundamental premises of the United States Bankruptcy Code and the bankruptcy statutes of other industrialised nations, it represents the first major overhaul of Brazil’s corporate reorganisation laws in over half a century and introduces a variety of innovative concepts into the field of insolvency.

Introductory considerations

Its underlying principle is that a viable company facing financial crisis possesses and generates greater socio-economic value as a going-concern than it would from the forced sale of its assets through a court-supervised liquidation and creates two legal proceedings, Judicial and Out-of-Court Reorganisations, which enable debtors to obtain court approval of reorganisation plans negotiated directly with their creditors. These two new restructuring proceedings will permit Brazilian debtors to engage in an extensive array of rehabilitation strategies familiar to debtors pursuing Chapter 11 reorganisations under the United States Bankruptcy Code. Moreover, these proceedings create a central role for creditors as they are contingent upon court confirmed plans of reorganisation negotiated directly with creditors.

Its key contributions are: (i) its strong orientation towards preserving viable businesses and respective jobs and resulting socio-economic benefits; (ii) provision of greater alternatives for the rescue of viable businesses, even in cases of bankruptcy liquidation, where priority is given to the maintenance of the going concern and the sale of the business as such rather than liquidating its assets at salvage values, which causes great damage to the complete value chain and jobs; (iii) the dissociation between the fate of the social cell called company and of its founders or controlling shareholders; (iv) diligence; and (v) ample reduction of the legal bureaucracy and proceedings.

Another significant improvement of the BNBL is that it eliminates successor liability with respect to certain categories of claims. In particular, purchasers of certain types of the debtor's assets during a Judicial Reorganisation (e.g. separate production units or branches of the debtor's operations) will no longer inherit legal responsibility to pay the debtor's obligations for tax claims (and possibly labour or work-related injury claims and social security claims).

Major procedures and dispositions of BNBL

Eligibility

Prior to initiating a Judicial Reorganisation, a company must demonstrate that it has been conducting its operations on a continuous basis for a two-year period and fulfill other requirements, including: (i) a debtor cannot be engaged in a pending insolvency proceeding under Brazil's prior bankruptcy law; (ii) cannot have been involved in a Judicial Reorganisation within the past five years - or within the past eight years if it is organised as a micro enterprise or small business entity; (iii) the company's directors and officers cannot possess prior convictions for bankruptcy crimes prescribed by the BNBL.

Petitioning

A company must file both a petition for Judicial Reorganisation and a set of statutorily prescribed documents: (i) a comprehensive description of the circumstances leading to the company's financial or economic crisis; (ii) financial statements covering the past three years as well as post commencement cash flow projections; (iii) detailed schedule of all of its creditors and related information existing as of the commencement date; (iv) a schedule of the company's employees and their claims; (v) a set of corporate documents; (vi) a complete inventory of its assets, including copies of bank statements and a description and value of all investments; (vii) an index of pending legal actions in which it is a party; and (viii) a list detailing the assets owned by its directors and officers. The petition and related documents should be filed in the state court having jurisdiction over the company's principal place of business.

Petition court approval

Once properly filing the petition and supporting documents in the appropriate venue, the court is required to enter an order granting the processing
of the Judicial Reorganisation. Among other things, the court's order will: (i) require the debtor to publish an official notice of the commencement of the Judicial Reorganisation which contains important information for creditors (e.g. deadline to file proofs of claim); (ii) impose a limited form of automatic stay on litigation or collection actions pending against the debtor; (iii) appoint a Judicial Trustee (Trustee); and (iv) instruct the debtor to adhere to certain guidelines during the reorganisation proceeding (e.g. file monthly operating reports).

**Automatic stay**

The BNBL imposes a non-extendable 180 days moratorium on the continuation or commencement of most types of litigation and collection proceedings against a debtor. The BNBL's automatic stay will bestow upon a Brazilian debtor an important reprieve from creditors permitting such debtor time to focus on restructuring its operations and negotiating an acceptable plan of reorganisation with its creditors.

Following the expiration of the automatic stay period, the debtor’s creditors possess an immediate right to resume or commence litigation or collection actions against the debtor without the need for further order of the court. The automatic stay does not apply to taxes. Accordingly, tax authorities may continue to pursue their claims against the debtor throughout a Judicial Reorganisation.

**Trustee**

As stated above, the court order granting the processing of a Judicial Reorganisation will appoint a Trustee. Supervised by the court and the Creditors Committee, the role of the Trustee is a combination of a claims administrator and an independent watchdog entrusted with supervising the debtor’s progress throughout the various stages of its reorganisation.

During a Judicial Reorganisation, a Trustee is required to perform statutorily prescribed tasks, including: (i) serving creditors with the notice of the commencement of the case; (ii) verifying claims; (iii) preparing and filing with the court the equivalent of schedules and statements of financial affairs; and (iv) submitting monthly status reports to the court describing the debtor’s restructuring activities or progress in fulfilling its obligations under a confirmed plan of reorganisation.

The BNBL empowers the Trustee to obtain any information from a debtor or its creditors which the Trustee believes is necessary to fulfill his or her obligations. Also, the Trustee may request the court to call a Creditors Meeting whenever the Trustee believes that there is an issue requiring creditor input (e.g. to consider approval of a plan of reorganisation). Furthermore, the Trustee may seek conversion of the Judicial Reorganisation to Bankruptcy liquidation in the event that the debtor fails to satisfy its obligations under the BNBL.

The BNBL authorises the Trustee to retain professionals with prior approval of the court. The professional fees for the Trustee, as well as for his or her retained professionals, will be determined by the court upon application. In assessing professional fee requests, the court is required to consider the complexity of the work performed, whether such tasks are typically charged to clients in other contexts, and the market rate for such services. On a Judicial Reorganisation, the maximum permitted professional fees for the Trustee may not exceed 5% of the total amount of consideration paid to creditors under a confirmed plan of reorganisation. Finally, any professional fees awarded to a Trustee and his or her retained professionals are to be paid from the debtor’s estate.

**Debtor in possession and judicial manager**

Despite the appointment of a Trustee, the BNBL vests broad authority in the debtor’s current management to conduct the company’s business during a Judicial Reorganisation. Debtor’s management may be removed for cause or by deliberation of the General Creditors Meeting. In particular, cause may be found where any of the debtor’s directors and officers are convicted of a bankruptcy crime or engage in any of the following proscribed activities: (i) commit fraud against the creditors; (ii) incur excessive personal expenses; (iii) bring about the equivalent of the deepening insolvency of the debtor; or (iv) fail to cooperate with the Creditors Committee or Trustee.

If debtor’s directors and officers are removed, BNBL empowers the court to convene a special Creditors Meeting for the purpose of selecting a Judicial Manager who will assume the administration of the debtor’s operations. Until a Judicial Manager is chosen by creditors attending the special Creditors Meeting, the Trustee is required to serve as the interim administrator of the debtor’s estate.

**Creditors Committee**

The Creditors Committee is comprised of three members, one representative appointed from each of three statutorily created classes of claims entitled to vote at a Creditors Meeting including: (i) labour and work-related injury claims (Class 1); (ii) secured claims (in rem) (Class 2); and (iii) all other claims (e.g. unsecured claims) (Class 3).

In the event that there are creditors existing in only two of the three classes, the BNBL permits a Creditors Committee to be formed by only two
representatives. The basic function of the Creditors Committee is to police the debtor and the Trustee.

**General creditors meeting**

If the proposed reorganisation plan is unopposed by any creditor, the court must confirm it. However, if any single creditor files an objection to the proposed plan within 30 days from the date on which the official notice is published, the court must convene a general meeting of creditors on at least 15 days’ notice to creditors for the purpose of formally voting to approve or reject the plan. Creditors attending the Creditors Meeting will be divided into one of three classes indicated above in accordance to the nature of their claims.

**Approval of reorganisation plan**

The debtor’s proposed reorganisation plan is deemed approved by creditors where votes in its favour are obtained from creditors attending the Creditors Meeting representing: (A) a simple majority in the number of claimants holding Class I claims; and (B) (i) a simple majority in the number of claimants holding claims in each of Class 2 and Class 3; and (ii) a majority in the amount of the claims in each of Class 2 and Class 3.

Even if a proposed plan is rejected by one of the three classes, a debtor may nonetheless succeed in obtaining the necessary creditor approval by acquiring votes in its favour from creditors attending the Creditors Meeting representing all of the following: (i) a majority in amount of the combined claims in all three classes; and (ii) two of the three classes (or approval by one of the classes if there are only two classes voting); and (iii) 33% of the claims in the rejecting class (in number for Class 1 or in amount for Class 2 and Class 3). If creditor approval is obtained for a proposed plan, the court must confirm it.

In the event that the debtor is unable or unwilling to amend the proposed reorganisation plan to the satisfaction of creditors attending the Creditors Meeting, the court must convert the case to a bankruptcy liquidation proceeding.

After a court confirms the proposed plan of reorganisation proposed during a Judicial Reorganisation, the debtor will remain under the court’s supervision for a period of up to two years from the date of such confirmation order. During this two-year period, the debtor must satisfactorily perform all of its obligations under the confirmed plan. The non-performance of any such duties represents cause for the court to consider the conversion of the debtor’s Judicial Reorganisation into bankruptcy liquidation.

Once this two-year period ends and the debtor has successfully fulfilled the terms of the confirmed plan, the court will enter an order terminating the Judicial Reorganisation. The order will include certain provisions, such as: (i) requiring the debtor to pay outstanding allowed professional fees of the Trustee and its retained professionals as well as any outstanding court fees; (ii) instructing the Trustee to submit a detailed report with respect to the debtor’s performance under the plan; (iii) dissolving the Creditors Committee (if any); and (iv) providing a release to the Trustee.

**Converting a judicial reorganisation into a bankruptcy liquidation**

A court may find cause under any of a variety of circumstances, such as where: (i) the creditors attending a Creditors Meeting adopt a resolution in favour of conversion; (ii) the debtor fails to timely file its proposed reorganisation plan; (iii) the debtor is unable to obtain creditor approval at the Creditors Meeting for any version of a proposed reorganisation plan; or (iv) the debtor fails to fulfill its obligations under a confirmed plan of reorganisation.

**Out-of-court reorganisation**

Somewhat analogous to a prepackaged chapter 11 proceeding under the United States Bankruptcy Code, the process of an Out-of-Court Reorganisation provides extensive flexibility for debtors to rehabilitate their enterprises. Rather than requiring a putative debtor to propose a plan of reorganisation dealing with all claims held against it, a company may instead negotiate one or more plans of reorganisation with individual creditors or select groups of creditors.

The BNBL permits a company pursuing an Out-of-Court Reorganisation to propose a prepackaged plan with a group of creditors of the same kind and subject to similar payment conditions—a company could propose a prepackaged plan which deals solely with unsecured debt held by “bondholders” but which does not tackle other unsecured claims, or it could develop a prepackaged plan that restructures its debts which are subject to “30-day payment terms”. As a result, companies are provided wide latitude to develop rehabilitation strategies which address particular needs more diligently and at a much lower cost.

After obtaining approval of the proposed prepackaged plan from creditors holding at least 60% of the amount of the claims in each class of creditors (cramdown), the company then initiates a legal proceeding to seek its confirmation by the court.

If the court denies confirmation, a debtor may petition for a new Out-of-Court Reorganisation or seek to initiate a Judicial Reorganisation.
There are limitations related to an Out-of-Court Reorganisation. Tax claims or labour and work-related accident claims, are not eligible for the debt discharge afforded by an Out-of-Court Reorganisation. Also, the automatic stay granted to debtors in a Judicial Reorganisation does not apply in discharge afforded by an Out-of-Court related accident claims. are not eligible for the debt subject to it. Other creditors may continue to confirmed prepackaged plan effectively dismiss Reorganisation. Tax claims or labour and work­

Critical issues which determine the success or failure of the reorganisation process
It is of supreme importance to understand that the BNBL constitutes a legal bedrock, whose objective is to provide the bankruptcy process with the legal regulatory framework, not a panacea for companies in difficulties, and represents a small part of what can be a large and complex puzzle, as the first empirical cases demonstrate. Relatively speaking, writing the new law was the easy part.

The basic nature of a business recovery is managerial-economic, not legal. If a business is not viable, it is not the BNBL that will save it. In the same way that, despite being viable, if management does not have the required credibility along its creditors and the market in general, and the execution capacity, it will not be this good law that will save it. Even if it has the proven viability and an able management with high credibility, in addition to a good strategy and well conceived recovery plan, if not executed in time, going past the point of return, the company will succumb, independently of the BNBL.

It is not the new statute that is being tested with the first bankruptcy cases filed under the new law, but the actions and competencies, and efficiency of its protagonists, companies' governance, management, the judiciary and stakeholders, on whose shoulders truly rely the success of the recovery process, as they are responsible to deliberate with sound experience and judgment, and clear understanding which solution is more suitable to each different situation.

A legal reorganisation must be seen as an exception – in the US the ratio is about 1.6 million liquidations to 12,000 bankruptcy processes per year. Thus, the Judiciary and stakeholders must exercise scrutiny in each individual case in order to avoid abuses, procrastination and frauds, which cause great financial damage and waste of time.

Judges play a central role in the BNBL – depending on their actions, viable businesses may be extinct while other, unfeasible ones, may engage in a never-ending process.

Aspects which need to be observed are: (i) corporate distress is mainly caused by mismanagement, for that reason most bankruptcy cases in developed economies imply on a change of command (more so when frauds are detected), fundamental measure to the success of the company's rehabilitation, as it avoids delays and retrogressions, which generate losses, insecurity and uncertainty; (ii) business viability; (iii) celerity and fulfillment of legal deadlines, as the degeneration process accelerates exponentially; (iv) the quality of the reorganisation plan – plans with low substance and inadequate level of detail generate uncertainty and lack of support from stakeholders; (v) the effectiveness and execution of the plan, which must contemplate changes needed in governance/management, strategy and operations – a "homework" and one of the key prerequisites for the company's recovery, without which it will be difficult to make the necessary balance-sheet restructuring and attract the new capital needed for the operations.

It is important to highlight that the approval of the judicial reorganisation plan constitutes a mere formality, as the real challenge lies in its execution. It may seem obvious, but there are cases where respective approved plans face performance problems; a clear demonstration that the plan was poorly prepared and analysed or of the inability of those responsible for its execution to deliver it or even both. The non-compliance with the approved plan poses serious risk to an already fragile relationship between debtor and its creditors, and above all to the going concern.

One needs to work by the book: (i) new management, reorganisation plan, viability analysis, valuation work and operational and business adjustments; (ii) vendors' support, continuing to supply under normal conditions and possible credit conversion; (iii) support from creditors, DIP finance and possible conversions; (iv) support of employees; and (v) new capital from new players. It is very unlikely that steps ii, iii and iv will occur without the fulfillment of the first, in the same manner that the fifth step will not materialise without the implementation of prior ones.

The logic is simple. If those parties who presently participate in the company's risk do not trust its governance/management and do not believe in the success of the reorganisation plan, those who are outside the risk will not have the slightest
motivation to participate, even if the company presents the most brilliantly conceived legal structure for raising capital.

The first cases show other critical aspects for the success of the restructuring process: judge's awareness as to the correct choice of the bankruptcy trustee, who must possess the required qualifications and experience to perform his/her work effectively — that his/her role is much broader under the new bankruptcy code than under the prior statute, mainly considering that he/she will work inside the company and need great experience in management, finance, control and operations in distressed company environment in order to understand the intricacies involved in the restructuring process; attention to frauds and financial crimes.

The emblematic Varig Airlines case
The initial large and emblematic experiences, such as Varig Airlines and Parmalat Brazil, under the new statute reveal the aspects indicated above, despite their peculiarities. Varig Airlines (estimated negative net worth of US$3.3bn and US$5bn debt), leader among Brazilian airlines in international flights and third domestically with falling market shares in both fronts today at 70% and 19% respectively; 12,000 workers; an aging fleet of 75 aircrafts, 53 in operation, with an average age of 10 years, is the largest bankruptcy case in Brazil's history and has been filed under the New Code of 2005.

To allow a more clear understanding of its dimension and to show that the execution of the reorganisation plan is by far the most important and vulnerable point of the process, we must present a practical comparison between Varig and United Airlines cases. The problems which affected Varig and United are similar; nonetheless the approaches were quite distinct.

The gigantic and well succeeded, recently concluded, United Airlines bankruptcy process is a prime example. In 2002 it had US$24bn and US$23bn in assets and liabilities respectively and had its request for governmental support rejected. In three years, with a new, experienced and effective management team, with high credibility, a well conceived and executed restructuring plan, valuation work and total transparency, it has reduced its costs by US$7bn/year, its debt by US$8bn, its workforce by 20,000 employees (68,000 in 2001), and adjusted its fleet size reducing it by 100 aircraft. United Airlines obtained US$3bn in exit finance and had the support of creditors, distressed investors and suppliers since the start of its rehabilitation process. It rigidly followed a conventional by-the-book method.

Varig's restructuring process started out-of-court in the last decade. Its difficulties worsened in the last four years up to the point that its credit lines were suspended and its vendors imposed more dramatic conditions, leaving the company exposed to an unprecedented crisis, which led it to file for creditors' protection under Brazil's new bankruptcy law in mid-2005.

Despite the long period that Varig is ailing, of the numerous consultants and Brazilian and international financial advisors which were hired, and of the more than 10 CEOs which led it during its decline, the actions taken did not produce the desired effects and the degenerative process continued to accelerate to the point of fatigue.

In fact, the remaining alternatives to save the business or part of it are reaching the limit and are quite latent — continuous reduction of fleet due to maintenance and financial problems, overdue payments on new agreements, government intervention and liquidation of Varig's pension fund, increased tensions with the federal airport agency —

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The Brazilian Corporate Recovery Institute (IBGT)
IBGT was established as an initiative to develop the culture for the prevention and solution of corporate distress in Brazil. With over 600 members and different chapters (including a US chapter in New York City), IBGT is the premier not-for-profit organisation in Brazil aimed at contributing to the research, development, education and dissemination of different crisis prevention techniques and alternatives for the recovery, rescue and restructuring of underperforming businesses. Taking a multi-disciplinary approach, the organisation also focuses on preserving the interests of creditors and investors during reorganisations, as well as ethical considerations during business recovery and insolvency operations. Its members work closely with the Brazilian Congress to provide recommendations on how to improve insolvency legislation. It is a forum that provides a rich cooperation environment among turnaround, corporate renewal and insolvency practitioners — specialists, attorneys, lenders, distressed & PE investors, auditors, accountants, appraisers, liquidators, executive search, consultants, trustees, judges, legislators and representatives of government and academic institutions and national and international organisations. IBGT is a member of INSOL International and American Bankruptcy Institute. Website: www.ibgt.org.br Email: ibgt@ibgt.com.br
Infraero, flight delays and cancellations, among others. If it has not lost the timing, Varig needs peremptorily to adhere to the conventional by-the-book method to increase the chance of success of its recovery process.

Alternatively, if it has past the point of return it would still have the possibility to alienate the business to one of the interested investors. The fact and lesson is: no one company is allowed the luxury of staying in the emergency room for too long.

Perspectives

The perspectives for the preservation of viable businesses are favourable, conditioned to: greater preventive consciousness on the part of companies and creditors; course adjustment on the first alert symptoms; greater transparency and celerity; preventive involvement of banks and creditors in general; judiciary initiatives – creation of bankruptcy courts, greater interaction among judges, international judges’ forums, continuous training; actions of the public attorneys where frauds and financial crimes are identified; greater and earlier involvement of corporate recovery experts and interim managers – including training programmes; training and development of judicial trustees; increase the numbers of informal, non-judicial, reorganisations; gradual reduction of conflict culture; development of a distressed debt market; increased participation distressed private equity investors; development of DIP finance; multi-jurisdictional legislation – model law.

The process of improvement of the application of Brazil’s new bankruptcy law requires proactive initiatives from the judiciary, banks, investors and companies, which will undoubtedly contribute to Brazil’s economic development and social welfare, attracting new investments and reducing the financial risk and interest rates.

About the author:

Jorge Queiroz is Founder and Council Chairman of IBGT (www.ibgt.org.br; chairman@ibgt.com.br) and Managing Principal of AlliancePartners – Business Recovery and Interim Management (www.alliancepartners.com.br). Mr Queiroz is widely regarded as a leading authority in corporate recovery, crisis management and financial restructuring involving large and complex cases of difficult solution; one of the pioneers in the turnaround and workout industry in Brazil with over 25 years of professional turnaround experience; has contributed to the formulation of Brazil’s Bankruptcy Reform of 2005 and the Tax Code of the 1988 Constitutional Reform; has managed numerous difficult and “mission impossible” type, high profile assignments, involving billions of dollars in liabilities. Mr Queiroz has been publicly recognised for his achievements, including awards for company of the year and CEO of the year.

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