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

Sales of Businesses in Insolvency in Brazil

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The Brazilian Bankruptcy Law of 2005 ("BBL") establishes three major mechanisms that may apply to troubled businesses: (i) bankruptcy as forced liquidation, (ii) in-court reorganization, and (iii) out-of-court reorganization (prepackaged equivalent).

For the purpose of the present paper, we will analyze how the BBL treats the sale of business operations more specifically when such operations are subject to in-court reorganization and liquidation and to demonstrate that it provides legal uncontested title and safety to the buyer in addition to representing a good mechanism to both buyer and seller in the pursue of their interests.

1) In-Court Reorganization

Article 47 of the BBL defines that the purpose of the in-court reorganization is to make the overcoming of the economic and financial crisis of the debtor feasible, allowing the maintenance of the going concern, respective jobs and creditors' interests, promoting the preservation of the business, its social-economic role and the stimulation of the economic development in the country.

In the BBL, it is possible to see direct or indirect references to the sale or assignment of the company under reorganization of assets.

Article 50 of the BBL, for example, provides a number of different mechanisms that can be used to reorganize a company, which includes the complete sale of the going concern, partial sale of the company's assets, changes in shareholdings, among others; it expressly authorizes the partial or complete sale of a business operation of the debtor if the sale is provided for in the reorganization plan, duly approved by the company's creditors.

In other words, the BBL gives the parties the possibility of making the reorganization plan feasible, leaving to the Court the duty of authorizing the "agreement" in a reorganization plan settled between debtor and creditors according to the applicable laws.

Such provision is also ratified by article 60 of the BBL, that establishes the sale of branches or operating units if provided under the reorganization plan, and article 66 establishes that after the in-court reorganization plea is filed by the debtor, it cannot sell or encumber assets or rights from its fixed assets in addition to the ones already provided in the reorganization plan, unless express plain and clear need is recognized by the Court.

In Brazil, the partial sale of assets - a manufacturing plant and operating units (jointly referred to as "general assets") - is a common solution used by debtors during in-court reorganization in order to raise their capital needs to maintain their operations or pay some strategic creditors, such as employees , essential vendors , etc.

The sale details as well as which assets it shall be comprised of, are usually part of the reorganization plan, dully approved by the creditors. It includes:

(i) the procedures that can be adopted by the debtor to sell the asset(s), manufacturing plant(s) or business unit(s);

(ii) how the proceeds from the sale are going to be used by the debtor (which creditors will be paid, the percentage that will be distributed among creditors, the percentage that will be used by the debtor as working capital, etc);

(iii) the requirements to sell a manufacturing plant, business unit or the company's control or ownership, etc.

It is also common under BBL that creditors help the company in arranging an interested buyer to one or more of the debtor's establishments or operating units.

In some of the largest in-court reorganization proceedings in Brazil, the financial institutions, which most times hold collateral against the debtor, such as pledges, mortgages, fiduciary property of assets etc., do participate in the sale of a certain establishment or operating unit of the debtor over which they hold collateral.

The main reason for creditor's involvement, besides the usual large sum of their credits, which makes them a strategic creditor with strong voting powers, is that any sale of assets or establishments that constitutes collateral to a creditor must be expressly approved by such creditor, as provided under article 50, paragraph 1 of the BBL.

The sales of the debtor’s general assets can be performed directly between the debtor and the buyer, under the Creditors Committee supervision or, if inexistent, the Judicial Administrator; it can also be sold through a public auction by the Court, or in any other form that is not forbidden by law, as long as it is dully provided under the reorganization plan. The sale, however, must be made at market value of the asset / establishment, with previous valuation by an expert appraiser, as agreed in advance by creditors and debtor.

It is worth to point out that, if an operating unit is sold through a public auction, the asset will be free from any encumbrance and the purchaser will not succeed the debtor in its obligations, including the tax liabilities, as provided under article 60, sole paragraph of the BBL.

Despite not expressly provided under the law, the Brazilian Courts have understood that there is also no succession over the labor claims. Such succession exemption is one of the strongest and most important aspects of the BBL, as it allows for the continuation of the business activity of the respective operating unit by the buyer free and clear of any burden, in observance to the legal principles of the maintenance of the going concern and jobs, as established in article 47 of the BBL.

However, if the sale occurs through a private agreement between the debtor as a seller and a third party buyer, the buyer may succeed in the labor and tax liabilities; at least the ones related to the specific operating unit acquired.

In any of those cases, though, the collateral that once was attached to the asset is no longer applicable.

It is important to emphasize that under BBL’s provisions of in-court reorganization, a sale of the debtor’s going concern business in its totality will not exempt the buyer from succession; BBL provides that only sales of part of the company’s assets, establishments or operating units shall be exempt of succession; it provides that only under liquidation (USC §363 sale equivalent) of the company, buyer is totally exempt of succession.

Nonetheless, a few debtors claim that the BBL does not define the meaning and the extent of what it called an “operating unit”. It can represent quite a risky adventure and even characterize misuse of the regulation, violating the principle of substance over form.

In fact, there have been a few cases in Brazil where debtors under in-court reorganization, according to the reorganization plan, constitute a new separate operating unit (NEWCO) to which it transfers its most important assets, or the majority of its operating business, leaving the original company under reorganization essentially “asset stripped” with only liabilities.

Afterward, the company’s shareholders sell that new operating unit (NEWCO) and, as a consequence, all or huge part of the Company’s assets, including its brand name, to a third party, using the sales proceeds free and clear as defined by NEWCO’s shareholders and leaving the ailing original Company and its creditors only with liabilities.

In such cases the third parties in effect actually purchase the entire company (despite trying to characterize it as an operating unit) without succession of any kind. Consequently, it may be considered a legal violation of BBL provisions and the acquiring party may be liable to the application of tax, labor and other succession rules.

Varig Case:

Varig S/A – Viação Aérea Riograndense (“Varig”),

This is a symbolic case as it was the first large scale judicial cross-border reorganization handled under Brazil’s Bankruptcy Reform of 2005; it took effect on June 9, 2005 and Varig filed its bankruptcy protection petition on the following week, on June 17, 2005.

Varig’s approved reorganization plan contemplated the sale of the company’s brand name, operating assets and business, pursuant to article 60 of the BBL. It also provided for the constitution of a new subsidiary, a new operating unit (referred to as Varig Productive Unit / “UPV” or “New Varig”) to which Varig would transfer its whole complex of intangible assets and rights as well as the moveable assets necessary for the operation of the newly created sub, including flight authorizations certificates (landing slots), contracts, etc, with Varig being called “old Varig”.

In other words, Varig (“Old Varig”) transferred all its most important assets, including its trademark, to its newly created subsidiary “New Varig”, remaining with its real estate assets, current assets, radio stations and Flight Training Center, which would partially provide the cash-flow needs to honor certain liabilities as established in the approved reorganization plan. Consequently Varig’s creditors, among them all its 12 thousand employees and tens of thousands of retirees, were left with an asset stripped debtor whose assets were worth dramatically less then its liabilities.

New Varig was then sold to Varig Logística S/A (“VarigLog” – that had its liquidation recently sentenced by a Sao Paulo Bankruptcy Court under BBL’s provisions), a former wholly owned subsidiary of the ailing Varig which was sold under its bankruptcy proceeding for US$ 24 million to a local SPC specifically created for such purpose, wholly owned by a well known US Vulture Fund.

In addition, the payment of certain creditors was made with debentures issued by the New Varig. As it turned out, Variglog was free and clear of any liens and encumbrances, as well as no succession of labor and tax liabilities from Old Varig.

Following those transactions Variglog’s new owners sold New Varig to Gol Airlines for US$ 320 million.

Employees of the old Varig filed legal claims for their labor and indemnification rights, taking the matter for Superior Court of Justice’s decision. Justice Ari Pargendler, who analyzed the claim, ruled that the sale of New Varig consisted of a sale of a Varig’s operating unit, not all of Varig, and consequently freed the ultimate buyer (Gol Airlines) of succession of responsibilities for the liabilities of the debtor (Old Varig), including debts related to labor and tax claims.

Varig’s case raised a discussion between the Brazilian jurists and Courts as to whether the sale of the UPV characterized the sale of an operating unit or the effective transfer of Varig’s business – the discussion of the principle of substance over form.

The answer to these discussions, however, will depend on a formal definition of the meaning of the expression “operating unit” established by BBL.

Other Cases:

Other cases of sale of assets under bankruptcy reorganizations can be observed in the restructuring of various large Brazilian meat processing - an export intensive segment strongly affected by 2008 crisis – and agribusiness companies such as Agrenco do Brasil S/A and its subsidiaries (“Agrenco”), Frigorifico Quatro Marcos Ltda. (“Quatro Marcos”), Grupo Arantes, Frigorifico Estrela and Friforifico Independencia.

Informal, non-judicial, reorgs also took place, with the largest one being the multi-billion merger of giants Sadia and Perdigao.

Agrenco Case:

Under its approved reorganization plan the company – a large agricultural commodities trading and biodiesel company - sold one of its operating units to a third party – Marialva, and the money raised with such sale was used to pay labor creditors and one of its strategic creditors, Banco do Brasil. Its bankruptcy proceedings raised many eyebrows as it filed for bankruptcy protection in August 2008 following a US$ 350 million IPO by its offshore company (located in the Bermudas) through a BDR, and the scandal involving its controlling shareholders who were imprisoned in June 2008 under a fraud investigation. KPMG informed the company it was no longer auditing its financial statements as of June 2008.

Quaro Marcos Case:

The general plan structured by Quatro Marcos and its creditors regarding the sale of assets was quite interesting. Quatro Marcos entered into an Export Pre-payment Agreement (“EPP”) with Royal Bank of Scotland NV

(“ABN NV”), giving, as collateral, the fiduciary property of certain receivables.

ABN NV, afterwards and before the filing of Quatro Marcos for its in-court reorganization, assigned its credits to third parties.

Such creditors constituted the majority of the credits of class II (credits with collateral), and their vote would be decisive to the success of the judicial reorganization.

Following large private discussions between Quatro Marcos and its creditors, as well as numerous Creditors’ General Meetings, Quatro Marcos’ controlling shareholders realized that the only way to make its bankruptcy reorganization feasible was by agreeing to pay the EPP creditors, otherwise they would never have any reorganization plan approved.

Quatro Marcos decided to sell one of its plants (operating unit) and with the money raised, paid the EPP creditors, which allowed for the approval of its judicial reorganization plan.

Grupo Arantes Case:

Grupo Arantes, once one of Brazil’s largest meat processors, with its COMI located in the State of Sao Paulo (Sao Jose do Rio Preto) and pre-petition annual sales of US$ 1 billion, with US$ 600 million of debt, filed for bankruptcy protection in January 2009; merger negotiations with a key player in the segment were interrupted.

Its plan also contemplated sales of assets but the bankruptcy proceedings caused tension among its creditors as its controlling shareholders filed for bankruptcy protection in a remote small town of difficult access located inside the Amazon Forest (so distant that can only be accessed by boat and 100 miles of dirt road, and which doesn’t have a resident judge). Its reorganization plan still was finally approved in January 2010 but financial situation is still precarious.

Frigorifico Independencia Case:

With a total debt of US$ 2 billion, Independencia – Brazil’s third largest - filed for bankruptcy protection in February 2009, three months after Brazil’s Development Bank (BNDES) injected US$ 150 million in Independencia’s capital, which gave BNDES a 22% stake of its control. Reorganization plan confirmed by the court in December 2009 includes the sale of US$ 70 million in assets and contemplates the sale of the control of the company. The company also filed for Chapter 15 relief in the US Bankruptcy Court, Southern District of NY, granted in February 2010. Under the plan its offshore affiliate raised US$ 165 million in Notes issued in March 2010.

The Brazilian Federal Revenue Authorities, understand that in order for the sale to be exempt of taxes to the purchaser, the operating unit must have existed prior to debtor’s filing for bankruptcy reorganization. It does not recognize the succession rule when a production unit is set-up after the in-court reorganization is filed.

Another aspect that must be considered under the BBL is the difference between the sale of part of the assets (including establishments) and the sale of part of the Company’s shares. Differently from the sale of assets, the sale of the Company’s shares does not imply in the change of the tax or legal status of an establishment. In case of partial sale of assets, such as the sale of one of the debtor’s establishments to an unrelated party, on the other hand, there is no succession of liabilities.

The sale of shares also constitutes an important means of reorganization. In such cases, the debtor finds an investor to assume the control of the company, maintaining, however, all debtor’s prior liabilities.

Sementes Selecta Case:

That is what happened, for instance, in the in-court reorganization of Sementes Selecta Ltda (soybeans, byproducts and seeds) in its prepackaged transaction ("Selecta"). Selecta filed for bankruptcy reorganization due to the economic crisis of 2008. Right after filing for bankruptcy protection, Selecta informed its creditors that it already had a new investor interested in the business, the Argentine company Los Grobo, which invested US$ 50 million in new shares issued by Selecta. After the reorganization plan was approved by Creditors, Credit Suisse, a creditor of Selecta, made a US$ 30 million DIP finance to Selecta.

2) Forced Liquidation Proceeding

As established by article 75 of the BBL, the forced liquidation of a company aims at preserving and optimizing the productive use of its assets and productive resources, including intangible assets (USC §363 equivalent).

When the forced liquidation is decreed by the Court, a Judicial Administrator will be nominated (or maintained, in case of a forced liquidation decreed after unsuccessful in-court reorganization).

The Judicial Administrator will consolidate all debtor's assets and documents, being also responsible to carry out the appraisal of such assets, separately or as a whole, requesting court permission to take the necessary measures for that purpose. All assets will be part of the bankrupt estate.

After assets have been identified by the Judicial Administrator, the consummation of the assets will be initiated. Section X of the BBL provides on how the sale of the assets will be handled.

Article 140 of the BBL establishes the forms by which the debtor's assets can be sold and the order of preference for such sale, as follows:

(i) sale of the going concern, with the sale of its establishments as a whole;

(ii) sale of the going concern, with the sale of its branches and operating units separately;

(iii) the sale as a whole of the assets that form each of the debtor's establishments and

(iv) the sale of assets separately considered.

The sale of the going concern as a whole is an innovation in the BBL. Brazil's previous bankruptcy code did not provide for such possibility. It can be noticed that the forced liquidation, aims at maintaining the operations of the Company and of the jobs, for the benefit of the economy and social welfare.

This procedure is similar to a §363 sale under USC. One of the differences is that the stalking horse figure, or a stalking horse for DIP purposes, has not yet been used in Brazil.

Many experts feel that this mechanism is what should have been used by Varig to maximize the proceeds from the sale and minimize losses incurred by tens of thousands employees, retirees and creditors.

The BBL of 2005 establishes that the company will be considered sold as a going concern business when the object of the sale is a group of assets needed to maintain a profitable operation, including the transfer of certain contracts.

Article 141, II of the BBL provides that the asset, establishment or operating unit sold will be free from any encumbrance, also establishing that there will be no succession of any debtor's obligations, including the ones arising from taxes, labor relations and labor accidents, to the purchaser, except:

(i) when the purchaser is a shareholder/quota holder of the bankrupt Company or is a Company controlled directly or indirectly by the bankrupt Company;

(ii) by a relative, in straight line or related up to the 4th degree in family line of the bankrupt shareholder or

(iii) identified as an agent of the bankrupt Company with the purpose of defrauding the succession,

hypothesis under which the purchaser will still be responsible for the purchased company's liabilities.

The sale of assets in a forced liquidation proceeding can be implemented by use of the following methods:

(i) public auction, with oral calls;
(ii) closed proposals and
(iii) trading session,

all of which shall be preceded by the publication of announcement of the liquidation in a widely circulated newspaper, 15 days in advance of the liquidation in case of movable assets and, 30 days of advance in case of immovable assets. The purchaser to claim the asset will be the one who gives the highest call.

The Court may also authorize other forms of judicial sale of the assets, through a justifiable request of the Judicial Administrator or the Creditors' Committee and dully approved by the General Creditors Meeting.

The possibility of selling assets of the company under liquidation regardless the conclusion of the general creditors claims' list is the most important change to the previous Brazil's Bankruptcy Code (Decree Law 7.661 of 1945).

Under the previous law, the possibility of sale of a going concern business was an exception – the alternative mostly employed for going concern businesses seen as viable was the lease of its operating units; in general, the company and all its assets were basically sealed by the Court.

Under BBL of 2005, however, the maintenance of the going concern is the rule and the sealing a last resort, when nothing else can be done to maximize value.

The immediate sale of assets provided in the BBL increases the possibilities of raising higher sums of money for creditors' payments, since in general, assets sold as going concern businesses have much greater value.

For instance, if a debtor detains a strong brand name and it is sold when it is still valuable, the purchaser will obviously be willing to pay more for it.

Mappin Case:

A good example is a large case in Brazil which started in 1999, before BBL's Reform of 2005, when Mappin - a very large billion dollar department store, founded in 1913 - had its liquidation decreed. Back then, Decree Law 7.661/45 was still in force, and it did not provide for the sale of assets before the general creditors claims' list was completed.

The sale of Mappin's trademark (highly valuable and strong in 1999) was only made ten years later in December 2009, when it was finally sold through a public auction for a mere R$ 5 million reais (US$ 2 million) , imposing additional losses to creditors.

Had the trademark been sold in 1999, the bankruptcy estate would receive a much higher amount, since Mappin had been one of the most important and successful department stores in the country for almost a century.

Mappin's liquidation proceedings are far from ending, despite the fact that it has been in place for over ten years, wasting enormous amount of time and money for many parties in interest including the Judiciary, consequently the whole Brazilian Society.

In whatever sales' method employed, any creditor can present an objection in 48 hours. The Judge shall adjudicate them in 5 days.

One of the means of transferring the property of a specific asset, establishment or operating unit is through the Bankruptcy Court authorization - and after the Creditor's Committee has been heard - of its immediate acquisition or adjudication by the creditors, separately or as a whole, by its market value and respected the classification and preference among creditors, as established in article 111 of the BBL.

Furthermore, article 113 provides that the perishable assets, the ones that are subject to considerable devaluation and the ones which conservation is risky or expensive may be sold, in advance, after its evaluation, through Court authorization, after the Creditors Committee and the debtor are heard.

Under forced liquidation, the sale or transfer of assets without the express consent or payment of all creditors and which ends up emptying its assets can be declared null and void; in this sense, it can be revoked by the Court, except if none of the creditors present an objection in 30 days after dully summoned.