

PARTING SHOT: Is Brazil's Bankruptcy Law Ready?

The financial crisis tests the limits of Brazil's bankruptcy system. While the 2005 insolvency law is much better than previous legislation, there is significant room for improvement.

by Thomas Benes Felsberg*



Brazilian law on corporate insolvency and restructuring was revamped in 2005. Prior to the reform, the law enacted in the 1940s was obsolete. It provided no incentive for restructuring of viable businesses, nor was it efficient in liquidating insolvent companies. Insolvent entities, inefficient as they are, were allowed to linger on and their inability to comply with tax, labor, environmental and consumer obligations provided an unfair competitive environment in which viable economic players were expected to thrive, or at least survive.

The enactment of Law 11,101 in 2005 was an initial step towards solving these problems. Drafting the law was no easy task: it demanded over a decade of discussions in congress, several versions and the work of two drafting committees formed in sequence by presidents Cardoso and Lula. The final result, although not perfect, was a modern insolvency law, in line with the standards and guidelines of the World Bank and UNCITRAL, aimed at modernizing credit recovery and preserving the going-concern value of businesses.

Brazil has gained experience in dealing with ajudicial restructurings, which are, in many respects, similar to US Chapter 11 proceedings. Parmalat and Varig were landmark cases, which set the course for approximately 1,000 proceedings since filed. However, experience with applying prepackaged (extrajudicial restructuring) provisions and new provisions related to the liquidation of businesses has been less fruitful due to difficulties of the judiciary and financial institutions assimilating changes made in these areas.

Clearly the time has come to enact certain amendments to the law, as happened in other countries which adopted new rules. In any event, the current crisis will certainly test the limits of the new rules, as well as the response of the judiciary in particular, and of the economy more generally to them.

When to File, How to Reorganize

The focus of the 2005 law is to preserve a business whenever possible and liquidate when necessary. A filing from a debtor's point of view is successful if the required majority of creditors approves a reorganization. From a creditor's perspective, a plan succeeds if it allows credit recovery exceeding the liquidation value of a business.

Under the prior insolvency regime, courts assisted by a public attorney decided whether a company should be liquidated based on rigid statutory provisions. Under the new law, this decision is taken jointly by debtor and creditors. If agreement is not reached, the company will be liquidated by a court-designated judicial administrator, although here again, preference is given to the sale of debtor's activities as a going concern, free from debts and other liabilities. The role of the courts is to supervise proceedings, avoiding distortions, inequalities and any violation of laws.

Brazil's insolvency law provides three mechanisms to deal with financially distressed companies:

(1) Judicial restructuring. A debtor-in-possession court supervised reorganization proceeding, inspired by Chapter 11 of the US Bankruptcy Code, in which the debtor submits a restructuring plan for creditors' approval and court confirmation. If a restructuring proceeding is filed, the debtor shall enjoy a 180-day stay, during which required majorities of creditors must approve a reorganization. If a plan is not approved, the company will be liquidated. The debtor maintains management of an insolvent entity.

The plan must contain a feasibility study and appraisal of a debtor's assets. It must also show that a reorganization is viable and contain a detailed description of the recovery process. The plan may contemplate a plethora of measures destined to restructure a failing company.

One of the most prominent new features is the sale of a debtor's productive unit in which the buyer is released from any of the obligations of the seller. This includes tax and labor obligations, a feature which has provoked the interest of many investors.

In the Varig case, most employees were dismissed and did not receive termination rights, before the company was sold to a US fund and then subsequently to Gol. The issue of whether or not Gol will be liable to cover redundancy payments, or whether the new insolvency law will be upheld, is now before the supreme court in Brasilia and should be decided shortly.

Another interesting feature of the Varig case is that the isolated productive unit which was sold encompassed the domestic and international transportation of persons and cargo, i.e. the bulk of Varig's business. This has set an important precedent for cases in which the principal activity of a business is sold to a third party free from any obligations, of whatever nature.

The judicial restructuring does not encompass tax claims, which continue subject to the rules which were in effect when the new law was approved. Nor does it affect the rights of creditors who hold title to assets such as leasing, chattel mortgages and conditional sales transactions, although the stay period prevents them from repossessing such assets during a restructuring proceeding. The restructuring does not affect advances made to pay foreign exchange contracts deriving from exports (ACCs and ACEs).

The law establishes class-based voting for approval of a judicial restructuring. For purposes of voting on a restructuring, creditors are divided into three classes: employees, secured and unsecured creditors. The plan must be approved by the three mentioned classes at a specially called general meeting of creditors. Once agreed, the plan is confirmed by court and also becomes binding to dissenting creditors. A cram down mechanism is also available if only one class of creditors rejects the plan.

(2) Extrajudicial restructuring. A proceeding where the debtor is able to obtain an agreement with a class or group of creditors before filing a restructuring. A debtor may propose an extrajudicial restructuring to one or more classes of creditors, or groups of creditors which share similar economic interests.

If 60% of the credits belonging to that class or group approve the plan, it becomes binding to all creditors in such a class or group upon court confirmation. All claims which are subject to a judicial restructuring may also be subject to extrajudicial restructuring, with the exception of labor credits.

The cases in which this alternative have been used are increasing, but still rare. One of the reasons is that if a debtor is able to restructure its debt with a large number of creditors, such a debtor in many instances can avoid going to court in order to make an agreement binding on dissenting creditors. The other reason is the novelty of the pre-packaged arrangement.

(3) Bankruptcy, or liquidation. Upon declaration of bankruptcy, the debtor loses control of the activity and is replaced by a judicial administrator. The assets of the bankrupt estate are collected, appraised and subsequently sold, preferably as a going concern, in order to pay creditors in accordance with priority rules provided by law.

Labor claims have the highest priority, but only up to the limit of 150 minimum wages per claim. Secured claims, up to the value of the security, rank second, above tax claims. Unsecured and subordinated credits come last in the list of priorities.

These three alternative procedures are available to any business entity, with the exception of financial institutions, insurance companies, cooperatives and government owned entities. A debtor in financial difficulties may file for any of the described proceedings. Creditors, however, may only request involuntary liquidation.

The debtor is more likely to file for restructuring due to the fact that (i) it retains control of the company (i.e. the debtor is kept in possession of the business); and (ii) it gives equity holders some hope of salvaging at least part of their investment.

An Agenda for Law Reform

The 2005 law was well received by the Brazilian business community. Courts tend to observe the principle of preservation of a viable businesses, mostly in order to protect the interests of stakeholders, which include the preservation of jobs, tax income and economic activity generally.

Due to the new insolvency law and the way it has been applied by the courts, Brazil seems to have an adequate institutional framework to deal with the current world crisis. However, even though the 2005 insolvency law is better, there is room for further improvement. The following shortcomings of the law are noteworthy and should be considered in any upcoming reform:

- (1) Insolvency law should not be restricted to business entities, but have a broader range of application to include cooperatives, non-entrepreneurial entities and government-controlled companies.
- (2) There should not be any creditors excluded from restructuring proceedings. It would make more sense to put them into separate classes and submit them to majority rules. Tax liabilities should receive specific treatment in restructuring proceedings instead of simply being excluded.
- (3) Rules regarding debtor-in-possession financing should be enhanced in order to encourage this activity.
- (4) The activity of the judicial administrator in insolvency cases should be better regulated, in order to protect them against the consequences of good faith error, while maintaining legal protection against willful misconduct or gross negligence.
- (5) Cross-border insolvency provisions should be enacted. Brazil lacks rules for cooperation in international cases. **LF**

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