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ARTICLE

A Short Overview of Brazilian Judicial Restructuring Law

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Synopsis

It is no secret that companies from all over the world have been doing business in Brazil for a long time. It is also well known that the country has faced many turbulent times as a consequence of chronic political crisis. That said, topics like insolvency and bankruptcy, and how the Brazilian legal system deals with such issues, as well as opportunities arising from distressed situations, are very relevant to foreign corporations and investors doing business in Brazil.

Introduction

The current situation in Brazil requires that foreign corporations or investors acquire a deeper understanding of Brazilian restructuring law in order to prevent financial damage and seize new business opportunities.

For example, the judicial restructuring process prevents creditors from lodging, commencing or continuing any demands or claims against the debtor while the debtor prepares a restructuring plan and submits it to the creditors to be discussed by them in a general creditors' meeting in which the restructuring plan will be approved or rejected. If approved, all creditors will be bound by the restructuring plan. If rejected, the judge will declare the bankruptcy of the debtor company.

In general, Brazilian law does not restrict what payment conditions in relation to the outstanding claims can be imposed on the debtor company in a restructuring plan, and restructuring plans therefore commonly include long-term payment proposals with lower interest rates, as well as possibly a significant reduction of the debts owed to the creditors. In many cases approval of the restructuring plan can even lead to a permanent release of contractual guarantees provided by members of the company or third parties.

With permission of the court, the debtor company may conduct a sale of its assets, including whole industrial properties and operating machinery. Provided procedural requirements are met, Brazilian restructuring law also provides for the legal protection of purchasers from succeeding the debtor company's obligations attached to the assets purchased.

General considerations and legal principles

The current law in Brazil that specifically deals with restructuring, insolvency and bankruptcy is Law 11.101 (the 'Bankruptcy Law'). It came into force approximately 13 years ago, replacing the previous legislation which used to regulate this subject matter for over six decades ever since it had been promulgated in June 1945, and is presently being revised.

The Bankruptcy Law permits two different forms of restructuring: judicial (in-court), and extra-judicial (or non-judicial, i.e. out-of-court) restructuring. It also provides for specific procedures for bankruptcy, which is traditionally understood as the liquidation of all assets of the debtor in order to use the proceeds for payment of the creditors and is conducted under complete supervision by a local authority. In this payment process, the local authority strictly follows a legal payment order that favours debts of a labour nature, i.e. payments due to employees or ex-employees, and tax debts.

The objectives of both of these procedures, restructuring and bankruptcy, are quite different, as are the associated procedures. In non-judicial and judicial restructuring the premise is to give the debtor company a chance to overcome the financial crisis it faces, thereby preserving employment, the continuity of its activities and thus stimulating the local economy. By contrast, a classic bankruptcy process focuses on completely removing the company from the market where material evidence and the circumstances confirm that the debtor company is bankrupt or cannot be saved by any other means.

Brazilian legal restructuring methods are similar to those provided for by foreign legislation: The Brazilian judicial restructuring process is similar to Chapter 11 in the USA, and bankruptcy in Brazil is similar to US Chapter 7.

This article does not propose to cover each and every aspect of the subject, but briefly outlines the most relevant aspects of one of the restructuring methods provided for by the Bankruptcy Law: judicial restructuring.

Before considering the process of judicial restructuring in more detail, a few preliminary comments need to be made by way of relevant background:

(i) the debtor is only permitted to commence judicial restructuring if it has been in business for more

than two years and has not undergone a judicial restructuring within the previous five years. The debtor company must not have entered into bankruptcy previously or, if it has, it must be in possession of a judicial decision that has reversed the effects of previous bankruptcy proceedings, and its owners or directors cannot have been convicted of bankruptcy-related crimes;

(ii) in judicial restructuring proceedings, the Bankruptcy Law clearly puts creditors at a disadvantage as a result of the Bankruptcy Law's underlying policy of giving the debtor company a chance to recover to keep the business alive;

(iii) it is common for debtor companies to submit to the creditors long-term payment proposals which offer lower interest rates and often impose significant write-downs of the debts owed to the creditors. In some cases, approval of the restructuring plan even leads to a permanent release of contractual and personal guarantees provided by members of the company or third parties;

(iv) judicial restructuring is a type of collective process to which all of the debtor's creditors (except for tax creditors) will be compulsorily subjected regardless of whether they participate voluntarily, including, for example, the government, government-related entities and debts that are regularly secured by fiduciary property or fiduciary transfer of collateral;

(v) creditors are divided into four distinct classes based on the nature of the debts owed to them: (a) labour and labour accident-related debts, (b) secured debts, (c) ordinary debts, and (d) debts due to smaller companies as defined by Brazilian tax law;

(vi) during the period of two years following the approval of a restructuring plan, the activities of the debtor company will be under regular supervision by a legal representative appointed by the court in order to avoid fraud and deviations from the restructuring plan. If any deviations are detected, bankruptcy of the debtor will normally be ordered.

Overview of the judicial restructuring process

Conceptually, a judicial restructuring process in Brazil can be divided into two distinct stages. The first stage commences when the company files a petition with the local bankruptcy authority and ends with the general creditors' meeting. The second stage represents a two-year period that commences with the judicial decision ratifying the result of the general creditors' meeting and ends with another judicial decision that completes the restructuring process provided the debtor company has strictly complied with the conditions of the restructuring plan during these two years.

As already stated, the process of judicial restructuring commences with the debtor company filing a petition with the local bankruptcy authority which includes all enclosures required by the Bankruptcy Law, such as financial statements, a detailed list of all employees, a complete list of the debtor company's owners' assets, bank statements of all bank accounts of the debtor company, as well as a complete and detailed list of all debts and their respective creditors. This first list is unilaterally produced by the debtor company and will only be inspected by the legal representative appointed by the court at a later stage.

As long as the debtor company filed the petition enclosing all documents required by the Bankruptcy Law, a court will accept the debtor company's petition for initial processing. It should be noted that there have been isolated decisions by a few Brazilian courts demanding that an opinion from an economic and financial viewpoint (principally produced by one of the judge's assistants) be produced before the court would accept to initially process the debtor company's request. The purpose of such an opinion is to check whether all the documents demonstrate a real viability of the business and the company actually has a chance to recover. This is not a strict requirement because there is no statutory provision that requires that judge order such opinion. Therefore, in many (generally most) cases, such opinion is not required by the court and as long as all required documents are enclosed with the petition, the court will accept the company's request. It should also be noted that the Bankruptcy Law does not prescribe a certain period within which the judge is required to decide whether or not to accept the request of the company, which means that it can take anything between a few days up to a few months.

Once the court has accepted the petition, the judge will, as required by law:

(i) appoint his legal representative to verify the origin, nature and value of the debts, organise the general creditors' meeting and monitor, on a monthly basis, the debtor company's strict compliance with its legal obligations;

(ii) order a moratorium on all claims against the debtor company for at least 180 days (known as the 'stay period'), so that creditors cannot individually demand the payment of their claims and thereby frustrate the central objective of the Bankruptcy Law;

(iii) order that the debtor company, on a monthly basis, present actual and detailed information about its activities to the court's representative. Noncompliance with this order may result in the removal of the company's directors.

The debtor company is then required to submit a restructuring plan within 60 days. This time is not extendable (Article 53 of the Bankruptcy Law) and

required in order to allow the court's representative to set the date of the general creditors' meeting. The creditors are entitled to object to the restructuring plan, according to Article 55 of the Bankruptcy Law. If there is no objection, the plan will be approved and the general creditors' meeting will be concluded.

As part of the preparations of the general creditors' meeting, the judge's representative will publish, in the official press, an initial list of creditors based solely on the debtor company's own list of creditors. This may be objected to by any creditor who believes that the amount of debt owed to it or the class in which it was included is not correct or that it has been falsely omitted from the list presented by the debtor company.

These so called 'divergence requests' are reviewed and decided by the judge's representative, who will then publish an updated list. If a creditor still does not agree with the updated list, the creditor can submit a petition directly to the judge, who will decide the request in due time taking into account that the above-mentioned measures are considered preparatory to the general creditors' meeting itself, given that all creditors have the legal right to attend the meeting to discuss the restructuring plan and to vote.

The restructuring plan must describe in detail the classes of the debtor company's creditors. As previously mentioned, creditors are divided into four distinct classes based on the nature of the debt or the nature of the creditor: (a) labour and labour accident-related claims, (b) secured claims, (c) ordinary claims and (d) debts due to small companies as defined by specific Brazilian tax law.

With the exception of labour and labour accident-related claims (which must be paid in 12 months from the approval of the plan by the general creditors' meeting), the Bankruptcy Law does not limit the payment conditions that the debtor company is permitted propose to its remaining creditors. This is in contrast to the previous law, according to which the debtor was strictly obliged to pay all its debts within a maximum of two years and which resulted in the great majority of distressed companies to fail in their applications. Under the Bankruptcy Law, the debtor's proposals will therefore be guided by what the debtor company considers the remaining creditors may be willing to accept. The debtor company, after the approval of the restructuring plan is under a legal duty to strictly to comply with the terms of the restructuring plan, for non-compliance risks that the restructuring process turns into bankruptcy by court order.

The above overview demonstrates that both of the two stages of the judicial restructuring process can result in the judicial recovery process being flipped into to bankruptcy proceedings: Both a rejection of the restructuring plan by the general creditors' meeting at stage one and a failure by the debtor company to comply with the approved restructuring plan will allow the court to order that the bankruptcy of the debtor company be commenced.

Asset sales as an alternative form of restructuring

An important practical option to be considered is the debtor company's ability to sell part of its assets to pay off its debts and thereby accelerate the time to its full recovery. For a debtor company in judicial restructuring, this will also require approval by the judge, who will consider whether there is a reasonable rationale for this course of action or an urgent need and will provide either specific approval during the period prior to the general creditor's meeting or express authorisation in the recovery plan itself once it is approved by the general creditors' meeting. This method is also used to dispose of loss-making companies within the group of the debtor company in order to avoid even greater losses and allow the debtor company to focus on its core business.

According to Brazilian law, this type of sale can be made either by a private and direct sale, by a public and judicial auction procedure. Approval for the asset sale can come directly from the judge, prior to the general creditors' meeting, upon detailed and reasoned request by the debtor company or after hearing his representative and other authorities required by law to supervise the process. Alternatively, such approval can be provided by the general creditors' meeting, provided this alternative form of restructuring is specifically mentioned in the restructuring plan. While a private and direct sale is legally permissible, a prudent purchaser should conduct careful diligence of the process as a whole in order to avoid risks associated with the legal succession by the purchaser and the debtor's obligations attached to the assets purchased.

By comparison, this type of risk does not exist when the assets are sold in a public auction procedure (judicial auction). According to Article 60 of the Bankruptcy Law, those who purchase assets from the debtor company by judicial auction do not thereby assume the debtor company's obligations related to such assets. Once existing liens on the assets sold by judicial sale are extinguished, they attach to the proceeds of the auction sale.

This alternative form of restructuring – which has to be strictly detailed in the restructuring plan – also permits the selling of legal names '*unidade produtiva isolada*' ('isolated productive plant'), i.e. whole industrial properties, including operating machinery, within and during the company's restructuring process.

Issues related to successor liability in the purchase of assets from struggling companies have always been a concern for investors and other parties interested in the purchase of individual assets. Therefore, as described, the Bankruptcy Law enables the purchasing of assets

'clear and free' of liens, which, however, requires an detailed analysis of the situation of the goods to be sold and the process, and a close cooperation with the court's representative, to avoid problems such as a reversal of the sale on appeal.

The general creditors' meeting

In the general creditors' meeting, the restructuring plan is submitted for discussion by all creditors who attend. It is organised directly by the court's representative to take place at an appropriate date within the time allowed in the judicial restructuring process.

It is generally assumed that any disagreement in relation to the creditors' claims has to have been definitively determined by the judge's representative or the judge itself by this point so as to ensure that the general creditors' meeting takes place with all creditors who are interested in attending present.

Personal attendance is not mandatory and proxy powers may be granted. Given that amendments to the restructuring plan can be proposed during the general creditors' meeting so as to give the debtor company the best chance to end the general creditors' meeting with an approved restructuring plan, a prudent creditor should ask its representative to document any objections relating to specific points in the restructuring plan raised during the meeting to ensure that its rights are protected and prevent objections from adversely affecting the creditor in the future.

If the restructuring plan is approved, its terms will bind all creditors, who will receive payment of their claims according to the terms and conditions detailed in the restructuring plan. If it is rejected, the judge will declare the bankruptcy of the debtor company, which results in its assets being listed individually for judicial sale under the supervision of the court's representative.

The proceeds of the sale will be used to satisfy the creditors' claims in accordance with the legal order of preference pursuant to Article 83 of the Bankruptcy Law. The highest priority is afforded to labour and labour accident-related claims, currently limited to a multiple of 150 minimum wages (as in force in Brazil at the time of payment). The next in the order of preference are secured claims (e.g. secured by liens). Payments to secured creditors are limited to the proceeds from the sale of the respective secured assets. The next in line are tax credits and privileged credits (pursuant to the relevant Brazilian laws), and then ordinary claims.

To approve a restructuring plan, all four classes of creditors must approve the plan. Alternatively, the restructuring plan is approved if it is approved by more than half of all of the creditors according to the total amount of debt, regardless of the classes. If the restructuring plan is approved by at least two classes and if, in the class that rejected the restructuring plan, the approval votes count more than one-third of the respective class, the judge can decide a 'forced approval' of the restructuring plan. This prerogative to 'cram-down' dissenting creditors is based on paragraph 1 of Article 58 of the Bankruptcy Law.

As mentioned previously, as there are no restrictions on the terms of a restructuring plan, such plans often contain clauses that personal guarantees from the members of the debtor company or even third parties will lose effectiveness and be fully released upon approval of the plan.

While paragraph 1 of Article 49 of the Bankruptcy Law states that even if such a restructuring plan is approved personal guarantees will not be released, and the highest courts in Brazil currently adhere to this provision, it should be noted that there are isolated judicial decisions which consider that, if the restructuring plan is approved without objection from the creditors as to the release of guarantees, the guarantees are released as provided for in the restructuring plan.

Post-creditors' meeting

Once the restructuring plan has been approved, it is sent to the local judge to ratify the general creditors' meeting's decision and to officially publish the result to all creditors. Any creditor and/or other public authorities legally involved in the restructuring process may appeal this decision, which will be decided by one of the special state courts.

In theory, the general creditors' meeting's decision regarding the restructuring plan conditions should be fully respected and the judicial ratification is a strictly ratifying act. However, the judge has discretion that allows him to partially reject the restructuring plan if it considers that, even if approved by the general creditors' meeting, some of the restructuring plan's conditions represent a violation of rights guaranteed by law.

A practical example of a judge's exercise of the aforementioned power to reject an approved restructuring plan in part would be in relation to a term allowing the payment of labour claims over a period exceeding 12 months. Since Brazilian law expressly requires that claims of this nature must be paid within 12 months, even if the restructuring plan which has been approved by the general creditors' meeting permits a longer period, the judge may deny the plan's effects in relation to this specific point.

From the moment the judge ratifies the restructuring plan, the debtor company will officially stay in recovery and will be inspected monthly by the court's representative during a period of two years.

Once the two-year period expires, if the recovering company has fully complied with the terms of the restructuring plan, the judge will end the judicial restructuring process by judicial decision. If, after this period, the company fails to comply with any of its

obligations under the approved restructuring plan, any creditor is allowed to demand payment of its claim or petition the court to open bankruptcy proceedings with respect to the debtor company.

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