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The New Brazilian Bankruptcy Law

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Introduction

The current Brazilian bankruptcy law was enacted in 1945 providing for the liquidation of insolvent companies instead of giving them the means to overcome their financial difficulties. As a result, the rules in this law establish a procedure that does not allow for the business recovery even if there is one activity which is technically feasible. Assets must be sold separately through auctions that take place many years after the beginning of such a procedure.

As a consequence, many Brazilian Companies in the 80s and 90s had to cease their activities, with prejudice to creditors, employees and the Government itself because there were no legal means which allowed creditors and debtors to renegotiate debts in order to keep a viable business going.

Thus, since 1993, the Brazilian Congress had been discussing the enactment of a Law relating to corporate recovery and bankruptcy proceedings (the 'Law'). After many amendments to its original version, in December 2004, the Brazilian Congress approved the Law. After being sanctioned by the President and published in the Official Daily Gazette, the Law will be effective after a period of 120 days.

It will be applicable from-mid June 2005 to all new requests for recovery or bankruptcy. It can also be applied to ongoing *concordata* proceedings if the company under *concordata* fulfils some specific requirements.

In contrast with from the current legislation, the Law contemplates the recovery of economically viable companies facing temporary financial constraints. In the short term, it protects Brazilian companies from creditors by giving them time for debt restructuring and encouraging creditors and suppliers to assist companies while they are facing such difficulties.

The Law is a major milestone in Brazil's improving economy and it is very important for the economic growth of the country. As soon as this Law is enforced, Brazilian companies will be able to seek temporary protection from creditors in order to reorganize their debts and operations ('Corporate Recovery').

This Law is also intended to increase the recovery of debt rates. The Brazilian legal system does not provide creditors with an efficient and immediate way to enforce their credits in court. Therefore, the average recovery of debt rates is very small.

According to economic studies, the interest rates paid by Brazilian companies could drop with the approval of this Law since it significantly changes the order of preference of credits in bankruptcy proceedings, granting secured credits (mostly banks) preference over tax and social security creditors ('Bankruptcy Proceedings').

Therefore, even if the company goes bankrupt, there is a greater possibility that secured credits will be paid. These are significant changes which may cause Brazilian banks to charge lower financing interest rates because the respective credit risks would be reduced with the enactment of the new Law, which will make Brazilian companies even more competitive at the international level.

Corporate Recovery

There are important changes in recovery proceedings, in order to speed up the solution allowing a company with financial constraints to present a restructuring plan to its creditors.

Corporate recoveries will be conducted through judicial or extrajudicial recovery proceedings.

The Law introduces judicial recovery proceedings which will replace the current corporate recovery process ('*concordata*'). In essence, debtors will be able to negotiate with creditors on the repayment of debts, including corporate restructuring, under the protection of the law.

All existing creditors prior to the judicial recovery request filing are subject to the proceeding, even though they are not due at the date.

The Law stipulates a stay period of 180 days for all claims and enforcement proceedings against the company in judicial recovery after the judicial reorganization is granted. Within this period, the company has to present a restructuring plan.

The court will approve negotiations between debtor and creditors on any type of liability, including, in particular, tax and labour liabilities. This is a major improvement in relation to the current legislation.

The parties will be free to negotiate how judicial recovery is implemented, including, for instance, the reduction of liability and priority of repayment.

Debtors may carry out corporate actions to facilitate recovery. Examples may include spin-offs, mergers, transfers or leases, conclusion of collective labour agreements, sale of assets, issue of debentures, replacement of guarantees and other analogous measures.

The judicial recovery is formalized by a petition presented in court by the debtor (the creditors cannot file for judicial recovery of a debtor) together with an analysis of its financial and economic condition and the feasibility of its business. After judicial recovery is granted, the debtor must present a restructuring plan to the creditors within 60 days.

The creditors must approve the plan. The Law provides for three different classes of creditors: (i) labour-related creditors; (ii) creditors with *in rem* guarantees; and (iii) unsecured creditors. The creditor will vote the restructuring plan separately in each class and the plan will be considered approved with the favourable vote of creditors representing more than 50% of all credits held by each class (value) and by a simple majority vote of the creditors present at the meeting (number). If the plan (or other proposal by the creditors) is not approved, the Judge must declare the company bankrupt.

The plan can also be implemented even if it was rejected by one of the three classes of creditors. In this case, the plan must (i) have been approved by the vote of creditors that represent more than 50% of the total credit presented at the Creditors' Meeting; (ii) have been approved by the two other classes; and (iii) have received a favourable vote of more than 1/3 of the number of creditors in the class in which it was rejected.

During the implementation of the restructuring plan, the managers will carry on their duties but the creditors will be able to create a special committee to follow up the execution of the plan.

The implementation of a restructuring plan is considered a novation and it is mandatory for the debtor and all creditors subject to it, without any prejudice to the former guarantees in case some requirements are fulfilled.

An important change in this Law that will guarantee the value of the company's assets in the restructuring process is the provision stipulating that an acquirer of assets will not be held liable for any tax liabilities of the debtor selling the assets. This is applicable to the sale of branches or individual sites but it cannot be applied to the transfer of shares or sale of the whole business. Case law may extend this avoidance of liability to other cases. Moreover, the debts incurred during the judicial recovery process have priority as to the order of creditors if judicial recovery fails and proceedings are converted into bankruptcy proceedings. In accordance with the current law, no preference is given to a creditor that lends money to a company after its '*concordata*' or bankruptcy is filed. As a consequence, the company facing financing constraints is normally pushed to bankruptcy and liquidation because there are no resources available thereto.

The extrajudicial recovery will be conducted through informal negotiation between a debtor and creditors. There will be two different types of extrajudicial recovery: (i) with acceptance of all creditors subject to the Restructuring Plan; and (ii) with acceptance of at least 3/5 of each class of creditors but with the fulfillment of more restrictive requirements.

This kind of recovery may not, however, deal with tax and labour liabilities. Because such liabilities are always present in a Brazilian company facing financial constraints, this rule may cause the extrajudicial recovery to be ineffective.

Bankruptcy proceedings

Bankruptcy proceedings will also suffer significant changes under this Law in order to speed up the judicial procedure and allow creditors to receive part of their credits even in the event of liquidation of the debtor.

As mentioned above, there will be a new order of priority for payment of creditors, i.e. secured creditors will be ranked second after employees. Tax and social security debts will only come third.

The Law allows the immediate sale of the company's assets to avoid their depreciation or deterioration.

The employees are ranked first in the preference order of payments. However, to avoid fraud, the amount to be paid to the employees is limited to the cap of 150 minimum wages per employee for labour liabilities of the company (currently around USD 13 000 or GBP 7300).

A minimum claim of 40 minimum wages (currently around USD 3465 or GBP 1926) is required for creditors to request the start of bankruptcy proceedings against a debtor in order to avoid minor creditors using the bankruptcy proceeding as a way to enforce their credits.

Conclusion

After ten years of discussions the Law was finally approved. It is clear that the text could be improved, mainly regarding the restructuring of fiscal debts, but case law can definitely correct some inconsistencies. The Law updates Brazilian legislation in order to allow the national economy to grow. Investors will now view the Brazilian market as a safer place to invest their resources.