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ARTICLE

The 'Principal Establishment' Concept under the New Brazilian Insolvency Law

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1. Introduction

Due to the many global economic crises over the last two decades (e.g. the Mexican peso crisis in 1995, the Asian crisis of 1997, the Russian crisis of 1998, Argentina's external debt default in 2001), several international organisations such as the World Bank, the International Monetary Fund, and the United Nation's Commission on International Trade Law (UNCITRAL) have made important contributions towards the establishment of more efficient legal frameworks to address insolvency around the world. With the globalisation of capital markets, the lack of predictability in the face of insolvency in one country could foster instability in the global market and restrict the access of that country to funding sources. The above-mentioned international organisations have therefore published guidelines to help countries build effective insolvency systems and have strongly encouraged the adoption of best practice in these areas.[1] This is the case with the Word Bank's Principles and Guidelines for Effective Insolvency and Creditor Rights Systems (2001) and the UNCITRAL Legislative Guide on Insolvency Law (2004).

The reform of the Brazilian Insolvency Law is part of this wider effort to modernise the bankruptcy system around the world. The recent reform that occurred in Brazil is a process that began in 1993 and was concluded in February 2005.[2] The former law that had been enacted in 1945 was outdated. In practice, the insolvency process had been ineffective at saving viable businesses and protecting creditor rights. Such inefficiencies resulted in higher interest rates, which in turn restricted the growth of Brazilian credit markets. The new law improved the existing legislation by creating a Chapter 11 type of restructuring, a pre-packaged restructuring and streamlining the liquidation rules in order to rescue the going concern value for the benefit of the stakeholders.[3]

However, many questions were not properly dealt with in the new legislation. One of the issues causing controversy is the criteria for determining a court's jurisdiction over an insolvency case. The new Insolvency Law has maintained the criteria of the old law, by defining jurisdiction as the court of the location 'where the [debtor] company has its principal establishment',[4] without however defining the term 'principal establishment'.

In Brazil, as defined by the Federal Constitution, insolvency proceedings are under the scope of each State's Judiciary. There are 27 States in Brazil and each State is responsible for enacting its own rules in respect to the organisation of its court system. The federal courts have no jurisdiction over insolvency matters in Brazil.

Thus, an insolvency case must be filed in the State civil[5] court where the debtor's principal establishment is located. The controversies that are occurring are

Notes

1 In the last few decades, a legislative reform process has taken place in several Latin American countries. Specifically in Argentina, Bolivia, Brazil, Chile, Colombia, Costa Rica, Ecuador, Mexico and Peru, such reforms being focused in their insolvency system and legal framework for bankruptcy.

2 Insolvency proceedings in Brazil were governed by Decree-Law No. 7,661, in effect since 1945. However, after nearly 12 years of discussions in the Brazilian Congress, and as a result of the efforts of law practitioners, economists, politicians and the civil society as a whole, a new bankruptcy law (Law No. 11,101/05) was enacted by President Luiz Inácio da Silva on 9 February 2005, coming into effect on 9 June 2005. The new bankruptcy law introduced significant changes and improvements to the Brazilian insolvency system, which was outdated and did no longer meet the needs of the Brazilian economy.

3 For a description of Brazilian restructuring, see Thomas Benes Felsberg and Andrea Arcebi, 'Brazil', in Bruce Leonard (ed.), *Insolvency & Restructuring* (2008), p. 41; Thomas Benes Felsberg, 'Brazil', in *Collier International Business Insolvency Guide* (2007); Thomas Benes Felsberg, 'As Modalidades de Recuperaçao de Empresas no Brasil', *Revista de Derecho Comparado* (Argentina 2009).

4 Article 3 (Law No. 11,101/05) – 'The courts of the venue of the principal establishment of the debtor or the branch of a company headquartered outside Brazil have jurisdiction to ratify out-of-court restructuring plans, grant judicial restructuring, or decree liquidation.'

5 See Article 109 of the Brazilian Federal Constitution of 1988.

related to certain key questions, such as: where is the venue when a group of companies that have several principal establishments file jointly? Or, is a principal establishment defined by the number of employees, by the respective revenue streams, by the place where management is located, or by the place where a company's legal headquarters are located? Or, is principal the place where the controlling shareholders decide the key questions in respect to a company? This context has resulted in filings of large companies in very small cities which very few people were aware even existed. Among such venues are the city of Coruripe in the State of Alagoas, the city of Nova Monte Verde in the middle of Mato Grosso's jungle, the city of Cajamar and the city of Jandira in the State of São Paulo, where the local courts have difficulties in handling the massive paper work and the difficult financial, commercial and business issues such proceedings entail. The São Paulo State Judiciary has established two specialised insolvency courts for the city of São Paulo (which do not have jurisdiction over companies which are not located in the capital of the State of São Paulo). In addition, the Court of Appeals of São Paulo has a specialised chamber for insolvency matters. Similarly, Minas Gerais and Rio de Janeiro have established specialised business courts (which also hear corporate insolvency cases). In any event, there are proposals to remove the larger cases to the capitals of the different States or to establish regional specialised insolvency courts to deal with these problems.

It is important to mention that Brazil is a continental country, with over five thousand municipalities and over four thousand district civil courts, thus in many cases there is probability that an insolvency proceedings end up in a non-specialised court.

2. The 'principal establishment' concept under Brazilian insolvency law

As mentioned above, Article 3 of Law 11,101/05 determines that the location of the principal establishment of the debtor defines in absolute terms the jurisdiction of the court. In addition, Article 76[6] of the same law determines that all matters related to the insolvency proceedings should be heard in one court, thus avoiding the fragmentation and contradictions of having different courts rule on the same insolvency.

The 'principal establishment' principle had already been established by Article 7 of the former Bankruptcy Law (Decree Law No. 7,661/45) thus permitting the existence of a body of case law and scholarly studies which are extremely valuable to support the interpretation of Article 3 of the new law.

The Superior Court of Justice, sitting in Brasília, the capital of Brazil, which has as one of its roles the unification of contradictory decisions rendered by the different State courts, has in several decisions defined the principal establishment as 'the vital centre of the principal activities of the debtor'.[7]

Amongst scholars, the debate was whether to consider the principal establishment under a formalistic approach (the registered office of the entity) or whether to consider the underlying 'de facto situation' which now seems to be the prevailing interpretation. It is noteworthy to relate the 'vital centre of the principal activities' adopted by the Superior Court of Justice of Brazil to the centre of main interests (COMI) adopted internationally.

While the new legislation was being discussed in Congress, Congressman Oswaldo Biolchi proposed an amendment[8] to Article 3 to reinforce the formalistic doctrine. The Deputy argued that his amendment would avoid 'forum shopping'[9] and prevent the debtor using last minute changes in the acts of incorporation of a company to find a more convenient venue. However, his amendment was rejected leaving the definition of the principal establishment to the courts and therefore we have to look to the 'vital centre of the principal activities', or, in our view, the COMI.

Other scholars have different views, such as the location where the most important assets of the company are located,[10] or where the main decisions are taken or where the board usually sits.

That notwithstanding, if filing takes place in a jurisdiction unrelated to the registered office of the debtor, it is prudent to spell out clearly the motives for that and present evidence why a different venue was chosen.

Notes

6 Article 76 (Law No. 11,101/05) – 'The bankruptcy court is indivisible and competent to hear all actions involving the bankrupt party's assets, interests and business, with the exception of labour and tax suits and those not regulated hereunder in which the bankrupt figures as plaintiff or co-plaintiff.' Sole paragraph – 'All actions, including those excepted under the main section of this article, shall proceed under the trustee, who shall be notified to represent the bankruptcy estate, on pain of voidability of the proceedings.'

7 Similarly in Superior Court of Justice 'Dispute over Jurisdiction' case no. 37.736/SP, no. 1.930/SP, no. 1.779/PR, no. 27.835/DF, no. 21.896/MG, and no. 32.988/RJ.

8 Emend no. 4,376-B/1993, para. 1 – 'For the purpose of the definition in Article 3, the legal transference of the debtor's registered office during the last 12 twelve month period before the filing of a bankruptcy procedure should not be considered.'

9 Forum shopping is the informal name given to the practice adopted by some litigants to get their legal case heard in the court thought most likely to provide a favourable judgment.

10 Fabio Ulhoa Coelho, 'Comentários à Lei de Falência e de Recuperação Judicial', *Saraiva* (2005), p. 28. and Oscar Barreto Filho 'In Comentários a Lei de Falência e Recuperação de Empresa', Coord. Francisco Satiro de Souza Junior, *Revista do Tribunais* (2nd edn), p. 122.

In 2003, the Superior Court of Justice decided in a paradigm case,[11] that the 'principal establishment of the debtor' shall be the 'vital centre of the principal activities of the debtor'. The Supreme Federal Court is of the same opinion and has confirmed that: 'the principal establishment of the debtor is not that which its bylaws have appointed, but instead the establishment where the vital centre of the company is located and where its main centre of business is materially expressed'.[12]

By doing this, the two highest courts in Brazil[13] have rendered an essential contribution to the interpretation of Article 3 of the new Brazilian Insolvency Law, clearly defining 'the vital centre of the principal establishment' as the principal establishment of the debtor for jurisdictional purpose.

3. Jurisdiction for a foreign corporation with a Brazilian subsidiary or branch

As mentioned before, the principal establishment of a business entity, Brazilian or foreign, defines whether a Brazilian Court has jurisdiction or not. This concept en also compasses Brazilian branches of foreign entities, as well as the Brazilian subsidiaries of foreign entities. If a Brazilian court has jurisdiction over an insolvent entity, Brazilian laws will not recognise any other court to have jurisdiction over such matters. Conversely, if under Brazilian law a foreign court has jurisdiction, such jurisdiction will be respected in Brazil. The new Insolvency Law has not adopted the provisions of the UNCITRAL Model Law for International Insolvencies, and therefore, we have no provisions to allow ancillary proceedings or cooperation between courts of different jurisdictions.[14]

4. Conclusions

The issues and possible solutions being discussed in Brazil with respect to the jurisdictional issues can be summarised as follows:

- The interpretation of 'principal establishment' should align itself with the concept of COMI, adopted internationally.
- If several companies belonging to a same economic group decide to file an insolvency proceeding jointly, the principal establishment of any of the companies could be used to define the competent jurisdiction.
- Large metropolitan areas should receive specialised bankruptcy courts.
- Different States should determine that large cases be tried either in their respective capital cities or create regional bankruptcy courts.
- States should consider creating specialised Court of Appeal chambers to decide insolvency matters.

Notes

11 In 'Dispute over Jurisdiction' case no. 37.736-SP, the Ministers of the Superior Court of Justice, Ari Pargendler, Fernando Gonçalves, Carlos Alberto Menezes Direito and Barros Monteiro decided 'the main establishment of Sharp Corporation is where its the activity is concentrated, regardless what the bylaws says but the establishment which form the main body, the vital centre of the principle activities of the debtor' (<www.stj.gov.br>).

12 In RTJ 81/705.

13 Superior Court of Justice and the Supreme Federal Court.

14 For a complete explanation of this issue and the description of cross-border provisions in the Brazilian Insolvency Law, see Thomas Benes Felsberg and Paulo Campana Filho, 'Corporate Bankruptcy and Reorganisation in Brazil: National and Cross-Border Perspectives', in *Norton Annual Review of International Insolvency* (West Publications, 2009).

International Corporate Rescue

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