International Corporate Rescue

ChaseCambria

3-4 SOUTH SQUARE BARRISTERS

UCL LAW FACULTY
CENTRE FOR COMMERCIAL LAW

Published by:
Chase Cambria Company (Publishing) Ltd
4 Winifred Close
Barnet, Arkley
Hertfordshire EN5 3LR
United Kingdom

Annual Subscriptions:
Subscription prices 2010 (6 issues)
Print or electronic access:
EUR 695.00 / USD 845.00 / GBP 495.00
VAT will be charged on online subscriptions.
For 'electronic and print' prices or prices for single issues, please contact our sales department at:
+ 44 (0) 207 014 3061 / +44 (0) 7977 003627 or sales@chasecambria.com

International Corporate Rescue is published bimonthly.

ISSN: 1572-4638

ARTICLE

Distressed Investment in Brazil

Luiz Fernando Valente de Paiva, Partner, and **Giuliano Colombo**,[1] Senior Associate, Pinheiro Neto Advogados, São Paulo, Brazil

Introduction

As a result of the most recent economic downturn, numerous companies burdened with overleveraged capital structures have voluntarily resorted or have been forced to resort to bankruptcy proceedings in order to restructure their debts and operations. Typically, these financially troubled businesses are in need of cash to fund their ongoing business and operations. In the absence of new financing, the sale of the debtor's assets has become an instrumental form of capitalising these companies. In other instances, without prejudice to contentious processes, financial creditors with their own issues have pressed for monetisation of debtors' assets in order to have them (re)pay their loans. Indeed, insolvency proceedings have somehow been consolidated as a useful mechanism for implementing merger and acquisition transactions involving distressed companies or their assets.

In Brazil, the vast majority of financially troubled businesses have sought relief by way of judicial reorganisation regime established by Law No. 11101/05 ('BRL'). The BRL replaced Decree-Law No. 7661/45 and completely overhauled the insolvency system in Brazil. Judicial reorganisation is one of the three insolvency regimes contemplated by the BRL.[2] In short, it is a court-supervised process – analogous to Chapter 11 under the US Bankruptcy Code – aimed at enabling the debtor-in-possession to overcome an economic, financial and/or operational crisis based on a reorganisation plan negotiated with and ultimately approved by its pre-petition creditors. Upon confirmation of the approved plan of reorganisation, its terms and conditions will be binding on the debtor, its creditors and all other interested parties. The debtor-in-possession will typically enjoy discharge of the claims subject to the plan.

The distressed market in Brazil was impaired for a long time, mainly due to certain successor liability issues. Especially within the context of bankruptcy proceedings, there was a significant risk that purchasers of distressed businesses or their assets would be held liable for payment of certain existing or contingent liabilities associated with the purchased businesses or assets. This has been especially critical in connection with succession of employee-related claims. Numerous transactions – which would provide creditors and other stakeholders with better recoveries – were never consummated because of the succession liability risk. In other instances, the deal was done but the price paid was significantly discounted as a form to provide the purchaser with a cushion for contingent or hidden liabilities, always to the detriment of the debtor, the creditors and other stakeholders.

Under these circumstances, when reformulating the Brazilian bankruptcy law, the legislators took into account the importance of fostering the development of a distressed market as a key part of effective corporate restructuring, seeking to maximise recoveries for interested parties in insolvency cases, notably creditors. Legislative history supports the proposition of the conscientious option of incorporating the concept of free and clear sales into the revised insolvency legislation as a mechanism to facilitate the maximisation of value of a debtor's assets.

Sale of assets free and clear

When under judicial reorganisation, the debtor-in-possession is generally permitted to continue selling property of the estate in the ordinary course of business. Conversely, it is generally prohibited from selling or encumbering any of its permanent assets (except with a prior approval of the courts, any Creditors´ Committee, or the Trustee), unless the sale is established in the reorganisation plan. Generally, the sale will be approved by the court if and when the need and utility of the proposed sale is properly demonstrated.

Notes

1 The opinions and views expressed herein are personal and not necessarily those of Pinheiro Neto Advogados.

2 The other two regimes are: (i) out-of-court reorganisation, analogous to a 'prepackaged' reorganisation under Chapter 11 of the US Bankruptcy Code; and (ii) bankruptcy liquidation, analogous to a Chapter 7 of the US Bankruptcy Code.

The BRL specifically provides that if the reorganisation plan submitted by the debtor-in-possession in a judicial reorganisation case establishes the public judicial sale of any of the debtor's *branches* or *isolated productive units*, the Judge presiding the case will order the sale to be conducted in one of the following forms: (i) public oral bidding; (ii) sealed bidding; or (iii) a combination of the preceding forms, in which case the higher sealed offer will eventually become the floor for the subsequent oral bidding. In any case, these bidding processes shall be preceded by proper notice to interested parties, including the creditors.

More significantly, the BRL expressly establishes that the purchased *branches* or *isolated productive units* will be free and clear of any liens, claims or other interests.[3] In addition, the purchaser will not be held liable for any existing or contingent obligations or liabilities of the debtor-in-possession, including tax related claims. Similar protections apply to any asset sales conducted in bankruptcy liquidation proceedings.

Public sale v. private sale

Although this is far beyond the scope of this article, it is well established in other jurisdictions that assets can be sold in insolvency proceedings either outside of a plan of reorganisation or pursuant to the terms and conditions of a confirmed reorganisation plan. There are several examples of cases where assets must be sold well before a reorganisation plan is even considered by the debtor-in-possession.

A more literal and strict interpretation of the BRL provisions governing the sale of assets free and clear of any encumbrance suggests that within the context of reorganisation proceedings this protection would only be available and achievable if the proposed sale is expressly established in a reorganisation plan and if conducted in some form of competitive public bidding process. Nevertheless, it is undisputable that a court with jurisdiction would have the power to authorise the sale of the permanent assets of the debtor outside the reorganisation plan when the need and utility of the sale is properly demonstrated.

In most cases, practical experience shows that this would likely be undertaken by way of a private sale involving a negotiated contract determining the price and other relevant terms and conditions of the transaction. In fact, in the absence of typical lock-out arrangements – which are generally viewed with skepticism as a form of circumventing a competitive process – an offer higher or better than that negotiated under the contract could be obtained and considered by interested parties during the course of the proceedings. In this case, the offeror would typically become a 'stalking horse' bidder. Accordingly, one would expect the private sale contract to provide for certain typical 'stalking horse bid' protections if the offer contemplated by the contract eventually becomes the floor for a competitive process.[4]

In any case, it has been generally argued that if interested creditors and other stakeholders acting upon proper notice approve a private sale of certain assets, *branches* or *isolated productive units* of the debtor-in-possession, absent fraud and provided there is appropriate consideration and Court approval or confirmation, the transaction should be deemed valid and the assets sold free and clear of any liens or claims, with no succession liabilities being attributable to the purchaser. This would better serve the objectives of the BRL and would be consistent with the legislative intention of incentivising this form of transaction as a tool to maximise the value of debtor's assets for the benefit of all stakeholders.

Court precedents

The BRL does not establish a clear test to determine the concept of *isolated productive units* when regulating the sale of these assets within the context of a judicial reorganisation proceeding. Legislative history suggests that such concept should not be so broadly interpreted as to permit the sale of all or substantially all the assets of the debtor-in-possession. The idea is to enable the sale of assets, group of assets or certain business units that would not jeopardise the existence of the reorganised debtor-in-possession as a going concern.

Nevertheless, in the leading case dealing with this matter, substantially all of the assets of the debtor-in-possession were dropped down into a so called *isolated productive unit* which was ultimately sold at a public auction. The case was heard before and recently concluded by the 1st Business Court in the City of Rio de Janeiro ('Reorganisation Court'), and involves the judicial reorganisation of Viação Aérea Rio Grandense SA ('Varig'), a Brazilian national airline and formerly one of the major carriers in Latin America. Indeed, after certain amendments, Varig's plan of reorganisation

Notes

3 Depending on the circumstances, the sale or encumbrance of an asset with a lien may require adequate protection and specific approval of the creditor holding the lien.

4 In addition to 'lock out' or 'lock up' arrangements, this protections would typically include provisions governing break-up fees and topping fee, in addition to other conditions in the bidding process, including rights of first refusal. In many instances, though, enforceability of these conditions might become an issue.

specifically provided for the creation of a NewCo – VRG Linhas Aéreas ('VRG'). The NewCo would also operate as an air carrier.

Accordingly, the plan provided for the transfer to VRG of essentially all of Varig's assets necessary to ensure the regular operation of an air carrier business, including, but not limited to, aircraft lease agreements, licenses, permissions, slots, trademarks, mileage programs and other tangible and intangible assets. In July 2006, VRG was ultimately sold in a public auction as an *isolated productive unit* of Varig, free and clear of any existing or contingent liabilities of Varig. It was further ordered that the successful purchaser should not succeed Varig in any of the existing or contingent liabilities resulting from obligations assumed until the effective date of the sale.

Under the circumstances, mainly because the transaction involved the transfer of the bulk of Varig's assets, several creditors, especially those holding employee-related claims, began disputing the succession liability of VRG and/or of its purchaser for payment of their respective claims existing as of the date of the sale. The Reorganisation Court systematically ordered and confirmed that the sale of VRG was free and clear of any liens, encumbrances or liabilities. The Court of Appeal of the State of Rio de Janeiro upheld these decisions, generally stressing that the sale of VRG was conducted pursuant to the applicable provisions of BRL governing the sale of assets free and clear of any encumbrance, in a competitive process, in the best interest of all stakeholders, notably in consideration of the social importance of Varig's reorganisation to the Brazilian air carrier industry.[5]

As a result of conflicting orders from the Reorganisation Court and other state courts regarding the sale of assets and other issues related to or affecting the reorganisation proceeding of Varig, in April 2007 the Superior Court of Justice ruled on an ancillary proceeding disputing the conflict of competence of these courts. The Superior Court of Justice essentially established that the Reorganisation Court had the jurisdiction and competence to rule and order in connection with Varig's assets.[6] The Federal Supreme Court subsequently ruled on an Extraordinary Appeal filed by the interested parties, upholding the decision rendered by the Superior Court of Justice.[7] In all these opinions, the relevant courts indirectly suggested that sales of *isolated productive units* included in a reorganisation plan and conducted during the judicial reorganisation proceeding are free and clear, pursuant to the applicable provisions of the BRL.

More significantly, the Federal Supreme Court recently ruled on a direct lawsuit disputing the constitutionality of certain provisions of the BRL, including the relevant provisions governing the sale of *branches, isolated productive units* or assets of debtors in reorganisation or bankruptcy liquidation free and clear of liens, encumbrances or obligations of any nature, as well as the provisions establishing the absence of succession liability of the purchaser of these assets. The lawsuit was filed by the Democratic Labor Party on the primarily argument that these provisions violated certain constitutional rights of employees.

By a majority of votes, the Federal Supreme Court ultimately found the lawsuit groundless, holding that the disputed provisions conformed to the Federal Constitution. Although the Court did not establish the test for determination of the concept of an *isolated productive unit*, it specifically noted that, as a result of a long legislative process, the bankruptcy legislators had validly and conscientiously elected to eliminate the succession liability issues and establish the sale of assets free and clear, in support of the proposition that this type of transaction would generally contribute to maximising the value of the debtor's assets, in the best interest of all stakeholders, including employee-related creditors. The Court also conceded that this sort of distressed merger and acquisition transaction would contribute to the effective and efficient reorganisation of financially troubled businesses, which would be consistent with the principal objectives of the BRL and of the constitutional principle of maintenance of business activities, in recognition of their social importance.

Conclusion

These precedents and other recent decisions rendered by estate trial courts and courts of appeal suggest that the Judiciary is generally enforcing the BRL provisions governing the sale of assets free and clear, with no succession liability applicable to the purchaser of these assets. Although one would expect the relevant provisions of the BRL to be supplemented in connection with this matter, especially to expand on procedural regulations, there is no question that the existing provisions already represent a significant step ahead in stimulating distressed investment in Brazil.

Notes

5 See e.g. Interlocutory Appeals Nos 23927/06 and 2007.002.08184, from the 4th Private Civil Chamber of the Court of Appeals of the State of Rio de Janeiro, Reporting Judges Reinaldo Pinto Alberto Filho and Fernando Fernandy Fernandes.

6 See e.g. Conflict of Competence No. 61.272, from the Second Session of the Superior Court of Justice, Reporting Justice Ari Pargendler. Similar decisions have been rendered by the Superior Court of Justice in numerous other cases involving debtors in judicial reorganisation proceedings.

7 See e.g. Extraordinary Appeal No. 583.955-9, from the Federal Supreme Court, Reporting Justice Ricardo Lewandowski.

Indeed, this market has expanded rapidly and significantly as a result of the increased opportunities afforded by this last economic downturn, and is expected to continue growing as potential local and foreign investors become more familiar with the increased safeguards afforded by BRL for such type of transaction, eventually consolidating insolvency proceedings as an attractive alternative platform for the implementation of mergers and acquisitions in Brazil.

International Corporate Rescue

International Corporate Rescue addresses the most relevant issues in the topical area of insolvency and corporate rescue law and practice. The journal encompasses within its scope banking and financial services, company and insolvency law from an international perspective. It is broad enough to cover industry perspectives, yet specialized enough to provide in-depth analysis to practitioners facing these issues on a day-to-day basis. The coverage and analysis published in the journal is truly international and reaches the key jurisdictions where there is corporate rescue activity within core regions of North and South America, UK, Europe Austral Asia and Asia.

Alongside its regular features – Editorial, The US Corner, Economists' Outlook and Case Review section – each issue of *International Corporate Rescue* brings superbly authoritative articles on the most pertinent international business issues written by the leading experts in the field.

International Corporate Rescue has been relied on by practitioners and lawyers throughout the world and is designed to help:

- Better understanding of the practical implications of insolvency and business failure – and the risk of operating in certain markets.
- Keeping the reader up to date with relevant developments in international business and trade, legislation, regulation and litigation.
- Identify and assess potential problems and avoid costly mistakes.

For more information about *International Corporate Rescue*, please visit www.chasecambria.com