January 2006 www.IFLR.com

IFLR
INTERNATIONAL FINANCIAL LAW REVIEW

Forecast 2006: What to look out for in the year ahead

The best networks for corporate finance revealed
Why Korea's class action law is failing
What China can learn from US securitization
Primacom gives lenders jurisdictional certainty
Brazil modernizes restructuring law

Brazil overhauls restructuring regime

Thomas Benes Felsberg, Steven Kargman and Andrea Acerbi explain why Brazil's new insolvency law should help more businesses avoid liquidation

Brazil's new bankruptcy law, which was under consideration by the Brazilian Congress for more than a decade before becoming effective on June 9 2005, has brought important and long overdue changes to the country's insolvency framework. Under the previous bankruptcy law, which was enacted in 1945, there was essentially no effective mechanism for reorganizing financially distressed enterprises in the context of an insolvency proceeding. Rather, such companies often faced the prospect of liquidation through a bankruptcy proceeding.

The new law, by contrast, emphasizes reorganization as a critical component of the Brazilian insolvency regime. In so doing, it reflects the growing international consensus that reorganization, as opposed to liquidation, might be the most effective means of preserving value in the case of distressed enterprises that are otherwise viable as going concerns. This view is evident in the important insolvency law reform work that has been conducted by the United Nations Commission on International Trade Law (Uncitral) in its *Legislative Guide on Insolvency Law,* and the World Bank in its *Principles and Guidelines for Effective Insolvency and Creditor Rights Systems*.

As with any new insolvency law, however, it remains to be seen how the Brazilian law will be interpreted and applied in practice. Already, there are two significant cases pending under the new rules: one case pending in the Rio de Janeiro commercial court involves Varig, Brazil's largest national air carrier, which filed under the new law just over a week after its effective date; the other case, which is pending in São Paulo's recently created bankruptcy court, involves the Brazilian operations of Parmalat. As these cases progress in their respective court proceedings, they might provide preliminary indications as to how the new law will be interpreted and implemented.

The new law may create opportunities for creditors involved in insolvency proceedings, as well as for parties that are considering investments in Brazilian insolvency and distressed debt situations. If the new law works as intended, creditors may find that reorganizations, whether reached in judicial proceedings or in out-of-court agreements, are more likely to succeed. Investors and/or new lenders, ie post-commencement lenders, might find that, under certain circumstances, the new law will create opportunities to purchase distressed debt, lend new money to distressed enterprises and/or purchase assets of distressed enterprises.

Creditors and investors might benefit from a number of important changes effected by or otherwise attendant with the new law. These changes include the following: a more robust reorganization mechanism; a potentially more expeditious procedure for the sale of assets by the debtor; the priority granted to post-commencement financing; the improved position of secured creditors in reorganizations; the possibility of pre-packaged restructurings; and the establishment of certain specialized bankruptcy courts.

Judicial restructuring versus *concordata*

The new law provides two ways for reorganizing companies: judicial restructuring and so-called extra-judicial restructuring, which is a type of out-of-court restructuring that results in a pre-packaged restructuring.

Under the old law, distressed enterprises could either petition for a *concordata* or file for bankruptcy, ie liquidation. A *concordata* effectively involved a legal moratorium on the payment by the debtor of unsecured debts for a period of two years. In practice, however, some *concordata* proceedings – and the associated debt service morarorium – continued for a considerably longer period of time.

As a mechanism for reorganizing distressed enterprises, the *concordata* process suffered from several deficiencies. First, the *concordata* did not apply to labour credits, secured credits and tax credits, despite the fact that these types of claims taken together typically represented the bulk of an insolvent company's outstanding debt. (Indeed, as more fully discussed

below, tax claims alone often constituted a significant portion of an insolvent company's outstanding debt.)

In addition, since many of the unsecured creditors were often suppliers, the *concordata*'s payment moratorium vis-à-vis the unsecured creditors meant that many suppliers simply ceased to provide the debtor with the necessary means to carry on its day-to-day business operations. Moreover, the stay on enforcement actions imposed by a *concordata* applied only to unsecured creditors but not to other types of creditors. Given the typical composition of claims of a debtor discussed above, a stay under a *concordata* was therefore fairly limited in its application and hence in its usefulness in keeping the insolvency estate intact.

The end result was that reorganization efforts undertaken pursuant to a *concordata* often failed. As a result, many debtors that originally filed for *concordata* simply ended up in bankruptcy.

However, bankruptcy proceedings under the old law were seen generally as being slow, bureaucratic and inefficient.

In bankruptcy, secured and unsecured creditors often had limited prospects of recovering any of the amounts owed to them in light of the priority under the old law accorded to labour and tax credits. Furthermore, the bankruptcy proceeding led to the closure and/or dismantling of the debtor's business rather than allowing insolvent but otherwise viable companies to recover.

In addition, the old law provided debtors with an escape hatch from a bankruptcy proceeding in the form of what was known as a *suspensive concordata*. This was considered to be a final "rebirth" option given to debtors at the end of a liquidation proceeding, whereby the debtor could pay 35% of the debt in cash to suspend the liquidation proceeding. But the fact that a debtor knew that it had this possible exit from bankruptcy proceedings meant that such proceedings might not necessarily proceed as quickly or efficiently as they might otherwise, with the result that the liquidation of assets might be delayed.

If a Brazilian company filed for bankruptcy under the former bankruptcy law, the accumulation of a potentially large sum of unpaid tax debts meant that secured creditors could end up with a meagre or even non-existent recovery

The new law provides a potentially more effective and timely mechanism for the judicial restructuring of companies. Parties will now have 180 days from the date of the judicial decision "granting", that is, opening, the judicial restructuring in order to reach an agreement to restructure the insolvent company. If an agreement is not reached within this time frame, the law requires the insolvent company to be liquidated in a bankruptcy proceeding. During this 180-day period, a stay on enforcement actions by all creditors, subject to a few exceptions, will be in place. The move towards a more time-bound reorganization procedure that converts to a liquidation procedure after a specified period of time is consistent with the approach being taken in other countries, such as Mexico, that have reformed their insolvency systems in recent years.

Unlike the *concordata* system where the only restructuring option consisted of the repayment of debt on an installment plan, the new law permits a broad range of restructuring approaches. Under the new law, there can be payment extensions, the partial or total sale of assets, the leasing of assets, the formation of wholly-owned subsidiaries to which the business can be transferred, employee buyouts, transfer of assets to creditors, or any other approach, subject to the approval of creditors in a general meeting of creditors and to certain restrictions provided for in the law concerning the payment of labour claims.

The new law provides that, during the course of a judicial restructuring, the debtor will continue to be in charge of the administration and management of the company, i.e. debtor in possession (DIP). However, the new law also provides that the court appoints a judicial administrator upon the granting of a judicial restructuring. The judicial administrator's primary role, however, is to supervise the debtor in the management of its business, submitting to the court monthly reports on the debtor's activities and on the performance of the restructuring plan. In turn, all of the judicial administrator's actions are directed and supervised by the judge and the official creditors' committee.

Nonetheless, under the new law, the court has the authority to remove the DIP where the court determines that the DIP has performed illegal acts or otherwise has taken certain actions that might be detrimental to the business or interests of the debtor. If the court removes a DIP, a judicial manager, appointed in a general meeting of creditors, will take over the administration of the business.

The new law establishes class-based voting for approval of a judicial restructuring plan. For purposes of voting on the judicial restructuring plan proposed by the debtor, creditors are divided into the following three classes: Class I, holders of labour-related claims; Class II, holders of secured claims; and Class III, holders of unsecured claims. The plan must be approved by all three classes of creditors at a meeting of the creditors.

In Class I (labour claims), the plan must receive approval of more than 50% of the creditors attending the meeting, regardless of the amount of their claims. In Classes II and III (secured and unsecured claims), however, the plan must not only be approved by a simple majority of creditors present in each respective class, but also by the creditors holding the majority of the value of credits within each such class.

Crucially, if all such approvals are obtained, the restructuring plan will bind all of the debtor's creditors, including dissenting creditors, within a particular class. Equally importantly, a restructuring plan rejected in one of the three classes of creditors might still be approved by the judge by means of a *cramdown* provided certain requisites provided for in the law are satisfied.

In short, the new law provides a time-bound reorganization process that allows management of the company by the DIP and gives the debtor the flexibility to pursue various restructuring approaches with its creditors. The law further provides that once a judicial restructuring plan is agreed on by the prescribed class votes, it can bind dissenting creditors, and then there is also the possibility of a judicially-imposed cramdown on a dissenting class of creditors.

Sale of assets

Under the previous law, the sale of the debtor's assets was hindered by two primary factors. First, in bankruptcy, the sale of assets could generally only take place after the so-called general list of creditors

was completed, that is, only after all creditor claims had been duly verified and after all objections filed against creditors' claims had been ruled on by the bankruptcy court. Since that process could take a considerable amount of time, the sale of assets could be significantly delayed, which in turn meant that there could potentially be a depreciation of the value of the assets being offered for sale. Under the old law, the immediate sale of assets could only be authorized by the court in exceptional cases.

Second, under the previous law, the purchaser of a distressed company's business unit assumed all of the debtor's tax and labour liabilities that were related to the business unit. Given that such tax and labour liabilities could be significant, the old law's requirement that a purchaser succeed to such liabilities presented a serious barrier to selling and/or transferring branches or business units of the distressed company as a going concern.

The new bankruptcy law makes important changes in this area. Under the law, the sale of assets in bankruptcy proceedings will begin immediately after they are scheduled to be sold, regardless of the completion of the general list of creditors. This change is designed to avoid the depreciation of assets. Furthermore, under the new law, the debtor is encouraged to sell the company as a going concern and/or to sell assets in blocks as opposed to engage in piecemeal dispositions of individual assets, which again is intended to maximize the value of the insolvency estate.

In addition, under the new law, in the case of a bankruptcy proceeding, it will now be possible to sell the bankrupt company or its branches at the inception of the proceeding without the purchaser succeeding to the debtor's pre-existing tax and labour obligations. On the other hand, in the case of a judicial restructuring, it will be possible to sell branches or business units of the debtor company without the purchaser succeeding to the debtor's pre-existing tax obligations. However, in the case of judicial restructurings, the new law does not explicitly exclude the purchaser's succession to the debtor's pre-existing labour obligations, which may lead some labour judges to conclude (whether or not such a conclusion is consistent with the legislative intent) that the purchaser of assets should succeed to pre-existing labour obligations.

The tax and labour succession issue does not generally arise where there are sales by the debtor of its individual assets such as pieces of machinery or parcels of real estate. As a general rule, such assets are sold free and clear of tax and labour claims.

These changes with respect to timing of sales and the issue of succession to pre-existing tax and labour obligations represent an important departure from the old law. They are designed to make it more economically attractive for potential purchasers to consider acquiring the assets of a distressed company.

Post-commencement financing

The question of whether there is financing available after an insolvency filing – so-called post-commencement financing – can be critical in insolvency situations. This is particularly the case in the context of judicial reorganizations where an effort is being made to maintain the business as a going concern, but is also important in the liquidation context where the possible sale of the business as a going concern might be contemplated. Nonetheless, under the old law, companies subject to the *concordata* were unable to attract any new financing because such new credit did not enjoy any special treatment in the event of a bankruptcy and lenders were therefore reluctant to step into the breach.

Although creditors that supplied good or services (or even loans) after a *concordata* filing were not affected by the *concordata*, lenders and suppliers usually refrained from continuing their regular business with a company under a *concordata* proceeding. In the event that the company was ultimately subject to a final declaration of bankruptcy, the chances of credit recovery for such creditors were considered to be remote. This unavailability of new credit was yet another factor that made it difficult for distressed enterprises to achieve a successful reorganization under the old law.

The provision in the new law for such extra-judicial restructurings is consistent with the work of Uncitral and the World Bank in the area of insolvency law reform

The new bankruptcy law, by contrast, is intended to encourage the provision of post-commencement financing. Fresh funds made available to entities being restructured through a judicial restructuring will enjoy an absolute repayment priority over pre-filing claims in the event of the bankruptcy of the company. Such newly-incurred debts assumed during the judicial reorganization period will be deemed *extraconcursais* in the parlance of the Brazilian law, which means that they will have priority over all other claims, including with respect to labour and tax claims. Moreover, the new law provides that pre-filing claims of creditors who continue to supply to the debtor during the restructuring period will enjoy a so-called general privilege over other pre-filing claims (that is, behind secured claims but ahead of unsecured claims), up to the amount of the post-filing credit.

In short, the new law's provisions regarding post-commencement finance are designed to encourage financial institutions to provide new credit to companies undergoing judicial reorganization. In turn, if the new provisions work as intended, they could help improve a distressed entity's chance of recovery. Of course, it remains to be seen whether financial institutions will view the protections provided under the new law as enough to incentivize them to provide post-commencement financing.

Improved position of secured creditors

The old law significantly disadvantaged secured creditors in the event of the bankruptcy of a company. Under the old law, tax claims enjoyed priority over secured claims, and tax debts typically represented the bulk of a bankrupt party's indebtedness. In the past, when Brazilian companies faced financial difficulties, many such companies simply stopped making their required tax payments; this effectively provided such companies with a source of working capital during the period of their financial difficulties. Moreover, in Brazil, the government, in its capacity as a tax creditor, was not allowed to file for a debtor's bankruptcy and that remains the case today.

If and when a Brazilian company filed for bankruptcy under the former bankruptcy law, the accumulation of a potentially large sum of unpaid tax debts meant that secured creditors could end up with a potentially meagre or even non-existent recovery. And under such circumstances, unsecured creditors often

stood no chance of making any recovery.

Under the new law, the position of secured claims has been improved substantially, since they now have priority over tax claims. Furthermore, labour claims, which had previously enjoyed an absolute priority in bankruptcy, will now be capped even though they will continue to enjoy a priority over all other types of claims, except for those claims considered *extraconcursais*, such as those arising from post-commencement financing as discussed above.

The priority of labour claims will now be limited to the equivalent of 150 *minimum wages* per individual worker, where minimum wages are considered to the minimum monthly compensation payable to an employee in Brazil as periodically established by the Brazilian Congress (at the current Brazilian real-to-dollar exchange rate, this is equal to about $19,500). Any labour claims in excess of the cap of 150 minimum wages will be treated as ordinary unsecured claims. It should be noted that this cap applies to all claims arising from an employment relationship, such as past due wages, unpaid vacation and Christmas bonuses, as well as certain idemnifications or protections provided for under Brazil's labour law.

In short, under the new law, secured claims will enjoy an improved position, and therefore a greater chance of recovery, in light of the lesser priority accorded to tax claims and the capping of the absolute priority accorded to labour claims. Nonetheless, the extent to which secured creditors will make a meaningful recovery in any given bankruptcy proceeding will obviously depend on various factors, including the value of the estate being distributed and the amount of labour claims as well as *extraconcursais* claims, such as those relating to post-petition finance and certain administrative expenses associated with the bankruptcy process that will still rank ahead of secured claims.

Yet with respect to the prospects for recovery by unsecured creditors, the new law does not change the ranking of such claims. Unsecured claims still rank behind all other claims. Nonetheless, under the new law, there is a possibility but certainly no guarantee that in a given case unsecured creditors may, depending on the facts and circumstances of such a case, potentially see some improvement in their recovery rates. If this happens, it might result from the general improvement in the functioning and efficiency of the bankruptcy proceedings under the new law. For example, there could be benefits to the bankruptcy estate that might result from the provision under the new law that allows for the immediate sale of assets. Therefore, although the new law does not change their ranking, unsecured claims could in certain cases nonetheless be the indirect beneficiaries of an overall improvement in the efficiency of the bankruptcy process.

Extra-judicial restructurings

One of the important innovations introduced by the new law concerns extra-judicial restructurings, otherwise known as *pre-packs* for pre-packaged restructurings or reorganizations. The provision in the new law for such extra-judicial restructurings is consistent with the general thrust of the work of Uncitral and the World Bank in the area of insolvency law reform.

The new Brazilian law does not incorporate the Uncitral Model Law on Cross-Border Insolvency, and this failure will maintain the uncertainty and unpredictability that existed under the old law with respect to multi-jurisdictional insolvencies that include a Brazilian component

The Uncitral *Legislative Guide on Insolvency Law* refers to such pre-packs as "expedited proceedings" and, in contrasting pre-packs with full reorganization proceedings, explains the purpose of expedited proceedings as follows: "Reorganization may also include ... proceedings commenced to give effect to a plan negotiated and agreed by affected creditors in voluntary restructuring negotiations that take place prior to commencement, where the insolvency law permits the court to expedite the conduct of those proceedings..." Similarly, the World Bank's *Principles* note that "[t]he informal [restructuring] process may produce a formal rescue, which should be able to quickly process a packaged plan produced by the informal process."

Under the old Brazilian bankruptcy law, debtors and their creditors often negotiated out-of-court restructurings, but there was no legal mechanism for taking an agreed restructuring plan into court and making it binding on dissenting creditors. This inability to bind dissenting creditors complicated efforts to reach successful out-of-court restructurings, particularly where there was a sizable enough group of holdout creditors that could continue to assert their right to the full value of their outstanding claims.

Under the new law, in an extra-judicial restructuring, the debtor will negotiate directly with its creditors in an out-of-court setting. Unlike a judicial restructuring, however, the debtor will not benefit from a stay if and when it negotiates an extra-judicial restructuring. Any restructuring plan agreed to in an extra-judicial restructuring could encompass one or more categories of the debtor's outstanding credits, excluding labour and tax credits, as well as credits arising from, among other things, pre-export financing, leasing agreements and conditional sales. Such excluded claims will remain payable in full since the new law does not permit them to be negotiated in an out-of-court restructuring plan, and the rights of the holders of such excluded claims will remain intact.

After the debtor has completed negotiation of the extra-judicial restructuring plan with the affected creditors, the debtor can then file the restructuring plan with the court for ratification. There are some basic requirements, including notice requirements, that must be followed in connection with tthe ratification process. If the plan presented to the court has been signed by creditors representing more than three-fifths of the credits by value encompassed in each category of claims addressed in the plan, then the extra-judicial restructuring plan will bind all creditors, including those who did not agree to it.

In sum, the changes introduced by the new law might encourage a debtor and its creditors to pursue pre-packaged or extra-judicial restructurings as an alternative to strictly out-of-court restructurings, on the one hand, and judicial restructurings, on the other hand. If the law works as intended, the debtor and its creditors might view pre-packs as a fast-track way to reach a restructuring solution and to do so in a way that provides an effective mechanism for binding dissenting creditors.

It is likely, however, that extra-judicial

restructuring might be more suitable to debtors that are not in the most serious financial distress, including with respect to tax and labour liabilities, or whose financial arrangements are not overly complex. Otherwise, the debtor might seek the more formal and far-reaching effects of the judicial restructuring procedure. Furthermore, since pre-packs may be limited to a discrete set of creditors (as determined by the debtor and its creditors) that may be a subset of the overall creditor body, pre-packs may be a useful vehicle to restructure debts held by one category of creditors, particularly if the debtor's financial difficulties relate to that one category of creditors, without affecting other types of debts of the insolvent company.

Specialized bankruptcy courts

In Brazil, under both the new and old laws, insolvency proceedings are filed with the state civil court whose geographic jurisdiction encompasses the debtor's principal establishment. In most Brazilian states, the court receiving an insolvency-related petition is a court of general jurisdiction as opposed to a specialized bankruptcy court.

However, simultaneously with the enactment of the new law, specialized bankruptcy courts were created in the city of São Paulo, which is Brazil's commercial and financial centre and the home to many of Brazil's important corporations. Accordingly, insolvency proceedings involving corporations whose principal establishment is located in the city of São Paulo will be heard by the newly established bankruptcy courts.

While the new law did not create specialized bankruptcy courts in the city of Rio de Janeiro, specialized commercial courts already exist there. Such commercial courts are charged with handling bankruptcy matters involving corporations whose principal establishment is located in the city of Rio de Janeiro.

Brazil's two main commercial centres are therefore likely to function as an important source of case law and expertise in the application of the new bankruptcy legislation. As always, the courts in the cities of São Paulo and Rio de Janeiro are likely to play a major role given the volume and complexity of the insolvency cases that come before the courts in these two jurisdictions. Furthermore, to the extent that the courts in these cities create noteworthy case law under the new statute, this could have a spillover effect in other Brazilian jurisdictions if the courts in those other jurisdictions look to São Paulo and Rio de Janeiro for guidance on issues under the new law.

Unfinished business

While the new bankruptcy law has the potential to create an improved environment for the restructuring of distressed enterprises, its ultimate success might depend on certain matters that were not fully or properly addressed in the new law. In the first place, the new law does not address cross-border insolvencies. Given the multinational nature of many businesses and the multi-jurisdictional nature of many insolvencies, this is an increasingly important issue.

In 1997 Uncitral promulgated a Model Law on Cross-Border Insolvency and several countries, including most recently the US in 2005 with the new Chapter 15, have incorporated the Model Law in their domestic insolvency laws. But the new Brazilian law does not do so, and this failure to incorporate the Model Law will maintain the uncertainty and unpredictability that existed under the old law with respect to multi-jurisdictional insolvencies that include a Brazilian component, including the process by which Brazilian courts will determine whether to grant recognition to, or otherwise cooperate with, foreign insolvency proceedings.

Second, although the new law ended tax and labour succession in relation to the judicial sale of business units in bankruptcy proceedings, the end of labour succession has not been clearly established in asset sales made in judicial restructuring proceedings, which as previously noted, might affect how certain labour judges view the issue of a purchaser's succession to pre-existing labour obligations. This could lead to some degree of uncertainty if and when investors try to determine the value of assets that they are considering for purchase in connection with such proceedings.

Third, the new law might ultimately only be as effective as the judges and others who are charged with administering it. This underscores the point that a sound insolvency system depends not only on having in place a modern insolvency law but also a well-developed institutional capacity, notably a well-functioning judicial infrastructure. Given the important changes made by the new law, it is critically important that there be intensive training of judges and public attorneys with respect to the operation and provisions of the new law. In addition, there needs to be further regulation with respect to the position of the judicial administrator, who is the court-appointed professional appointed to take over the debtor's business in a bankruptcy proceeding and supervise the debtor's activities in a judicial restructuring proceeding (known under the old law as the trustee/inspector).

Finally, the new law's effectiveness might also be hampered by its requirement that tax clearance certificates be obtained from the government tax authorities before a debtor can be granted judicial restructuring. As a practical matter, this requirement means that a debtor will not be able to enjoy the benefits of a judicial restructuring unless it is able to pay in full all of its tax debts or otherwise obtain tax clearance certificates by means of agreeing to installment plans proposed by the tax authorities.

A new bill is being discussed in the Brazilian Congress, however, which would regulate the granting of installment plans for the payment of tax claims where the debtor is applying for judicial restructuring. The terms of such installment plans have still not been fully defined. However, the maximum period for the payment of tax debts provided for under the legislative proposal as it currently stands - six years - might not be a long enough period for most Brazilian debtors, given their typical tax burdens when they file for insolvency.

Despite this unfinished business, the new law has the potential to create interesting opportunities for creditors and investors in the areas discussed above. Yet in pursuing any such potential opportunities, creditors and investors will obviously need to bear in mind that since the new Brazilian bankruptcy law has only been effective for a period of roughly six months, it is effectively a work in progress. The new law may be given greater definition and clarity as the courts begin to address more cases. Therefore, perhaps only with the passage of time will there be greater certainty as to whether the new law has the beneficial effects that were intended to be achieved with its passage and enactment. ■

Thomas Benes Felsberg is a partner and Andrea Acerbi an associate with Felsberg e Associados in São Paulo.

Steven Kargman is president of Kargman Associates in New York.

Thomas Felsberg was involved in the drafting of the new Brazilian bankruptcy law and Felsberg e Associados is involved in the Parmalat case mentioned in this article.