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ADVOGADOS

OVERVIEW OF JUDICIAL REORGANIZATION IN BRAZIL

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Current Brazilian law on reorganization and bankruptcy (Law 11,101/05 - the “Bankruptcy and Reorganization Law”) passed eleven years ago, replacing a former statute dating as back as 1945. Considering the speed discussions take at the judicial branch, a 11-year old law is still considered as a new law. As such, not all matters arising from the law have been tested, which gives the market certain degree of uncertainty, worsened by the fact that the country still does not count on specialized courts in most of its States and thus judges are generally not familiar with this type of proceeding.

In Brazil, the term "bankruptcy" is understood as liquidation, and is similar to "Chapter 7" in the United States, while "reorganization" is understood as the equivalent to "Chapter 11".

OVERVIEW OF A JUDICIAL REORGANIZATION PROCEEDING

In accordance with the Bankruptcy and Reorganization Law, the purposes of the judicial reorganization are to (a) allow for the recovery of the company from its economic and financial crisis, (b) allow for the maintenance of the productive source, (c) allow for the maintenance of employment of workers, (d) watch the interests of the creditors, (e) preserve the company, (f) preserve the company's social function; and (g) stimulate economic activity.

Reorganization proceedings enable debtors and creditors to discuss the future of the company's activities. With that, the law intends to encourage positive results to establish a debt and liability reorganization plan that might provide the debtor with better conditions to sort out temporary economic difficulties.

Current law created important mechanisms existing in most advanced jurisdictions like DIP financing (credits extended during the judicial reorganization have super-priority rights) and the possibility of third-party investors purchasing branches or isolated productive units (IPU's) free of any liens and liability, including without limitation tax and labor (except if purchaser is a shareholder of or a subsidiary controlled by the company, a related party or an agent of the partner in fraudulent conveyance to avoid succession).

Our law provides for two types of reorganization: in-court and out-of-court. The first runs at a judicial court and the latter is obtained out-of-court and simply approved by the court. The in-court reorganization involves labor, secured and unsecured credits, while the out-of-court reorganization does not comprehend labor credits. Neither of them comprehend tax credits.

The law brings the requirements and conditions for a company to request judicial reorganization, including a minimum of two years performing the business, five years not requesting judicial

reorganization, obviously not being declared bankrupt or having duly recovered therefrom and not being found guilty for any of the crimes provided in the Bankruptcy and Reorganization Law.

Once the petition has been accepted by the court the company will have sixty days to propose the reorganization plan, which will then be submitted to the General Creditors Meeting for approval, refusal or amendment, the latter only with the consent of the company. If the plan is not approved then the court must declare the company bankrupt.

The law provides for a 180-day stay period for all execution actions (claims for illiquid amounts remain in course) existing against the company on the date of the acceptance of the petition by the court. The stay does not apply to claims against guarantors.

Super-priority rights provided in the law - other than DIP - include credits extended through the so-called ACC's (advances on foreign exchange contracts) and credits secured by fiduciary assignment of assets of the company, among others, which entitle holders to the right of restitution (though subject to the stay period of up to 180-days from the acceptance of the reorganization by the court).

The law provides for a non-exhaustive list of means for the judicial reorganization, including: (a) the concession of term and special conditions for payment of matured or not yet matured financial obligations, (b) corporate restructurings (spin-off, merger, split-off, transformation of corporate type, creation of subsidiaries), (c) change of control, (d) capital increase, (e) transfer or lease of establishments of the company, including to a company created by the workers, (f) payment in kind with assets - including through the creation of special purpose vehicles for this purpose - or novation of debt, (g) partial sale of assets, (h) debt issuance, among others.

The reorganization plan must set out a detailed description of the alternatives that the company will follow to implement the reorganization and the payment to the creditors, its economic viability, and must be accompanied by a financial report on the company's situation.

The creditors’ representatives are also responsible for deliberating on the implementation of a fully revised reorganization plan.

The general creditors meeting comprises four credit classes generally described as follows:

(i) Class One: creditors encompassing the holders of credit rights arising from labor laws or indemnities owed due to labor accidents;

(ii) Class Two: creditors holding credit rights collateralized by security over assets (i.e. mortgages, pledges etc);

(iii) Class Three: unsecured creditors; and

(iv) Class Four: creditors considered as a micro or small business.

Except for deliberations regarding the approval of the reorganization plan or any terms thereof, each creditor's vote is to be considered proportionally to the respective credit for purpose of deliberations taken during the general creditors meeting.

In the event of deliberations regarding the terms of the reorganization plan, approvals must be granted upon favorable votes from each of the four classes, based on the amount of the credits and number of creditors in classes Two and Tree, and based solely on the number of creditors in classes One and Four.

If the reorganization plan is not approved in all four classes, the court may decide on the approval, provided that the following conditions are cumulatively met: (i) there is a favorable vote of credits representing more than half of the amount of the credits attending the creditors meeting, regardless of classes, (ii) there is approval in at least two of the classes, and (iii) in the class where the reorganization plan was rejected, at least one third of the creditors (per amount and per head) have voted in favor of the plan.

At the general creditors meeting, the creditors are represented by fully empowered attorneys-in-fact in charge of carrying out discussions about the features of the reorganization plan, as well as challenging and proposing amendments to the reorganization plan, as necessary. However, the debtor shall always have the last word on the format of the reorganization plan. The power of the creditors is only to approve or reject it. Creditors may not impose changes to the plan that are not agreed to by the debtor.

If at the closing of the general creditors meeting the plan is approved, the company must comply with the provisions of the plan under the joint supervision of the presiding judge and the designated judicial trustee (who is appointed by the presiding judge) for a period of two years (regardless of the terms of payment actually approved by the general meeting, which usually are much higher), during which any breach of the plan will lead to bankruptcy. After the 2-year monitoring period any creditor may request enforcement of the breached obligation or bankruptcy if the case.

The reorganization may be turned into bankruptcy in the following situations:

(i) the general creditors meeting decides to reject the proposed reorganization plan;

(ii) the company fails to file the reorganization plan in a timely fashion; or

(iii) the company breaches any of its covenants under the approved reorganization plan during the 2-year monitoring period.

In the event of extrajudicial reorganization, the reorganization plan is submitted to the creditors by the debtor. If the plan is approved by three fifths of creditors whose credits are subject to the extrajudicial reorganization, the plan is considered approved and the minority (two fifths) will be bound by it.

Extrajudicial reorganization has different effects in comparison to judicial reorganization, in particular in the sense that it does not stay the enforcement of legal actions initiated by creditors against the debtor and does not bind labor creditors.

BANKRUPTCY RELEVANT ASPECTS

In case a judicial reorganization turns into bankruptcy for any of the reasons stated in this article, it is important to note that the court will establish a hardening period retroacting back up to ninety days prior to (a) the bankruptcy request; (b) the judicial reorganization request or (c) the date of the first protest of bill, if any. Certain transactions performed during the hardening period may be declared ineffective by the court.

Finally, the Brazilian Bankruptcy and Reorganization Law provides for the possibility of interested parties bringing a claw back claim within three years from the date of the bankruptcy decree, aiming to revoke acts performed with the intent of harming creditors by proving the existence of fraudulent conveyance between the debtor and a third party and any damage caused to the bankrupt estate.

MARKET PRACTICE AND ROOM FOR LEGAL IMPROVEMENT

Local practitioners and the market have experienced that only a very small percentage of cases are successful in the sense that the reorganizing company in fact recovers and fully complies with the plan. On the contrary, most cases turn into bankruptcy and in practice effective means to overcome the crisis and repay creditors are not provided to the company.

Players argue that this unsatisfactory result arises from the fact that under the current statute the company in crisis holds too much power in connection with the terms and conditions of the plan, as the law does not give creditors sufficient voice to impose them or reasonably control the elaboration of the plan.

In addition to that, a number of companies submit the request for reorganization in a late stage, where actual recovery may no longer even be feasible.

One single and substantial review of the Bankruptcy and Reorganization Law performed by specialists and submitted to Congress on a priority basis would be very welcome to address those and other issues with the aim to increase the percentage of success in reorganization cases in Brazil, with actual fulfillment of the noble purposes of the law, ultimately resulting in more investment, production, employment, creditors satisfaction, economic activity and social welfare.

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