Brazil

Legal Analysis: Brazil's Bankruptcy Reform Presents Opportunities for Investors; New Law Expected to Increase Creditor Leverage in Restructuring Negotiations, According to BMA Advogados, Reed Smith

Fri 02/26/2021 11:37 AM

Relevant Document:
Webinar Slides

Brazil's new insolvency legislation came into force on Jan. 23, bringing improvements to mechanisms available to debtors in court-approved restructurings and liquidations, including debtor-in-possession lending, bankruptcy sale of assets and cross-border insolvency regime recognition rules under the UNCITRAL model law.

The new legislation also introduces restrictions on the number of times the stay period can be extended, and it includes the ability for creditors to file alternative plans, which is expected to increase creditor leverage in negotiations.

This increased creditor leverage may lead to more balanced negotiations during the debtor's exclusivity period to submit a plan, as discussed on a Jan. 26 Reorg webinar with Sergio Savi and Eduardo Wanderley, both partners at Brazilian law firm BMA Advogados, and Felipe Berer and Aaron Javian, partners at U.S. law firm Reed Smith.

Some of the key points of the bankruptcy reform, as discussed on the webinar, are outlined in the graph below:

Federal Law 14.112/2020	
Stay Period	In practice under the previous rules, a *recuperação judicial* stay period could be extended over lengthy periods of time. The new law imposes restrictions on how long the stay period can be extended for, up to a maximum of one year. Other protections are included which may shorten that period even more, in certain circumstances
Voting procedure	Votes will not need to be cast physically under the new rules, they may now be cast remotely, a useful addition for US-based creditors, for example.
Sale of assets	The bankruptcy trustee, the so-called 'Judicial Administrator' must sell assets under a bankruptcy within six months. Some insolvencies in the past have seen asset sales taking as long as 5 to 7 years. The new law significantly reduces the timeframe.
Codifying case law into legislation (ie Substantive Consolidation)	The new law codifies some of the legal mechanisms developed through case law into legislation. For example, the development of Procedural Consolidation, whereby separate group companies are consolidated into a single procedure, and Substantive Consolidation where in addition to group companies filing one single procedure their assets and liabilities may sometimes be grouped together. While the new law maintains courts' discretion to approve Substantive Consolidations, it provides criteria to be observed by judges when considering such issues, which is expected to provide more legal certainty to proceedings.
Post-petition financing	Processes were improved, and there have also been improvements to creditor rankings in a liquidation. For example, Article 69A grants power to a bankruptcy court to authorize DIP financings backed by any sort of collateral, including fiduciary liens. Further, DIP loans will have priority of payment over almost all debts in a bankruptcy liquidation, however, they would still "rank junior" to creditors with fiduciary liens (unless they are themselves backed by that collateral), since those creditors have restitution rights over the collateral granted in fiduciary lien
Sale of assets and M&A	More legal certainty has been provided, with the new law introducing the ability for a business to be sold as a whole, for example. The draft bill would have allowed a buyer not to inherit liabilities including those linked to anti-corruption and the environment. The provisions on the environment and anti-corruption liabilities specifically were vetoed by the president, however.
Extrajudicial Reorganization (prepacks)	The voting quorum has been reduced to a simple majority to approve a plan, compared with 60% previously. Also, a case can be started by having only one-third of claims supporting a plan, as opposed to 60% in the previous regime. The scope of a *recuperação extrajudicial*, or EJ is now wider, as labour claims can be included in the prepack.
Creditors' Ability to Present Plan	If the debtor's plan is either not voted on by the end of the stay period (an initial 180-day period, which can be extended for another 180 days) or if the debtor's plan is voted on, and rejected, then creditors will be able to propose an alternative plan. This change to the new law is expected to change the balance in terms of debtor/creditor negotiations.
UNCITRAL Model Law	The introduction of cross-border insolvency recognition rules will allow for foreign insolvencies to be recognised in Brazil via a chapter 15-equivalent mechanism

(Click HERE to enlarge.)

The conversation kicked off with the Reed Smith partners' views on the environment for investors who become involved in Brazilian restructurings.

Problems With Previous Restructuring Environment

Drawing on his experience, Reed Smith partner Aaron Javian explained that in general, international investors investing in Brazil have fallen into two general categories: those who are willing to put new money to work by originating loans in private credit transactions with borrowers, and buyers of bonds issued by corporates in the public debt markets.

Those who fall under the first category generally want to minimize downside risk by taking collateral over their loans in a way that is as protected as possible in the context of a bankruptcy - for example, by obtaining fiduciary liens over assets where available.

"The goal there is to have as little exposure as possible to a Brazilian bankruptcy, by taking advantage of the bankruptcy-remote status afforded to fiduciary lienholders," he said.

The second group is generally more exposed to Brazilian bankruptcy risks, with bondholders sometimes experiencing frustration over the lack of an absolute priority rule - whereby shareholders are not allowed to recover any value from the reorganized debtor if senior claims are not paid in full - as well as the fact that Brazilian bankruptcies, historically, have been debtor-run processes where creditors have struggled to exert leverage.

"Really only the debtor can propose a plan in the Brazilian bankruptcy process, which gives the debtor a huge amount of leverage; the only veto right that creditors have is essentially to force a liquidation, which is potentially bad for everybody," Javian explained. "It is a blunt instrument with limited tools for creditors to influence the plan."

Participating in a bankruptcy can be challenging for U.S. investors, as the Brazilian process is sometimes difficult from a voting perspective, with creditor meetings which are often called but postponed, he added.

Further, substantive consolidation is also lenient in Brazil, which means credit analyses can be upset if investors are looking at recourse to a specific entity, for example, and the predictability about voting in a proceeding can also be made more difficult where separate group companies are consolidated into a single procedure for voting purposes.

There has also been some uncertainty with regard to Brazil's jurisdiction over corporate groups that are based outside of the country, which can pose issues in large corporate group restructurings, he added.

Reed Smith partner Felipe Berer said the lack of any specific rules on substantive consolidation created scenarios with distorted outcomes over the years, especially in terms of complex restructurings with many entities as part of a single corporate group, where structural seniority was disregarded and claims and liabilities were mingled to the detriment of creditors.

Berer added that there was a clear need to encourage investments in the form of DIP financing rules and rules related to sale of assets free and clear.

"Debtors tend to seek RJ very late in the game, when their liquidity position is already very dire. In these scenarios debtors would be craving cash, but the Brazilian bankruptcy rules were not satisfactory in terms of DIP financing and the sale of assets," Berer said. "For instance, before this most recent reform, certain trustee fees and expenses would be paid before a lender - there was a striking need to provide for clearer rules on super-seniority for DIP loans."

In Brazilian in-court restructurings, the isolated business units, or IBUs, mechanism allows the purchaser not to be held liable for any of the debtor's existing liabilities. However, it was uncertain whether IBUs could consist of any subset of a debtor's assets, and there was also the requirement that IBU sales be included in a reorganization plan.

“As plans typically take a while to be approved after an RJ filling - on average seven months -- the debtor was often unable to complete the sale to take the cash when it needed it the most,” he said.

Berer added that because debtors often held a lot of power in being the only party to propose a plan, creditors would sometimes approve suboptimal plans as the only alternative to a liquidation.

Passing Brazil’s New Bankruptcy Law

In general, the reforms address many of the issues mentioned, though when Brazil’s Finance Ministry set up a working group in 2018 to discuss changes to the country’s previous legislation, an even wider and more comprehensive plan was being discussed.

At that time, the original plan contemplated an absolute priority rule and the inclusion of fiduciary liens within the RJ proceedings, which would make the rules more akin to chapter 11, BMA’s Eduardo Wanderley said. However, following pushback from banks and tax authorities, those provisions were removed from the draft bill.

After the Covid-19 pandemic hit, those backing the bill took advantage of the situation to push it through Congress. After adjustments to the text, it passed in the House of Representatives in the final quarter of last year, then passed in the Senate on an emergency basis, before being signed into law on Dec. 24, Wanderley explained.

The new law brings improvements to the insolvency scenario in Brazil.

DIP Financing

Sergio Savi, partner at BMA Advogados, sees the most relevant element of a restructuring system as predictability and legal certainty, which the new law has intended to achieve, at least to a certain extent.

Some of the key provisions are those dealing with protections to DIP finance lenders (section IV-A) and amendments to article 83 and article 84 of the legislation, which deal with the recovery waterfall in a bankruptcy liquidation scenario.

Apart from the lack of clear rules on DIP financing previously, the main problems were twofold, he explained:

- Lack of seniority afforded to DIP lenders in the recovery waterfall in a bankruptcy liquidation; and
- A lack of legal certainty due to the DIP loan potentially being affected through appeals.

In that regard, the new law brought improvements. Article 69A grants power to a bankruptcy court to authorize DIP financing backed by any sort of collateral, including fiduciary liens.

Further, Savi explained, under the previous regime, a postpetition DIP lender would rank junior to more than four types of creditors. The new law now makes it clear that the DIP will have priority of payment over almost all debts in a bankruptcy liquidation, ranking junior only to:

- The bankruptcy estate’s management and emergency expenses;
- Labor claims related to salaries over the three months prior to the liquidation up to five minimum wages per employee; and
- Restitution of assets owed to third parties, including fiduciary liens.

“The improvements could have been greater, considering that the new lender will always run the greatest risk. The new law should have provided for a superpriority of DIP loans, even greater than it has already provided, even in the case of an unsecured lending transaction," Savi said.

The new law should also have granted powers to the bankruptcy court to prime liens for the benefit of the DIP lender. The new law only allows for the granting of subordinate liens over already encumbered assets without the need for the secured creditor's authorization. However, this does not apply to fiduciary liens, he explained.

However, another positive is that the rules incorporate the equivalent of the equitable mootness doctrine - applied to U.S. bankruptcies - to DIP loan and asset sales provisions in Brazil (article 69-B), whereby, for example, the seniority granted to a DIP lender cannot be modified or reversed by subsequent appeals processes in case money has already been disbursed by the investor.

Article 69-E of the new insolvency law provides that anyone can be a DIP lender, including prepetition lenders and debtor-shareholders, provided the negotiations are at arm's length. Shareholders ranking senior in a situation where they provided a DIP loan, as is the case with the new law, are expected to foster new-money injections, Savi explained.

Fiduciary Liens in Context of DIP Loans, Investor Incentives

The new legislation does not disrupt a pre-existing priority scheme that provided for fiduciary liens to, in effect, stay outside of the RJ process. This may mean that DIP lenders may need to ask for fiduciary liens in order to be given additional protection; although, unencumbered assets will need to be available in such a scenario, according to panelists. Alternatively, investors would need to be comfortable that there is enough enterprise value to warrant being behind the fiduciary lienholders in a bankruptcy scenario.

Responding to a question about what incentives DIP lenders will have to inject postpetition financing in a scenario where assets are encumbered by fiduciary liens, BMA Advogados' Wanderley explained that sometimes the solution is to structure exit financing.

Often, holders of fiduciary liens are in a situation where they are stuck with the collateral that cannot be sold if the assets are nonfixed assets and are deemed "essential" for the debtor's business. In such a situation, debtors can request an injunction to stay any foreclosure proceedings. The creditors, in such a scenario, can either wait until the end of the stay period to foreclose on the collateral, which would take at least one year, or they can sit down and restructure the facility under a bilateral deal with the debtor.

"We have this balance of leverage. On the one hand the debtor cannot restructure the facility; on the other hand, the creditor is stuck with the collateral," Wanderley explained.

An exit financing can be structured in this instance, whereby the claims are acquired at a discount by a DIP lender in return for the fiduciary lien, he explained. In such a scenario, the original lender would be prepaid at a discount, releasing the fiduciary lien to be granted as collateral to the DIP lender.

Free and Clear Asset Sales

Whereas the previous law provided that an IBU buyer would not be held liable for any of the seller's existing liabilities, the new law clarifies that an IBU can encompass any assets or rights of any nature, tangible or not, including shareholdings. This is important as the new law now expressly recognizes the right for the debtor to drop down some of the assets it intends to sell to a NewCo, then subsequently sell shares of that unit as an IBU under the IBU mechanism, something that is common in Brazilian bankruptcies.

"It is an improvement; however, in my opinion, it could have been better if the law simply excluded the concept of the Isolated Business Unit and simply provided that the sale of any assets in a judicial reorganization would be 'free and clear,' as is the case with bankruptcy liquidation proceedings," Savi explained.

An important provision of the new law was vetoed by President Jair Bolsonaro, Savi explained. Paragraph 3 of article 66 would have provided similar provisions to those included in section 363 of the U.S. Bankruptcy Code - where free and clear asset sales can be concluded even before a plan is voted. “We would have had an expedited sale protecting the investor,” Savi explained.

Another improvement is the ability for all of a debtor’s assets to be sold as a going concern through the IBU mechanism. To do so, the bankruptcy court would have to run a test to determine whether non-impaired creditors would be in a situation at least equivalent to what would happen in a bankruptcy liquidation proceeding, he explained. In other words, the court would need to be satisfied that the sale proceeds would exceed the liquidation value of the business and that sufficient amounts would be set aside to pay the non-impaired creditors (for example, tax claims).

Comparing the provisions to the U.S. Bankruptcy Code, Reed Smith’s Javian explained that the Brazilian provisions introduce something like the “best interests” test that would need to be satisfied in a sale conducted pursuant to a chapter 11 plan, rather than one conducted as a stand-alone 363 sale.

The “best interests” test requires each creditor to obtain at least as much in a chapter 11 plan as it would in a chapter 7 liquidation.

“In Brazil, considering there are certain credits, including fiduciary liens and certain tax credits, that sit outside of the bankruptcy, it will be interesting to see how the value realized from a whole-business sale will be allocated to the payment of these claims going forward,” Javian said. “For example, must non-impaired claims be paid in full if the proceeds of a sale exceed liquidation value, or would their receipt of liquidation value now be sufficient?”

Creditors’ Ability to File Alternative Plans

The webinar panelists agreed that the exclusive power to file a bankruptcy plan provides debtors with extremely strong leverage in a bankruptcy.

Based on the experience under chapter 11, the 18-month time limit on the debtor’s exclusive period to file a chapter 11 plan introduced in 2005 has incentivized debtors to start negotiating with creditors before they file for bankruptcy, whenever possible. Since 2005, the United States has seen an increase in the number of prearranged plans, which have been negotiated with key creditor constituents before filing, or prepackaged plans, which are completely solicited and often have acceptances from all the relevant creditor groups before the debtor files, Javian explained.

BMA’s Wanderley agreed that the ability for creditors to file an alternative plan will change the negotiation dynamic between creditors and debtors and may lead to more accelerated processes.

“I do think this is a game changer,” Wanderley said. “I’m not sure if at the end of the day creditors will have the opportunity to file a competing plan in all bankruptcies, but the sole fact that they may file a plan will likely lead to more balanced negotiations during the debtors’ exclusivity period to file a plan.”

There are two scenarios where creditors will be able to file alternative plans, he explained:

- If the debtors’ plan filed within the exclusivity period is not voted on by the end of the stay period (180 days, which can be extended for another 180 days); and
- If the debtors’ plan is voted on and rejected.
    - If, at the meeting where creditors rejected the debtors’ plan, creditors holding 50% or more of all claims attending the creditors’ meeting would approve the possibility for creditors to file a plan, then creditors will have 30 days to file one. That plan will need to be backed by at least 25% of all claims across all classes or by 35% of the claims attending the meeting that rejected the plan.

BMA's Wanderley explained that under the new law, there are also some restrictions which are imposed on the creditors' plan. For example:

- Creditors would not be able to force shareholders to capitalize the company; and
- The plan cannot place the debtors and the shareholders in a position which is worse than they would be in in a hypothetical bankruptcy liquidation.

There is room for debate on exactly what this last provision means, he said. Whether, for example, the hypothetical bankruptcy liquidation should be considered in the context of equity only, equity plus prepetition loans, or if postpetition loans should also be included in the hypothetical liquidation.

Further, a creditor-backed plan would have to provide for the release of personal guarantees granted by shareholders that are natural persons. In Brazil, where purely unsecured loans are a rarity and banks obtaining collateral from shareholders is commonplace, this may impose a challenge for Brazilian banks in such circumstances, Wanderley said.

Responding to an audience question, BMA's Savi and Wanderley clarified that creditors only have one shot to present a plan, but the stay period would be extended for a further 180 days under those circumstances. The new law also provides for a 90-day limit to conclude creditors' meetings duly installed, which means that creditors meetings would most likely not be extended for months on end and sometimes for years.

In general, negotiations should tend to take place over the course of six to nine months following the initial 180-day stay period, according to panelists.

Further, the ability to file alternative plans applies only to cases filed after the new law came into effect.

UNCITRAL and Chapter 11

Reed Smith's Berer discussed the incorporation of the UNCITRAL cross-border insolvency recognition rules into Brazilian law, allowing for chapter 15-equivalent rules in the country.

Until now, Brazil lacked cross-border insolvency recognition law rules similar to, for example, chapter 15 in the United States, which was added to the U.S. Bankruptcy Code to foster international cooperation in international insolvencies.

This meant that, for example, the Brazilian subsidiary of LATAM Airlines, which was added to the group's chapter 11 proceedings last year, was potentially unprotected against enforcement by local creditors in Brazil.

"Now that we do have the UNCITRAL model rules and recognition of foreign proceedings in Brazil, some companies like LATAM Airlines would be in a much better situation because litigation would be stayed and Chapter 11 proceedings would be recognized in Brazil," Berer explained.

Will the new rules encourage more Brazilian companies to seek protection through Chapter 11?

Berer said the new law will at least make it easier for companies to file for insolvency proceedings outside of Brazil.

"The new law and the adoption of the new model rules will increase forum shopping between Brazil and the U.S. I don't know if we will see more cases in Brazil versus the U.S., though, I think it will probably be the opposite," Berer said.

Presidential Vetoes

Bolsonaro vetoed parts of the original bill, blocking provisions that would allow asset sales free and clear of liabilities including those related to the environment and anti-corruption.

Case law had already clarified that buyers could purchase assets free and clear.

"Due to the original wording of the legislation, courts will not need to respect the veto. However, with it, we now have a situation where we might have more discussions around whether environmental and anti-corruption liabilities will be transferred to an eventual buyer," Savi explained.

Further, provisions related to the reduction of tax costs applied to haircuts in a restructuring or to capital gains in a sale were also vetoed.

The vetoes will be remanded to Congress and may be introduced back into the legislation, according to the panelists.

Despite the vetoes, panelists agreed that Brazil's new bankruptcy reforms will likely bring improvements to the previous 2005 legislation. "After 15 years of practice and case law, we could say we have achieved some degree of predictability and legal certainty - at least with regards to the most relevant legal issues in restructuring cases," Savi said.
