THE GUIDE TO RESTRUCTURING

Editors
Joy K Gallup and Michael L Fitzgerald

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Publisher's Note

Latin Lawyer is delighted to publish *The Guide to Restructuring*.

Edited by Joy K Gallup and Michael L Fitzgerald of Paul Hastings LLP and containing the knowledge and experience of 25 leading practitioners from throughout the region and across disciplines, it provides guidance that will benefit all practitioners advising on restructurings in Latin America.

Restructurings are by their nature both international and deeply domestic, and moves to standardise and draw together the legislative framework in the region demonstrate the benefits and challenges of this trend. Understanding the commonalities, but also the differences, in both black letter law and common practice around the region is critical. This guide draws on the expertise of highly sophisticated practitioners to draw out these trends and give practitioners the tools they need. Its aim is to be a valuable resource for insolvency and restructuring advisers of all stripes as they play their role in the complex economic situation facing the region today.

We are delighted to have worked with so many leading firms and individuals to produce *The Guide to Restructuring*. If you find it useful, you may also like the other books in the Latin Lawyer series, including *The Guide to Corporate Compliance* and *The Guide to Mergers and Acquisitions*.

My thanks to the editors for their vision and energy in pursuing this project and to my colleagues in production for achieving such a polished work.

Clare Bolton
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Part 1

Introduction

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CHAPTER 1

Recent Restructuring Developments in the Region: Brazil

Thomas Benes Felsberg, Fabiana Solano, Clara Moreira Azzoni and Thiago Dias Costa[1]

Overview of recent reforms in Brazilian Bankruptcy Law

The current Brazilian Bankruptcy Law, enacted in 2005, represented a major paradigm shift from the previous bankruptcy legislation, which by then had been in force for more than 60 years. With the 2005 Law, the legislators recognised the obsolescence of the rules relating to companies facing financial crisis (which focused solely on liquidation) and introduced elaborate turnaround mechanisms through collective negotiation between a debtor and its creditors – the judicial and extrajudicial (pre-pack) reorganisation proceedings, both heavily influenced by the Chapter 11 proceeding of the US Bankruptcy Code.

Having represented such a profound shift from the previous legislation, introducing mechanisms which at that point were entirely new to Brazilian legal practice, it is not surprising that the 2005 Law has been severely criticised since its inception. Problems with the legislation were accentuated with the passage of time and the maturity of the judicial practice of reorganisation proceedings, making clear, from quite early on, that there was a need for reform.

In 2020, the deep economic recession caused by the covid-19 pandemic increased the challenges already being faced by Brazilian companies and Brazil's economy as a whole – both were already weakened by successive economic crises

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resulting from the unstable political situation in the country. These circumstances highlighted the need for an urgent and comprehensive reform of bankruptcy legislation, which was already more than 15 years old.

The expected reform came – after a great deal of discussion – through Federal Law No. 14,112/2020, approved in December 2020 and entering into full force and effect in January 2021. This piece of legislation changed several provisions of Law No. 11,101/2005 (the Brazilian Bankruptcy Law) and introduced a series of material changes in reorganisation and bankruptcy proceedings, the most relevant being:

- the possibility of presentation of an alternative plan by creditors if an insolvent company does not present its plan or if the presented plan is rejected;
- the introduction of new treatment for debtor-in-possession (DIP) financing;
- healthy reforms of the liquidation in bankruptcy system, including a 180-day deadline to complete the sale of all assets;
- the possibility of selling the debtor company or group of companies as a whole, with the restructured indebtedness, to a new investor interested in continuing the business, including measures to protect the buyer from being held liable for the seller's other debts;
- an improvement in the tax treatment of distressed companies;
- the option to replace in-person creditor meetings with virtual meetings or written adherence terms that prove the achievement of the deliberation quorums;
- new rules for substantive consolidation, with proposed objective criteria to guide its application by the courts;
- the possibility of replacing the two-year judicial monitoring of insolvent companies with private monitoring (thus terminating the reorganisation procedure with the court's confirmation of the plan);
- reduction of the quorum needed to approve pre-packaged reorganisation plans, from 66 per cent to more than 50 per cent of the claims of each impaired class of creditors; and
- the possibility of a fresh start for insolvent companies and related individuals, with a significant reduction of the applicable time frames.

The main objectives of the reorganisation proceedings, as introduced by the 2005 Law, can be described as (1) providing mechanisms for the debtor to reorganise its capital structure and overcome its liquidity problems, avoiding the aggravation of a financial crisis that would evolve into an irreversible liquidation, and

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(2) saving creditors from a destructive and unsatisfactory predatory rush for the debtor's assets, since it is assumed that the debtor company does not have sufficient assets to cover the full payment of its debt.

In a judicial reorganisation, the debtor is obliged to present a reorganisation plan containing a detailed description of the process being employed to turn around its business. Creditors with the right to vote on the plan are organised into four distinct classes: labour, secured, unsecured and small business. Decisions about the plan are made separately by each class under a simple majority rule (more than 50 per cent), which can involve headcount or claim value, depending on the class. The decision made by the creditors as a group will affect dissenters.

The new 2020–2021 rules were enacted with the declared intention of improving the tools available for the recovery of the debtor. To this end, the new rules strengthened the position of creditors (as discussed below in more detail) and imposed new challenges on debtors in addition to those experienced previously.

Below, we discuss some of the more relevant changes introduced by Law No. 14,112/2020 and their potential consequences.

Creditors' reorganisation plan

Traditionally in Brazil, it has been assumed that the debtor would be the only qualified agent to propose its own judicial reorganisation plan. The concept was that, since the debtor is the sole conductor of its economic activity, of which it remains 'in possession' during the judicial reorganisation proceeding, only the debtor would know which paths and measures would or would not be viable for its own turnaround. The creditors would have the role of negotiating and approving the plan, but its proposal or any modification in its terms should always require the debtor's consent.

Reversing that traditional assumption, undoubtedly one of the most important of the many changes made to the Brazilian Bankruptcy Law by the 2020–2021 reform, is the possibility of a group of creditors presenting a reorganisation plan that will then be voted on by the creditors and, if approved and confirmed, will be imposed on the debtor regardless of its agreement.

Under the reform, there are two instances in which creditors can present a reorganisation plan. The first is based on the concept of an 'exclusivity period', as adopted by the US Bankruptcy Code. The Brazilian reform partially adopted this concept by providing that if the plan presented by the debtor is not voted on by creditors within 180 days, creditors are entitled to propose a plan (provided that certain requirements are met). The Law continues to provide that the debtor must present a plan within a non-extendable period of 60 days after publication of the decision that commences the judicial reorganisation, under penalty of liquidation.

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The second instance in which creditors are allowed to submit a reorganisation plan is if a plan presented by the debtor is rejected by a general meeting of creditors. If this happens, the bankruptcy trustee will ask the creditors if they wish to be granted a further 30 days so that a creditors' plan can be presented. The granting of this additional term must be approved by creditors representing more than half of the claims present at the meeting and there is no provision allowing for any extension to this term. If the creditors do not approve this additional term, or if it lapses without any plan being presented, the judicial reorganisation may be converted into a liquidation in bankruptcy. If the creditors approve the additional 30-day period for the filing of a plan by the creditors, the 180-day stay period is considered automatically renewed.

For the creditors' plan to be presented for approval by vote, it must meet the following requirements:

- The plan presented by the debtors (and rejected by the general meeting of creditors) does not fulfil the requirements for approval via cramdown.
- The plan must be supported or subscribed by more than 25 per cent of the impaired claims, or more than 35 per cent of the claims presented at the general meeting of creditors that rejected the debtor's plan.
- The plan must describe the process of reorganisation and be accompanied by feasibility and assessment reports.
- The plan cannot impose new obligations on the debtor's equity holders.
- The plan must release the personal guarantees provided by third-party natural persons (not legal entities) in favour of creditors who propose the plan or who approve it.
- The plan may not impose on the debtor or its equity holders greater sacrifice than they would bear in the case of a liquidation in bankruptcy.

It is important to note that, apart from the above-mentioned rules regarding the debtor's equity holders and no worse conditions than those they would face in a liquidation, the law imposes no restrictions on the content of the creditors' plan. This plan can provide virtually everything that can be provided for by the debtor's plan – including debt-to-equity conversion (under conditions set by the creditors themselves) and any consequent change in the control of the debtor company, subject to granting withdrawal rights to the debtor's equity holders.

One of the main consequences of a creditors' plan is a significant increase in the power and influence of creditors in the fate of the company under reorganisation. Creditors (who, until recently, could only approve or reject the debtor's proposal) may now take an active role, being able to prepare and impose their own reorganisation proposal, simply by rejecting the debtor's proposal. It is interesting

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to note that there is no express restriction on the vote of creditors who have offered the plan, which could eventually raise a potential conflict of interest between these creditors (who have sufficient claims to draft and propose the plan) and the others (who do not have enough claims to influence it). However, the courts have been granted the power to decide whether a plan complies with insolvency law guidelines.

In view of the significant effect they could have in practice, the legal community had some reservations about the provisions relating to the creditors' plan. For example, it has been criticised for allegedly resulting in an excessive imbalance of power in the negotiations between the debtor and its creditors, as certain groups of creditors may tend to reject the debtor's plan (albeit reasonable) just to be able to impose their own version of the plan (which may not be as reasonable). There is also no express legal requirement that the creditors' plan be concerned with preserving the debtor company (one of the central pillars of the Brazilian Bankruptcy Law), nor with protecting the interests of other stakeholders. The courts will probably act to restrain abusive plans as case law has been developing in this area in recent years.

The creditors' plan may well become an interesting tool for investors who are interested in acquiring control over distressed companies. The express provision that the creditors' plan may provide for debt-to-equity conversion and impose a change of control allows potential investors to acquire non-performing loans and other claims against the debtor company and organise a takeover of the debtor company through the approval of their own judicial reorganisation plan. The new law also permits the free and clear acquisition of distressed businesses and companies, with their debt restructured. It is expected that case law will evolve significantly in the coming years, as potential transactions are submitted to the judiciary for the resolution of insolvencies. At present, it is noticeable that there is an increase in negotiations to resolve insolvencies – an interesting and positive development in this area.

New DIP financing rules

Another major innovation brought about by the 2020–2021 reform concerns the provision of express rules for the financing of companies undergoing judicial reorganisation – known as DIP financing. The Brazilian Bankruptcy Law, as enacted in 2005, did not contain express rules to guarantee any type of priority or security to lenders interested in lending new money to companies undergoing judicial recovery. As a result, access to credit by companies undergoing reorganisation has always been very restricted, which has contributed greatly to the low success rate of judicial reorganisations to date in Brazil.

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In an attempt to change this situation, the reform introduced new rules regarding DIP financing, creating a partial priming, by allowing second-degree guarantees of assets securing debts, the value of which is less than the guarantee. According to these rules, the court, after hearing the creditors, may authorise the debtor to contract loans guaranteed by its own fixed assets or those of third parties, to finance the debtor's activity, to obtain funds to cover the expenses of the restructuring and to preserve asset value.

DIP financing operations authorised by the court have the following advantages:

- they can be provided or guaranteed by any person, including equity holders of the debtor and other companies in its economic group;
- they may involve subordinated guarantees (except if fiduciary) without the need to obtain the consent of the creditor holding the senior guarantee;
- claims derived from the DIP loan (limited to the amounts actually disbursed by the creditor) are given superior priority in bankruptcy; and
- the priority and the guarantees are not prejudiced if the decision authorising the DIP loan is overturned by the court of appeals, or in the event of the debtor's liquidation decree.

The new rules are not immune to criticism, however, as there are aspects that are not clearly defined, for example, in respect of superior priority and whether DIP loans authorised by the plan would still require court authorisation. These questions will need to be clarified in future court cases.

In general, we expect that the new statutory rules on DIP financing will generate greater confidence for potential lenders and will stimulate the financing market for companies in distress.

A faster and more efficient liquidation proceeding

In addition to the changes relating to reorganisation proceedings, another main focus of the reform was the process for liquidation in bankruptcy. Liquidation proceedings in Brazil have always been very inefficient and they have tended to last for many years. Under these circumstances, it is very common for assets to get lost in a long and bureaucratic process, remaining unsold for a long time and without adequate protection, consequently losing a considerable part of their value. Such long liquidation proceedings not only clog up the courts and are bad for the economy, but also represent an unnecessary burden to individuals.

To eradicate this situation, the new rules now foresee, as one of the general objectives of the bankruptcy process, the optimisation of the productive use of assets, through the rapid liquidation of unviable companies and the efficient

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reallocation of their assets and resources in the economy. More specifically, the law provides that a bankruptcy trustee must present an organised liquidation plan for the assets, which shall provide for a period not exceeding 180 days for the sale of all of such assets. Failure by the bankruptcy trustee to comply with this term may lead to his or her dismissal.

To make it possible for asset sales to take place within such a short period (180 days), the new rules also removed the restrictions concerning the minimum price at which such assets may be sold. More specifically, under the new rules, sales of assets in liquidation proceedings are not impaired by the legal concept of 'unrelated to base cost' – according to which assets in a judicial proceeding cannot be sold for less than 50 per cent of their appraised value under any circumstance. This means that, for the sale to take place quickly, the assets may be sold at extremely attractive prices.

Despite the good intentions of the new rules, we believe they will be effective only to the extent that the courts embrace the reasons why they were enacted. In any event, whether or not they will result in an effective reduction in the duration of the bankruptcy process as a whole, it is clear that the new rules, by establishing the sale of all assets in such a short period, may generate good investment opportunities for domestic and foreign investors who are interested in acquiring assets from companies being liquidated.

Adoption of the UNCITRAL Model Law

The Brazilian Bankruptcy Law, as enacted in 2005, lacked any provisions regarding cross-border insolvency cases, or even cases of insolvency of corporate groups in general. The absence of specific legislation for cross-border cases, coupled with the rise in the number of such cases, led to a lack of legal certainty with respect to the recognition of foreign insolvency decisions and proceedings, which is inconsistent with the requirements of modern economies.

In attempting to close that gap, the 2020–2021 reform adopted the Model Law on Cross-Border Insolvencies issued by the United Nations Commission on International Trade Law (the UNCITRAL Model Law). Law No. 14,112/2020 introduces a new chapter in the Brazilian Bankruptcy Law entirely dedicated to international insolvency, in which the UNCITRAL Model Law is adopted almost in its entirety, with very few necessary adaptations to make it compatible with the Brazilian legal framework.

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In addition to the general provisions relating to international insolvency, Law No. 14,112/2020 also presents specific rules concerning and, in many ways, reaffirming:

- equal standing of the rights held by foreign and Brazilian creditors in insolvency processes;
- access to Brazilian jurisdiction by foreign representatives;
- requests to Brazilian courts for recognition of foreign proceedings;
- cooperation between foreign and Brazilian courts; and
- specific regulations for proceedings running concurrently in Brazil and overseas.

The adoption of the UNCITRAL Model Law as a reference for cross-border insolvency rules in the Brazilian Bankruptcy Law is one of the most important aspects of the reform. The inclusion of solid and tested rules in the area will avoid many of the problems that have already occurred in other cases and will bring much more reliability to the courts in deciding on cross-border matters.

New role for hedge funds in reorganisation

As already mentioned, one of the main consequences of the reform is the attribution of greater power to creditors. This occurs both through the inclusion of the possibility for creditors to offer a reorganisation plan, as explained above, and through the inclusion of a number of guarantees and protections for certain unimpaired claims (not subject to the reorganisation proceeding), including a rule that states that 'unimpaired' creditors have the right to file for the debtor's liquidation in bankruptcy if the latter disposes of assets in such a way that there are no assets or insufficient cash flow to pay these unimpaired claims. This provision particularly benefits financial institutions, which are often holders of fiduciary guarantees and, therefore, unimpaired by legal determination.

In these circumstances, in which greater power is attributed to large financial creditors, attention may be drawn to an especially important player, which could come to have a decisive influence on reorganisation procedures going forward: the hedge fund.

It is a fact that, with the new dynamics of the reorganisation proceedings, the power of large creditors (banks and financial institutions) increases, as does the tendency of creditors to unite into large groups to strengthen their influence. In this circumstance, smaller creditors and those who are unable to unite into groups lose much of their influence and, consequently, tend to sell their claims. This circumstance increases the supply of non-performing loans and other claims held

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by smaller creditors (with a consequent reduction in the price of these claims), thereby encouraging the activity of hedge funds and bringing good business opportunities to those that specialise in distressed investment.

With the acquisition and pooling of a good number of claims from smaller creditors, hedge funds may also prove to be an important part of the development of a reorganisation strategy – either through the union with large financial creditors with the purpose of structuring operations for the acquisition of control of the debtor company, or through opposition to these large financial creditors, preventing such a strategy from being carried out. In any case, this opens a compelling and unprecedented door for hedge funds looking to invest in distressed companies, with very interesting opportunities ahead.

Conclusions

Overall, despite a number of issues and points to be noted, the changes that the 2020–2021 reform brought to the discipline of the Brazilian Bankruptcy Law are welcome. In particular, the new rules that privilege lenders and investors should be highlighted, since they can contribute to the creation of an important market – still non-existent in Brazil – for granting credit to companies in distress. It is true that some aspects of the reform deserve more attention, many of which are mentioned above, but the initial balance is that the advantages of the reform outweigh the disadvantages. These positive effects are expected to be felt in practice very soon.

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Published by Latin Lawyer and edited by Joy K Gallup and Michael L Fitzgerald, partners at Paul Hastings LLP, *The Guide to Restructuring* is designed to assist restructuring advisers of all disciplines, and affected companies, as they negotiate complicated restructurings.

This guide delivers specialist insight to our readers across the region – advisers, practitioners, corporate decision makers and court officials – throughout the process.

In preparing this guide, we are grateful for the cooperation and insight of the broad range of participating advisers and practitioners, who have contributed a wealth of knowledge and experience.

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