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Spotlight on Brazil

Cross-Border Insolvency: Recuperação Judicial vs. U.S. Chapter 11

The bankruptcy proceedings of Brazilian oil companies OGX and OSX have all the makings of a financial soap opera: one high-profile billionaire filing for bankruptcy on behalf of two related enterprises with a combined debtload of more than $5 billion[1] equals expensive clashes with the U.S.'s largest bondholders and Brazilian financial regulators. As the world has watched OGX and OSX owner Eike Batista fall from grace after his initial October 2013 default, it has also gained an unprecedented view into the topsy-turvy nature of Brazilian bankruptcy and restructuring laws.

PIMCO and Blackrock were among the biggest holders of OGX bonds at the time of the bankruptcy filing, but they are not the only foreign investors with a substantial stake in Brazil. Demand for Brazilian bonds skyrocketed between 2008 and 2012 thanks to Brazil's strong overall economic growth. Supply kept pace: the Brazilian government issued billions of sovereign debt during that period, in part due to the costs associated with hosting the recent 2014 FIFA World Cup the 2016 Summer Olympics. The country spent an estimated $11.5 billion on the World Cup,[2] and the $2.3 billion initially allocated toward the Rio de Janeiro Olympics is slated to grow.[3] Brazilian corporations, for their part, issued a record $47 billion in bonds in 2012, up over seven-fold from just $6 billion in 2008.[4]

Now, however, the Brazilian economy is slowing down faster than special events can buoy it up. GDP growth slid from 7.5% in 2010 to 2.3% in 2013, and S&P recently cut the country's sovereign debt rating to BBB-, one step away from speculative grade territory.[5] Many investors are learning that the debt that once looked so attractive may produce significant losses instead of gains. They're also discovering that the process of stemming the potential losses is more complex and less certain than they may have assumed, thanks to a Brazilian bankruptcy system that varies significantly from the U.S. model upon which it is based.

Amid this uncertainty, one thing is clear: knowledge is power. Here, we review the basics of Brazilian bankruptcy law and procedures to equip investors to defend their claims and maximize their recovery rates.

1 "OSX becomes second Batista company to file for bankruptcy," Sabrina Lorenzi, Reuters, November 11, 2013. http://mobile.reuters.com/article/topNews/idUSBRE9AA0U920131111?irpc=935

2 "Hope Fades in Brazil for a World Cup Economic Boost,"John Lyons and Loretta Chao, Wall Street Journal, May 27, 2014. http://online.wsj.com/articles/hope-fades-in-brazil-for-a-world-cup-economic-boost-1401242039

3 "Rio Olympic Infrastructure Costs of $2.3billion Are Set to Rise," Tariq Panja and David Biller, Bloomberg, January 28, 2014. http://www.bloomberg.com/news/2014-01-28/rio-olympic-infrastructure-costs-of-2-3-billion-are-set-to-rise.html

4 As cited in Jeffrey M. Anapolsky, & Jessica F. Woods, *Pitfalls in Brazilian Bankruptcy Law for International Bond Investors*, 8 J. Bus. & Tech. L. 397 (2013)

5 "S&P Cuts Brazil Credit Rating in Blow to Rousseff," Alonso Soto, Reuters, March 24, 2014 http://www.reuters.com/article/2014/03/24/ratings-brazil-idUSL4N0ML4HZ20140324

Background of Nova Lei de Falências e Recuperação de Empresas (Lei No. 11.101)

Brazilian legislators signed the existing bankruptcy law, Nova Lei de Falências e Recuperação de Empresas (Lei No. 11.101), on February 9, 2005. The 2005 law replaced a 1945 law and improved the outlook for firms filing for bankruptcy protection in a number of ways, namely by introducing the concept of an organized court-supervised restructuring process to Brazil.

Previously, Brazil's bankruptcy system was based on stretching out interest payments over longer terms and at higher interest rates rather than restructuring the debt or the business. As a result, the demise of ailing firms was practically ensured as secured creditors foreclosed on their collateral to recoup what little they could. Inspired by the U.S. bankruptcy code's Chapter 11 procedure, the new Brazilian law and the specialized restructuring process contained within it—Recuperação Judicial—incentivizes creditors to take an active role in preserving a troubled firm's value rather than bleeding it dry. This potential for value preservation has more than tripled the number of ailing companies seeking Recuperação Judicial each year; from 252 in 2006 to 874 in 2013, according to Serasa Experian. During the same period of time, liquidation requests fell by half, to fewer than 2,000 in 2013. The process also allows for asset sales, which can increase the value of the estate.

The OGX saga is the largest and most recent test of the new system. The oil exploration company filed for bankruptcy protection in October 2013 with approximately $3.8 billion of debt,[6] and the next month, its sister company, oil rig shipbuilder and lessor OSX, also filed for bankruptcy protection with approximately $2.2 billion in debt, making the combined filings the largest in the history of Latin America.[7] Prior high-profile cases include airlines Viação Aérea São Paulo SA (known as VASP) and Viação Aérea Rio-Grandense SA (VARIG); pulp producer Eucatex SA; the agricultural company Agrenco; the beef producer Frigorífico Independência; and the electricity holding company Grupo Rede Energia SA.

So far, Recuperação Judicial proceedings have produced mixed outcomes for investors. One recent study shows that few firms filing for bankruptcy protection since 2005 emerged as operating companies. Eucatex SA is one example of a successful exit from the process. Some companies in Recuperação Judicial, such as Grupo Rede Energia SA, were sold off to healthier firms that continue to operate the assets. Many others, such as VASP and VARIG, were liquidated. However, the potential for a higher recovery rate can be strong. Of 10 pre-OGX high-profile Brazilian bankruptcy cases examined by Goldman Sachs, the average so-called haircut, or losses of secured bank lenders' principal, amounted to 49.7 percent.[8]

What Investors Need to Know About Nova Lei de Falências e Recuperação de Empresas (Lei No. 11.101)

While the new Brazilian bankruptcy law is inspired by U.S. Chapter 11 procedures, many important differences exist between the two. Some of the most relevant include:

1. **Brazilian bankruptcy law prioritizes equity holders over secured and unsecured debt holders, rather than putting them last in line as U.S. Chapter 11 does.** Even when equity appears to have no value, equity holders of troubled companies in Brazil can strongly influence the restructuring process from behind the scenes, since their ownership under Brazilian law affords them ultimate authority to approve a restructuring plan. Controlling shareholders, such as OGX/OSX's Batista, can present the recovery plan for their companies, veto any undesired adjustments, and often hand-pick a buyer for the assets. Secured and unsecured creditors, conversely, have a limited voice in how the debtor restructures, as they cannot officially present their own plan. However, they are not necessarily prevented from doing so. Unorganized creditors, unaware of the powerful potential of unity are left with no choice and may only vote on what the company presents. "International debt investors are often surprised to learn how little influence they have in a Brazilian bankruptcy proceeding, even when they hold substantial stakes in a company," says Antonio Aires, a partner at Demarest Advogados law firm in São Paulo. This is a critical point since the law is still relatively new where few precedents exist. A reasonable judge may consider a creditor plan that makes sense and potentially implore the Debtor to adopt the plan if it is reasonable. Organized creditors that present a sensible and reasonable plan to the judge in the best interest of the Estate that competes with the debtor's plan, may actually compel the debtor to consider it or modify their existing plan. Equity holders have some incentive

6 OGX highlights flaws in Brazil's bankruptcy laws By Joe Leahy and Samantha Pearson, São Paulo, November 7, 2013 http://www.ft.com/intl/cms/s/0/e1d5ecb6-47cd-11e3-9398-00144feabdc0.html#axzz3aDmL69je

7 OSX becomes second Batista company to file for bankruptcy, by Sabrina Lorenzi, Rio de Janeiro, November 11, 2013 http://www.reuters.com/article/2013/11/11/us-brazil-batista-osx-idUSBRE9AA0U920131111

8 Analyzing the legal recovery law and alternatives for OGX; Goldman Sachs Equity Research, October 10, 2013

to negotiate with creditors who are large enough to potentially block a restructuring plan, however; leading to preferential treatment for some and disadvantages for others.

2. **The Brazilian court system handles bankruptcy very differently and much less consistently than the U.S. one does.** Unlike the U.S., Brazil does not have a separate specialized federal bankruptcy court to handle bankruptcy proceedings, so restructuring decisions are adjudicated through the general Brazilian court system. However, a few states such as São Paulo have specialized bankruptcy courts. As a result, judges' familiarity with the Brazilian bankruptcy law can vary greatly by state and bankruptcy case experience. However, troubled companies have no choice as to venue: debtors are required by law to file bankruptcy petitions in the state where the company is headquartered.

   Adding to the complexity, employees who are owed wages by the troubled company can stymie the restructuring process by filing actions in a separate labor court, but they may be overruled by the competent Brazilian bankruptcy judge. Note that each single creditor's vote, despite the amount of their claim, counts as one vote—just as much as a single $100 Million secured bondholder's vote. This issue came to bear in the 2005 VARIG case, which was the first large case to be filed under the new law. The case lasted on for about two years, as a labor court judge's order to freeze assets blocked the sale of the airline that creditors had approved. An appellate court ultimately allowed for the sale to proceed, free of labor claims. This decision was affirmed by the Brazilian Supreme Court.

3. **Legal timelines are highly variable.** On paper, the Brazilian restructuring process is efficient (see page 5). Once a judge approves the processing of a reorganization, and the debtor enumerates what it owes, debt holders have a brief 15 days to challenge administratively the values or to submit missing claims. The debtor also must work quickly, as the deadline to file a reorganization plan is 60 days from the judge's processing approval. Creditors then have 30 days from the plan's filing to object, with the caveat that they must vote on the reorganization plan within 180 days of the judge's processing approval to avoid the suspension of the stay period. Unlike in the U.S., creditors do not have the right to propose their own plans or extend the timeline to consider other value preserving options. In practice, this timeline can be extended, if the postponement is not caused by the debtor.

   According to Goldman Sachs' analysis of large cases prior to OGX, seven out of ten lasted two years or more, with several going much longer. For example, Parmalat Brasil's plan was approved within the 180 day deadline, but it was amended several times and the whole process took more than five years to resolve. Also VASP, which was liquidated, has vintage 2006 payments still under discussion.

4. **A judicial administrator is a key point of contact for creditors in Brazil.** Brazilian bankruptcy and reorganization law requires bankruptcy judges to appoint a Judicial Administrator (JA) for each case. The JA plays a critical and dynamic role; supporting the judge, debtor and creditors while monitoring the restructuring process. Among the JA's duties are examining, adjusting and listing the credits for the reorganization, presiding over the creditors' meetings and monitoring the approved restructuring plan. The JA issues monthly reports on the activities and financials of the debtor company and its compliance with the approved reorganization plan. He or she typically has the power to communicate information to creditors and help them organize, resolve disputes, and explain their viewpoints to the judge. Upon request, the JA may also advise the judge on business, accounting and even legal issues related to the management of the reorganization.

   If an approved JA restructuring plan fails during the judicial plan period for any reason, then the JA has the legal obligation to communicate the failure to the judge, who should initiate the process to liquidate the company. In reality, however, the JA's implicit role is to give the judge an overview of the whole situation and avoid a decision to liquidate based on a minor covenant or default.

How Investors can protect their interests

Creditors have limited legal leverage in the Brazilian bankruptcy process, but they may have opportunities to improve their recovery rate by understanding which parts are negotiable and where irregularities are likely to emerge.

When it comes to the reorganization plan, Brazilian law only affords creditors indirect and limited influence. However, creditors can advocate for the size of the claims they are owed, providing solid documentation and compelling logic. They can also challenge figures the company might provide with the reorganization plan, such as the value of remaining assets, to ensure that the total amount available for recovery by creditors is as large as possible.

As they work through the restructuring process, investors should also leverage the influence of the JA. While the JA produces some perfunctory reports about the debtor's detailed and timely financial situation, they can often provide more detailed and timely information upon request.

Creditors can also consider organizing themselves more formally to improve recovery rates. "There are a number of actions that groups of sophisticated investors should—but often don't—take to unify negotiations," says Aires of Demarest Advogados. Among those are: hiring well-known advisors to uniformly represent the whole group of creditors and creating a detailed intercreditor agreement that sets out parameters including terms, haircuts, and other specifics, such as how expenses will be shared. This type of organized effort "would not only increase the chances of negotiating a reasonable recovery plan, but also create an environment of stability and visibility that may attract other investors," Aires notes.

The most concrete way that creditors can stem losses is by providing Debtor-in-Possession (DIP) financing, or putting "new money" into the debtor to improve the chances and rate of recovery on their pre-existing troubled investment. However, the "new money" has in practice only been provided if the debtor has solid guarantees to offer. This financing is the first to be paid back but it is shared by all those who have extended credits after the filing. Therefore, the guarantee requirement is of essence and the vote of confidence can upgrade existing debt to a higher pay-out level. DIP lenders also can negotiate to receive equity in the new, reorganized company, which is typically a good value thanks to its restructured balance sheet as a result of the reorganization.

Absolute priority list

1. **Salaries due:** In the 3 months before the bankruptcy filing (up to 5 minimum wages) (art. 151)
2. **Excluded credits:** Advances on foreign exchange agreements, judicial administrator's fees, fiduciary liens (art. 84)
3. **Labor:** 150 minimum wages [approx. US$ 50,000.00 and occupational accidents (art. 83, I)
4. **Secured credits:** Mortgages, pledges (art. 83, II)
5. **Tax credits:** (Art. 83, III)
6. **Special privilege:** Rural worker's right of retention of tools for salaries, worker for improvements made in a machine, etc… (art. 83, IV)
7. **General privilege:** Taxes of the current and previous year (art. 83, V)
8. **Unsecured credits:** Plus surplus labor credits and secured guarantees (art. 83,VI)
9. **Fine and pecuniary penalty:** Include tax and contractual penalties (art. 83,VII)
10. **Subordinated credits:** (art. 83, VIII)

Source: Demarest Advogados

Unfortunately, getting the benefits of DIP financing may require knowledge, since the process for selecting these lenders should be offered to all creditors. In the OGX case, for example, this is being disputed as original creditors together injected an additional $215 million into the company in a debt for equity swap (as of early 2014).[9] This amount was later increased to almost US$300MM. However, large creditors holding about 55% of the bonds formed an ad hoc committee that was responsible for the bulk of the financing and saw the greatest benefits, according to Barclays.[10] This group, led by investment giants such as PIMCO, injected almost US$300 million into OGX in exchange for a 66.7% equity stake in the new company. This DIP financing was not converted into equity as originally envisaged because of the fall of oil prices, which may generate a litigious recovery. Had such DIP loan been converted, the remaining creditors, who had less opportunity to participate in DIP financing, but may have also been reluctant to risk additional funding due to uncertainty, would only see a 14.6% stake in the company.

While creditors may argue unequal treatment, the OGX case does include a number of encouraging developments for lenders, including the remarkable amount of equity that transferred hands. Batista, who by law could have retained 100% of his stake, gave up all but 5% in early negotiations and sold several assets that provided much-needed cash for ongoing operations. "The OGX/OSX reorganization procedure reveals how creative many players involved have been in trying to maintain a lifeline for the operations," says Aires.

In the end, as is often the case in any complex reorganization regardless of the home field not everything goes according to plan. The OGX story continues to evolve as Batista has now regained de facto control of the company, as the DIP lenders are no longer interested in the conversion due to the recent precipitous drop in oil prices. However, OGX/OSX set a trailblazing precedent in Recuperação Judicial on how to create a DIP facility and structure debt to equity swaps within the framework of the law, unleashing and eliciting the very spirit of restructuring as creative Brazilian company renewal and deal making experimentation continues in live reorganizations, such as Eneva, Aralco, Lupatech and Inepar.

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9 Bloomberg: OGX Creditors to Inject $215 Million as Batista Bows Out, By Cristiane Lucchesi, Juan Pablo Spinetto and David Biller, Feb 9, 2014

10 Bloomberg: OGX Holders Advised by Barclays to Inject More Cash for Swap,By Cristiane Lucchesi, Boris Korby and Peter Millard, Jan 15,2014

Conclusion

Looking ahead, the OGX/OSX saga will likely prompt international bond investors to look more warily at Brazilian debt deals, but may also spur a better environment for a workout when they hit trouble. The increase in corporate restructurings also appears to be galvanizing a new market for distressed debt in Brazil, giving investors a reasonable alternative to working through Recuperação Judicial. For example, BlackRock, one of OGX's largest bondholders, reportedly sold its distressed shares in the company rather than participate in the DIP financing. "Recuperação Judicial has been in high demand in 2015 and should remain so. Bankruptcy is like surgery, you try to solve it negotiating and restructuring, re-profiling debt, reorganizing the company and the business activity," says Thomas Felsberg, a partner at Felsberg e Associados. Learning the ins and outs of the law is likely to help investors improve recovery rates in ailing firms now and for years to come, as the number of firms entering bankruptcy and Recuperação Judicial rises.

What happens when a company files for bankruptcy in Brazil?

1. A local judge (as opposed to a federal judge in U.S. bankruptcy cases) is assigned to the case and appoints a Judicial Administrator to assist him or her in the management of the bankruptcy/reorganization.

2. Within 60 days of filing for bankruptcy protection, the company's management team must present a detailed recovery plan, provide an independent estimate of its existing assets, and outline concrete steps to restore financial viability, which will likely include a proposal for debt renegotiation. Unlike U.S. procedure, which offers 120 days and the option to extend up to 18 months, this period cannot be extended in Brazil. Also, only the company may present a plan in Brazil, unlike in the United States where creditors are given the opportunity to do so if no plan is submitted within 180 days.

3. Creditors, on an individual basis, have 30 days from the presentation of the recovery plan to declare themselves in favor of the plan or opposed to it.

4. If there is at least one objection, a creditors meeting must be summoned to decide on the plan. Any adjustment to the plan must be approved by the company's controlling shareholders or management, as the case may be. If no approval is reached, the company automatically goes into bankruptcy liquidation. As a result, creditors generally have limited ability to influence the company plan.

5. If the recovery plan is approved, the company must comply with it during a monitoring period of two years from the date of the judge's approval of the reorganization plan. Should the company fail to implement the plan, the court may be able to force it into bankruptcy liquidation.

Source: "Analyzing the Legal Recovery Law in Brazil and alternatives for OGX", Goldman Sachs Equity Research 10 Oct. 2013: 7.

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