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OGX Insolvency – What Distressed Investors Need to Know About Brazilian Bankruptcy Process

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On October 30, 2013, Brazilian oil company OGX Petróleo e Gas Participações SA (OGX) filed for bankruptcy protection (or “judicial reorganization”) in Rio de Janeiro after restructuring discussions between the company and its major creditors ended without agreement. With nearly \$5 billion of debt, OGX is the largest and most complex bankruptcy proceeding to be conducted in Latin America and will not only test Brazil’s nascent bankruptcy law, but also presents itself as the latest potential opportunity for distressed investors focused on Latin American emerging markets.

OGX values itself between \$2.4–\$2.7 billion, with liabilities between \$5.1–\$6.8 billion. Its largest single creditor is its sister company, OSX Brasil SA (OSX), a shipyard and ship-leasing company, which claims it is owed at least \$1.1 billion (representing approximately 21 percent of OGX’s obligations). Despite currently low expected recoveries for unsecured creditors, there still exists substantial opportunity to uncover value in the company’s distressed debt and trade claims. OGX’s creditor list contains upwards of 250 creditors, including major companies such as Diamond Offshore Drilling, a Houston-based drill-rig operator; EnSCO, Inc., a London-based drill-rig operator; and General Electric. The company’s largest bondholders (with a total of \$3.6 billion outstanding), are led by PIMCO and BlackRock.

The current Brazilian Bankruptcy Law (No. 11101/05) (BBL) was enacted in 2005 for the purpose of increasing the effectiveness and efficiency of judicial reorganization and liquidation proceedings in Brazil. Inspired by Chapter 11 of the US Bankruptcy Code, the BBL was designed to remedy Brazil’s prior insolvency system, which was widely regarded as heavily anti-creditor and resulted in creditors demanding exorbitant interest rates from Brazilian borrowers to offset their dismal bankruptcy recovery risk.

Due to its magnitude and intertwined corporate structure (i.e., OSX is not only OGX’s largest creditor, but is also expected to file its own bankruptcy petition next week), OGX and OSX’s insolvency proceedings will certainly test the competence and efficacy of Brazil’s eight-year-old judicial reorganization process. If administered properly, OGX’s reorganization can offer the struggling company a chance to reduce its liabilities and to emerge as a going concern. However, if the plan is not timely approved by creditors, under the BBL, the case will automatically convert into a liquidation.

Although the BBL was modeled after the US Bankruptcy Code, a number of important differences do exist, with significant implications for bankruptcy claim traders. When compared against common US Bankruptcy Code provisions, there are critical issues that claim traders must be mindful of when investing in OGX, including (i) the ranking of unsecured claims, (ii) treatment of executory contracts, (iii) timing of voidable transfers, (iv) the key parties and timeline for effectuating a plan of reorganization under the BBL (a Plan) and (v) the consequence of not timely agreeing to a Plan.

Below is a comparative list highlighting some of the relevant differences between the US Chapter 11 process and Brazilian judicial reorganization which may be of concern to investors seeking to invest in OGX distressed bonds and/or claims.

Issue	US Chapter 11 Reorganization	Brazilian Judicial Recovery
Automatic Stay:	Commences as of the petition date; effective for the duration of the bankruptcy proceedings, except to the extent creditors may be granted relief for cause or with respect to their collateral.	Commences as of the court's decision to grant judicial reorganization; effective for only 180 days. Cannot be extended.
General Priority Rules:	<ol style="list-style-type: none"> 1. Secured creditors are entitled to be paid first from proceeds of their collateral, subject to competing liens; 2. Administrative expense claims, including: <ul style="list-style-type: none"> - Debtor's post-petition operating expenses and professional fees - Reclamation claims for goods shipped within 20 days pre-petition); 3. Priority claims, including: <ul style="list-style-type: none"> - Claims for certain wages and benefits - Tax claims - other claims under Section 507 of the Code (not generally significant component of total claims) 4. General unsecured claims (includes all non-priority claims, such as): <ul style="list-style-type: none"> - trade claims; - unsecured bonds; - deficiency claims, etc.; 5. Ownership interests. <p>Comity recognizes foreign proceedings even when substantive laws differ from US law, provided foreign laws are not offensive to US public policy.</p>	<ol style="list-style-type: none"> 1. Post-petition claims; 2. Labor debts resulting from: (i) salary owed/due up to a limit of 150 x minimum wages (currently, approximately \$350) and (ii) compensation of work-related accidents; 3. Creditors holding security interests, limited to the value of the secured asset; 4. Tax claims, excluding fines; 7. Credits including special statutory privileges; 8. Credits including general privileges; 9. Unsecured claims; 10. Contractual and tax fines; 11. Subordinated credits; 12. Shareholders (these are subordinated creditors).

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Executory Contracts:	<p>In order to maximize the value of the estate, the debtor has the option to:</p> <ol style="list-style-type: none"> 1. Assume; 2. Reject; or 3. Assume and assign the contract to a third party. 	<p>General Rule: In each of judicial reorganization and liquidation, the debtor must comply with its contractual obligations to preserve such contract.</p> <p><i>Exception to General Rule:</i> A contract relating to an asset deemed essential to the debtor's continued business activities may be protected for up to 180 days in certain circumstances.</p> <p>In a liquidation it is the administrator (not the DIP creditors) who may accept or reject executory contracts.</p> <p>In a judicial reorganization or liquidation a party to an executory contract with the debtor has 90 days from the date of the administrator's appointment to demand that the administrator confirm the debtor's intention to retain or terminate the executory contract. The administrator then has 10 days to reply to such a demand.</p>
Voidable Transfers:	<p>Preferences: Payments on account of an antecedent debt to insiders made within one year before filing petition and, in the case of non-insiders, made within 90 days before filing petition.</p> <p>Fraudulent Transfers: Payments made within 2–6 years of filing (depending on state law):</p> <ol style="list-style-type: none"> 1. made with intent to defraud creditors, or 2. made for less than reasonable equivalent value while debtor was insolvent. <p>Dividends made while debtor was insolvent.</p>	<p>Payments on debt made within 90 days before filing petition or before the first formal protest filed against the debtor, if such payment was not overdue at the time;</p> <p>Transactions entered into within 2 years before filing petition, if such transactions were for no consideration;</p> <p>Sale of an asset without consent from all creditors that results in insufficient funds to pay back creditors, if challenged by any creditors upon their notification of the sale.</p> <p>In certain circumstances, third-party creditors may challenge other transactions as voidable (e.g., non-arm's length transactions between the debtor's affiliates).</p>
Plan of Reorganization: Key Parties	<p>Creditors can file competing plans of reorganization after exclusivity period expires:</p> <ul style="list-style-type: none"> - Incentivizes Debtor to timely file its plan; - Incentivizes Debtor to submit plan that is "fair and equitable" to creditors. 	<p>Only the Debtor can file a plan of reorganization:</p> <ul style="list-style-type: none"> - Threat of liquidation as only alternative to judicial reorganization; - Incentivizes creditors to accept plan if marginally better than expected reorganization in liquidation.
Voting: Required Classes	<p>All impaired classes of claims must vote on the plan.</p>	<p>Voters include:</p> <ol style="list-style-type: none"> (a) labor-related claims; (b) secured claims; and (c) unsecured claims, including claimants with special or general privilege, or subordinated claims. <p>No single class has priority over another. A plan may still be approved even if one class rejects it (see below).</p>

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Voting: Rules of Acceptance	<p>Plan must be approved by each impaired class of claims, subject to debtor or other plan proponent's right to cramdown non-accepting classes, provided that there must be at least one impaired accepting class to confirm plan.</p> <p>An impaired class is deemed to accept if:</p> <p>(a) >50% in number of allowed claims accept; and</p> <p>(b) >2/3 in \$ amount of the allowed claims accepts.</p>	<p>Plan approval requires acceptance by all classes.</p> <p>A class is deemed to accept if:</p> <p>(a) approval of >50% in value of all credits held by each class of claims; and</p> <p>(b) >50% in number of all creditors present at the General Meeting of Creditors.</p> <p>Rejection by one class may be overridden provided at least 1/3 of the "rejecting" class voted to approve the plan. The calculation of 1/3 approval is conducted on a weighted and per-head basis.</p>
Plan of Reorganization: Timing	<p>Debtor has the exclusive right to submit a plan within 120 days after case filing; court has discretion to extend this timeframe up to 18 months from filing.</p> <p>After submitting a plan, debtor has an additional 60 day exclusivity period for creditors to accept the plan, after which creditors can submit competing plans of reorganization.</p> <p>If debtor does not submit a plan within 120 days after petition date or submits plan within 120 days but fails to obtain acceptance by each impaired class within 180 days, (absent an extension), creditors are free to submit their own alternative plan of reorganization.</p>	<p>Debtor must file a plan of reorganization within 60 days after the date of the publication in the official State newspaper of the decision granting the judicial reorganization; this timeframe cannot be extended.</p> <p>Creditors must vote whether or not to accept the debtor's plan at the general meeting of creditors within 150 days after the date granting the judicial reorganization.</p> <p>Creditors have 30 days to file their objections to the plan. Approval or rejection must occur during the general meeting of creditors.</p> <p>If the plan is not approved the case is automatically converted to a liquidation. However, a plan may be amended and it routinely takes longer than the 150-day period to finalize a plan. The strict timeframe for approval can be extended through different measures (e.g., a meeting will be temporarily "suspended" instead of being adjourned).</p>
Successor Liability:	<p>Assets can be sold free and clear of claims and liens, including, in most cases, successor liability claims. Note, however, that certain courts have limited a debtor's ability to sell free and clear of successor liability claims that have not accrued at the time of sale.</p>	<p>Assets can be sold free and clear of successor liability claims, including tax and labor liabilities. This protection applies if:</p> <p>(a) the sale is provided in the reorganization plan approved by creditors and ratified by the court;</p> <p>(b) the sale does not involve all the debtor's assets, but part of them integrated in an operational unit (<i>unidade isolada</i>);</p> <p>(c) the sale is supervised by the court – in most of the cases, a competitive auction is adopted.</p>

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DIP Financing:	Entitles DIP lender to increasingly extraordinary protections depending on circumstances, up to and including superpriority claims and priming liens.	Upon liquidation, all post-petition financing gets super-priority status. No formal provisions for judicial reorganization treatment.
Cross-Border Provisions:	Chapter 15 recognizes main proceedings administered in foreign courts. Comity recognizes foreign proceedings even when substantive laws differ from US, provided foreign laws are not offensive to US public policy.	No provisions recognizing foreign proceedings; parties must file with Brazilian courts. Absence of formal rules of recognition leads to unpredictable treatment of international proceedings in Brazilian courts. Although there is no express recognition of foreign bankruptcy proceedings, the US principle of comity may lead to reciprocal treatment by Brazilian courts.

The bankruptcy filing of OGX presents an unprecedented situation for Brazilian courts. The size of the bankruptcy and the involvement of prominent trade creditors and international asset managers will certainly challenge the systemic integrity of Brazil's nascent system of reorganization and the outcome could substantially affect Brazilian capital markets with reverberations across the region. Katten Muchin Rosenman LLP, through its Distressed Debt Trading and Insolvency and Restructuring groups, as well as its contacts with highly qualified Brazilian counsel, is well positioned to assist prospective debt/claim traders interested in participating in the OGX or OSX bankruptcy proceedings.

For more information, please contact your Katten Muchin Rosenman LLP attorney, or any of the following members of the **Distressed Debt and Claims Trading** and **Insolvency and Restructuring** practices.

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Katten's Distressed Debt and Claims Trading practice combines the talents of attorneys from several disciplines—derivatives, structured products, financial services, insolvency and restructuring, private equity and tax, among others—to counsel clients in all aspects of distressed debt transactions. Attorneys in Katten's Distressed Debt and Claims Trading practice have represented investors in distressed companies in connection with thousands of transactions with an aggregate value in the billions of dollars. Our experienced team of professionals guides investment banks, commercial banks, and domestic and international hedge funds through the acquisition and sale of distressed investments, including bank loans, trade claims and swap claims, as well as privately traded securities.

Katten's Insolvency and Restructuring practice advises lenders, creditors, official and unofficial committees, fiduciaries, debtors and other parties in complex bankruptcy proceedings, out-of-court restructurings and related state law enforcement actions. We are a recognized market leader in the representation of financial institutions (including in their capacity as administrative agents or indenture trustees) and lender groups in the bankruptcy context, and our attorneys have significant experience in the acquisition and disposition of businesses and assets out of distressed situations.

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