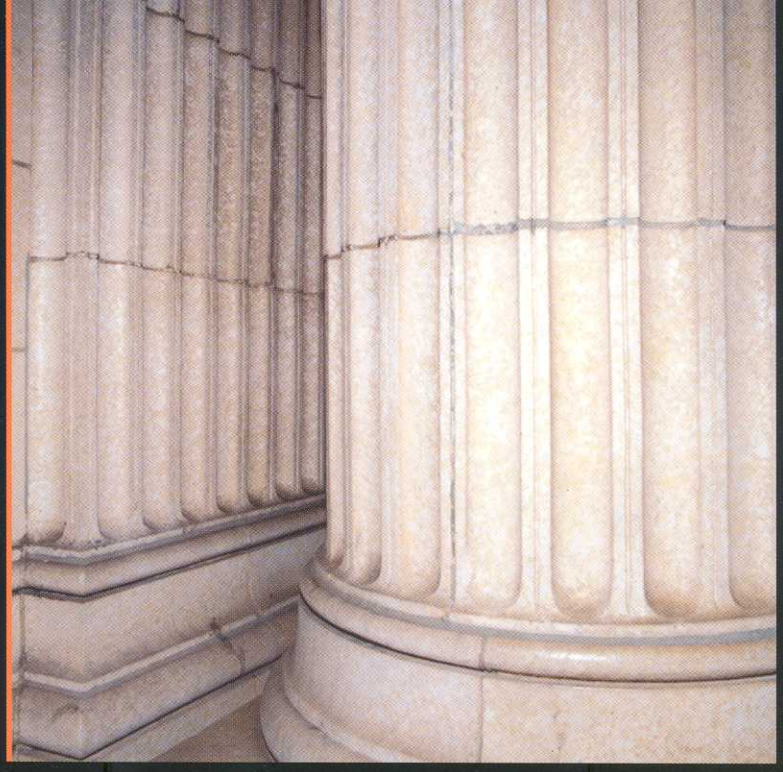

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The new Bankruptcy Law and its impact on financial and securities markets in Brazil

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On February 9, 2005, the President of the Republic of Brazil sanctioned Law 11.101/05, the new Bankruptcy Law, which will substantially modify the legal relationship between creditors and debtors. This law entirely substitutes the former bankruptcy law, dated as of June 21, 1945. The objective of this article is to discuss the relevant legal modifications presented in the new Bankruptcy Law and its impact in the operations carried on within the financial and capital markets.

Creditors' rights improved

We strongly believe that creditors' rights will be significantly improved with the new Bankruptcy Law, which has the preservation of the company and the payment of secured creditors as a priority. A better environment for creditors may, in turn, generate many benefits to the Brazilian economy, as it will turn investments in the country more attractive.

A good example of the importance of creditors' rights to allure international investors comes from the evaluations made by the California Public Employees' Retirement System (CalPERS), a US based pension fund, one of the largest in the world. This institution has a very rigorous methodology for evaluating countries eligible for receiving investments. Among the criteria used to define the eligibility of a country is the level of creditors' rights. In order to understand the level of creditors' rights in different countries, CalPERS outsourced to an UK consulting firm, Oxford Analytica, a worldwide ranking.

Currently, according to Oxford Analytica, in terms of creditors' rights, Brazil has a grade two, in a scale of zero to four. Brazil aligned with Argentina, Peru and Colombia, and below Indonesia, Morocco and Pakistan. One of the more relevant aspects of this analysis is the priority in the country's law to pay secured creditors, in which Brazil is severely penalised with grade zero.

This evaluation reflects the Brazilian legal structure regarding the credit recovery in existence since 1945, modeled with proceedings that do not solve the problems of companies with transitory financial problems and do not grant priority in payments to secured creditors. In such way, the current law does not offer a safe environment for credit providers, which, consequently, severely constrains the amount of credit available for businesses.

The main elements introduced by the new Bankruptcy Law that we will explore in this article are: (1) judicial and extrajudicial reorganisations; (2) the new payment priorities in the bankruptcy process; (3) the new rule regarding securities deposited in the Clearing Houses; and (4) the support to netting agreements. Moreover, there are also some important tax implications worth discussing in light of the new Act.

Judicial reorganisation

The Judicial Reorganisation is the legal instrument that substitutes the current *concordata*, a privilege conferred by law upon companies, by means of which a debtor in financial difficulties is granted the right to pay his creditors in a pre-defined schedule, established by the Court, which may never exceed two years after the date the company has petitioned for the *concordata* procedure.

The new legal instrument aims for the rehabilitation of organisations that are undergoing transitory financial difficulties. But, differently from the concordata, the Judicial Reorganisation enables the re-settlement of debts and their renegotiation, simultaneously with the contracting of new loans. According to the Act, loans granted in the reorganisation period have priority over the other credits against the estate, in case of bankruptcy; thus, stimulating new credits to the company under rehabilitation.

According to the new law, a legal reorganisation commences when the debtor files an economic-financial recovering plan with the Court. It is important to note that differently from the *concordata*, creditors must previously approve the reorganisation plan, during a creditors' committee session.

The Creditors' General Meeting and Committee are important features introduced by the new law, which enable the effective empowerment of the creditors in the reorganisation process of the company. The Creditors' Meetings or Committees will allow creditors to approve, modify or reject the legal reorganisation plan. In addition, the new law also concedes powers to creditors in the administration of

assets of the company under the reorganisation plan.

Creditors representing a minimum of 25% of the total credits of a certain class may request the Court to convene a General Meeting. The Creditors' General Meeting can deliberate on: 1) the constitution of the Creditors' Committee; 2) the approval, rejection or modification of the legal reorganisation plan filed by the debtor with the competent Court; 3) the sale of debtor's assets, being the Court responsible for approving deliberations of such kind; and 4) any other issue that may affect creditors' interests during the judicial reorganisation process.

The General Meeting should be attended by holders of: 1) labour credits; 2) secured credits; and 3) unsecured credits.

The managers of the companies under reorganisation will be constantly subject to the investigation of the creditors. This right granted to the creditors will lead to more transparency of the company's management and of the activities of the legal administrator or trustee, minimising or even eliminating the occurrence of manipulation, fraud or actions that could harm the creditors during the judicial reorganisation process.

Extrajudicial reorganisation

The Extrajudicial Reorganisation is also a new legal institution created by the new Bankruptcy Law. The objective of this institution is to stimulate private negotiations between creditors and debtors.

In order to require the Extrajudicial Reorganisation, a company shall fulfill the same requisites established to qualify for the Judicial Reorganisation process, i.e. it shall have regularly exercised its activities for more than two years and, cumulatively: 1) have not been declared bankrupt (or its responsibilities deriving from former bankruptcy shall have been declared extinct), and 2) have not been condemned for any bankruptcy crime.

Finally, the new law approved by the Brazilian Congress foresees two types of extrajudicial agreements: 1) the agreement that only binds its undersigned creditors; and 2) the agreement that constrains all creditors, as long as creditors representing at least 60% of the debts of each class (secured and unsecured debts) have accepted the plan. This last type of extrajudicial reorganisation avoids that the intransigence of a minority of creditors harms the execution of an agreement in the interests of the majority.

Also, as previously said, an innovative feature of the new law is the precedence that credits granted during the legal recovering period will have over other credits, including loans and labour credits, if the judicial reorganisation is converted into a bankruptcy.

Payment priority in the bankruptcy process

In the bankruptcy process, secured credits will have preference over tax credits. This is another important modification presented by the new Bankruptcy Law – the 1945 Act assured the preference of tax credits over secured credits – that will reflect positively in the banking and capital markets, as the secured credits represent most of the credits in such markets.

We point out that this modification in payment priorities is not an isolated creation of the Brazilian legislator. On the contrary, the credits with collateral have the preference over tax credits in many countries, such as Belgium, Sweden and Russia. In the US, Portugal and China the credits secured by collateral do also have priority over tax credits, and even over labour credits.

Regarding the payment of labour credits, which remained as the ones having priority over all credits, it is important to stress that such priority, will be limited to 150 minimum wages (approximately US$14,500 in December 27, 2004) per creditor. This way, high salaries of managers that might have led the organisation to bankruptcy will be paid only after the payment of all other credits, including, most importantly, secured credits.

Guarantees deposited in clearing houses

The new law confirms the understanding already stated in Law 10.214/01, which established the legal framework for the new Brazilian payment system, implemented in 2002. According to that law, the financial assets, goods or rights deposited as guarantees with a Clearing House should be discharged according to the provisions set forth in such Clearing's regulations.

Therefore, if an investor that trades, for example, in the São Paulo Stock Exchange (BOVESPA), is subject to a reorganisation or bankruptcy proceeding, the obligations of such investor arising out of a trade shall be honoured, and the financial assets deposited with the relevant Clearing House (the Brazilian Clearing and Depository Corporation – CBLC) shall be duly collected, according to such Clearing House's operational provisions, irrespective of any bankruptcy or reorganisation proceeding in relation to the aforementioned investor.

Clearing agreements between financial institutions and companies-netting agreements

As for the financial transactions negotiated outside of a Clearing system environment, the new Bankruptcy Law eliminates any questions related to the possibility of netting. If there is a netting agreement, it will be supported by the new Bankruptcy Law.

This means that, if irrespective of any bankruptcy or reorganisation proceeding of a company, a bank is liable before this company (for example, a time deposit agreement) and, concurrently, has granted a loan to such company, the bank will be able to offset the credit arising out of the loan against the time deposit obligation, as long as the parties have entered into a netting agreement.

Although netting agreements were already supported by banking rules and the Brazilian Civil Code, the new Bankruptcy Law treats this matter explicitly for transactions within the Brazilian financial system, clarifying any remaining doubts regarding the enforceability of such agreements.

Tax succession and the priority of tax payments in the Brazilian Tax Code

The Brazilian Tax Code was also modified to harmonise with the objectives of the new Bankruptcy Law. It was adapted to include the provision set forth in the new Act, in the sense that secured credits should have priority over tax credits.

Currently, the prices of branches or production units sold during the process of bankruptcy may suffer discounts due to the tax debts of the company. According to the Bankruptcy Law of 1945, the new owner of such assets becomes the tax successor of the bankrupt company and, as such, is responsible for the payment of the tax debts of the same. For that reason, new owners, as a rule, subtract the tax contingency amount from the purchase price of a branch or production unit.

After the modification of the Brazilian Tax Code, the purchasers of businesses, branches or production units of a company undergoing a bankruptcy process or a judicial reorganisation process will no longer be subject to the present tax succession rules, and will not respond for the company's prior tax debts, which will have to be paid by the selling company or the bankrupt estate.

The legal reorganisation of a company, by means of the sale of its branches and production units, will not only be possible but also advantageous for the company and for the new owner, as the prices of the assets sold during the process of judicial reorganisation will not suffer discounts and the

transferee risk will be significantly minimised.

Nevertheless, it is important to observe that current rules of tax succession will remain valid when a company or its branches are sold to: 1) one of the shareholders of the company under bankruptcy or judicial reorganisation; 2) a company controlled by the company under bankruptcy or judicial reorganisation; or 3) relatives of a shareholder of the company under bankrupt or judicial reorganisation. In these cases, the shareholders, affiliates of the company or relatives of a shareholder of the company under bankruptcy or reorganisation should become the successors of such company's tax debts.

Moreover, the amounts resulting from sales of assets during a bankruptcy process should remain deposited at the Court's disposal for the period of one year, as of the relevant sale. During this period, these amounts may only be used to pay creditors that prefer the tax creditors, such as the secured creditors.

Conclusion

We can conclude that the new law intends to establish a financial reorganisation process managed together by creditors and debtors. This process should serve all parties' interests, aiming at preserving the company's assets, jobs and the investment incurred by the shareholders and by the creditors. It is important to observe that the judiciary power will have well defined functions, seeking minimal intervention, thus fastening the judicial and extrajudicial reorganisations, and even the bankruptcy procedures. With the new law, the reorganisation process of a company will acquire a business feature, much more attained to the dynamics of the market.

Brazil will become one of the most advanced countries in the world regarding the reorganisation of assets and commodities. By the end of 2005, investors of Brazilian companies will finally be able to realise the effects of the new law and the novel legal mechanisms aimed at the reorganisation of companies and the effective recovery of credits.

In a nutshell, the new law improved many legal and commercial concepts, and this should result in a greater stimulus for the credit market in Brazil.

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