CHALLENGES AND OPPORTUNITIES FOR CANADIAN INVESTORS IN BRAZILIAN INSOLVENCY PROCEEDINGS: LESSONS FROM THE IBA'S 2019 GLOBAL RESTRUCTURING CONFERENCE

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Canada and Brazil share a long and significant common history of business and investment. Over a century ago, Canadian companies were heavily involved in building electrical and other infrastructure in São Paulo and Rio de Janeiro. Today, over 50 public companies listed on the TSX and TSX-V have substantial assets and operations in Brazil. In 2018, direct investment between the two countries exceeded $14 billion in each direction. Over $260 million was raised on Canadian exchanges for companies with Brazilian mining assets alone, and Canadian listed companies own over 100 mining properties in the country.[1] Canadian pension funds and other investors continue to pursue opportunities in Brazil to acquire assets across various sectors. In recent years, insolvency proceedings in Canadian courts have restructured hundreds of millions of dollars of debt owed by companies with principally Brazilian assets and operations.[2]

Beginning in 2014, Brazil experienced a prolonged economic crisis marked by slow and negative growth, high unemployment and stagflation.[3] At the same time, the country has been rocked by corruption scandals implicating some of its largest corporate groups and business leaders. The start of Brazil's economic trouble coincided with the end of a 14-year long commodities super-cycle that had propelled much growth in the country's resource sector. The economic and political crisis has resulted in several high profile insolvencies. These conditions represent both challenges and opportunities for Canadian investors and other stakeholders that are active or interested in Brazil. They would do well to learn about the country's insolvency regime, which is different from Canada's in important ways.

The International Bar Association's 2019 Global Restructuring Conference was held in São Paulo and its content revolved largely around corporate insolvency in Brazil. Lawyers from top firms in the country shared their perspectives on recent developments and aspects of the domestic insolvency regime that should be of interest to anyone who might be involved in a Brazilian insolvency proceeding or has substantial investments in the country.

Debtor-Friendliness and the Role of Equity

One aspect of a Brazilian Court-supervised restructuring proceeding ("*recuperação judicial*") that is unfamiliar to Canadian practitioners is the role played by equity holders. In Canada and elsewhere, equity has a negligible role to play in insolvency proceedings once it is 'out of the money'. The conference participants explained that, in Brazil, equity continues to hold a great deal of power because, among other reasons, a plan of reorganization ("*plano de recuperação*") can only be proposed by the debtor. Under Brazil's insolvency legislation, a plan must be approved at a general meeting of creditors by a majority of four separate classes of creditors: labour creditors, secured creditors, unsecured creditors and micro and small business creditors. However, plans can create sub-classes of creditors within each class and, because there is no general rule against unfair discrimination, the plan can give different treatment to different sub-classes, even if they belong to the same class of creditors. Therefore, plans can be designed to give better treatment to certain sub-classes to achieve majority approval in a given class. Brazilian judicial reorganization adopts a *relative* priority rule that enables the bankruptcy court to "cram down" a plan on a class of dissenting creditors, even if senior creditors are not paid in full and junior creditors or equity holders retain an interest in the corporation.

If the plan is rejected at the general meeting of creditors, the judicial reorganization proceeding should be (in theory) converted into a bankruptcy liquidation ("*falência*"), which generates notoriously small recoveries and is usually a worst case outcome for creditors. In practice, Brazilian courts usually exercise equitable powers to extend the stay period and timelines while the debtor continues to negotiate a plan with its creditors.

A consequence of the debtor-controlled plan and bankruptcy alternative is that Brazilian companies, which remain mostly family-owned private corporations, can negotiate with their creditors from a position of power. Such features makes Brazil a relatively debtor-friendly jurisdiction.

Successor Liability

Brazilian law allows for a company's assets to be sold 'free and clear' of successor liability. Outside of bankruptcy proceedings, the purchaser of assets is liable for previous debts. In an insolvency proceeding, the purchase of assets included in one or more branches or divisions of the debtor's business ("*unidade produtiva isolada*" or "*UPI*") is made 'free and clear' of liabilities. Similar to bankruptcy sales in Canada and the United States, the acquisition can be achieved through the incorporation of a new acquisition entity, whose shares are acquired by the purchaser. According to many leading Brazilian practitioners, purchasers are immunized from successor liability through such sale arrangements. However, there is no express statutory provision or case law regarding protection against successor liability for anti-corruption fines, which is a source of ongoing concern. In such cases, purchasers can seek protection by requesting a waiver from the authorities in charge of investigating corruption practices prior to closing a sale transaction.

Limited Liability

Brazilian statutory law recognizes the distinct legal identity of corporations with separate rights and liabilities from their shareholders, and limits shareholder liability as is common elsewhere. However, a concern expressed by Brazilian insolvency professionals is that Brazilian courts routinely hold shareholders and companies' management liable for legacy labour and tax liabilities. One leading practitioner attributed this to strong equitable powers possessed by courts that allow them to overcome statutory law, including the basic concept of distinct corporate identity. One practitioner told the conference audience that he advises creditors against participating in any *plano de recuperação* that includes a debt-for-equity conversion because of uncertainty as to shareholder liability. An aversion to shareholder status can be a significant obstacle to a successful restructuring. In Canada and elsewhere, a plan of compromise will frequently involve creditors taking some form of equity interest in the restructured debtor company.

DIP Financing

The market in Brazil for Debtor-in-Possession (DIP) financing is underdeveloped. DIP financing allows a debtor company to fund its ongoing operations while it goes through a restructuring process. It is a crucial aspect of large insolvency proceedings in Canada and elsewhere. In Canada, DIP lenders are granted a 'super-priority' security interest in the debtor's assets that ranks ahead of most other interests or charges. This status makes a DIP loan low-risk from the lender's perspective. In Brazil, as there is no statutory power to grant a super-priority charge, the market for DIP financing relies on provisions in the *plan de recuperação* granting the DIP lender 'super-security' over the debtor assets.

While the DIP finance market remains shallow, there are some active DIP lenders in Brazil. Brazilian hedge funds are financing distressed corporations in loan-to-own DIP financing arrangements. In the *OGX* case (involving a group of companies founded by convicted billionaire industrialist Ike Batista), a DIP loan was advanced by an existing group of creditors. In the OAS case, the Canadian investment powerhouse Brookfield Asset Management set precedent in Brazil by advancing a DIP loan where it did not already have some relationship with the debtor. Brookfield was interested in acquiring the very asset that was encumbered to secure its DIP loan (the debtor's stake in a public concessions company). Following multiple appeals and an injunction, the DIP order was upheld by an appeal court. Practitioners have noted the absence of a 'mootness doctrine' in Brazil, which serves in Canada and elsewhere to limit the possibility of approval of DIP priority being subsequently reversed on appeal.

Most conference participants agreed that a change in Brazil's insolvency law is required in order to achieve a mature and reliable market for DIP financing. Reforms of the Brazilian Bankruptcy Law currently under consideration would include super-priority charge provisions for DIP loans. In the meantime, interim financing is often secured by 'fiduciary liens' ("*alienação fiduciária*") - a type of security interest that is enforceable notwithstanding the stay of proceedings imposed during a *recuperação judicial*. However, many participants

shared the view that fiduciary liens have limitations.

Jurisdiction in Cross-Border Insolvencies

A *recuperação judicial* involving Canadian or other foreign stakeholders is likely to have some cross-border element, so matters of jurisdiction are of special importance.

Brazil has not adopted into its insolvency regime the UNCITRAL *Model Law on Cross-Border Insolvency*, which provides various mechanisms for recognition and aid among and between courts in different jurisdictions in cross-border insolvencies. In Canada, the *Model Law* is incorporated into Part IV of the *Companies Creditors' Arrangement Act* and Part XIII of the *Bankruptcy and Insolvency Act*. It is also incorporated into Chapter 15 of the *US Bankruptcy Code* as well as the insolvency legislation of most of Canada's major economic partners.

Conference participants explained that Brazilian courts' approach to their own jurisdiction in cross-border insolvency proceedings has varied. They traditionally adopted a 'territorialist' view of their jurisdiction (deeming Brazilian courts to have exclusive jurisdiction over the assets of a debtor located in Brazil, strictly delineated by territorial boundaries) without any deference to the decisions of foreign courts affecting assets in the country. Courts have moved towards a 'universalist' or 'modified universalist' approach in some recent cases, though not consistently.

Notwithstanding the absence of the *Model Law* in Brazil, some *recuperação judicial* proceedings have benefitted from its application elsewhere. In both the OAS and Oi cases, courts in the United States recognized Brazil as the debtor groups' 'center of main interest' (COMI) and declined to recognize separate proceedings in the British Virgin Islands and Holland, respectively, as 'foreign main proceedings' in respect of the debtors' financing subsidiaries, which was sought by bondholder groups.

Other Uncertainties

Conference participants acknowledged that, in Brazil, collateral is often not effectively available for foreclosure by creditors. Brazilian courts have the power to protect a debtor's assets from enforcement by deeming them "essential" to the company's ongoing operations.

Other areas of uncertainty in Brazilian insolvency law are the availability of 'stalking horse' bid structures in Court-supervised sale processes, and confusion between procedural and substantive consolidation. Many practitioners expressed concern that a trend was emerging in Brazilian courts to effectively impose a substantive consolidation (combining the assets and liabilities of different companies in a corporate group), creating uncertainty over the security and priority of creditors' collateral.

Conclusion

Brazil's current insolvency regime was enacted in 2005 and is still relatively young. The country's courts are grappling with many of the same issues that have arisen in Canada and elsewhere as insolvency legislation confronts market realities and competing stakeholder interests. While this implies a measure of uncertainty, it also allows room for creativity for practitioners and investors who see opportunities in the current climate in Brazil. We will be watching with interest as Brazilian insolvency law continues to evolve.

About the Authors

Stephen is a partner in McMillan's Litigation group in Toronto. His practice focuses on insolvency, corporate law and securities disputes. He has experience with major cross-border insolvency proceedings. Stephen is a member of McMillan's Brazil Country Desk. Tushara is a partner in McMillan's Restructuring group in Toronto. She has significant experience in cross-border insolvency proceedings and M&A transactions. She represents Canadian and foreign participants in Court-supervised and out-of-court restructurings, including debtors, creditors, DIP lenders and court officers.

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By Stephen Brown-Okruhlik and Tushara Weerasooriya

[1] TSX/TSXV Market Intelligence Group and S&P Global Market Intelligence.[ps2id id='1' target='/]
[2] For example, *Re Jaguar Mining*, CV-13-10383-00CL, involved a conversion of $268.5 million of debt and an overall reduction of $323 million of debt of a Canadian mining company whose operations were exclusively through Brazilian subsidiaries. *Re MBAC Fertilizer Corp. et. al.*, CV-16-11475-00CL, involved a restructuring at the level of the Canadian parent of a group of companies with phosphate mining operations in Pará and Minas Gerais, Brazil, and financing subsidiaries in Barbados and Holland. The Canadian CCAA proceeding involved parallel insolvency proceedings in Tocatins state of Brazil in respect of its Brazilian subsidiaries and engaged concepts of consolidation under Brazilian law.[ps2id id='2' target='/]
[3] Brazil's economy contracted in the first quarter of 2019 and in several recent fiscal quarters.[ps2id id='3' target='/]

A Cautionary Note

The foregoing provides only an overview and does not constitute legal advice. Readers are cautioned against making any decisions based on this material alone. Rather, specific legal advice should be obtained. The authors of this bulletin are not licensed to practice law in Brazil or to provide legal advice related to proceedings in Brazil. To the extent that the foregoing refers to Brazilian law and practice, it merely reports the content of presentations and discussions delivered at the International Bar Association's 2019 Global

Restructuring Conference.