JUDICIAL RESTRUCTURING IN BRAZIL – CREDITS NOT SUBJECT TO THE PROCEEDING

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§ 1 – BRIEF OVERVIEW OF THE JUDICIAL RESTRUCTURING PROCEEDING IN BRAZIL

In Brazil, Federal Law 11,101/2005, known as the Brazilian Bankruptcy and Restructuring Law ("BRL"), came into effect on June 9, 2005, bringing significant changes to the legal treatment of Brazilian companies that are insolvent or facing financial difficulties[1]. BRL applies to entrepreneurs and business companies in general. It does not apply to state-owned companies, mixed capital companies, financial institutions, insurance companies, and some other entities expressly excluded by the law[2], which are subject to specific insolvency proceedings. BRL establishes three major mechanisms that may apply to companies in difficulties: judicial restructuring[3], out-of-court restructuring and forced liquidation. As one of its main features, the BRL offers the debtor company an opportunity for rehabilitation and, in most cases, continuity of management.

Any debtor that meets certain conditions specified in the BRL may apply for judicial restructuring proceeding[4]. The request must be accompanied by several documents and information, including explanations about the financial difficulties faced by the debtor, financial statements, a list of creditors[5], and a list of employees. If the application is in proper form, the court will authorize the initiation of judicial restructuring proceeding. A public notice will then be published in the official gazette containing, among others: a summary of the request made by the debtor, a list of creditors,

[1] The previous law was in force since 1945. (Decree –Law 7661/1945).
[2] Section 2 of BRL.
[3] Judicial restructuring replaced the old *concordata*, provided for in Decree-Law 7661/1945. *Concordata* could be precautionary (to avoid a forced liquidation decree) or suspensive (to suspend a forced liquidation already decreed). Only unsecured creditors were subject to a *Concordata* and its payment should be done in up to two years, with no possibility of negotiation between the debtor and its creditors.
[4] Section 48 of BRL
[5] Including creditors of non-monetary obligation.

and a warning about the applicable term for any challenges to the list of creditors, including requests for adjustments and inclusions. In relation to the judicial restructuring proceeding, the BRL establishes that: (i) only the debtor may file a court application for restructuring; (ii) there is a non-automatic 180-day stay period for credits subject to the proceeding, applied when the court authorizes the proceeding; (iii) the BRL does not provide for a specific status such as "debtor in possession" as in the Chapter 11 of the US Bankruptcy Code. As a general rule, the existing management of the debtor continues to operate the business and regular business acts are allowed, except that any sale of "permanent" assets[6] is only allowed if authorized by the Bankruptcy Court or approved in the reorganization plan approved by the creditors; (iv) a judicial manager is only appointed when the debtor's existing management has been removed from their positions. This occur in exceptional legal cases, such as when (i) there are indicia of bankruptcy crimes, (ii) some act were performed with willful misconduct or engaged in fraudulent schemes against creditors, (iii) the managers have been making personal expenditures that are not compatible with their income, or (iv) the management removal is specified in the reorganization plan, (v) the appointment of a creditors' committee is optional and it has more a supervisory than a decision-making role[7], (vi) while a judicial administrator nominated by the Court monitors the activities performed by the debtor, he/she mainly manages the judicial procedure acts, instead of replacing the management of the debtor company in operating the business, (vii) the general meeting of creditors is essential to the process, since it has the power to approve or reject the reorganization plan.

The debtor company shall submit a reorganization plan within 60 days from the publication of the court order authorizing the initiation of the proceeding[8]. If the plan is not submitted, the debtor shall be declared bankrupt (as forced liquidation). The reorganization plan must contain (i) a detailed description of restructuring mechanisms to be used, which may include debt rescheduling, corporate reorganization, transfer of corporate control, partial sale of assets, leasing of on going concerns, and a series of other measures, (ii) demonstration of the economic feasibility of the debtor's business, and (iii) a report on the debtor's assets prepared by an expert appraiser or company. The plan cannot provide that overdue labor credits and credits deriving from accidents at work will be paid in a term longer than

[6] "Permanent assets" is a concept provided for by accounting rules.

[7] Commonly, creditors´ committees are not constituted, because creditors avoid being part of it, as Brazilian Laws are unclear in respect to the liability of creditors that participate of the committee.

[8] The plan may be modified after its presentation, due to negotiation with creditors.

one year from the ratification of the approved plan by the Bankruptcy Court.

Creditors will be informed about the reorganization plan and the applicable term to challenge the plan through a public notice. If any objection to the proposed plan is submitted by any creditor, the court shall call a General Meeting of Creditors. In the meeting, creditors may (i) approve the plan as originally proposed, (ii) approve a modified version of the plan, as long as there is no opposition from the debtor and no harm to absent creditors, or (iii) reject the plan, in which case the debtor should be declared bankrupt (as forced liquidation).

The reorganization plan may provide for a judicial sale of branches or individual on going concerns belonging to the debtor. The judicial sale may (i) take the form of an auction, (ii) be carried out through proposals submitted in sealed envelopes, or (ii) be a combination of the former two options.

Once the judicial sale is effected, if the requirements provided for in BRL is fulfilled[9], the relevant branch or on going-concern will be free and clear of any liens and encumbrances, and the purchaser will not succeed the debtor with respect to any indebtedness[10]. As a consequence, creditors from a debtor that is subject to judicial restructuring will not be able to claim any amounts from the purchasers of branches or on going concerns, and the corresponding assets will not be attached to satisfy their credits. Therefore, creditors will simply retain their original claims against the debtor and may enforce the reorganization plan.

Any reorganization plan must be approved by the following four categories of creditors in a General Meeting of Creditors: (i) labor creditors and creditors from accidents at work, (ii) secured creditors, (iii) unsecured creditors, creditors with special or general preference, and subordinated creditors, and (iv) small business creditors[11].

In the first and fourth classes of creditors, approval is achieved with the favorable vote of the majority of creditors present at the meeting, regardless of the amount of their credits. In the other two classes, approval is achieved with the favorable vote of both (i) creditors representing more than half of the credit amounts represented at the meeting and (ii) the majority of creditors present at the meeting.

If certain vote combinations specified in the BRL are achieved in the General Meeting of Creditors, the court may grant the judicial restructuring even when the plan was not approved pursuant to

[9] Section 60 together with Section 142, both of BRL

[10] In Brazil, the purchaser is in principle liable for the obligations related to the asset bought, except under the provisions of BRL.

[11] Small Business are companies that have a yearly revenue up to a specific amount provided by law.

the quorum requirements explained above, if some requirements are fulfilled ("cram down")[12].

Judicial restructuring proceedings shall remain in place until all obligations maturing within 2 years that are specified in the plan are fully complied with by the debtor. If the debtor fails to comply with any obligation within such period, BRL provides that its forced liquidation should be declared[13][14]. Any obligation unfulfilled after the 2-year period entitles creditors to initiate collection proceedings or request the declaration of the debtors' forced liquidation.

Verifying that all obligations maturing within 2 years were fulfilled, the Court must order the termination of the judicial restructuring proceeding. Although no longer subject to court proceedings, the debtor remains liable for all obligations specified in the plan that are still outstanding.

§ 2 – CREDITS NOT SUBJECT TO THE PROCEEDING

BRL provides that credits existing on the date of the filing are subject to the proceeding, even if they have not matured yet[15]. As a consequence, those credits may not be enforced during the stay effect and will be paid within the proceeding and in accordance to the reorganization plan as approved by the majority of the creditors.

However, some specific types of credits are not subject to the proceeding, and in principle may be enforced while the restructuring proceeding is in place and must be paid according to its original terms and conditions, regardless of any provision in the reorganization plan. In other words, credits not subject to the proceeding are also not subject to the moratorium and to the debt restructuring imposed by the judicial restructuring.

BRL introduced the "Principle of the Company's Preservation"[16], by which the main purpose of a judicial restructuring is to enable the debtor company to overcome its crisis, allowing the maintenance of the revenue source, the employment and the interests of creditors, promoting the preservation of the company´s social function and the stimulus to the economic activity.

Following such principle, any credit not subject to the proceeding may be enforced and paid, as long as it does not prevent the debtor company to overcome its crisis. Therefore, the creditor is

[12] Section 58 of BRL.
[13] Section 94, III, f of BRL.
[14] In practice, the debtor may renegotiate its obligation with the creditors and the forced liquidation will not be declared if the majority of creditors reunited in a general creditors meeting approves a modification of the plan.
[15] Section 49 of BRL.
[16] Provided for in Section 47 of BRL.

not allowed to sell or withdraw any assets that are essential to the debtor´s business activity.
Credits not subject to the proceeding are: credits existing after the date of the filing; (tax credits[17]; (credits with title to assets[18]; Foreign Exchange Advancements[19].
The enforceability of the credits against the co-debtors is not the objective of this study.

§ 3 – CREDITS EXISTING AFTER THE DATE OF THE FILING

As mentioned above, BRL provides that credits existing on the date of the filing are subject to the proceeding, even if they have not matured yet. Thus, the "existence" of a credit is the criterion adopted by BRL to classify such credit as subject or not to the proceeding.
If the credit exists on the date of the filing, it will be affected by the moratorium and should only be paid in accordance to a reorganization plan, which will probably impose new terms and conditions for payment. On the other hand, if a credit does not yet exist, it may be paid immediately and in accordance with its original terms and conditions.
Being subject or not to a restructuring proceeding has a major impact not only on the creditor, but also on all players involved in the judicial restructuring. The ability of the debtor company to overcome its crisis and to pay its debts is directly related to its possibility to reschedule as many debts as possible.
Except from BRL, Brazilian Law adopts terms such as "constitution", "definition" and "enforceability" of a credit, concepts better established in Brazilian doctrine and case law. BRL opted to adopt a more informal term ("existence") to allow those unfamiliar with legal concepts to understand the full content of BRL.
Although apparently simple, this term has culminated into several controversies related to the subjection of credits to judicial restructuring proceedings due to the wide extension of the concept of existence of a credit.
This study will demonstrate the variety of discussions that may arise in this regard, without exhausting all controversial points or presenting a definitive solution.

A) Lease agreement

A lease agreement is a contract between a lessor and a lessee that allows the lessee rights to use a property owned by the lessor for a period of time, in exchange for a payment. The lessor has the

[17] Section 71, I of BRL.
[18] Section 49, § 3º of BRL.
[19] Section 49, § 4º together with Section 86, II, both of BRL.

obligation to ensure the lessee the peaceful use of the propriety, and the main obligation of the lessee is to pay the agreed price.
This topic analyzes the typical lease agreement (in Portuguese, *contrato de locacao*), whereby the lessor intends to continue being the owner of the asset after the termination of the agreement. Later, in another topic, the financial lease will be analyzed (in Portuguese, *arrendamento mercantil*), which is more commonly used as a vehicle for a financing and mostly aims at transferring the ownership of the property to the borrower/lessee once the agreement is terminated.
Some argue that the credit originated from a lease agreement begins to exist on the day the agreement is signed, since from this moment on both parties are legally bound by the contract.
Others defend that the credit will only exist on the day the lessor is obliged to make the property available to the lessee, because until that moment there is no obligation of any party, and the respective credit is only an expectation of a right, thus the right as such does not yet exist.
Finally, there are those who affirm that the credit exists only after the lessee effectively uses the property and has the obligation to pay the price, once a credit is an obligation to pay certain amount. So, even though there is no obligation from the counter party (make the property available), such obligation is not a pecuniary obligation, therefore, is not a credit.
Most recently, some Brazilian Courts have decided that credits originating from a lease agreement exist only on the date they became due, regardless of the BRL provision that a non-matured credit may be subject to the proceeding[20].
The discussion regarding lease agreements is still very controversial and has been analyzed by Brazilian Courts on a case-by-case basis, depending on the contractual provisions and the asset been leased (real state, equipment, among others).

B) Wrongful Act

In general, a wrongful act gives rise to an obligation to indemnify the one that has suffered from such an act. The obligation to indemnify may be based on a contractual clause (most often the "hold harmless" clause) or on the civil legis lation.

1) *Contractual Obligation*

It is common for complex agreements to provide a "hold harmless" clause, whereby the parties agree that a wrongful act

[20] 1st Chamber of the Court of Appeals of São Paulo, Interlocutory appeal 2112614-89.2015.8.26.0000, 29th Chamber of the Court of Appeals of São Paulo, Appeal 0002673-19.2013.8.26.0322.

will be subject to a third party analysis (through a litigation, arbitration or mediation proceeding) who will declare if any indemnification is due. The hold harmless clause may pre-establish the amount of the indemnification or may determine that the third party will set such amount.
Although there is no unanimous position in doctrine or case law, the prevailing understanding is that in cases like this, if the contractual clause is fully valid and applicable, the respective credit will only exist after the third party renders a decision recognizing the obligation to indemnify

2) *Non-Contractual Obligation*

When there is no contractual clause governing the consequences of a wrongful act, civil legislation applies. As a rule, someone will be indemnified if he/she proves in court that (i) a wrongful act was performed, (ii) this act was performed intentionally, (iii) the one claiming for indemnification was harmed and (iv) the wrongful act is directly linked to the harm caused.
Although a judicial decision is essential to recognize the obligation to indemnify, civil law rules that the one that performs a wrongful act with non-contractual provision is considered in default from the date the act is performed. Based on this, the leading position is that a credit originating from a non-contractual wrongful act exists on the day the act is performed[21].
Recently, in a prominent case, the Court stated that the credit is only constituted with the recognition of the obligation to indemnify, but its existence initiates with the performance of the wrongful act.

C) Letter of guarantee

Letter of guarantee is a contract issued by a guarantor (usually a bank) on behalf of an acquirer of goods or services, whereby the guarantor promises to meet a financial obligation to the supplier in the event of default of the acquirer. The original creditor of the transaction is the supplier and the debtor is the acquirer, but once the acquirer defaults, the guarantor pays the respective debt to the supplier and becomes the creditor against the acquirer (the debtor).
The controversy in this regard is when the existence of the credit that the guarantor holds against the debtor initiates: From the date of the issuance of the letter of guarantee, the acquirer´s default against the supplier or the payment by the guarantor and its replacement as a creditor.

[21] 2nd Chamber of the Court of Appeals of São Paulo, Interlocutory appeal 2013137-93.2015.8.26.0000, 29th Chamber of the Court of Appeals of Minas Gerais, Interlocutory appeal 10024038947131005.

There are those who argue that the guarantor´s credit will only exist after the payment by the guarantor and its replacement as a creditor. Until that moment, the supplier is the one that holds a credit (against both the acquirer and the guarantor). Once the guarantor makes the payment, the credit held by the supplier ceases to exist and a new credit arises – the credit the guarantor holds against the acquirer.

Others defend that at the time the acquirer fails to fulfill its obligation to the supplier, the guarantor has an obligation to pay the amount due and, therefore, its credits against the acquirer begin to exist. Until then, the guarantor has no credit against the supplier, who may meet all its obligation without any interference from the guarantor.

The tendency of Brazilian Courts is to consider that the credit the guarantor holds against the acquirer exists from the day of the issuance of the letter of guarantee[22]. From that moment, the guarantor is bound by the letter and accepts the risk of default of the acquirer and is aware it may have to face difficulties to recover its credit (once it makes the payment to the supplier). In addition, civil legislation provides that after the payment the guarantor replace the original creditor in its rights against the debtor.

D) Tax Credits

Tax credits are public goods and, by virtue of the principle of the unavailability of the public good, should never be freely negotiated and may only be rescheduled or settled in accordance with a law that provides specific terms and conditions for the settlement, with abdications of both the private company and the public authority. As an example of abdication of the private company is its waiver to discuss the enforceability or the amount of the tax credit.

In a judicial restructuring, credits are freely negotiated and the final settlement aims to satisfy the interest of the majority of the players involved (not only of the public authority), being impossible to determine in advance the terms and conditions of payment. In addition, it is not common for the debtor company to waive any right, especially if it may reduce its total debts.

Therefore, tax credits are not subject to the proceeding and BRL establishes that a separate law shall provide conditions for the rescheduling of tax credits against companies under judicial restructurings[23]. This specific tax law was enacted in 2014[24] and

[22] 14th Chamber of the Court of Appeals of Rio de Janeiro, Interlocutory appeal 0033812-72.2016.8.19.0000, 14th Chamber of the Court of Appeals of Rio de Janeiro, Interlocutory appeal 0036829-87.2014.8.19.0000.
[23] Section 68 of BRL.
[24] Law 13.043/2014.

still creates some controversy about its actual applicability and effectiveness.

In addition, BRL establishes that, as a condition for the ratification of the reorganization plan by the Bankruptcy Court, the debtor company is required to submit tax certificates attesting that it has no outstanding tax debts[25].

If there are outstanding taxes, the debtor must submit evidence that (i) a tax rescheduling is in place, (ii) assets have been attached to secure existing tax collection proceedings, or (iii) the enforceability of the relevant tax credits has otherwise been suspended as provided by law. In all these cases, the debtor will receive what is known as a "negative tax certificate with the effects of a clear tax certificate".

However, courts have frequently disregarded the condition above with grounds on the Principle of the Preservation of the Company.

Also, case law has shown that, despite the possibility of tax collection proceedings continuing their course, the assets of the debtor company cannot be seized without authorization from the Bankruptcy Court, as otherwise the judicial restructuring will not be viable.

E) Credits with title of assets

Some Brazilian agreements provide that a contractor receive the right to use certain assets belonging to the other contractor in exchange for a payment. In case of default, the owner (creditor) may choose to terminate the agreement and repossess the asset held by the debtor, instead of maintaining the contract and its right to receive payment for the whole period of agreement. Credits arising from such agreements may be referred to as credits with title to assets.

Considering the right of repossession, BRL opted to exclude from the proceeding credits originating from the following agreements: fiduciary transfer; financial lease; irrevocable purchase commitment agreement; and purchase agreement with maintenance of property right[26].

Even though those credits may be repossessed regardless of the judicial restructuring, BRL prohibits the creditor to repossess any assets that are essential to the debtor´s business activity until the approval of the reorganization plan.

The most relevant debate on this topic is related to the assignment of receivables, a fiduciary transfer agreement whereby the creditor becomes the owner of the payments (money) that the debtor will receive.

[25] Section 57 of BRL.
[26] Section 49, § 3º of BRL.

Some judicial decisions have ruled that assignments of receivables are subject to the proceeding because receivables are future assets and it is not possible to own (and repossess) an asset that does not yet exist. Besides, excluding assignments of credit from the proceeding would violate the Principle of Company´s Preservation.
In the end, Brazilian Superior Court have ruled that assignments of receivables are not subject to the proceeding, once receivables are a type of credit and, according to Brazilian law, credit is a movable asset and, therefore, may be owned and repossessed[27].

F) Foreign Exchange Advancements

Any amounts disbursed to a debtor pursuant to an advancement of foreign exchange agreement, as long as the applicable banking regulations pertaining to this type of advancement are observed, are also not subject to judicial restructurings.
Amounts so disbursed refer to exports made by the debtor when, before the debtor delivers the foreign currency to its counterpart under the applicable foreign exchange agreement, such counterpart (normally a bank) delivers the corresponding amount in Brazilian currency to the debtor. In such cases, the indebtedness in foreign currency incurred by the debtor remains in its original form unaffected by the restructuring plan.

[27] Superior Court of Justice, Special appeal 1202918, Superior Court of Justice, Internal appeal in a special appeal 1475258.