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The Brazilian Business Insolvency Act in a Nutshell

- An Introduction to Insolvency Law in Brazil -

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Introduction

Brazilian business insolvency law offers debtors, their creditors as well as potential investors in distressed assets a broad range of options. The advisability of either informal corporate workouts (out-of-court debt restructuring), judicial or extrajudicial recovery, liquidation or regular winding up outside insolvency proceedings depends on the outcome of a profound legal and financial analysis of the distressed company's extent and reasons of indebtedness and the respective interests of the stakeholders involved in individual cases.

In this light, Brazilian insolvency law is of crucial importance to debtors, creditors and investors doing business in Brazil, particularly in exit, turnaround, debt collection and distressed asset investment scenarios.

The Current Insolvency Situation in Brazil

With the Brazilian economy in recession in both 2015 and 2016, and a corresponding surge in the number of filings for liquidation and judicial recovery in insolvency proceedings, Brazilian insolvency law is undergoing a serious acid test.

Companies in the oil and gas as well as construction and engineering sectors in particular are currently common subjects of insolvency proceedings. This is largely due to the decline in oil prices and sanctions around the criminal system "*Petrolão*" and the investigations concerning *lava jato* (car wash).

The following figures published by the Brazilian credit bureau Serasa Experian on 5 December, 2016 illustrate the dimension of the current insolvency situation in Brazil.

Steady Growth of Liquidation in Insolvency Proceedings

There appears to have been a rather steady growth in the number of liquidations in insolvency proceedings. In 2015, 1,783 applications for proceedings were registered, in comparison to 1,661 in 2014, representing a slight increase of 7.3%. Even in 2016, a similarly modest increase has been maintained compared to 2015, with 1,718 applications for liquidation in bankruptcy proceedings between January and November, implying a progression of 3,9% in comparison to the same period in 2015 (1,654 applications).

Judicial Recovery Proceedings at Record Levels

At the same time, judicial recovery in insolvency proceedings are developing at record levels. In 2015, 1,287 debtors applied for such proceedings, compared to 828 in 2014, representing a striking rise of 55.4%. This trend has hitherto continued in 2016, with 1,718 applications in the period from January to November alone, representing an increase of 51,1% in relation to the same period in 2015 (1,137 applications).

The Statutory Framework of Insolvency Law in Brazil

The Brazilian Business Insolvency Act of 2005

The year 2005 saw a complete reform of the Brazilian law on insolvency and recovery of companies and individual entrepreneurs in financial distress, which was particularly inspired by US and European models. The central provisions governing liquidation and recovery in insolvency proceedings of entrepreneurial debtors are contained in the "*Lei que regula a recuperação judicial, a extrajudicial e a falência do empresário e da sociedade empresaria (lei nº 11.101 de 9-2-2005*)" (hereinafter "LFRE" or "Brazilian Business Insolvency Act"). This Act comprises a total of 201 articles and can be divided into a general part (Chapters I and II) and a special part (Chapters III to VIII).

Last Reform in 2014

The Act was most recently amended in 2014 by *lei complementar nº 147/2014 de 07/08/2014*, which introduced rules aiming to improve the position of micro companies or small companies as creditors (Articles 26 IV, 41 IV, 45 (2), 83 IV d) LFRE) as well as limiting the remuneration of insolvency trustees in cases where the debtor qualifies as a micro or small company (Article 24 (5) LFRE).

Subsidiary Application of the Brazilian Code of Civil Procedure

The LFRE itself stipulates that the rules of the Brazilian Civil Procedure Code apply to business insolvency proceeding on a subsidiary basis (Article 189 LFRE).

Legislator's Objectives Regarding the Brazilian Business Insolvency Act (LFRE)

Liquidations as part of Brazilian insolvency proceedings aim to satisfy creditors in a speedy and efficient manner, while recovery proceedings seek to preserve companies that can feasibly be rescued (Articles 75, 47 LFRE). However, there are significant differences as to how much weight the LFRE attaches to these objectives in comparison to US and European insolvency law. The Brazilian Business Insolvency Act focuses more strongly on continuing the debtor's business and strongly emphasises the social functions of the business, particularly the provision of jobs.

Restricted Personal Scope of Application of the LFRE

Applicable to Persons and Entities Engaged in Entrepreneurial Activities

The LFRE's scope only extends to natural and legal persons engaged in entrepreneurial activities (Article 1 LFRE), that is sole traders (*empresários*) and "entrepreneurial" corporations (*sociedades empresárias*).

Whether or not a given undertaking is classified as "entrepreneurial" depends on the type of the debtor's economic activity in question, its extent and the debtor's form of incorporation, if any (Articles 966, 981 f. Brazilian Civil Code). The Brazilian Civil Code classifies a debtor as "entrepreneurial" where it engages in business on a permanent and organised basis by way of generating or distributing goods or services (Article 966 Brazilian Civil Code). There is a statutory presumption that stock corporations (*sociedade anônima*) are entrepreneurial while cooperatives (*sociedade c*ooperativa) are presumed to be non-entrepreneurial (Article 982 Brazilian Civil Code in its only paragraph).

Side Note 1: "empresarial" as the decisive term

The repeal of the Brazilian Commercial Code in 2003 – with the exception of the chapter on maritime trade law – and the insertion of a chapter governing the law of business entities

("*do direito da empresa"*) in the Second Book of the Special Section of the Brazilian Civil Code (Articles 966–1,195) entailed the introduction of new terminology. Instead of the formerly used term "*mercantile" or "comercial"*, the law (the Brazilian Business Insolvency Act and the Brazilian Civil Code) now employs the term "*empresarial*". For the avoidance of misleading associations, "*empresarial"* is translated here as "entrepreneurial". However, the aforementioned reform has still not been broadly noticed by the Brazilian business and legal communities. For this reason, the used nomenclature is far from uniform and duly updated.

Exceptionally Inapplicable: Specific Corporate Entities Despite their Entrepreneurial Activities

The LFRE does not apply to the following corporate entities regardless of their potential entrepreneurial nature (Article 2 LFRE):

- public sector companies (*empresas públicas*)
- public-private mixed corporations with economic objects (*sociedades de economia mista*)
- financial institutions (*instituiçoes financeiras*)
- credit unions (*cooperativas de crédito*)
- pension funds (*entidades de previdência complementar*)
- insurance companies (*sociedades seguradoras*)

The abovementioned entities are subject to separate regulatory regimes that are neither contained in the LFRE nor the Brazilian Code of Civil Procedure.

Side Note 2: The "*Sociedade de Economia Mista*"

The "*Sociedade de Economia Mista*" is a Brazilian public stock corporation incorporated pursuant to a special Act with objects of an economic nature. The majority of its ordinary shares must be held by federal authorities. Article 5(3) of the legislative decree governing the organisation of federal authorities (*decreto-lei nº* 200/1967 *que dispõe sôbre a organização da Administração Federal*) defines this term. The oil company Petrobras (Petróleo Brasileiro S.A.) and Banco do Brasil are among the most prominent examples of a "*Sociedade de Economia Mista*".

Generally Inapplicable: Specific Entities and Non-Entrepreneurial Persons Fall Under the General Civil Insolvency Regime

Natural or legal Persons not engaged in entrepreneurial activities are subject to the general civil insolvency regime (*insolvência civil*) under the Brazilian Code of Civil Procedure (Articles 1,052 Brazilian Code of Civil Procedure of 2015 in conjunction with Articles 748–786A Brazilian Code of Civil Procedure of 1973). Persons undertaking activities that are predominantly of an intellectual, scientific, literary or artistic nature (such as actors, architects, artists, doctors, musicians and writers (Article 966 Brazilian Civil Code in its only paragraph) or those carried on without a

significant organisational structure (no employees, low trade volume etc.) are considered non-entrepreneurial in the sense of the Brazilian civil and insolvency law.

Types of Business Insolvency Proceedings in Brazil

Brazilian Business Insolvency law offers the following three types of insolvency proceedings:

Original Brazilian name	Literal English translation
recuperação judicial	judicial recovery
recuperação extrajudicial	extrajudicial recovery
Falência	liquidation (in insolvency)

Considering the figures of the first decade since the LFRE first came into effect, judicial recovery (Chapter III, Articles 47–72 LFRE) and, to a lesser degree, liquidation proceedings (Chapter V, Articles 75–160 LFRE) are by far the most important in practice. In the same period, extrajudicial recovery proceedings have lived a wallflower existence with very few cases. However, since 2015, such proceedings, being much simpler, faster and swifter than judicial recovery proceedings, have started to finally become more relevant in practice.

Liquidation in Insolvency Proceedings

Brazilian liquidation in insolvency proceedings with their comprehensive realisation of the debtors' assets are akin to Chapter 7, subchapter I and II, of the United States Bankruptcy Code and to regular insolvency proceedings under the German Insolvency Act *InsO* (*Regelinsolvenzverfahren ohne Planverfahren und ohne Eigenverwaltung,* Articles 1 to 216 *InsO*).

Side Note 3: Winding-up of Company According to Brazilian Civil Code as Alternative to Liquidation Proceedings

Even when indebted, winding up a company outside of insolvency proceedings, based on the Brazilian Civil Code and the Brazilian Stock Corporation Act, may constitute an appropriate alternative. In particular, this will be the case where the shareholders are prepared to increase the corporate capital and manage challenging cash issues during the liquidation phase. It is important to ensure that all liabilities of the company are discharged before the company is being wound up. This is because the shareholders and administrators/officers of a company that is being wound up are jointly and severally liable for any outstanding liabilities the company owes the tax, labour and social securities authorities.

Judicial Recovery Proceedings

Judicial recovery in insolvency proceedings aim to overcome the economic and financial crisis of the debtor. It combines an automatic stay with a recovery plan under self-administration of the

debtor. As such, Brazilian judicial recovery proceedings can be compared to Chapter 11 of the United States Bankruptcy Code and to the German insolvency plan procedure (Articles 217 to 269 *InsO*) combined with a debtor *in* possession procedure (Articles 217- to 285 *InsO)*.

Extrajudicial Recovery Proceedings

The extrajudicial recovery in insolvency proceedings (Chapter VI, Articles 161–167 LFRE), despite its name, still involves proceedings before an insolvency judge as the debtor's recovery plan negotiated out-of-court requires judicial approval to become legally binding on dissenting creditors (Article 165 *caput* LFRE). The court approves the plan (*homologaçaõ do plano de recuperação extrajudicial*) if it is signed by affected creditors holding at least three-fifths of the overall value of the claims of all affected creditors. Such proceedings resemble a court approved pre-packaged restructuring plan in the sense of Chapter 11 of the United States Bankruptcy Code.

In contrast to judicial recovery proceedings, the extrajudicial recovery does not cover labour claims and only awards limited protection against creditors enforcing claims on an individual basis (Article 161(1), (4) LFRE).

Further, and also contrary to judicial recovery proceedings, in a sale of an isolated productive unit of the debtor to an investor by way of judicial auction, the extrajudicial version of recovery proceedings does not grant immunity from succession to the debtor's liabilities.

Side Note 4: Informal Work-Outs According to General Rules of the Brazilian Civil Code as Alternative to Extrajudicial and Judicial Recovery Proceedings

If convenient, a debtor may negotiate with its creditors its original debt, and implement informal work-outs as alternative to formal (judicial or extrajudicial) recovery in insolvency proceedings. However, if a cram down or automatic stay is necessary or desirable, the debtor must have recourse to formal recovery proceedings.

Administration of the Debtor's Business

In Judicial Recovery Proceedings

As a general rule, throughout the whole judicial or extrajudicial recovery process, the debtor's management remains in control of the debtor's business. In a judicial recovery, a court-appointed trustee and a creditors' committee, if eventually formed, oversee the self-administration of the debtor.

In Liquidation Proceedings

In contrast to self-administration as part of recovery proceedings, in liquidation proceedings, the debtor no longer retains its self-management power, such that the insolvency trustee is in charge of the management of the debtor's insolvent estate/business.

Locus Standi

Debtor

It is the Brazilian debtor itself that has standing to petition for either of the three types of insolvency proceedings. However, for the plan in recovery proceedings (judicial or extrajudicial) to be valid, it requires both creditors' consent and approval by the insolvency judge.

Creditors

At the same time, creditors can only initiate liquidation proceedings over the debtor's assets; they are unable to compel judicial or extrajudicial recovery in insolvency proceedings.

Side Note 5: Debtor's Duty to Initiate Proceedings?

Article 105 *caput* LFRE stipulates that the debtor must initiate (*deverá requerer*) insolvency proceedings for its own liquidation if there is no prospect of success in judicial recovery proceedings. However, due to a lack of precedent, the consequences of non-compliance with this duty remain unclear.

In any event, Brazilian law does not contain provisions comparable to the German criminal offence of trading whilst insolvent and unreasonably delaying filing for insolvency (*Insolvenzverschleppung* in the sense of § 15a of the German Insolvency Act (*InsO*)).Be that as it may,, debtors in distress are well advised to timely analyse their legal and financial options regarding a turnaround or winding-up of their businesses, and avoid conducting transactions potentially harmful to creditors in insolvency scenarios.

General Legal Effects of the Commencement of Judicial Recovery or Liquidation Proceedings in Brazil

Suspension of Limitation Periods

Once the court has opened the liquidation or judicial recovery in insolvency proceedings, limitation periods no longer run with regard to creditors' claims (Article 6 *caput* LFRE).

Stay of Individual Enforcement Measures

The insolvency opening order suspends all individual enforcement measures against the debtor (Article 6 *caput* LFRE). However, pending regular contentious proceedings (*ação que demandar quantia ilíquida*) as well as those concerning employment-related disputes will not be suspended (Article 6(1), (2) LFRE). Plaintiffs in such proceedings may apply to have their claims entered into the claims register at a (preliminary) reserve value, subject to a different binding decision in the judicial recovery or liquidation proceedings (Article 6(3) LFRE).

Appointment of Insolvency Trustee

The insolvency judge will appoint an insolvency trustee (Article 52 *caput* I, 99 in conjunction with Article 21 LFRE) which shall be a professionally qualified natural person – preferably a legal practitioner (*advogado*), accountant (*contador*), business economist (*administrador de empresas*) or macroeconomist (*economista*) – or an appropriately-specialised legal entity (*pessoa jurídica especializada*) (Article 52 *caput* I, in conjunction with Article 21 *caput* LFRE).

Procedural Issues

Competence of the Brazilian Insolvency Court

Insolvency proceedings come before the insolvency judge (*juízo de direito*) in the civil court (*Vara Cível*) in the jurisdiction where the debtor has its main domicile (Article 3 LFRE). If the debtor has multiple domiciles in Brazil, the competent court is in the jurisdiction where the debtor generates most of its turnover, irrespective of any contrary provisions in the debtor's corporate corporate constitutions.

General Lack of Brazilian Regulations for Cross-Border Insolvency Cases

The LFRE does not contain international procedural rules within the meaning of the UNCITRAL Model Law on Cross-Border Insolvency. The Brazilian Code of Civil Procedure, which governs the liquidation of assets of non-entrepreneurial persons in the event of default of payment, and which applies beside the LFRE on a subsidiary basis, does not contain regulations regarding cross-border insolvency cases either. Only the Latin-American Agreement on Private International Law, the so-called *Código de Derecho Internacional Privado* (Also known as "*Código de Bustamante"*) which applies in Brazil, contains some regulations regarding jurisdiction and further cooperation in procedural matters with respect to cross-border insolvencies.

As the Código's territorial scope of application only extends to the 15 Latin American signatories, it does not cover any country outside Latin America. There is no rule analogous to Chapter 15 of the United States Bankruptcy Code allowing the recognition of a foreign main insolvency proceeding.

No Standing for Legal Pursuit in Germany as to Claims Affected in Brazilian Insolvency Cases

According to a decision of the German Regional Labour Court of Hesse (Decision of 4.8.2011 – 5 Sa 1549/10 (source: BeckRS 2012, 69431)) Brazilian judicial recovery in insolvency proceedings constitute recognised foreign insolvency proceedings ("*ausländisches Insolvenzverfahren"*) within the meaning of § 343(1) of the German Insolvency Act (*InsO*).

Consequently, creditors (of the Brazilian domiciled debtor) domiciled in Germany must register their claims and pursue their rights in the Brazilian insolvency proceedings according to the

applicable Brazilian rules and within the relevant limitation periods as legal action in Germany would be inadmissible for lack of standing.

Consequences of German Insolvency Proceedings Involving a German Holding Company Regarding its Brazilian Subsidiary

In cases involving corporate groups with operations in both Brazil and Germany, creditors may need to apply for separate insolvency proceedings in each of the two countries. In principle, German (main) insolvency proceedings cover the worldwide assets of a company. However, it is not possible to bring secondary insolvency proceedings within the meaning of the EU-Council Regulation (EC) No 1346/2000 with respect to the Brazilian subsidiary as the law of Brazil lacks such international regulations.

Insolvency proceedings commenced in Brazil are governed exclusively by Brazilian law. This has the result of hampering the unbundling and realisation of the debtor's assets. By exercising shareholder rights, it remains open to the German insolvency trustee to exert influence on the Brazilian subsidiary or its executives respectively, or to sell the company shares to an investor.

Concluding Remarks, Disclaimer and Copyright

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