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BRAZIL ENACTS NEW FEDERAL BANKRUPTCY LAW

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After more than a decade of debate in Congress, Brazil has recently enacted a new Bankruptcy Law (Law). The Law was published as Federal Law No. 11,101 on February 10, 2005 and will become effective 120 days after its publication.

The Law not only updates the current legislation, Federal Decree-Law No. 7,661, enacted in 1945, but also replaces the *concordata*, which was a procedure for deferring and/or reducing repayment of unsecured debts, with a new and more comprehensive reorganization procedure. Furthermore, the Law changes the credit preferences and expedites the liquidation procedure.

The Law generally provides for two reorganization procedures: (i) judicial reorganization, in which the court supervises each stage of the process from preliminary negotiations to the post-approval period, and (ii) extrajudicial reorganization, in which the court only consents to plans previously negotiated among the debtor and creditors.¹

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¹ An optional procedure will also be available for small businesses (as defined in the Law). However, this optional procedure will only allow the debtor to defer repayments of unsecured creditors for up to 180 days from the request for relief and reschedule such payments over a three-year period.

Under judicial reorganization, the debtor will have up to 60 days following the acceptance of the procedure by the court to present a reorganization plan. If any creditor objects to the plan, it will need to be approved in a creditors' meeting by each of the following classes of creditors:

- a) holders of labor claims and claims arising out of on-the-job accidents;
- b) holders of secured claims; and
- c) other eligible creditors.

The court may also grant the reorganization if one of the above classes of creditors rejects the plan, provided that it is approved by the holders of more than 50% of the aggregate amount of the claims and by the holders of at least one third of the aggregate amount of the claims of the class opposed to the plan.

Some creditors are excluded from the judicial reorganization. These include commercial lessors, owners or acquirers of real property (if they have entered into irrevocable agreements) and fiduciary owners of assets. In addition, the Law provides for the repayment of tax and social security debts on an installment basis. The terms and conditions for the repayment, however, will need to be determined by future legislation.

The Law also allows the debtor to avail itself of any legal means to achieve reorganization, including mergers, sales or leases of assets or commercial establishments, changes of control, and the issuance of securities.

As for extrajudicial reorganizations, in addition to the creditors that are excluded from judicial reorganizations, the Law also excludes creditors with labor, tax, social security and on-the-job accident claims.

The Law expedites the liquidation procedure, making it possible for the court to allow the sale of assets of the bankrupt estate as assets are collected. The Law also provides that the court should give preference to selling the entire business rather than selling off individual business assets.

The Law also changes the preferences in a liquidation scenario. Among other changes, labor claims that currently rank first in payment priority will be limited to the equivalent of 150 times the minimum wage.² Under the Law, tax claims, which under the current system rank second in payment priority, will now take third priority, following secured claims.³

Overall, the Law will provide companies in financial distress with a better legal framework for reorganization, allowing the debtors to present a reorganization plan based on their economic and financial capabilities rather than applying for deferment and/or reduction in repayment of unsecured debts. Thus, the law should ultimately reduce creditor risk and tighten interest rate spreads to the extent that they relate to the probability of a creditor's claim being satisfied.

² The minimum monthly wage is equivalent to R\$260.00 (approximately US\$96) and is expected to be increased in May 2005.

³ Note that the referenced claims shall be paid after the payment of post-petition claims, as defined by the Law, which include the claims arising out of obligations contracted by the debtor during the judicial reorganization, including those relating to contracts with goods or service providers and loan agreements.