Legislative changes to the Brazilian Bankruptcy Law on the sale of assets in judicial reorganisation proceedings

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The Brazilian Bankruptcy Law (Federal Law no 11.101/2005) was recently amended by Federal Law no. 14.112/2020 (the 'Reform'). The main driver of the Reform was to improve the efficiency of the Brazilian insolvency regime, expedite insolvency-related court proceedings – notably the judicial reorganisation (*Recuperação Judicial* or RJ) – and create a safe and reliable environment for investors to deploy capital in debtors undergoing insolvency proceedings.

Among other issues, the Reform introduced to the Brazilian Bankruptcy Law several provisions concerning the sale of assets in RJ proceedings. These provisions, which seek to settle certain issues that have been debated since the enactment of the Brazilian Bankruptcy Law, afford additional protections for investors and foster the efficiency and expeditiousness of asset sale transactions in RJ proceedings. It is indisputable that asset sales have historically been of paramount importance for debtors to reorganise and raise new money necessary to successfully implement the intended restructuring.

Although the Brazilian Bankruptcy Law already afforded relevant protections for certain types of asset sales, and numerous transactions have been successfully implemented, certain issues still pose uncertainties that prevent a larger number of sales in RJ proceedings. This has emphasised the need for modifications in the Brazilian Bankruptcy Law.

This article highlights the main points of the Reform dealing with the sale of assets in RJ proceedings.

General framework under the Brazilian Bankruptcy Law

As typically occurs in insolvency legislation (eg Section 363(b)(1) of the US Bankruptcy Code and Article 62 of the Italian Bankruptcy Code (*Codice Amministrazione Straordinaria*)), the Brazilian Bankruptcy Law imposes restrictions on sale of non-current assets undergoing an RJ proceeding. Any sale either requires a specific court approval or to be part of the reorganisation plan approved by creditors and confirmed by the court.

Further, prior to the Reform, the Brazilian Bankruptcy Law provided sales of 'isolated business units' (*Unidade Produtiva Isolada* or UPI) would be concluded free and clear of liens and successor liability. Sales of UPIs, however, were and still are performed pursuant to a reorganisation plan and require a court-supervised competitive process.

On the other hand, the Brazilian Bankruptcy Law did not expressly afford investors the same benefits for sales that did not qualify as 'sales of UPIs' and were performed upon court approval. Neither was there was a streamlined process for such sales; therefore, any stakeholder involved in the RJ proceeding could object to the motion requiring court approval for a transaction and further litigate the issue.

Relevant modifications

Clear definition of UPI and sale of entire business of the debtor

Neither the Brazilian Bankruptcy Law nor any other statute provided clear guidance on the meaning of UPI, and which assets could or could not be sold under the structure of a UPI sale.

Some academics and practitioners supported the contention that the UPI should correspond to an establishment of the debtor. Therefore, sales of UPIs that resulted in a de facto liquidation would not be permitted since the debtor would need to maintain a certain level of operational activity to support payments to creditors following the intended transactions.

Despite that understanding, debtors and creditors typically had wide discretion to create UPIs under reorganisation plans. The lack of an express concept of

the UPI, and the Brazilian Bankruptcy Law's drivers of the preservation of the business enterprise as a going concern and maximisation of value, supported the case for the view that the UPI could essentially consist of any asset of the debtor.

In the early years of the Brazilian Bankruptcy Law, the Court of Appeals of São Paulo set an important precedent,[1] authorising the sale of a piece of land from the debtor's non-operating assets as a UPI. Likewise, the same Court of Appeals decided in the *Pantanal* case that all assets related to Pantanal's airline business could be incorporated into a UPI, including certain contractual and regulatory rights.[2]

Further, although not expressly provided for in the Brazilian Bankruptcy Law, equity interests of debtors have also been sold as UPIs. This happened, for instance, in the *Abengoa* and *Sete Brasil* cases. A similar provision was included in the OAS reorganisation plan, but the transaction ultimately did not go through. However, in a previous decision, the Court of Appeals of São Paulo had not afforded the protection of UPI sales to a sale of the shares of a newly incorporated entity to which certain assets were contributed, even though the reorganisation plan expressly provided that the transaction was to be considered a UPI sale.[3]

To settle the issue and avoid uncertainties as to which assets could be sold as UPIs, the Reform added Section 60-A to the Brazilian Bankruptcy Law, which expressly states that UPIs may comprise any tangible and intangible assets or rights of the debtor (segregated or sold as a block), including equity interests. The requirements for a sale of UPI have not been modified; therefore, sales of UPIs still require:

- specific treatment in the reorganisation plan approved by creditors and confirmed by the court; and
- a court-supervised competitive process.

However, the Brazilian Bankruptcy Law now provides that the competitive process may take the form of either:

- a court-supervised electronic or physical auction; or
- an extrajudicial process organised by a specialised agent, whose procedure should be detailed in the reorganisation plan (or the asset sale plan in sales in liquidation proceedings).

This procedural modification seeks to increase flexibility around the current necessity of an in-court process for all sales of UPIs – modernising the competitive process for sale of UPIs, notably in cases of sophisticated and complex sale of assets.

The Reform also eliminated the discussions about the possibility of the sale of the entire business of the debtor as a UPI. Despite specific provisions of the Brazilian Bankruptcy Law that suggested that this would not be permissible, the main concern was that the sale of all (or substantially all) of the assets of the debtor pursuant to a reorganisation plan would render the debtor incapable of making payment of claims that, by operation of law, are not impaired by RJ proceedings. These include tax claims and claims collateralised by certain types of security interest.

The Reform included in the Brazilian Bankruptcy Law the possibility of the sale of the entire business of the debtor, in which case the sale will be considered a sale of a UPI for the purposes of affording the purchaser the protections of sales free and clear from successor liability.

To come up with an alternative to protect creditors not impaired by the RJ, the Reform also states that the sale must guarantee to creditors not subject to or impaired by the RJ 'conditions at least equivalent to the ones they would have in a liquidation proceeding'. Consequently, the Reform sets out that the debtor may be subject to involuntary liquidation if there is proof of disposal of substantially all of its assets in detriment to creditors not subject to RJ proceedings, including tax claimants.

The liquidation ruling based on this provision, however, does not render the sale transaction void or result in the unwinding of the sale, but the proceeds of the sale will be seized by the court so that it may release them in accordance with the corresponding rules that apply to liquidation proceedings.

This newly incorporated provision is of paramount importance. It grants investors protection against a transaction being adversely affected by a finding of the court that the transaction would be detrimental and/or violate the rights of specific bankruptcy-remote creditors, who do not necessarily participate in the RJ.

Extension of the protection against successor liability

Generally speaking, Brazilian courts have widely tested and confirmed the protection against successor liability provided for in the Brazilian Bankruptcy Law. On this topic, the Brazilian Supreme Court has already recognised the constitutionality of the no-successor liability rule, the ultimate goals of which are the preservation of the business enterprise and the creation of incentives for investors to purchase assets in RJ proceedings.[4]

The Reform, however, addressed two relevant issues concerning issues related to the extension of protection against successor liability.

Firstly all assets – not just UPI sales – are afforded protection against successor liability provided that the sale is performed under a court-supervised competitive process provided for in the Brazilian Bankruptcy Law.

Although this category of sale also requires court approval and a competitive process, it does not require that the transaction be made pursuant to a plan, which is relevant from a timing perspective. In other words, in contrast with a UPI sale, a given asset sale may take place at the outset of the case and be afforded the same protections, as long as it meets the aforementioned requirement.

Second, the former wording of the Brazilian Bankruptcy Law gave room for debate on whether the protection against successor liability would apply to any and all type of liability of the seller, particularly because the language of the relevant provision only expressly mentioned labour and tax liabilities. The issue was particularly relevant with respect to regulatory, environmental and corruption-related liabilities, all of which are governed by a specific set of rules that are typically more restrictive. Particularly, the corruption-related liabilities were subject to several debates in the context of the numerous bankruptcy proceedings that were filed in connection with car wash operations. Courts, however, have not tested the matter.

Pursuant to the Reform, the protection against successor liability applies to all liabilities, including, but not limited to, environmental, regulatory, administrative, anti-corruption, tax and labour liabilities. The wording also protects the buyer from certain rules related to successor liability set out in the Brazilian Anticorruption Law (Federal Law no. 12.846) sanctioned in Brazil on 1 August 2013.[5]

It is clear that the Reform sought to reinforce the protections to investors in the spirit of fostering transactions in RJ Proceedings.

Protection against litigation and restrictions to objections

The Reform included in the Brazilian Bankruptcy Law a provision stating that the sale of assets, or the granting of a security interest by the debtor to a good-faith purchaser or new money provider, will not be rendered void or unenforceable following conclusion of the transaction and receipt of proceeds by the debtor, provided that the transaction is authorised by the court or provided for in a reorganisation plan. Likewise, similar protection is granted to the sale of the entire business of the debtor as a UPI, as mentioned above.

This is a relevant and welcome modification to the Brazilian Bankruptcy Law. Protections to good-faith investors against uncertainty related to the outcome of potential litigation arising from RJ has been historically seen as necessary to encourage investments in distressed companies in Brazil. The prospect of endless litigation or the risks of the transaction being further unwound because of pending litigation against confirmation of the plan, the transaction or any other issue has consistently been highlighted as a significant legal risk that discouraged investors, particularly foreign ones, from pursuing asset sale transactions in Brazilian RJs.

Hence, the legal provision protecting investors from the risk of future voidance, or the unenforceability of the asset sale or financing transaction, tends not only to increase the number of asset sales but also to maximise prices and capital availability to the debtor.[6] This potentially promotes better alternatives for a successful restructuring, which is clearly consistent with the scope and the ultimate goals of the Reform and the policy underlying the Brazilian Bankruptcy Law.

Likewise, to avoid baseless litigation over asset sale transactions, the Reform also included provisions in the Brazilian Bankruptcy Law restricting creditors' (or other interested parties') ability to object to transactions.

In case of a sale subject to court approval, creditors representing at least 15 per cent of the value of claims subject to the RJ may request that the court convene a creditors' meeting to put the transaction to a vote, provided that the objecting creditors post a bond in the amount of the transaction and pay all expenses related to the creditors' meeting.

On the other hand, in the event of a sale under a court-supervised competitive process, objections based on the valuation/purchase price of the assets must be supported by a third party offer in a net present value higher than the winning bid and require a cash deposit (bond) in an amount equivalent to ten per cent of the offered price. Any frivolous objection subjects the objector to penalties under both the Brazilian Bankruptcy Law and the Brazilian Code of Civil Procedure.

These two provisions also confirm the goal of the Reform to streamline the asset sale processes in bankruptcy proceedings, avoid uncertainties, and grant additional protections and incentives to investors seeking to acquire assets from debtors undergoing insolvency proceedings.

Conversion of debt into equity

Although no provision of the Brazilian Bankruptcy Law prevented creditors and debtors from agreeing on reorganisation plans providing for debt-to-equity conversions, there was no specific provision dealing with the topic in the context of the RJ proceedings.

Pursuant to the Reform, debt-to-equity conversions are now expressly included among the 'means of reorganisation' set forth in the Brazilian Bankruptcy Law. Additionally, creditors may propose debt-to-equity workouts in the context of creditor-proposed plans pursuant to new rules that mitigate the exclusivity of the debtor to propose a plan.

More importantly, the Reform introduced a provision expressly stating that there should be no successor liability or liability for debts of any nature to creditors, investors or new officers of the debtor as a result of the mere conversion of debt into equity, new funding or replacement of management of the debtor.

'Stalking horse' protections

The Reform did not expressly deal with compensations or bidding protections for investors willing to submit 'stalking horse' offers that backstop and set the floor for asset sales under RJ proceedings. Consequently, the Brazilian Bankruptcy Law remains silent on the availability and legality of protections for investors who spend time and energy to deploy resources to present a stalking horse to anchor and backstop the competitive process for the sale of assets.

Although Brazilian courts have not widely tested the issue, stalking horse protections have increasingly been adopted in asset sales under RJ proceedings in Brazil.

In the *OAS* case, the reorganisation plan provided certain investors a right to top any competing offer and a break-up fee in the event another bidder was declared the winner of the competitive process. In the *Abengoa* case, both the right to top and the break-up clause were litigated. The court confirmed the enforceability of the right to top, but it refused the break-up fee since it would likely hinder competition. During the competitive process, the investor exercised the right to top since a competing offer was presented during the competitive process. More recently, similar structures were successfully implemented in the RJ proceedings of Oi Group, Renova Energia and Estre Ambiental.

Stalking horse structures have been welcomed by courts to the extent that the binding offer presented by the anchor investor grants certainty to the successful outcome of the transaction sale. Naturally, there should be balance between the competitive nature of the sale process and the need to protect an investor who undertook diligence efforts, spending time and money on the transaction. Therefore, the transactions should not be structured in such a way as to make competition impossible or untenable in practice.

Despite the above, the lack of guidance on the protections granted to stalking horse bidders gives room for litigation over the issue, and corresponding uncertainty to the stalking horse or the process as a whole, since the granting of such protections are typically conditions precedent for the validity of any binding offer, which would be ultimately inconsistent with the goals of the Brazilian Bankruptcy Law.

Conclusions

The modifications to the Brazilian Bankruptcy Law implemented by the Reform with respect to the sale of assets are welcome. They are likely to stimulate new transactions in existing or yet-to-be-filed RJ proceedings to the extent that the rules enhance legal certainty and confirm and expand the needed protections for investors willing to acquire assets in an insolvency environment.

Naturally, given that the Reform is quite recent, the provisions have not yet been tested in such a way as to give rise to peremptory conclusions. However, they are consistent with the goal of making bankruptcy proceedings – primarily the RJ – more dynamic and attractive to investors, which ultimately promotes the underlying goals and policies of the Brazilian Bankruptcy Law.

Notes

1 Interlocutory Appeal No 624.330-4/0-00, 5 May 2009.
2 Interlocutory Appeal No 994.09.316372-9, 26 January 2009.
3 Interlocutory Appeal No 2029620-72.2013.8.26.0000, 29 May 2014.
4 See ADI (*Ação Direta de Inconstitucionalidade)* 3934, 25 May 2009.
5 In this matter, the Brazilian National Counsel of Justice (CNJ) had already rated that there is no succession of the acquirer of assets concerning pecuniary penalties applied to the debtor based on Anticorruption Law, on the hypothesis of Art 60 of Federal Law No 11.101/2005 (Enunciation No 104, *III Jornada de Direito Comercial*).
6 Marcelo Barbosa Sacramone, *Comentários à Lei de Recuperação de Empresas e Falência,* 2nd ed. (Saraiva, 2021).

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