In- court recovery acts in Brazil

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Preface

Since February 2005, the law for in-court recovery acts has been introduced, substituting the former company failure act with immediately following wind-up process („*concordata*"). The former juridical rule determined that an insolvent company was given a two years period to re-adjust its business assets and debts. During this period, the companies were protected from bankruptcy. Facilitated self-administration decided about how to resurrect the company. Practice proofed that this process did not work out well. Up to 90% of all company failure processes lead into bankruptcy after the period of grace. As a result the in-court recovery act („*recuperação judicial*") was amended to better rescue companies facing serious problems. The new law was inspired by the American legislation, particularly the well known Chapter 11 Act. In case of an insolvent Brazilian company applies for in-court recovery regulation it gains a protection shield against bankruptcy for 180 days. The company then is obliged to prepare a resurrection plan and present it to its creditors who are free to approve or reject the plan. If the plan is rejected, the bankruptcy is declared automatically, however, if the plan is approved it must be enforced – thus, the decision is entirely in the hands of the creditors. During the period of the in-court recovery act the company stays under supervision of a juridical administrator, whereas the operative management remains with the company. The juridical administrator is to safeguard the fulfillment of Brazilian law, but he will not be part of the operative management of the business. The company will stay under this regime for two years. Only with a favorable juridical evaluation the company is to re-gain its full autonomy and leaves the in-court recovery process.

Only 1% of all companies seeking the national in-court recovery act successfully left the process. After the new law went into effect approximately 4.000 companies passed through the procedures, but only 45 companies succeeded as regular and recovered entities. These figures reflect the situation by the end of 2012. During the same period only 23% of those companies facing insolvency had the restructuring plans approved by the creditor assembly. 398 companies were submitted to the bankruptcy process and consequently the obligatory winding-up procedures. The majority of all in-court recovery act cases is passing through the juridical system without any positive solution visible on the horizon.

The majority of all approved restructuring plans are not elaborated in that much detail that they may serve as a master plan to restructure the company economically. Basically, those plans are nothing more than plans for the conversion of debts. This explains, in part, why the success rate of in-court recovery acts is very low in Brazil so far. First and foremost the in-court recovery act was created to better the former company failure process, thus, avoiding bankruptcy. Only if the business owner does not see a way out of the critical situation, he starts to submit the company to an in-court recovery act and lays the future into the hands of creditors and the juridical authorities.

„The problem is not the legislation, but the long execution time which compromises the liquidity of the company."

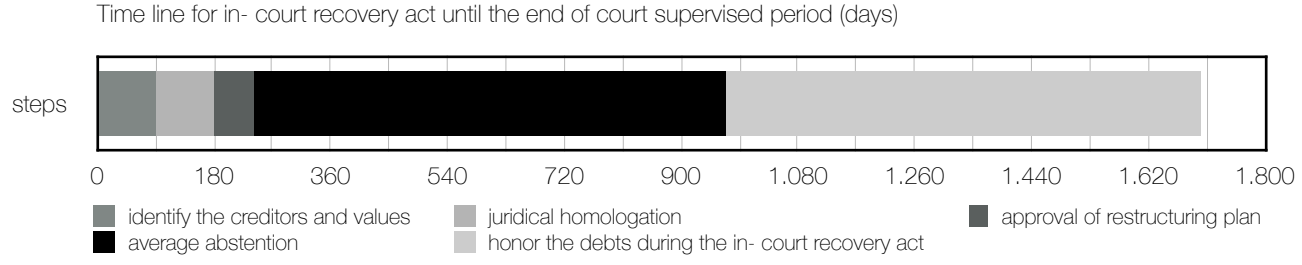
- PROJECT MANAGER -

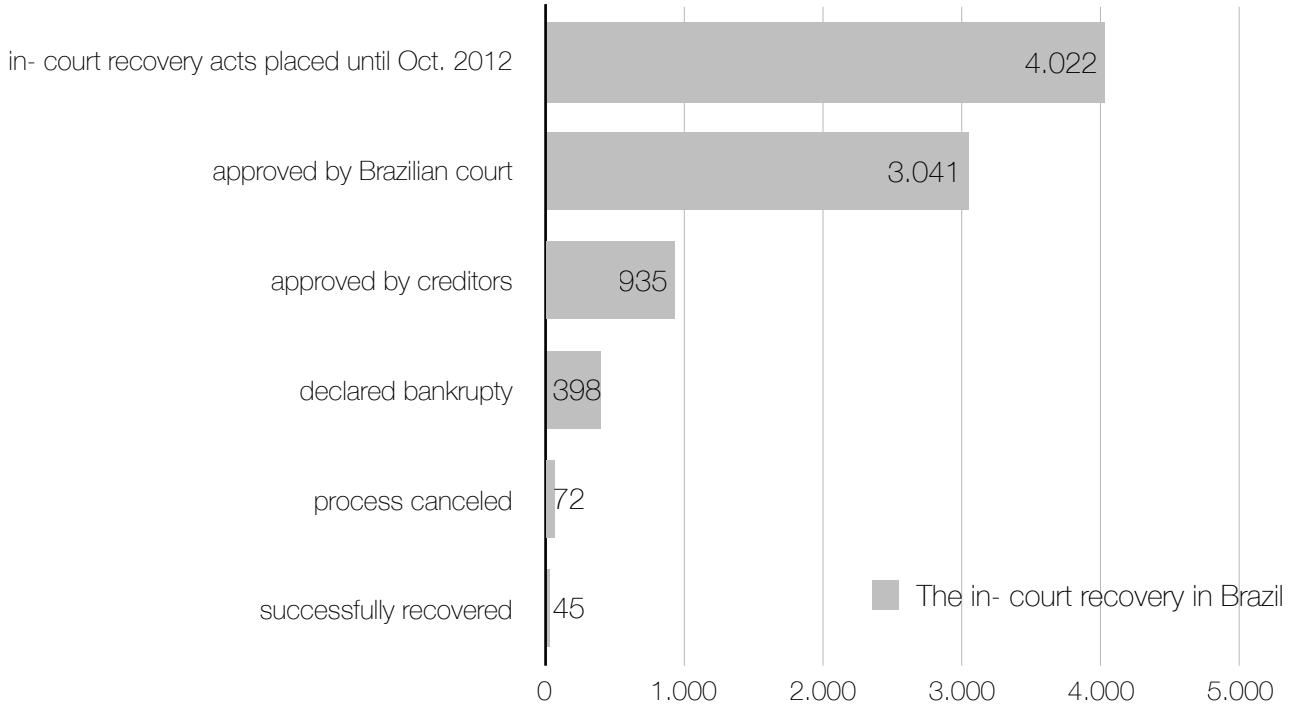
The task to rescue a company involves, at least, two large challenges: regain the confidence of the creditors and keep the company operative. Many companies discontinue their activities due to the lack of cash flow and, therefore, can't fulfill the basic commitment to pay the employees salaries. Furthermore, purchasing raw-material to continue the production process means a great challenge, too. It proves to be very difficult to recover a company once it interrupted the activities. First, the recovery plan has to consider where the cash resources are to come from that will keep the company operative. Once the operation stopped, the company will not be able to meet any orders loosing the clients and the stock of finished products and products in process will rise rapidly. If a company reaches that status it is only a question of time to do the next step - declare bankruptcy. When bankruptcy is declared it is normal that the judge affirms that the in-court recovery act has failed, because the company does not exist any more. The race for corporative survive is against the time.

More than once the in-court recovery act turns into a juridical battlefield between the creditors, the managers, the shareholders and the juridical administrators. All parties involved start to interpret the law, trying to guarantee and safeguard their own interest. The recovery of the company becomes secondary. At this particular time, investors with questionable interest show up. Mostly such interest is focused on speculative gain in accompany with criminal financial and fiscal structures. If the company faces this situation, it is worth to approve a risky recovery plan instead of a bankruptcy declared seeking for specialized juridical assistance, too.

The Brazilian in-court recovery act was inspired by the so called „*Chapter 11*" of the American legislation. In the United States, the success rate varies from 20% to 30%, which is far better than the Brazilian reality with 1.12% only. The American legislation is more sophisticated, but the main advantage is the juridical agility and maturity of the market. The involvement of the (US) creditors is higher in comparison with the limited responsibility of the Brazilian creditors, who by law can only approve the recovery plan or deny it.

The final decision to close an in-court recovery act is with either the judge or the creditors. In Brazil it happens that a company presents a positive scenario and satisfies the creditors as scheduled and without any delay, however, the judge and some creditors are not convinced that the company will remain sustainable once the in-court recovery act was closed. No time limit is set for any renegotiation of debts. Generally a company obtains a grace period of one to three years for paying the first installment of the renegotiated debt. The total debts may be distributed to eight or ten years. The shareholders of the company do not have any authority whatsoever to





decide the future of the company outside the approved recovery plan.

Trying to explain the low flexibility of the Brazilian in-court recovery act, we identify these obstacles: inexperienced regional judges, absence of previous negotiations with creditors and lack of organization of creditor groups. The average period to pull through an in-court recovery act in Brazil takes approximately 4.5 years. The low quota of investment recovery is related to the repayment of debts out of sales revenue and not so much to the effective restructuring process itself. If a company is up for sale, the creditors are pushed to the pain threshold. For the buyer, such transaction usually means real benefits of different nature, e.g., financial, fiscal or commercial.

It is our experience that a manager, shareholder or business owner starts to consider an in-court recovery act only once it ought to be under the responsibility of a court already – in other words too late. It is vital to perform a pre-evaluation to determine all creditor classes and priorities. The Brazilian law gives a guideline of priorities, first to be served must be the labor creditor. Furthermore, the pre- evaluation prepares the the urgent cash flow funding, purchasing of raw material and other resources in order to keep the production alive. It is recommendable that all those tasks will be executed by independent interim project managers, together with a specialized attorney office. The process fluids well if the interim project manager and the attorney office had prior experience working together on same projects. The administrative and financial management must be delegated to a manager with experience in difficult periods - the tension and pressure will be very elevated and beyond a common manager is familiar with.

Once the restructure plan is approved, the company must be guided back to normal conditions. Don´t forget, without a adequate and quick preparation, the company submitted to the in- court recovery act is without credit lines, suppliers and clients. The continuous communication with all involved parties is vital to be one more among the group of successfully recovered companies in Brazil. iManagementBrazil participated on several projects of in-court recovery acts in different business sectors assuming management and negotiator functions. Our negotiation experience goes along with unions, suppliers and Brazilian banks, as well as new investors for recovered asset companies. We have been active with in-court recovery acts in the construction sector, engineering sector and infrastructure sector, mainly the oil and gas industry. We are working together with highly specialized attorney offices. *(FN)*

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