Fall 1995

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A Brief Incursion into Bankruptcy and the Enforcement of Creditor’s Rights in Brazil

Antonio Mendes*

I. INTRODUCTION

In deciding whether to lend, and under what financial terms, international lenders have traditionally factored in both the credit status of the borrower as well as the credit standing of the country (sovereign risk). Far less attention, if any, is given to “recovery risk.” Even specialized agencies which evaluate the credit standing of corporate borrowers and countries do not assess recovery risk. Nevertheless, the bankruptcy laws where the debtor is established and doing business can affect the recovery rights of creditors, even where a credit transaction was negotiated outside of the debtor’s jurisdiction. In fact, such laws can operate to reduce or eliminate any recovery by the creditor in the event of default. Exactly how a particular country’s laws will impact a creditor’s recovery rights will depend on the specific substantive provisions of the governing domestic law. For instance, in Brazil, as in most countries, secured creditors are subject to very different treatment than unsecured creditors. Whether a creditor is secured will, in turn, depend on whether an asserted security interest is recognized under Brazilian law - an issue of some complexity, implicating various provisions of the Brazilian civil code. This brief incur-

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1 Recovery risk calculates the likelihood of recovery in light of the available assets and the effect of local bankruptcy laws on the availability of estate proceeds to satisfy creditor claims.
sion into the Brazilian bankruptcy regime will be largely limited to the situation confronting unsecured creditors.2

II. OVERVIEW OF THE BRAZILIAN BANKRUPTCY REGIME

Brazilian law provides for two types of legal proceedings which can significantly impact the rights of creditors who recover amounts due under a credit agreement or other instrument calling for the payment of a sum certain.3 One of these - concordata - is a defensive remedy available to commercial debtors.4 Those qualifying for this remedy will either be able to have part of their unsecured debt extinguished or, at the very least, obtain a deferral of a payment obligation. There are two basic concordata forms, which differ both procedurally and substantively. A preventive concordata must be applied for before a bankruptcy proceeding has been initiated. The other, a suspensive concordata, is a remedy available to a debtor after the initiation of bankruptcy.5

Brazilian law also recognizes a conventional bankruptcy process analogous to a United States Chapter 7 proceeding. Unlike concordata which can only be initiated by the debtor, bankruptcy may be initiated by either the debtor or creditor. The end result of this procedure, unless a suspensive concordata is successfully invoked, is liquidation of the debtor's assets.

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3 Federal Decree Law No. 7661, June 21, 1945, as amended, governs special reorganizations and bankruptcies (hereinafter referred to as "Bankruptcy Law" or "Brazilian Law").

4 Brazilian law distinguishes between comerciante (businessmen)—individuals engaged in trade and in industrial and commercial enterprises—and professionals and private persons. Concordata is only available to comerciantes, as is bankruptcy under the bankruptcy law. Professionals and private persons are not covered by the bankruptcy laws but are subject to a concurso de credores which is governed by civil law. Brazilian Civil Code, arts. 1,554-1,571 (Law No. 3,071, January 1, 1916, as amended) and Brazilian Code of Civil Procedure, arts. 748-786 (Law No. 5,869, January 11, 1973, as amended). Corporations (sociedades por acoes), will always, regardless of their objectives, be considered commercial by their nature and therefore subject to concordata and bankruptcy.

5 Bankruptcy Law, art. 139.
III. Preventive Concordata

A. Purpose

Brazilian law does not currently provide for the opportunity to reorganize a troubled company in the sense of U.S. bankruptcy laws. However, Brazilian law does provide a mechanism for obtaining partial debt forgiveness under a “preventive concordata.” A preventive concordata is intended to give a Brazilian company the opportunity to avoid the loss of its ongoing business which results from a liquidation of its assets in bankruptcy. In general, judges are lenient about granting such protection.

B. Petition for Protection

A concordata procedure may only be initiated by the debtor. Under the concordata rules of procedure, the debtor must file a proposed plan of repayment to the court. The court will then submit the plan for consideration by the creditors and a special referee (Comisário) selected either from among the unsecured creditors or a panel of professional referees. Comisários are responsible for the preparation of a detailed report on the status of the debtor which will then be submitted to the court. The report will typically include an analysis of the financial situation of the debtor, the causes of financial difficulties, any guarantees that may have been offered, the debtor’s conduct before and after the filing of the request, and the likelihood that the debtor will fulfill its obligations under concordata. Based on the Comisário’s report, the court may grant the debtor’s request for relief provided the debtor meets all the legal standards, as defined below.

A petition for concordata may be opposed by the unsecured creditors. However, the only grounds upon which such protest may be based are that the proposal does not satisfy the statutory requirements, that the plan is not feasible or that the concordata would result in a loss to the creditor greater than a pro rata distribution from the liquidation of the business.

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6 Bankruptcy Law, arts. 156-176.
7 Bankruptcy Law, art. 139.
8 Bankruptcy Law, art. 156.
9 Bankruptcy Law, art. 161.
10 Bankruptcy Law, art. 169, X.
C. Legal Standards

Eligibility for preventive concordata requires that the following conditions be met: (1) no official protest\textsuperscript{11} has been filed against the debtor for failure to pay a debt; (2) a debtor has been in business for at least two years; (3) the debtor has not in the past been found guilty of a bankruptcy crime;\textsuperscript{12} (4) the debtor has not filed for concordata relief within the preceding five years; (5) the debtor has complied with the terms of any previously granted concordata decree; (6) the debtor has duly filed in the Commercial Registry all relevant records; and (7) the debtor possesses assets worth greater than 50% of its unsecured debts.\textsuperscript{13} In addition, the debtor must establish that its financial situation will allow it to satisfy the reduced or rescheduled payments contemplated by the concordata.\textsuperscript{14}

D. Creditor Coverage

Once granted, the concordata binds all general, unsecured creditors.\textsuperscript{15} Secured creditors will not be subject to the proceedings and will be able to separately foreclose on their collateral or sue the debtor to collect their claims. In addition, unsecured creditors are not barred by the concordata proceedings from pursuing any personal guarantees they may have received from third parties, including officers of the bankrupt business.

E. Relief Schedule

A preventive concordata allows a debtor to propose a deferral of payment as well as a reduction in the amount of the debt due to individual creditors. The terms of any repayment that may result from a successful concordata are governed by an official schedule. Thus, for instance, a debtor may elect to petition to pay 50% of the debt due immediately and have any balance due extinguished. The percentage of debt that may be extinguished is inversely proportional to the length of time in which payment is to be made. Thus, if payment is to

\begin{footnotes}
\item To protest a debt, the unsecured creditor must present the debt to an officer of the state judiciary for presentation to the debtor for payment. If upon presentation the debtor fails to make payment, the officer will publish a record of such non-payment in the Official Gazette. The existence of a protested debt would strictly preclude a debtor from initiating preventative concordata proceedings, but courts may and most often do waive this requirement.
\item Bankruptcy Law, arts. 186-190, provide a list of acts or omissions deemed to constitute a bankruptcy crime.
\item Bankruptcy Law, art. 140.
\item Bankruptcy Law, arts. 159, 160.
\item Bankruptcy Law, art. 147.
\end{footnotes}
be postponed six, twelve, eighteen or twenty-four months, the debtor must pay a minimum of 60%, 75%, 90% or 100% of the total debt, respectively. Additionally, if any part of the payment is to be made after one year, at least two-fifths of the total amounts due must be paid within the first twelve months.\textsuperscript{16} Since \textit{concordata} involves either debt relief or a moratorium or both, the end result is generally a loss to the creditors. Those holding credits denominated in a foreign currency may be particularly disadvantaged since any credits denominated in a foreign currency are converted into a local currency obligation as of the date of the granting of the \textit{concordata}.\textsuperscript{17} The lack of any provision for monetary correction of the converted debt generally serves to further diminish recovery by those creditors where claims were denominated in a foreign currency.

F. Effect of \textit{Concordata} Proceedings on Business Operations

During the \textit{concordata}, the company may continue to conduct its business and manage its own affairs under the supervision of the Comisário and the court. It may not, however, dispose of real property, nor pledge assets as collateral, except in cases of obvious necessity or vital interest to the company as approved by the Judge upon petition by the Comisário. Since the company operating under \textit{concordata} does not lose control over its administration, bilateral agreements are not terminated and must be fulfilled by the parties.\textsuperscript{18} All post filing purchases made by the company in \textit{concordata} must be paid for in cash.

A \textit{concordata} proceeding may be converted into bankruptcy if, during or after the proceedings, the debtor fails to comply with its legal obligations under the \textit{concordata} decree. Such conversion may be declared by the judge "ex-officio" or upon request by a creditor.

IV. \textbf{Bankruptcy}

A. Purpose

The sole purpose of a bankruptcy proceeding in Brazil is essentially a court-supervised liquidation of the debtor’s business. Accordingly, the function of the bankruptcy court is to (1) identify, recover

\textsuperscript{16} Bankruptcy Law, art. 156.

\textsuperscript{17} Whether credits filed in \textit{concordata} should be monetarily corrected from the date of the granting of the \textit{concordata} to the date of actual payment has been the subject of some debate. Court decisions on this point have varied enormously due to the constant changes that occurred in Brazil in this area of law in response to the economic plans that have been adopted in Brazil.

\textsuperscript{18} Bankruptcy Law, arts. 165 and 167.
and liquidate the debtor’s assets, and (2) identify and distribute any remaining assets in accordance with a schedule of priorities.

B. Mechanics of Bankruptcy Proceedings

Under Brazilian law, a debtor who, without reason, fails to pay a liquid debt is technically obligated to petition for bankruptcy. Such petition must include a statement of the reasons for default supported by the required documentation, including a current balance sheet and list of creditors with their respective credits. While the law imposes on the debtor the obligation to apply for its own bankruptcy whenever it becomes insolvent, application for bankruptcy by the debtor is a rare event.

More commonly, bankruptcy will be initiated by one or more unsecured creditors. A filing for bankruptcy by a creditor must generally be supported by a prior protest for nonpayment of a mature debt. An unsecured creditor’s application may be based on either a failure of a debtor to pay a liquid obligation, or where the debtor has sought concordata protection and has failed to comply with the requirements of the decree.

Administration of the bankruptcy estate is entrusted to a trustee (Sindico) appointed by the court. The responsibilities of the trustee include but are not limited to: (1) hiring an accountant to examine the debtor’s books and prepare a corresponding report; (2) collecting all assets belonging to the debtor; (3) representing the bankruptcy estate either as plaintiff or as defendant in any proceedings; (4) taking all steps necessary to preserve the debtor’s rights; (5) collecting any debts due to the estate; and (6) with the authorization from the court, disposing of assets, nearly always through public auctions. The trustee is also responsible for marshaling the assets of the estate and paying its debts according to the distribution schedule.

A declaration of bankruptcy must be published in the Official Gazette and in a widely-circulated local newspaper. Such publication

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19 A debt is considered to be liquid when the amount due is not in dispute and is supported by clear and convincing evidence. The fact that the instrument does not provide for an express amount does not affect the liquidity of the claim, when its amount can be determined by means of a simple arithmetic computation on the basis of factors already accepted by the parties and not subject to any conditions. Thus, the nature of the document evidencing the claim that, without reason, has not been paid at maturity, is the key factor for the determination of bankruptcy.

20 Bankruptcy Law, arts. 7 and 8.
21 Bankruptcy Law, art. 9, III.
22 See supra note 6.
23 Bankruptcy Law, art. 14, IV and 60.
24 Bankruptcy Law, art. 63.
serves to provide potential claimants with notice. Claimants then have twenty days to file their claims.\textsuperscript{25} Claims are subject to objection by the debtor, trustee and other creditors. Those that are approved are then included in the general list of claims by creditors for distribution from the estate.

C. Interim Effects of Declaration

As noted, a declaration of bankruptcy is a judicial act.\textsuperscript{26} The two immediate effects of a bankruptcy declaration are (1) a divesting of the debtor from possession of the business, and (2) an acceleration of all of the debtor’s obligations.\textsuperscript{27} Additionally, a declaration of bankruptcy also has a number of other subsidiary effects.\textsuperscript{28}

D. Conversion of Bankruptcy Proceedings into \textit{Concordata}

A bankruptcy proceeding may be suspended or terminated by an initiation by the debtor of a suspensive \textit{concordata}.\textsuperscript{29} If granted, a suspensive \textit{concordata} has the effect of permitting the debtor to regain control of the operation of his business. To be eligible for a suspensive \textit{concordata}, a debtor in bankruptcy must meet two conditions. First, the debtor must be able to convince the court that continuing the business will be more beneficial to the estate than ceasing operations. Second, the debtor must offer its general creditors payment of

\begin{footnotesize}
\textsuperscript{25} Bankruptcy Law, arts. 80-86.
\textsuperscript{26} A final declaration of bankruptcy serves to establish the date in which the bankruptcy began. The date selected may not be no more than sixty days before the date that any outstanding debt was first protested. Bankruptcy Law, art. 14, III.
\textsuperscript{27} Most important for foreign creditors, all credits denominated in foreign currency are converted into a local currency obligation at the exchange rate prevailing in Brazil on the date of the declaration of bankruptcy. At the time the bankruptcy law was initially enacted, Brazil was not suffering the effects of rampant inflation and conversion to a local currency obligation made sense in that it facilitated administration of the bankruptcy estate. However, with inflation and the continuous devaluation of Brazilian currency, the application of this conversion provision has led to perverse results and the nearly total erosion of creditor’s rights. As a consequence of this conversion rule, foreign creditors are obviously reluctant to push a debtor into bankruptcy and, in fact, may take extraordinary steps to avoid the debtor entering into bankruptcy.
\textsuperscript{28} Such subsidiary effects include: (1) the debtor can no longer operate its business; (2) all the debtor’s obligations are accelerated; (3) contractual penalties resulting from acceleration determined by bankruptcy cannot be claimed against the bankrupt estate; (4) interest shall only be due in the event the bankruptcy estate is sufficient to cover the payment of all principle obligations; (5) expenses incurred to participate in the bankruptcy cannot be claimed from the estate; (6) penalties of a criminal or administrative nature cannot be claimed from the estate; (7) debts of the bankrupt company matured up to the date of declaration of the bankruptcy may be offset, even where the maturity was determined by the bankruptcy itself; and (8) application for the statute of limitations against the bankrupt company will be suspended. Bankruptcy Law, arts. 24-58.
\textsuperscript{29} Bankruptcy Law, art. 177.
\end{footnotesize}
at least 35% of the total debt if paid immediately or 50% of the total debt if payment is to be made in installments not to exceed two years. Additionally, if part of the payment is to be made after one year, the offer must stipulate that at least two-fifths of the payment must be made within the first twelve months. If both conditions are met, a bankruptcy proceeding is essentially converted to a **concordata** proceeding and the debtor regains control over its assets and business.

Once granted, suspensive **concordata** binds all unsecured creditors unless they can prove that the debtor's proposal makes them worse off than a pro rata distribution from the bankruptcy. Additionally, a suspensive **concordata** will be lifted if the debtor subsequently defaults on the terms and conditions of the **concordata** decree. Secured creditors remain free to foreclose on their collateral or otherwise pursue their claims against the debtor.

### E. Priorities of Distribution

As under most bankruptcy laws, distribution of the estate is governed by a statutory schedule of priorities. Significantly, this list of priorities reaches secured creditors who may be subject to higher priority claims under the statutory schedule. In essence, the schedule establishes the following list of priorities for the distribution of the estate's assets: (1) claims for compensation for on-the-job accidents; (2) claims for wages and dismissal compensation; (3) claims for overdue taxes; (4) claims resulting from social security and other mandated governmental programs; (5) claims relating to the debts and expenses of the bankruptcy estate; (6) various classes of secured credits; and (7) unsecured credits. Any surplus which may exist following distribution will be refunded to the bankrupt debtor.

A debtor who goes through bankruptcy is discharged from all pre-existing debts. Moreover, upon the conclusion of the bankruptcy proceeding, the debtor may immediately resume his business activities unless he has been convicted of a bankruptcy crime. In the latter case, the debtor may resume his business activities only after a certain time has passed following the imposition of criminal sanctions.

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30 Bankruptcy Law, art. 177.
31 Bankruptcy Law, art. 102, para. 1.
33 National Taxation Code, arts. 186-187.
34 National Taxation Code, art. 187, Law No. 6, 830, Sept. 20,1980; Decree-Law No. 858, Sept. 11, 1969, art. 2.
35 Bankruptcy Law, art. 124.
36 Bankruptcy Law, arts. 138 and 197.
V. Observations

The above sections have described the essential legal provisions governing *concordata* and bankruptcy proceedings in Brazil. As noted, the substantive standards under which *concordata* relief is applied, which, if successful, have the potential of substantially changing the recovery rights of the creditors, are loosely framed and invest substantial discretion in the judges and *Comissários*. As a consequence, any assessment of how *concordata* and bankruptcy impact the rights of creditors must take into account how the discretion which the law grants is exercised.

A further variable effecting the actual impact of these laws is the economic/financial environment in which they are administered. For instance, in a high inflation economy, the conversion of a foreign exchange obligation which allows a conversion into a local currency obligation, without any monetary correction, obviously may erode the recovery rights of the creditors. Similarly, in a high-inflation economy, any judicial remedy which imposes a moratorium on a debt obligation without, at the same time, requiring monetary correction to cover the period of the moratorium, also has the potential of substantially reducing the recovery rights of credits even beyond any express debt forgiveness mandated by a *concordata* decree.

There has been little systematic study in Brazil of how the *concordata* and bankruptcy laws are actually applied by judges and their delegates. There is also a paucity of information as to how these laws actually impact on the rights of creditors under the economic and financial conditions which prevail in Brazil. The observations which follow reflect the experience of professionals who have worked in this area of law:

1. Brazilian bankruptcy law, as currently written, is very inflexible and only authorizes the liquidation of the debtor’s assets. Moreover, whatever assets may be marshaled will be sold at auction, generally under conditions which will preclude obtaining maximum value.

2. Currently, Brazilian law does not authorize creditors to take over the operation of a company in bankruptcy, even where this might minimize loss. Such take-over is only possible outside of the bankruptcy proceedings and requires the consent of the debtor. Generally, such agreement will only be obtained under conditions most creditors find unacceptable because it involves a payment of compensation to the debtor in bankruptcy or one who is on the verge of bankruptcy.
3. The devastating effects of bankruptcy on the recovery rights of creditors has an effect on the operation of the *concordata* laws. The mere threat of bankruptcy by the debtor will cause creditors to make concessions in a *concordata* proceeding, such as the forgiveness of debt (beyond that authorized by the *concordata* schedule) or the withdrawal of a protest for non-payment (as noted previously, an official protest of non-payment of a matured debt obligation forecloses a debtor from being eligible for *concordata*).

4. The *concordata* process is frequently abused by debtors who utilize the procedure to eliminate debt even where they are not, in fact, insolvent or confronted with serious liquidity problems. Typically, in a “bad faith” *concordata*, a business debtor who operates on the basis of purchased inventory, will prepare for the *concordata* by stock-piling inventory. This allows a debtor who has filed for *concordata* and is cut off from his suppliers (since suppliers will only sell for cash under these circumstances) to continue operating his business during the *concordata* process.

VI. Conclusion

As currently written, Brazilian *concordata* and bankruptcy laws are a major deterrent to the development of an efficient and dynamic domestic credit market. Together, these laws, in effect, make it possible for solvent debtors who have failed to demonstrate a compelling need to either obtain a moratorium and thereby repay the debt in depreciated currency or to have some part of their debt extinguished. In either event, unsecured creditors run the risk of substantial losses. Obviously, these risks are understood by sophisticated lenders and, for this reason, conventional, unsecured lending does not take place with the resultant economic consequences. Unless these anomalous results are eliminated by changes in the law, the development of a normal credit system, with banks as financial intermediaries, will be impeded if not foreclosed.