

Why Brazil's Courts Need to Let OCRA Ripen

The Status of Restructuring Under Brazil's 'New Law'

by
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In June 2005, the old Bankruptcy Law in Brazil was replaced with a law known as the Corporate Restructuring Law. The so-called "New Law" was designed to preserve jobs, generate tax income, improve the chances of recovering credits and avoid the liquidation of otherwise viable businesses. As a result, Brazilian legislation now offers two paths to restructure distressed businesses: traditional Judicial Restructurings and new Out-of-Court Restructuring Agreements (OCRA). Plus, Judicial Restructuring itself recently replaced the former *concordata preventiva*, or preventive creditor protection. Today in Brazil, all creditors - secured and unsecured - are included in restructurings. However, tax credits, forward foreign-exchange contracts, trustee and leasing agreements are not always included. In fact, OCRA Agreements affect only a category or group of creditors, and, therefore, may not include labor or tax debt, etc.

Galeazzi & Associados has a 15-year history of restructuring organizations under both the former and current Brazilian bankruptcy laws. We fully believe that the so-called "New Law" is a significant step in the right direction and that positive effects are already being seen. But, at the same time, our experience is that the New Law, and OCRA, are far from perfect, and still have a lot of "maturing" to do—a fact that has great ramifications for virtually any company doing business in Brazil today, the world's ninth largest economy.

As noted in the Brazilian newspaper *Valor* recently, according to official sources only five requests for OCRA's have been filed since the new law was enacted in 2005. This is a very small number if we look at the 446 requests for Judicial Restructuring submitted during this same period. Of the five requests submitted, only one has been approved by the courts, a clear indication that the spirit of the new law, enacted to facilitate company turnarounds and preserve and protect businesses and all their stakeholders, has yet to be fully grasped by the interested parties – including the distressed companies themselves.

A key aspect of the new law is that it allows a debtor to contact group(s) of its creditor base to negotiate their debts independently. This means that, for instance, a distressed company may renegotiate its bank debt and keep the rest of the business operating normally. More ever, if 60% of the creditors in any group approve a restructuring plan accepted by the courts, that plan becomes binding upon all other creditors in the group, even those disagreeing with its terms.

There are a number of reasons that contribute to the lack of popularity of Out-of-Court Restructuring Agreements. Among them: a) labor and tax debts may not be included in such agreements; b) management often waits until it is too late and the company's finances

are too weak to implement an out-of-court agreement, and, as a result, a Judicial Restructuring may indeed be the best option to avoid having creditors ask that the company be declared bankrupt; c) if a company manages to negotiate with all of the debtors in a given category, then it becomes a normal debt negotiation and there is no pressure to file for an OCRA.

Below is a brief description of a recent negative experience we had with an Out-of-Court Restructuring Agreement, which may help others understand why this instrument is still evolving and may take some time to mature in Brazil.

Our client was the subsidiary of NorthAmerica-based multinational company in the automotive industry, with some 1,000 employees and annual revenues of around US\$120 million. It was established in 2002 and started out manufacturing auto parts. It slowly ramped up its operation and was only able to come completely on-stream in August 2006, after it retained a consulting specialist to conclude the ramp-up and restructure the organization so as to improve productivity, operations, cost and management indicators. The time taken to ramp up the operation, fluctuating currencies and the significant investment required resulted in a business with a very high level of debt, which crippled the company's capital structure.

In March 2006, the company saw clearly that by August, when some of its bank debt was to mature, the firm would face serious cash constraints. Unsuccessful attempts were made to secure additional financing and/or postpone payments. In July our client retained legal counsel and contacted all of its creditor banks to explain the situation and to ask for a 120-day standstill period in order to prepare a restructuring plan. Four of the creditor banks agreed, one verbally and three in writing. The fifth bank refused to accept the standstill and also refused to participate in any future discussions, assuming a hostile position vis-à-vis the company and the other banks.

The subsequent negotiations with the creditor banks were very complex, involving legal counsel from all parties, counsel for the company's headquarters and international creditor advisors. The complex nature of the discussions was the result of the number of parties involved, the magnitude of the debt and the multiplicity of payment instruments that were included in the final agreement, including: a) payment in kind; b) supply agreements; c) chattel mortgages of assets and real estate; d) pledge agreements; e) guarantee agreements; and f) other guarantees, in addition to the structure of the OCRA itself.

The final agreement gave the company a grace period of 18 months, after which it would pay the principal in 18 installments plus Libor +3% interest. By November 2006, the OCRA had been signed by the company and three of the five banks (the participating banks, which held 75% of the company's bank debt) and was submitted to the courts. The other (non-participating) banks filed a claim for the amounts owed, which the courts suspended until such a time as the judge ruled on the OCRA.

Our client needed the courts to approve the OCRA, which would make it binding upon the two non-participating banks. This would enable the company to continue its day-to-day business without affecting its relationship with clients and suppliers. The company was able to operate normally under the OCRA during the four months it took for the judge to rule, which clearly reflects that market's positive reaction to the measure. During this four-month period a number of legal suits and countersuits were filed, and finally, on March 15, in a major upset, the court ruled against the company. Although it is not our intention to describe the legal issues involved, suffice it to say that we were very disappointed in the decision.

Put another way: The courts ruled against the company in favor of the two non-participating banks that held only 25% of the category's debt. And with that, the decision wiped out the company's bank accounts and prevented it from paying vendors or receiving payment from clients, effectively causing it to default on its obligations to banks and suppliers. The court ruling also rendered the OCRA null and void, claiming, in the process, to "protect" the banks from the company – three of the largest banks in all of Brazil!

The company appealed the decision, but the appeal was denied and it was left with no option other than to file for Judicial Restructuring.

The company was forced to interrupt its operations in the 45 days that it took to file for Judicial Recovery, following the unfavorable court ruling and appeal. It made a valiant attempt to preserve its workforce by giving employees 20 days paid vacation, but in the end, it had to lay off 98% of the staff when they came back, as the company's crisis in Brazil had resulted in a cross-default in the main offices in North America, limiting the amount of money that could be wired to Brazil.

The company is now protected by a Judicial Restructuring, but inactive for over 70 days. It is preparing a restructuring plan that will be submitted to all creditors (not only the banks as before) for approval. Cross-default has resulted in an inability of the main office to provide funds to the Brazilian operation, and the company will have to resort to DIP financing from a third party if it is to resume its activities. Because it was unable to honor its supply agreements, the company's clients lost confidence and now will have to be recaptured (if possible) and new agreements will have to be negotiated.

Anyone in the corporate restructuring business knows that time is always of the essence, the one commodity that can never be retrieved. As little as a week can mean the difference between success or failure in recovering distressed enterprises. The case above is a clear example of a company that could be operating normally under an OCRA, but instead is struggling under a Judicial Restructuring Agreement, a much more complex instrument that involves a large number of parties.

Everyone doing business in Brazil—and today, that includes virtually any corporation calling itself "international," let alone "global"—needs time to understand Out-of-Court Restructurings. In particular, the courts in Brazil need to understand how important it is to

avoid unintentionally setting off a chain of events that hurt companies and hurt jobs. To that point, it would be a shame if decisions such as the one in this case were relied on in future rulings.

It's time for the courts of Brazil to let OCRA ripen, not wither on the vine.

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Galeazzi & Associados has been a pioneer in providing corporate management services in Brazil since 1990, serving companies in all industries and in situations that range from a desire to increase profitability to turning around critical situations. Galeazzi & Associados has a group of consultants with specific expertise in several fields, and offers the full range of Management Consulting services, including Performance Improvement, Creditor and Investor Services, Turnaround & Restructuring, Crisis Management, Interim Management and Corporate Governance (site: www.galeazzi.com.br).

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