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Law 147/2014 and changes to court-supervised reorganisation process

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March 20 2015

Introduction

On August 7 2014 Complementary Law 147/2014(1) came into force. The law was enacted to modify the *Simples Nacional* tax regime(2) and has introduced important changes to the court-supervised reorganisation process. For example, it altered the Reorganisation and Bankruptcy Law (11,101/2005) by creating a new class of creditor – Class IV(3) – which consists of micro-enterprises and small businesses. The law also modified the corresponding legal rules,(4) including those on special court-supervised reorganisation plans for micro-enterprises and small businesses (Article 71 (I)(II)).

Creation of Class IV

Law 147/2014 created a new class of creditor based on the description of the party holding the credit (ie, a micro-enterprise or small business), in addition to the Reorganisation and Bankruptcy Law's sole criterion, which had distributed creditors into classes based on the nature of each creditor's claim.

The inclusion of the new class recognises that micro-enterprises and small business creditors – regardless of the nature of their claim – have interests which are different from those in other classes; thus, it is necessary to categorise them separately.

Law 147/2014 has already generated two points of uncertainty:

- For reorganisations which were already underway when the law came into effect, should the creditors' list be changed to include Class IV?
- For future reorganisations, what should be done if a micro-enterprise or small business creditor ceases to qualify for inclusion in one of these two categories during the course of a court-supervised reorganisation?

The preparation of a list of creditors and the publication of any announcements are covered by the rules of procedural law, as they involve the progress of a reorganisation. As such, they have immediate effect. Therefore, in relation to perfected judicial acts, it is unreasonable to require debtors that filed petitions for court-supervised reorganisation before Law 147/2014 was enacted to amend their initial petitions if the list of creditors has already been published. However, it is reasonable to require debtors that filed petitions before Law 141/2014 was enacted to amend their petitions to include Class IV if the second list of creditors has not been published. The same should apply to court-supervised reorganisation plans already presented by the debtor, provided that they have not yet been submitted to the creditors for approval.

Where the classification of a creditor company changes during the course of a reorganisation so that it is no longer a micro-enterprise or small business, the classification at the time that the petition was filed should prevail, as the rule on classification of claims is one of substantive law (changes in substantive law generally do not have immediate effect in the legal system).

Other doubts have arisen regarding the changes introduced by Law 147/2014. For example, what if a micro-enterprise or small business holds an *in rem* guarantee securing part of its claim? Will that part of its claim be in Class II (secured creditors) and the rest in Class IV, or will the claim that exceeds the guarantee be 'relegated' to Class III (unsecured creditors), as established by Article 41, Section 2? Despite this provision, the rationale behind Law 147/2014 appears to suggest that the claim that exceeds the *in rem* guarantee should be classified in Class IV, rather than Class III.

Bargaining power of micro-enterprises and small businesses

The introduction of Class IV has increased the negotiating power of micro-enterprises and small businesses. In past court-supervised reorganisations, these small companies typically had commensurately small claims, generally falling within Class III under the original wording of the Reorganisation and Bankruptcy Law. Thus, small creditors were typically ignored because of the existence of much larger debts to other creditors.

Companies undergoing court-supervised reorganisation often established special rules for small creditors which stipulated faster payment to them as a means of reaching the necessary majority for a cramdown (eg, payment of claims below R10,000 within 30 days). However, in reality, micro-enterprises and small businesses rarely participated in the negotiation of these plans. Because they were placed in a class that generally contained larger players, the payment conditions for their claims conformed to what the larger creditors in the same class decided.

The new power held by micro-enterprises and small businesses is not without its drawbacks to their interests. Increased bargaining power can make access to credit more difficult, as the power of large companies (suppliers and financial institutions) is diluted. Large suppliers of goods and capital base their decisions to extend claims on the potential for future repayment, even in a crisis scenario. With less power to recover their claims, they will be less willing to lend or finance purchases, which will affect all companies, including micro-enterprises and small businesses.

Challenge – what is the majority required for a cramdown?

A clear indication of the lack of sufficient dialog between legislators and insolvency law professionals was the unjustifiable omission in Law 147/2014 regarding common practices which are highly relevant to distressed companies.

Under the Reorganisation and Bankruptcy Law, the courts can grant court-supervised reorganisation even when a plan is not approved by all of the creditor classes at the general meeting (Article 58, Section 1). To impose a cramdown, a plan must cumulatively receive:

- the approval of creditors representing more than half of the claims by value present at the meeting, regardless of class;
- the approval of two classes of creditor, as defined by Article 45 of the Reorganisation and Bankruptcy Law or, if there are only two classes with voting creditors, the approval of at least one of them; and
- in the class where approval was not received, the approval of more than one-third of the creditors (calculated as set out in Article 45, Sections 1 and 2 of the Reorganisation and Bankruptcy Law).

Although common, this situation was not addressed by Law 147/2014; as such, the Reorganisation and Bankruptcy Law remains intact on this point, as if no new class of creditor needed to be considered. In light of the most recent case law and the spirit of the Reorganisation and Bankruptcy Law (which allows distressed companies to overcome crises and maintain their business activities, even if this means the partial sacrifice of creditors' interests), it is expected that cramdowns will still be applied if a plan is approved by at least two of the four classes of creditor that now exist – at least until an amendment to the Reorganisation and Bankruptcy Law is introduced.

Special plan for micro-enterprise and small business court-supervised reorganisation

Previously a 'dead letter' in the Reorganisation and Bankruptcy Law, the special plan for court-supervised reorganisation underwent necessary alterations. Before the advent of Law 147/2014, Article 71(I) of the Reorganisation and Bankruptcy Law stated that the special reorganisation plan for micro-enterprises and small businesses covered only existing unsecured claims. However, under Law 147/2014, the special plan now covers all claims existing on the filing date, even if not yet due; the only exception is claims resulting from on-lending of official funds and taxes.

Law 147/2014 also altered the rule on adjusting the value and payment term of claims under the special

plan for court-supervised reorganisation. Debts can now be paid in up to 36 monthly instalments, plus interest at the special clearance and escrow system rate (the Central Bank's benchmark rate). The previous wording called for inflation adjustments, plus 12% interest per year.

Even with the alterations, the special plan option is not very attractive because it does not consider other means of recovery (eg, a discount on the face value of claims in return for a shorter payment period). This limitation is even more relevant when considering the introduction of another class of creditor and the automatic conversion into bankruptcy if there is an objection to "creditors holding more than half of any of the classes of credits set forth in Art. 83, computed pursuant to Art. 45 of this Law" (Article 58, Section 1 (III) of the Reorganisation and Bankruptcy Law).

While Law 147/2014 aims to safeguard the interests of micro-enterprises and small businesses, it fails to consider practical everyday situations and, to a certain extent, is divorced from the economic reality of the market.

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Endnotes

(1) Complementary laws enable constitutional provisions to take effect.

(2) The *Simples Nacional* regime establishes general rules on preferential treatment for micro-enterprises and small businesses.

(3) Complementary Law 123/2006 contains the following criteria for the classification of businesspersons and enterprises:

- Individual micro-entrepreneurs – an individual entrepreneur that received gross revenue in the previous calendar year of up to R60,000 (Article 18-A, Section 1);
- Micro-enterprises – a businessperson, legal entity or equivalent entity that receives gross revenue of less than or equal to R360,000 (Article 3, I) in each calendar year; and
- Small businesses – a businessperson, legal entity or equivalent entity that receives gross revenue greater than R360.000 but less than R3.6 million in each calendar year (Article 3, II).

(4) The modifications to the legal rules including the following:

- In the case of micro-enterprises and small businesses, the remuneration of the judicial trustee was reduced to (at most) 2% of the amount owed to creditors submitted to court-supervised reorganisation (Article 24, Section 5).
- A 20% longer period for micro-enterprises and small businesses to pay tax debts in instalments than those applied to other companies was introduced (Article 68, sole paragraph).
- A representative of Class IV must now be included in the creditors' committee if any of the creditors fall in this class (Article 26, IV).
- The waiting period for micro-enterprises and small businesses to file for court-supervised reorganisation was reduced from eight years to five years of formation of the company (Article 48, III).
- The way in which objections to reorganisation plans are calculated was amended to include labour creditors (Article 72, sole paragraph).
- The classification of claims in bankruptcy was amended (Article 83, IV (d)).

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