

2004 NORTON ANNUAL SURVEY OF BANKRUPTCY LAW

BRAZIL

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OVERVIEW

Reorganization and bankruptcy proceedings in Brazil have historically suffered from an absence of consistency and transparency. Due to a lack of specific legislation to deal with many insolvency issues, the civil courts in Brazil have been forced to use various measures to address the complicated nature of bankruptcy proceedings.

This lack of consistent proceedings has resulted in various incongruent results, which in turn have inhibited the effectiveness of rescuing financially troubled businesses. To illustrate the complex nature of insolvency proceedings in Brazil, the World Bank's latest indicators on world development stated that it takes approximately 3,650 days to receive the final distributions from insolvency proceedings in Brazil. India, which takes approximately 4,115 days to receive final distributions, is the only country with a longer average distribution period.

Many businesses operating in Brazil have become growingly concerned with the prospect of dealing with the complex nature of bankruptcy and reorganization proceedings. Therefore, to address the problems with these proceedings in Brazil, the current Brazilian Bankruptcy Law will be officially revised some time in the year 2004. The new law will contain many of the required modern reorganization methods and recovery mechanisms available in other jurisdictions. The Brazilian Congress has actually been considering making revisions to the bankruptcy legislation since 1993, but had not officially acted until recently. The new Brazilian Bankruptcy Law should also better address the complex, and often inconsistent, regimes that govern cross-border insolvencies. Brazil, like many other jurisdictions, is experiencing a challenging transitional period, being forced to cope with modern international bankruptcy concepts via an antiquated domestic legislation.

RELEVANT LAW

Decree Law No. 7,661 of June 21, 1945 (the “Brazilian Bankruptcy Law”) governs the current Brazilian Insolvency and bankruptcy system. The Brazilian Bankruptcy Law contains the principle regulations relating to the rights of creditors and the rights and duties of insolvent commercial debtors. The Bankruptcy Law also contains specific statutes and regulations that apply to certain debtors, for example, financial institutions, insurance companies, and airlines.

Presently in Brazil, two main proceedings exist for the recovery of outstanding merchant debts: the *concordata* and bankruptcy (*falência*) proceedings. The *concordata* is a moratorium proceeding, and allows the debtor to continue business operations under judicial supervision. During this period, the debtor entity is allowed to continue its business and pay unsecured creditors

in accordance with the relevant schedule that is contained in the Bankruptcy Law. Bankruptcy proceedings, on the other hand, usually result in the liquidation of the debtor business, with all of the debts being accelerated and all assets collected and sold in order to facilitate the payment of creditors to the fullest extent possible.

Credit instrument proceedings that are not covered by the Bankruptcy Law are governed by the Brazilian Civil Code, various statutory laws, and the Civil Procedure Code. Due to the limitations of the recovery options against insolvent debtors under the Bankruptcy Law, creditors must consider all remedies available under law. The enforcement of unsecured claims varies according to the type of debt instrument.

Brazilian law recognizes three types of security instruments, each with specific enforcement requirements: (1) the mortgage, (2) the pledge of chattel, and (3) the chattel mortgage (*alienação fiduciária em garantia*). Also, conditional sales and leasing are subject to specific enforcement procedures, which are often more effective under both a bankruptcy and a non-bankruptcy scenario. Due to the restrictions of the Bankruptcy Law and the potential pitfalls of the proceedings thereunder, the standard debt enforcement laws remain an important part of the legal strategies for the recovery against insolvent merchants.

The UNCITRAL Model Law on Cross-Border Insolvency has not been adopted by Brazil in any form, and the current Bankruptcy Law does not directly address cross-border insolvency issues. Because of this absence of specific cross-border insolvency provisions in the current law, legal scholars have referred to provisions of the Code of Bustamante, and to the previous Civil Procedure Code of 1939, for solutions.

BUSINESS ORGANAZATION FORMS

Business entities in Brazil are considered separate and distinct legal entities (*sociedade personificadas*). The Civil Code specifies four main forms of the the *sociedades personificadas*: the *sociedade em nome coletivo* (art. 1.039), the *sociedade em comandita simples* (art. 1.045), the *sociedade limitada* (art. 1.052), and the *sociedade anônima* (art. 1.088).

The *sociedade em nome coletivo* is similar to a registered general partnership. The *sociedade em comandita* is a limited partnership with a general partner, but is rarely used. The *sociedade limitada* is the Brazilian version of a Limited Liability Partnership. The *sociedade anônima* is considered the standard Brazilian corporation, which may have public or private capitalization.

UNSECURED OBLIGATIONS IN GENERAL

In order to determine the judicial course of action available to an unsecured creditor, the nature of the unsecured claim must be analyzed. The available actions will depend upon whether the credit is classified as a judicially enforceable instrument (*titulo executivo*) or an ordinary debt instrument (*titulo ordinário*). A creditor may file an enforcement action (*ação executiva*) if the obligation is a prima facie judicially enforceable debt instrument (*titulo executivo extra-judicial*) or an ordinary debt instrument that has received a favorable decision (*titulo executivo judicial*). If these conditions are not met, those creditors must first file an ordinary suit (*ação ordinária de cobrança*) to obtain judicial recognition of the debt instrument. Only after obtaining this judicial recognition may the creditor commence an enforcement action.

Upon such a finding of judicial recognition by the court, the creditor may then commence an enforcement action. A creditor may also file a so-called monitory action (*ação monitória*) if he holds a written debt instrument which does not meet all of the requirements for a judicially enforceable instrument. In a monitory action, if the debtor fails to contest the petition, then the creditor may proceed with the enforcement action. However, the monitory action will convert to an ordinary action if the debtor does file a defense.

SECURED OBLIGATIONS IN GENERAL

Security devices taken on real property are generally classified as: (1) Mortgage, and (2) Chattel Mortgage.

A Mortgage is a public instrument contract that is duly registered with the proper real estate registry, by which real property is used as a security for the repayment of a loan/debt. Sometimes the purchase price of the real property itself is the subject of the loan. However, if the debtor is not able to fully satisfy the mortgage, the property will not automatically revert to the creditor in satisfaction of the loan/debt. Instead, the mortgaged property must be sold at a public auction and the proceeds of the sale will be used to pay the creditor. Contractual provisions that allow for the lender to automatically take possession of the mortgaged property, in the event of a default, are considered null and void.

A Chattel Mortgage (*alienação fiduciária em garantia*) is a legal instrument which conveys a property interest, generally as security for a debt. An example of this is when the property is used as collateral for the debt. In a chattel mortgage, the debtor will retain possession of the property. The creditor will hold title to the property until the debt is fully satisfied. This is usually used for

personal property, although Brazilian legislation has recently permitted this concept to be applied to real property as well. This provides for creditor's rights of repossession in case of default.

Security devices taken on personal property are generally classified as: (1) Pledge (penhor), and (2) Chattel Mortgage.

A Pledge (*penhor*) is a deposit of personal property belonging to, and delivered by, a debtor as security for a debt until the debt is repaid. Brazilian law prohibits a lender of pledged assets from taking title of the assets if the borrower defaults in accordance with Article 1428 of the new Brazilian Civil Code (Law No. 10406/2002). In this case, the pledged assets will have to be seized and then sold at a public auction by order of the court. However, the new Civil Code provides that after the maturity date, the debtor may extinguish his debt by giving the pledged assets to the creditor, in accord and satisfaction.

A Chattel Mortgage is a legal instrument which conveys a personal property interest through a fiduciary sale. In this instrument, the debtor retains direct possession of the property while the creditor retains title, until the satisfaction of the debt. Structuring deals as conditional sales or finance lease transactions may also be used as methods to secure transactions.

DETERMINATION OF INSOLVENCY

To make an official determination of insolvency, the debtor will be called to go before the court, at which time he will be required to pay the relevant outstanding obligation within a twenty-four (24) hour period. If the debtor is solvent, an execution action may be filed where the debtor will have the option to pay the debt within 24 hours, or identify assets for attachment to satisfy the

outstanding debt. If the debtor fails to fulfill the obligation or identify assets for attachment, then the court may attach debtor assets sufficient to cover the claim. If sufficient assets are not found, the debtor will be considered insolvent and a bankruptcy petition may be filed. Only after the claim is secured by assets may the debtor present its defense.

Some examples of remedies that may be obtained in an enforcement action are prejudgment liens, attachments and restraining orders. When an ordinary action is taken, these enforcement mechanisms are not as readily available. An enforcement action may have the consequence of forcing a debtor into bankruptcy, one of the prerequisites being the failure to pay a creditor on a judicially enforceable debt instrument without “relevant legal right” where the creditor has formally declared the debtor in default through protest; although, The filing of such an enforcement action is not a pre-requisite for a bankruptcy filing.

Depending on the circumstances, an entity in Brazil undergoing financial difficulties can be subjected to many proceedings, such as: bankruptcy or *concordata* pursuant to Decree Law No 7661/45; liquidation under Law No. 6,404/76 (governing judicial and extra-judicial liquidation of corporations, but restricted to companies that are solvent, i.e. where assets are greater than liabilities); intervention or extra-judicial liquidation (the last two proceedings are applicable to Financial Institutions, Law No. 6,024/74); liquidation of cooperatives under Law No. 5764/71; liquidation of private health insurance companies under Law No 9656/98; and liquidation of airlines companies under the Aviation Code Law 7565/86.

REHABILITATION PROCEDURES (*CONCORDATA*)

Brazil does not currently have a traditional rehabilitation proceeding, although, the Brazilian *concordata* process is similar to a moratorium type rehabilitation proceeding. To initiate a *concordata* proceeding, a debtor must file for *concordata* with the proper court. In principle, the *concordata* proceeding permits the debtor to remain in possession of its assets and continue operating its business under judicial supervision, during which time it must pay its unsecured creditors in accordance with the terms provided for under the Bankruptcy Law. The *concordata* proceedings apply exclusively to unsecured credit obligations.

There are two types of *concordata* proceedings: “preventive *concordata*” and “suspensive *concordata*.” The preventive *concordata* protects the debtor from being declared bankrupt. In Brazil, a declaration of bankruptcy generally involves a complete liquidation of the debtor’s assets. A suspensive *concordata* results in the suspension of a previously declared bankruptcy, which would otherwise result in liquidation.

To qualify for a *concordata* proceeding, the debtor entity must demonstrate the following: (1) it has free assets worth more than 50% of its unsecured liabilities; (2) it has registered or filed with the commercial registry the necessary documents and books required for the regular exercise of its business; (3) it has not failed to apply for protection within the prescribed period; (4) its administrators have not been convicted of any bankruptcy offense, theft, robbery, fraud, smuggling or other similar crime; and (5) it has not petitioned for *concordata* relief within the past five years or failed to comply with the terms of any previously filed *concordata* decree.

In addition, in order to qualify for a preventive *concordata*, the entity must demonstrate that it has carried on business regularly for more than two years and that it has neither been declared bankrupt, nor have had any documents filed protesting the entity’s failure to pay a debt.

Upon the filing of the *concordata*, all law suits that have been previously filed by unsecured creditors shall be suspended, except those lawsuits which will continue in order to make a final determination of the amount owed by the debtor.

Should the court approve the *concordata* petition, all unsecured creditors of the debtor will be subject to the terms of the *concordata*. All bilateral agreements remain in effect and must be fulfilled by all parties. The court may automatically convert the *concordata* to a bankruptcy proceeding if the debtor fails to make necessary payments to unsecured creditors pursuant to the *concordata*.

Jurisdiction for *concordata* proceedings is held by state civil courts located in the city where the debtor has its principal place of business. In some jurisdictions, however, several state court judges have been assigned specifically to hear these matters.

In order to commence a request for *concordata*, the debtor must file with the court a detailed report that contains an analysis of the company's financial profile. The report should include a review of the debtor's financial problems, identify any credit guarantees, detail the debtor's conduct during the petition process, and assess the chances of meeting the obligations under the chosen *concordata* option. In review of this report, the court shall accept or reject the company's petition. This decision is to be based principally on the fulfillment of the formal requirements listed in the law. The unsecured creditors, and/or the public attorney, also have proper standing to oppose the petition if the legal requirements are not met.

In the event that a *concordata* is brought, but not in a bankruptcy proceeding, the debtor retains the right to administer its business, and may continue to run it under the supervision of an inspector (*comissário*), who similarly to a *síndico* (who runs the bankrupt estate), will be appointed by the court from among the major creditors.

The Public Attorney's office is the only governmental institution that is directly involved with insolvency proceedings in Brazil. The Public Attorney's Office has the legal obligation and right to intervene in any and all insolvency proceedings. When financial institutions are involved, the Brazil Central Bank plays the principal role for intervention and liquidation proceedings. Similar rules apply to insurance companies, aircraft carriers and pension plans, where respective regulatory agencies play the central role.

Secured creditors, such as those holding mortgages and commercial pledges, or certain other creditors holding debts with some statutory priority (such as labor and tax debts), are not subject to *concordata* proceedings. As a result, these secured creditors may enforce their rights and remedies against the debtor or its property outside of the *concordata* proceeding. In bankruptcy proceedings, secured creditors participate because their priority, up to the value of the security, ranks directly after the labor and the tax credits.

The remedies of the *concordata* proceedings only affect the rights of unsecured creditors (*quirografários*). In a *concordata* proceeding filed in Brazil, all unsecured creditors will have equal rights, regardless of the national origin of the creditor. Unsecured creditors may also file ordinary lawsuits to collect their credits. Courts may grant protection to creditors consisting of injunctive relief, temporary restraining orders and even, under exceptional and well defined circumstances, the seizure of property.

Under the Bankruptcy Law, there is no specific remedy available to unsecured creditors. Their only option is to register their credits with the bankrupt estate and look to the distribution of dividends once the secured creditors have been satisfied.

The applicable law (Decree-Law No. 7661/45) does not differentiate in its treatment of domestic and foreign creditors, except that foreign creditors must have the value of their claims

converted into Brazilian currency on the date of the bankruptcy or on the date that the *concordata* is granted.

It is the responsibility of the debtor to offer payments to the unsecured creditors in accordance to prescribed amounts, as provided under the Bankruptcy Law. The debtor may utilize a series of fixed payment schedules with fixed percentages for the total of the unsecured debt. This may result in the reduction or extension of time, together with the reduction in payment obligations, if the payment is made within the corresponding (and fixed) period of time.

The current law does not favor providing financing for entities that are filing for *concordata*. Generally, entities which have filed for *concordata* will have no available credit, although creditors who supply goods or services or loans after the filing of the *concordata* are not adversely affected. During the *concordata* proceedings, the entity may only provide guarantees if it has previous authorization from the court. Under the new law being discussed in Congress, any credit extended to a company that is being restructured, if approved by the Creditors Meeting and the Court, will be considered an expense of the estate. If the entity should then go bankrupt, the estate will enjoy absolute priority.

During the *concordata*, debtor entities continue as commercial businesses and are not legally considered an estate, as is the case in bankruptcy. Creditors are represented by the inspector (*comissário*) in the *concordata* proceedings. A *comissário* has the legal obligation to audit the business in *concordata* and also to supply the court with all of the documentation that is required by law. The trustee of the bankrupt estate is called the *Síndico*.

Any potential sale of assets during the *concordata* proceeding may be allowed by the court, but first there must be a hearing with the inspector (*comissário*) and the public attorney. The sale or transfer of any assets of a productive unit (*estabelecimento*) of a debtor requires that the consent of all of the unsecured creditors be obtained. In a bankruptcy, it is possible to request that the business

continues to operate. These continued operations must be under the direction of a trustee and provide for the protection of the creditors.

RECOGNITION OF CLAIMS, DISTRIBUTION OF PROPERTY, AND TERMINATION OF THE REHABILITATION PROCESS (*CONCORDATA*)

In preventive *concordata* proceedings, the entity must offer the creditors payment of at least fifty percent of their claims at sight, or it must offer sixty, seventy-five, ninety, or one-hundred percent of their claims within six, twelve, eighteen, or twenty-four months, respectively. In the case of an eighteen or twenty-four-month preventive *concordata*, at least forty percent of the debt must be discharged within the first year.

In suspensive *concordata* proceedings, the entity must offer its unsecured creditors payment of at least thirty-five percent of their claims at sight, or fifty percent within the maximum period of two years. At least forty percent of the debt must be discharged within the first year. The other rules for preventative *concordata* also apply to suspensive *concordata*.

The purpose of the *concordata* is to safeguard the merchant against the consequences of the bankruptcy, either by avoiding declaration (*concordata preventiva*) or suspending the effects (*concordata suspensiva*). A *concordata* will be deemed fully complied with if the merchant fulfills the obligations assumed within the term allowed, which is not to exceed two years.

The judge may cancel or deny the *concordata* at any point in the proceedings, provided that a petition for termination has been filed by any creditor admitted to the proceedings and subject to the effects of the proceedings. There is a declaration of bankruptcy if the court should decide to

cancel a *concordata preventiva*. Conversely, a decision by the court to deny or cancel a *concordata suspensiva* will result in the re-initiation of the bankruptcy proceeding.

There is a two year moratorium for the payment of all unsecured debts in a *concordata* proceeding. Because the *concordata* proceeding applies only to unsecured creditors, secured creditors are not restricted from enforcing or collecting their debts during and after this two year period.

BANKRUPTCY PROCEEDINGS (*FALÊNCIA*)

Bankruptcy liquidation proceedings (*falência*) result in the court-supervised liquidation of the debtor's assets. This liquidation procedure adheres to a legally fixed set of priorities for creditor claims. The court will appoint a bankruptcy trustee (*síndico*) to manage the liquidation and distribution of the bankrupt estate. All actions of the *síndico* are directed and supervised by the bankruptcy judge. As a result, the court has absolute authority in all affairs of the bankruptcy, including appraisals and the sale of assets.

In contrast, the purpose of the *concordata* is to safeguard such merchants against the consequences of bankruptcy, whether by avoiding declaration thereof or suspending its effects. Under *concordata*, the debtor entity does not forfeit the business administration and the right to dispose of property. However, the sale of real property and the pledging of collateral must be authorized by the judge.

Pursuant to Article 8 of the Bankruptcy Law, the debtor will initiate the petition for bankruptcy upon its failure to pay a debt that has remained due and payable for at least thirty (30)

days. A debtor's voluntary bankruptcy (*auto-falência*) petition must be supported by a statement explaining the reasons for default, along with the applicable documentation, including a balance sheet (with an appraisal of the assets of the debtor entity) and a list of the creditors' claims.

Once the bankruptcy petition is filed, the creditors are notified of the bankruptcy by publication in the Official Gazette. Upon publication, the creditors are allowed twenty days to file any claims against the debtor. Late claims by a creditor may be allowed, provided the creditor pay for the court costs and that the creditor had not participated in any distribution of dividends before the claim was presented. Pursuant to Decree-Law No. 7661/45, a creditor has standing to request the commencement of bankruptcy proceeding.

Article 7 of the Bankruptcy Law specifically provides that jurisdiction and venue will be determined by the principal place of business of the company (*principal estabelecimento*). There is no separate federal bankruptcy court system in the Brazilian legal system. The state court of proper jurisdiction has absolute and complete jurisdiction over all parties related to the bankruptcy proceeding, including the trustee and/or administrator, the debtor and assets, and the creditors that are a party to the proceedings[FA1]. Therefore, the trustee and administrator will act at the direction and supervision of the presiding civil court judge.

If a debtor is located in Brazil, a local Brazilian civil court will assume jurisdiction and the legal effects of the Brazilian insolvency proceedings shall be applicable to all of the debtor's assets, including those assets which are located outside of Brazil. In the event that there are simultaneous bankruptcy proceedings outside of Brazil, with respect to the same debtor or the same assets, this foreign process will have no legal effect upon the proceedings in Brazil.

The Brazilian Bankruptcy Law provides that the presence of a local Brazilian office of a foreign business will be sufficient to grant jurisdiction of the bankruptcy proceedings to local civil courts, thus allowing the courts to assume jurisdiction with respect to foreign debtors doing

business in Brazil. Therefore, a branch office will be treated like any Brazilian subsidiary or legal entity. Also, the disposition of any real estate assets located within Brazil will be subject to the exclusive jurisdiction of the local civil courts of Brazil, regardless of the location of the principal place of business of the debtor.

A trustee (*síndico*) will be appointed by the court to manage the bankrupt estate. All actions by the *síndico* are directed and supervised by the bankruptcy judge. Therefore, the court has exclusive jurisdiction and is absolute in all the affairs of the bankruptcy, including appraisals and the selling of assets.

Any creditor that is a party to the proceeding, or a public attorney, can file a complaint against the bankruptcy trustee. All duly qualified complaints must be evaluated and investigated. Should the facts warrant such an action, a filed complaint may result in the dismissal of a trustee. The trustee has standing to represent the bankrupt estate and to initiate litigation against third parties, although any creditor may file a lawsuit to void fraudulent transactions should the trustee not do so within the timeframe established by law (Article 55 of Law 7661/45).

The Public Attorney's Office is normally the only governmental institution involved in commercial insolvency proceedings. The Public Attorney's Office is the public agency that oversees the application of the law. In bankruptcy proceedings, as well as in *concordata* proceedings, the Public Attorney's role is to prevent any harm to the economy, to society, and to the parties.

The Public Attorney's actions within the bankruptcy proceeding may be divided into obligatory and discretionary interventions. Among the obligatory interventions is the participation in the initial accusation process for crimes (Article 108 of Law 7661/45), and the giving of an opinion in several other areas, such as in the replacement of the trustee (Articles 65 and 66), the trustee's rendering of accounts (Article 69), the collection of assets, books, and documents of the

bankrupt entity (Article 70), the functioning of the bankrupt business (article 74), and the auctioning of assets (article 117).

The Public Attorney must also give an opinion in every lawsuit filed by or against the estate, and must, in any phase of the bankruptcy proceeding, recognize the necessary requirements to secure the interests of justice. The Public Attorney is entitled, but not obligated, to give an opinion when a claim of a certain creditor is objected to by other parties, as set forth in article 95 of Law 7661/45.

There is no guaranty of recovery to any class of creditors. In fact, it is entirely possible that certain classes of creditors will receive nothing. In Brazilian liquidation proceedings, even secured creditors often do not receive any distribution. This is due to the priority treatment that labor and tax claims enjoy.

As stated earlier, under the Brazilian Bankruptcy Law, there is no specific remedy available to unsecured creditors. Therefore, the only option an unsecured creditor has is to register their claims with the bankrupt estate and look to the distribution of dividends once the secured creditors have been satisfied. Although, due to the priority system of the distribution of assets in bankruptcy, it is unlikely that an unsecured creditor will collect on any outstanding claims if they choose to only utilize traditional bankruptcy procedures.

The court costs of the bankruptcy proceeding must be paid by the estate, as well as the court costs resulting from other proceedings and lawsuits in which there were rulings against the estate.

The debtor estate is responsible for court costs, expenses resulting from the collection, and costs of the administration and selling of assets. The estate must also pay for taxes, the trustee's commissions, public fees and any judgment related to employment actions that were awarded after the bankruptcy was declared.

All bankrupt estate debts will be declared immediately payable. They are given preference over all other claims admitted to the bankruptcy proceeding; except for labor and tax claims. Bilateral agreements are not automatically terminated as a result of the bankruptcy, but enforcement of these agreements may only be effected by the trustee if he deems that it would be beneficial to the bankrupt estate.

According to Articles 122 and 123, the creditors can request a meeting to discuss how the assets are will be sold in order to pay the credits. Creditors representing two-thirds of the credits are vested with the power to organize a corporation for the continuation of the bankrupt entity's business, or to authorize the trustee to assign the debtor assets to third parties.

According to the Bankruptcy Law, certain transactions that are entered into prior to the declaration of bankruptcy may be considered ineffective by the bankrupt estate, regardless of whether either party had knowledge of the eventuality of the bankruptcy or the intent to defraud. These transactions, within the prescribed time limits, include: (1) payment of a debt that has not yet matured; (2) payment of a matured debt in a manner not contemplated by the obligation; (3) granting security interests for an obligation previously assumed; (4) donations made within a two year period prior to the bankruptcy; (5) waiver of inheritance within a two year period prior to the bankruptcy; and (6) sale of a commercial establishment or business without creditor consent.

Notwithstanding this doctrine, contracts entered into within the sixty (60) day period set forth in Article 14 of the Bankruptcy Law (suspect period) may be reviewed, and will be subject to being declared void if the court finds any intent to defraud or to cause damage to the debtor company. The debtor's assets involved in such void transactions must be returned to the estate. If that is not possible, damages must be paid to the estate.

RECOGNITION OF CLAIMS, DISTRIBUTION OF PROPERTY, AND TERMINATION OF BANKRUPTCY PROCEEDINGS (*FALÊNCIA*)

Once served notice of the bankruptcy proceeding, the debtor may choose to pay the claim, present a defense to the action after depositing an amount in escrow, or present a defense without making a deposit. If the debtor chooses to present a defense without depositing an amount into escrow, they run a greater risk of being declared bankrupt. To be successful in the defense, the debtor must provide evidence that the bankruptcy petition is not substantiated.

Should there be a final declaration of bankruptcy by the court, the debtor business will be liquidated and all of the obligations of the company will be accelerated. The debtor entity will forfeit any rights to the assets of the bankruptcy estate, and all of the assets in its possession will be attached. The assets and proceeds of the bankrupt estate shall be distributed according to a legally fixed set of priorities. All creditors are bound to this legally prescribed priority list. The list of creditor priorities is as follows: (1) labor indemnities; (2) wages and severance pay; (3) debts and expenses of the bankrupt estate; (4) unpaid federal, state, local, and independent agency taxes; (5) social security and other mandatory governmental programs; (6) secured credits; and (7) unsecured credits. Those categories of claims with the highest priority must be satisfied in full before the other categories receive any proceeds. With limited exceptions, cases affecting the assets of the bankrupt estate are automatically suspended at the time the debtor is declared bankrupt.

It is possible for a bankruptcy proceeding to be suspended or terminated if the debtor entity petitions for a *suspensive concordata*. To qualify for a *suspensive concordata*, the debtor entity must demonstrate to the bankruptcy court that rehabilitating the business is of greater benefit to the estate than liquidation. The debtor entity must also agree to pay its unsecured creditors a minimum of thirty-five percent (35%) of the total debt owed if payment is to be made immediately, or fifty

percent (50%) of the total debt owed if payment is to be made in installments over a two-year period.

A *suspensive concordata*, if granted, would permit the debtor company to regain control of its assets and operations, and bind all of the company's unsecured creditors. As in the case of a preventative *concordata*, secured creditors are not affected by the *suspensive concordata* proceedings and they remain free to foreclose on their collateral (Article 179). If the debtor entity fails to comply with the terms of the *concordata* decree, the *concordata* proceedings will revert back to bankruptcy proceedings.

With the exception of the presence of force majeure, bankruptcy proceedings should be dissolved and formally terminated by a court order two years after the date on which the bankruptcy was declared. In reality, termination within this prescribed two year period rarely happens. Notwithstanding other methods of discharging debts that are referred to in the bankruptcy law, the entity's liabilities will automatically be extinguished five years after official termination of the bankruptcy proceeding, provided there has not been any conviction based on any bankruptcy offense. If the debtor has in fact been convicted of a bankruptcy offense, its liabilities will not be discharged for ten years.

A court order discharging the debtor entity from liabilities will authorize the entity to carry on its trade or business, unless it is awaiting the outcome of proceedings brought as a result of a bankruptcy offense. The shareholders or quotaholders will then decide what happens with the remaining entity shell. The entity shell may be dissolved and extinguished, or it may engage in business if sufficiently capitalized

CIVIL LIABILITY OF OFFICERS, DIRECTORS AND SHAREHOLDERS

As a general rule, officers and directors are not personally liable for financial obligations that are incurred in the corporation's name while the officers and directors are performing acts in the normal course of business.

Article 10, Decree 3.708, of October 1, 1919 (the Limited Liability Companies Law) and Article 158, Law No. 6404 of December 15, 1976 (the Corporation Law) state exceptions to this rule. These articles provide that corporate officers and directors will be held personally liable when, and within the scope of their powers, they act recklessly, negligently, below the accepted standard of competence for a corporate director, or act fraudulently. They will also be held liable in situations of ultra vires.

When directors or managers act recklessly, negligently, below the accepted standard of competence for a corporate director, or fraudulently, they will only be held liable for damages if it is in fact proven that they actually acted in such a manner. The entity will subsequently be held liable for the damages to third parties caused by these manager or director actions. However, the company will have the right to file suit against the managers or directors in order to indemnify the losses.

An officer or director will be held strictly liable for ultra vires acts, regardless of whether they were negligent or fraudulent. In principle, a company is not liable for the ultra vires acts of its officers and directors. However, if third parties were acting in good faith, the corporation may be held liable.

According to Article 159 of the Corporation Law, after there is a finding of liability, a corporation, any of its shareholders, or an injured third party may bring an action against the responsible director in an attempt to recover its losses. Paragraphs 1 to 5 of article 158 of the

Corporate Law establish rules in connection with the joint, several and individual liability of corporate directors. Liability that is derived from illegal acts is distinguished from liability that arises from a failure to carry out duties and obligations in connection with the regular functioning of the company.

A director is generally not held responsible for the illegal acts of other directors, unless he is involved in conspiracy with them or is deemed negligent relating to the discovery of the illegal acts or, having knowledge of the wrongdoing, fails to attempt to impede such wrongdoing. Board of directors that are participating in joint decisions in accordance with the company's by-laws will be subject to joint and several liability.

Directors will be held jointly and severally liable for damage resulting from a failure to carry out their duties and obligations in connection with the regular functioning of the company. This joint and several liability is present even if each director is not responsible for the performance of all duties. Therefore, for example, failure to produce and publish annual balance sheets, which could possibly impair the normal functioning of the company, may result in the joint and several liability of the directors. However, in the case of public companies, directors will only be held liable for damage resulting from a failure to perform their individual duties in accordance with the company by-laws.

A director who becomes aware of a failure on the part of a current or former director to perform his corporate duties must communicate this fact to the shareholders at a general meeting in order to exonerate himself from liability for damages caused as a result of the director's failure to act.

For public companies, the Brazilian Securities and Exchange Commission has the authority to impose administrative penalties on directors through means of administrative hearings. The decisions of these administrative hearings may be appealed to the National Monetary Council.

Examples of possible administrative penalties are warnings, fines, and the suspension or disqualification of directors. For directors of financial institutions, the Central Bank is empowered with a similar authority to issue warnings and to impose fines, and to suspend or disqualify directors.

Article 6 of Decree-Law No. 7661/45 states that if the company has declared bankruptcy, the managers are not personally liable for obligations incurred in the corporation's name by virtue of administrative acts performed in the normal course of business.

Brazilian law provides for the separation of assets and liabilities between corporate entities and their principals/shareholders. Therefore, the assets of a principal/shareholder in a company undergoing bankruptcy are in theory separate, and thus protected from the company's creditors. Any potential manager's personal liability, according to the Brazilian Bankruptcy Law, will be taken through an ordinary process in the bankruptcy jurisdiction.

For a limited liability company, the partners are considered liable as sureties, as well as being jointly and severally liable for the company's debts for up to the value of the LLC capital. This liability is only applicable if the capital is not fully paid up. In the case of joint stock companies, shareholder liability is held to be more restricted than the liability of the partners of limited liability companies. The liability of each a shareholder in a joint stock company is limited to the respective issue price of the shares subscribed or acquired.

However, the general rule of the separation between the net worth of the company and that of the partners or shareholders, and consequently the limitation of their liability for the company debts, is not absolute. There exist exceptions when, for instance, the legal entity is being utilized for fraudulent purposes or solely for the personal benefit of the partners. This concept of utilizing such fraudulent practices led to the development of the theory of "piercing the corporate veil", also called the "disregarding the legal entity" doctrine.

This legal concept provides, similar to other country jurisdictions, that if the recognition of the corporate fiction will result in an injustice or injury the public, such a corporate fiction will be disregarded and the principals/shareholders will be considered personally liable for the corporate actions and debts. The principals would be liable as if the corporate entity did not exist: directly, jointly, severally and without limit. Furthermore, the corporate entity will not be recognized in circumstances to defraud creditors, evade existing obligations, circumvent a statute, justify fraud, defend crime or defeat the public interest.

Examples of where the corporate veil has been pierced in Brazil are the irregular dissolution of a company; the intermingling of corporate assets with a sole shareholder and administrator; the carrying out of activities incompatible with the corporate purposes; and the company control being under the absolute power of just one partner, who in turn has committed fraudulent acts.

These rules are also applicable in determining when creditors will be able to bring an action against the principals behind the false corporate entity. However, according to Article 5 of the Bankruptcy Law, the principals who are deemed liable for corporate debts are not individually subject to the effects of the company's bankruptcy, but they will be subject to other legal effects that may be brought about by Bankruptcy. In other words, the principals will not be declared bankrupt and may be held responsible for the company's debts depending on the corporate form and their resulting level of liability.

It should be noted that there is a strong trend in the labor courts to pursue "deep pockets" whenever unfulfilled labor obligations are at issue, regardless of the legal limited liability of companies and corporations. This means that in addition to parent and affiliate companies, the assets of administrators and shareholders are often attached in the enforcement claims of labor obligations.

Lender's liabilities are not yet an important factor in Brazil. Initial cases are being argued in courts of competent jurisdiction, but generally financial institutions have not realized the potential damage such claims may cause. Reckless lending, as the basis to indemnify other creditors, has also not yet been recognized by statutory legislation. Case law is still very underdeveloped in this area.

CRIMINAL LIABILITY OF OFFICERS, DIRECTORS AND SHAREHOLDERS

Certain and specific acts of corporate administrators may be defined as being crimes in the Brazilian Criminal Code, and thus punishable by imprisonment and/or fines. It is deemed a crime to make false assertions as to the financial status of the company or to fraudulently hide facts related to the financial status (in a report, balance sheet, communication to the public or to a shareholder); to promote the false quotation of shares; to use corporate assets for personal benefit or for the benefit of third parties without the prior authorization of the shareholders; and to obtain the approval of minutes or opinions through collusion with the shareholders, etc. Non-payment and misappropriation of taxes may also result in the criminal liability of corporate directors, administrators and managers. The holds true for misappropriation of social security taxes as well.

In addition to the laws contained in the Criminal Code, various other laws specifically address the criminal liability of corporate administrators. One of these laws is Law No. 4137/51 (crimes against the public economy), which determines that administrators may be found criminally liable for committing crimes such as the falsification of registrations, reports, and other data for the purpose of withholding profits, dividends and bonuses, or in order to misappropriate funds. Law No. 4137/62 (abuse of economic power) establishes that administrators may be criminally liable for corporate abuse of economic power.

For criminal purposes, the corporation's directors and administrators will be identified with the debtor and the bankrupt party should there be an official declaration of bankruptcy. The use of improper means to obtain resources and to delay the declaration of bankruptcy, such as making sales at prices below current market value during the six months prior to filing for bankruptcy, will be considered a criminal offense.

Other examples of criminal offenses relating to the petition for bankruptcy are the failure to adequately keep required books; fraudulent acts that are committed prior to or subsequent to the declaration of bankruptcy for the purpose of obtaining unfair advantage or to the prejudice of other creditors; accelerated payments to certain creditors to the prejudice of others; and the recognition of false or simulated claims.

For administrative duties, both the courts and legal scholars have established the general rule that negative acts, resulting from omissions or a failure to act, even if not the result of a joint deliberation, will result in joint and several liability for the administrators. However, if an individual administrator is responsible for a positive or intentional act, he will have the liability limited to himself. For either negative or positive acts that are the result of a joint deliberation, joint and several liability will apply unless an individual expressly objects.

Generally, the courts have not found liability if an individual was not participating in the administration of the corporation at the time of the occurrence of the crime. However, any new administrators who become aware of the existence of any former or continuing criminal acts have the duty to inform the shareholders accordingly in order to exonerate themselves from liability.

A legal entity generally cannot be held criminally liable, except for environmental violations. Although, the Bankruptcy law does provide for the criminal liability of an entity's legal representatives (directors, officers, administrators, managers or liquidators). Bankruptcy crimes are provided for in Articles 186 to 190 of the Bankruptcy Law.

RECOGNITION OF FOREIGN PROCEEDINGS AND EXTRATERRITORIAL JURISDICTION

Certain conditions must be met for the recognition and enforcement of foreign judgments in Brazil. These conditions are as follows:

- 1) The judgment was rendered by a court of competent personal and subject matter jurisdiction;
- 2) There was a proper service of notice for the defendant;
- 3) The judgment is final in the awarding country and is not subject to any further analysis or appeal;
- 4) Brazil's notion of sovereignty, public policy or morality must not be offended by the judgment; and
- 5) The judgment has been consularized by a competent Brazilian authority and then translated into Portuguese by a certified translator in Brazil.

The most frequently contested foreign judgment recognition requirement is the need for proper service upon a defendant domiciled in Brazil. Because Brazil is not a member of the Hague Convention on the Service Abroad of Judicial and Extrajudicial Documents in Civil or Commercial Matters of 1965, service of process must be accomplished in accordance with Brazilian law. Therefore, the appropriate method for properly serving process on an individual domiciled in Brazil is via a rogatory letter (Brazil is a member of the Inter-American Convention on Letters Rogatory, which was signed in Panama on January 30, 1975, and ratified by Brazil on December 27, 1995).

If another method of service is used upon a Brazilian domiciled defendant, the eventual foreign judgment will be deemed unenforceable in Brazil. Unfortunately, following the prescribed guidelines for proper service of process in Brazil is a lengthy procedure that may often drag on for months. If the defendant voluntarily accepts the jurisdiction of the foreign court by appearing and defending the foreign claim, then the service of process rules do not apply.

There is no discrimination against foreign creditors in the Brazilian Law. Foreign creditors are entitled to be listed along with Brazilian creditors filing claims against the Brazilian entity in the same manner as a Brazilian creditor. The foreign creditor may be represented by a Brazilian attorney, provided that a duly executed power of attorney is accomplished. This power of attorney must be notarized, “legalized”, translated into Portuguese in Brazil by an authorized translator, and then registered with the appropriate Registry of Titles and Documents.

Foreign signatures (those not signed in Brazil) must be notarized in the country of the signatory and then “legalized” at the nearest Brazilian Consulate’s office. This applies to any document that will be submitted to a Brazilian court. If documents are drafted in a language other than Portuguese, there must be a translation done within Brazil, by an authorized translator, prior to the document being registered with the appropriate registry of Titles and Documents (*Cartório de Títulos e Documentos*).

In order to file a bankruptcy petition, any creditor not domiciled in Brazil, pursuant to Article 9, item IIIc, of the Brazilian Bankruptcy Law, must provide an amount of money in escrow that corresponds to the costs and payment of compensation for damages and losses that would occur if the claim should be denied on account of any malicious nature (Article 20).

The Civil Code and the Supreme Court Internal Regulations address foreign judgments generally, without specific reference to bankruptcy or insolvency matters. The Bankruptcy Law

itself does not specifically provide enforcement mechanisms for foreign bankruptcy judgments; guidance is taken from the Civil Code and the Supreme Court Internal Regulations.

Pursuant to Article 15 and 17 of the Introductory Law of the Civil Code and Article 217 of the Internal Regulations of the Federal Supreme Court, the recognition and enforcement of a foreign judgment in Brazil requires that certain conditions be fulfilled, as previously mentioned in Section VII-A.

In instances where Brazilian law claims the exclusive jurisdiction of a party or subject matter, the Brazilian courts will not recognize a foreign judgment. If the debtor has its principal place of business in Brazil, a Brazilian court will not recognize a foreign judgment. Brazilian law has exclusive jurisdiction over these entities, pursuant to Article 7 of the Bankruptcy Law, and the Supreme Court will not ratify any foreign judgment.

Additionally, according to the Supreme Court, real estate assets are to be considered within the exclusive jurisdiction of Brazilian courts. These exclusions from foreign judgment recognition, although not uncommon in other jurisdictions, further limit any extension of a universal insolvency approach in Brazil. With respect to these parties and assets, creditors must bring their action in Brazil in order to protect their rights.

For insolvency and bankruptcy matters, it is common that many decisions not qualify for recognition, due to the Brazilian party not being served properly, the foreign jurisdiction not being appropriate under Brazilian law, or because the decision was not final and unappealable.

With no clear direction in the law, and little published precedent in cases of foreign bankruptcies, Brazilian legal scholars have advocated varying approaches for analyzing judgment enforcement and related issues. A number of issues are still open to interpretation, as the published

case law regarding foreign bankruptcies is largely limited to issues involving the conversion of claims held in a foreign currency into domestic Brazilian currency.

Although satisfying the requirements for proper personal and subject matter jurisdiction may be the most important issue in international actions of any kind, for multinational bankruptcies this issue is quite complex and uniquely challenging. Nonetheless, the Brazilian Bankruptcy Law addresses this complex matter by using traditional jurisdictional standards of domestic actions. These domestic standards are based mainly on the defined contacts test: either the action is proper for the Brazilian court to review or it is not. In the jurisdictional analysis, the Brazilian Bankruptcy Law contemplates a very contained bankruptcy or insolvency proceeding, where the proceeding is either entirely subject to its jurisdiction or not.

In Brazil, the bankruptcy law does not envision parallel proceedings with respect to the same debtor in different jurisdictions. This would occur where, for example, a “main” proceeding and an “ancillary” proceeding would run at the same time. This "parallel proceeding" concept is acknowledged in the U.S. Bankruptcy Code. Parallel proceedings would suggest that jurisdiction is proper in more than one court, with respect to the same debtor and creditors, and potentially the same assets. These concepts are simply not present in the Brazilian Bankruptcy Law. The Brazilian Bankruptcy Law also does not provide for the coordination of creditors or the pooling of assets within bankruptcy proceedings in other countries.

Article 7 of the Brazilian Bankruptcy Law specifically states that jurisdiction will be located at the principal place of business of a company (*principal estabelecimento*). Therefore, according to this Article, proper jurisdiction may be in Brazil or abroad, depending on the specifics of the case. If a debtor has there principal place of business in Brazil, a local civil court will take jurisdiction and the legal ramifications of Brazilian insolvency proceedings will be applicable to all of the debtor’s assets, including those assets that are located outside of Brazil. A parallel

bankruptcy proceeding outside of Brazil, with respect to the same debtor or the same assets, will have no legal effect on the Brazilian proceedings.

The Brazilian Bankruptcy Law provides that the presence of a local office of a foreign business within Brazil will be sufficient to grant bankruptcy jurisdiction to a local Brazilian civil court. This allows for the local courts to exercise territoriality in respect to foreign debtors doing business in Brazil. The extent of these proceedings, however, is likewise territorial. Only the foreign debtor's assets in Brazil will be subject to disposition by the court proceedings. For these purposes, a branch office will be treated like any Brazilian subsidiary or legal entity.

FUTURE LEGAL REFORMS

The Brazilian House of Representatives approved the New Brazilian Bankruptcy Law - Bill of Law 4376/93 - on October 15, 2003. This was finally accomplished after nearly 10 years since the law's first proposal. On the same day, the House of Representatives also approved Bill of Law 72/2003, which amends the National Tax Code (Law. 5,172, 1966 - the "NTC") in order to harmonize it with the New Bankruptcy Law. Both bills of law have been submitted to the Brazilian Senate and are still subject to further amendments. These new bills are expected to be finalized and approved sometime in the year 2004 session.

The New Bankruptcy Law will equalize the priorities of secured claims with tax claims. This will provide a much greater chance for secured creditors to realize some of their claims. The ability to effectively restructure a distressed company should also increase once the New Bankruptcy Law is enacted. The new law provides for judicial and extra-judicial (pre-packaging) restructuring proceedings. Also, the *suspensive concordata* procedure will be extinguished and the

preventive *concordata* will be retained for only very small businesses. This new preventive *concordata* will be in a considerably simplified form.

To better facilitate operations of the troubled entity, the new law will encourage the early sale of assets in insolvency cases and make great efforts to maintain the entity as a going concern. Also, the buyers of assets, bundled together, will no longer be liable for past tax and social security liabilities. This will increase value and enhance the chance of credit recovery.

The New Bankruptcy Law will be a welcome addition to the ongoing process of modernizing the Brazilian legal system. Once the New Bankruptcy Law is officially adopted, Brazil will be in a better position to effectively meet the challenges of the modern legal world and the global marketplace.