TMA International NEWS

Realities of turnarounds in Latin America—the case of Brazil

by Peter Gault

Turnaround management is a relatively new concept in Latin America due to the lack of an effective legal framework to facilitate corporate restructuring and a historic lack of credit. While some countries in the region have taken steps in recent years to improve their legal insolvency laws, inconsistent implementation of new laws and a continuing shortage of adequate funding for distressed companies are the principal challenges to a new breed of turnaround managers.

Brazil is of particular interest to turnaround professionals, since it has emerged as a lead player on the international stage in the wake of the global financial crisis.

Background

While the global credit crunch has leveled the playing field somewhat for turnaround managers worldwide, most Latin American countries have suffered from a historic scarcity of credit. One of the main reasons for the scarcity (and high cost) of credit has been the ineffectiveness of national insolvency systems, based on the Napoleonic Code and dating back to the 19th Century. With lenders unable to realize their security, and liquidation the most common remedy for companies unable to pay their debts, archaic insolvency laws and a historic prejudice against ailing companies inhibited bank lending and presented a serious barrier to economic growth.

Over the past 15 years, however, internal and external pressures for economic growth and trade liberalization have produced a move towards the reform of insolvency laws to support the rehabilitation of companies in distress. While the process of reducing the length, cost and bureaucracy of insolvency proceedings began in Chile in 1982 (copied by Colombia in 1999), significant changes to insolvency laws followed in Argentina (1995), Mexico (2000) and finally in Brazil (2005).

Brazil—a giant awakens

The case of Brazil is of particular interest to turnaround professionals, now that the proverbial "country of the future" has emerged as a lead player on the international stage in the wake of the global financial crisis. That Brazil should have been the last of the major countries in Latin America to introduce a modern insolvency law may come as a surprise to observers who are unfamiliar with the complexities of this hitherto sleeping giant.

In fact, the long delay in approving the New Bankruptcy and Restructuring Law (NBRL) in February 2005 followed 12 years of heated political debate about how best to integrate it within the wider legal and commercial laws of Brazil. Approval was forthcoming only after an agreement was reached with the Federal Association of Banks, a powerful organization that had urged legislators not to affect privileged loans.

The new law, also known as the law of enterprise recovery, is based on the U.S. Chapter 11 model that aims to achieve a balance between reorganization and liquidation while facilitating corporate renewal and the protection of jobs. It provides for reorganizing distressed companies by either judicial, extrajudicial means (similar to a prepackaged plan) or bankruptcy (similar to Chapter 7 liquidation).

It is important to appreciate, however, that an insolvency system involves much more than an insolvency law. Changing the way that an insolvency system functions within a historically complicated judicial hierarchy is an extremely complex task. This is particularly the case in a country as diverse as Brazil, where outdated institutional practices and inauspicious cultural values are deeply ingrained.

Cultural challenges

Looking back to the case of a small automotive component manufacturer in São Paulo that was referred to my turnaround practice in

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2003 provides a good example of the challenges involved. With annual sales of R$10 million, the company was suffering from cash flow problems. The owner explained that R$4 million was owing to suppliers and R$2 million to a local bank. On examination of the books, it transpired that the company owed R$15 million in overdue federal and local taxes!

With companies in Brazil being subject to a myriad of local taxes, it is perhaps not surprising that tax avoidance was the first step that many companies resorted to when confronted with cash flow problems. Not only did an inefficient tax collection system facilitate non-payment, but it provided such companies with a huge competitive advantage over its tax paying competitors.

Due to the preferential status afforded to labor liabilities and tax claims under the 1945 bankruptcy law, these liabilities would have to be paid ahead of trade creditors and banks in event of a liquidation. Furthermore, even if these commercial debts could have been restructured, a potential buyer would be burdened with successor liability for overdue taxes as well as labor and work-related injury claims that had accrued during the previous ownership.

This case also provided a good example of what could be called the "rich owner, poor company" culture in Brazil. In the case of this small manufacturing company, the owner was a person of considerable wealth who admitted to having taken cash out of the business in better times. Whether due to his company's huge tax liabilities, or to a refusal to risk his personal wealth, he was unwilling to put new money into his own business to save it.

In this business environment, opportunities to restructure companies prior to 2005 were limited to a handful of extrajudicial restructurings for larger companies.

Key changes under the new law

The NBRL contained measures to address the most blatant shortcomings of the 1945 bankruptcy law by providing new protections for secured creditors and buyers of distressed assets in Brazil.

a) it changed the order of priority between secured claims and tax claims, placing secured claims second in priority behind labor and work-related injury claims.

b) a nominal cap was placed on the value of first priority labor claims, whose value had previously been potentially unlimited.

c) successor liability was eliminated with respect to certain claims where the debtor sells part of its business through the reorganizational plan, or where the court-appointed administrator sells the debtor's assets in a bankruptcy liquidation.

While these measures were much needed, the new law left two vital issues unresolved:

- tax claims were not included in the judicial restructuring process and therefore remain a cause of uncertainty
- the provision of new money or debtor-in-possession (DIP) financing in restructuring proceedings is not adequately addressed

Furthermore, real guarantees provided to banks remain largely unaffected by insolvency proceedings, which provide the debtor with a limited 180-day stay to reach a restructuring agreement with creditors.

The first test for the new law came in June 2005 when Varig, the troubled national airline, petitioned for *"recuperacao judicial"* (RJ). Several thousand Varig employees were dismissed without compensation prior to the sale of the bulk of Varig's operations to a competitor airline, Gol.

Challenges to the new law

In August 2007, a lawsuit was filed challenging this action and the constitutionality of several articles of the NBRL. In June 2009, the Supreme Court upheld the successor liability limitation in the 2005 law, thereby freeing Gol from liability for making the redundancy

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Turnarounds in Latin America *-continued*

payments. This landmark decision of the Supreme Court also re-confirmed the cap on individual labor claims.

In September 2009, the RJ process for Varig was concluded. Although the primary business of Varig has survived, albeit on a much reduced scale, the judicial process failed to bring relief to the original creditors. With debts of R$8 billion in 2005, it is feared that creditors will soon call for the liquidation of the company.

Issues on the ground

While the recent Supreme Court ruling was vital to reinforce the legitimacy of the NBRL and promote the continuing move towards stimulating the recovery of insolvent businesses, the fact is that there have been less than 1,500 RJ filings under the NBRL. This compares with more than 160,000 Chapter 11 filings in the United States since 2005.

There remain important administrative challenges to be overcome in order to create an environment in which turnarounds can be undertaken successfully in Brazil. The same is true in other Latin American countries that have also reformed their insolvency laws.

It is recognized that implementation of the new law is lacking in many respects.

- The court appointed administrators are not adequately trained for the role.
- There is little meaningful interaction with either the debtor or creditors.
- Reorganization plans are often submitted late and are not subjected to the rigorous analysis required.
- Creditors are rarely consulted prior to submission, although plans normally require the rescheduling of debts for long periods.

The distressed companies themselves must also accept responsibility for the relatively poor results achieved to date. Among the most common problems are the following:

- many distressed companies fail to acknowledge their problems in time
- they rarely have a clear plan when entering into RJ
- management tends to focus on rescheduling debt rather than profitability and future cash flow
- although the cooperation of creditors is vital to the success of the restructuring, communication is generally poor

Conclusions

Clearly, the environment in Brazil is ripe for turnaround professionals with experience in applying internationally recognized standards in a newly invigorated economy that is trying to shed off the lethargy and local business practices of the past.

To be successful, however, important initiatives will need to be forthcoming:

- new sources of funding will be required to finance successful restructurings and the use of debt-to-equity swaps encouraged
- this will require a modification to the NBRL to prioritize DIP lending and encourage the development of an active market for distressed debt in Brazil. The treatment of overdue taxes is also a critical issue to be addressed
- a dedicated effort to educate all participants in the insolvency process of the benefits and techniques of modern turnaround practices

According to Eduardo Lemos, President of the Turnaround Management Association-Brazil, [a provisional international affiliate of the Turnaround Management Association] the biggest challenge to successful turnarounds is a cultural one. By providing an active forum where bankers, prominent lawyers and judges can meet with professional turnaround practitioners and business managers, TMA-Brazil is playing an active role in reversing the exaggerated prejudices of the past toward ailing companies. Furthermore, by teaching best

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management practices to managers, the goal is to help many distressed companies avoid making the mistakes that took them to the brink in the first place.

With many prominent TMA-Brazil members having been actively involved for several years in drafting the NBRL, it is pleasing to note that the same individuals are playing an equally important role in drafting amendments to improve the law as part of a focused group representing turnaround professionals throughout Brazil. TMA-Brazil is also stressing the importance of training in order to prepare judicial administrators and business managers to undertake the corporate renewal challenge effectively.

A similar approach to expand the reach of best turnaround management practices into other Latin American countries is a goal of TMA International that can only bring positive results to corporate renewal throughout this diverse region.

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