

**OECD ECONOMIC SURVEY OF BRAZIL 2005:  
REFORMING BRAZIL'S BANKRUPTCY LEGISLATION**

*This is an excerpt from Chapter 2 of the OECD Economic Survey of Brazil, 2005*

Current bankruptcy legislation is deficient because of the priority it gives to unlimited labour and tax claims to the detriment of other secured and unsecured credits, particularly bank loans. The low precedence given to these credits during bankruptcy discourages credit creation in the first place because bank loans are important mechanisms to finance a firm's working capital. Moreover, the need for unanimous approval by all creditors makes restructuring more difficult and time-consuming, during which time the value of collateral is likely to depreciate. Asset repossession is also hampered by the sluggishness of the legal system. Against this background, recent efforts towards improving bankruptcy legislation, through the easing of restriction of loan recovery and greater facility in the use of collateral, should reduce credit risk and consequently intermediation costs. A new bankruptcy law is currently under discussion in Congress, addressing most deficiencies in current legislation (Box 2.5).

**Box 2.5. Brazil's bankruptcy legislation**

In principle, the role of bankruptcy legislation is to organize the sharing of losses among an enterprise's different stakeholders, in particular between shareholders and creditors of different sorts (banks, employees, suppliers, and tax authorities). Legislation should therefore strike a balance between protecting creditors — encouraging them to participate in and support the firm during restructuring — and shareholders, thus providing an incentive for them to invest and take risks. The other role of a bankruptcy law is to protect socially valuable assets while the firm is being restructured or closed down.

**Current legislation**

Current bankruptcy legislation discourages credit creation because the settlement of financial claims is not prioritised when a firm is declared bankrupt. Instead priority is given to the settlement of labour and tax liabilities.<sup>1</sup> In practice, however, neither labour nor the tax authority tends to initiate a bankruptcy procedure, because employees fear job losses and the tax authorities are not legally active in bankruptcy cases. It is usually only after payment to suppliers and banks (typically the last to suffer default) is suspended that bankruptcy is declared. But, again, the priority given to labour and tax liabilities, rather than credits, weakens the incentive financial creditors have to initiate bankruptcy procedures. In general, when a bank or supplier wins a bankruptcy action, the little that is left after paying for legal fees is barely enough to settle labour and tax claims.

In current legislation, the option of enterprise restructuring (*concordata*) consists of a two-year debt rescheduling arrangement set in law that only applies to unsecured credits (*i.e.*, excludes labour, tax, and secured credits). More flexible restructuring plans require approval by all creditors, as the law does not provide for these arrangements. There are two kinds of *concordata*: the first is at the request of the firm's owner (preventive *concordata*) and the second is through a bankruptcy procedure, where all execution actions are halted, except for those related to tax claims. The judge then nominates a *síndico* (usually the largest creditor) who will act as manager, assessing the quality of the

firm's assets and liabilities, and whether bankruptcy law has been observed.<sup>2</sup> If the enterprise faces liquidity problems but remains solvent, it is put in suspensive *concordata*, whereby management returns to its owner(s). The judge issues an authorisation for debts to be rescheduled according to a timetable established in the law. In the case of liquidation, where the company is found to be both illiquid and insolvent, assets are collected, sold at a judicial auction, and used to settle debts to creditors (according to the quality of credit, and proportionally for credits of the same quality). As the owner may benefit from a suspensive *concordata*, the effective liquidation process only starts after a long period of legal valuation of assets and debts. When assets are finally auctioned, they may have lost most of their value, with depreciation of the real assets and devaluation of intangibles.

### New legislation

New bankruptcy legislation, awaiting approval by Congress, gives priority to the settlement of guaranteed loans and, along the lines of Chapter 11 provisions in the United States, makes the restructuring of firms in financial distress more cooperative and conducive to recovery. Amendments to the Tax Code will also be made to reconcile it with the main provisions of the new bankruptcy law. The main features of new legislation are that: *i*) labour credits continue to take precedence over other secured credits, but are capped at 150 minimum wages, preventing the fraudulent increase in stakeholders' salaries prior to bankruptcy as a means to repossess assets, *ii*) secured credits have precedence over tax claims, and *iii*) tax succession (*i.e.*, the new owners of a bankrupt firm are liable to any outstanding tax liability, including those unveiled after the acquisition of the firms or its assets) will be abolished for purchases under bankruptcy and judicial recovery procedures.

The possibility of extra-judicial restructuring has been strengthened. Borrowers in distress will be allowed to negotiate restructuring directly with creditors without judicial interference. Should extra-judicial restructuring fail, creditors will have first claim on their investment. Court-supervised restructurings will continue to exist, but judges will have to accept decisions by creditors, whose votes are to be weighted according to their level of exposure. If liquidation occurs, administrators will first try to sell the bankrupt company. But, failing this option, the firm will be split into parts that preserve employment and intangible assets, such as brands. Fire sales are to be a last resort. The elimination of the tax succession mechanism should facilitate this process by reducing uncertainty over future tax liabilities, paving the way for the sale of assets at fair prices. Furthermore, a significant speeding up of the bankruptcy procedure is expected to occur.

- 
1. In current legislation, debts are paid in the following order: *i*) employees' wage claims and indemnities, *ii*) tax claims (first federal claims, then state and, finally, municipal tax claims), *iii*) secured credits, *iv*) credits with special privileges over certain assets (for example, *cédulas de crédito comercial* with *penhor* are senior to *penhor*); *v*) credits with general privileges (for example, *cédula de crédito industrial*); and *vi*) unsecured credits. *Cédula de Crédito Bancário* (CCB) is an executable security to be used in any credit operation held by a financial institution, allowing banks to start judicial collection with an execution action, instead of cognizance action. CCB can therefore reduce costs, speed up credit recovery, and even be traded in secondary markets.
  2. Banks usually show little interest in participating in the management committee of bankrupt firms. They fear that employees and society at large might expect the bank to assume responsibility for liabilities it is not responsible for, such as paying salary arrears.

Despite the improvement of new bankruptcy legislation, challenges remain. *First*, although tax succession will be eliminated for purchases of assets under bankruptcy and judicial recovery, labour claim succession will be abolished only in the case of bankruptcy procedures, being transferred to the new owners in the case of judicial recovery, thus weakening incentives for the purchase of assets in the case of judicial recovery. *Second*, unsecured creditors will continue to have third-rank precedence in the recovery of assets, thus also mitigating the otherwise stronger incentives for credit creation. *Third*, the participation of banks in restructuring is unclear and will depend on how the legal system implements the new law. *Fourth*, law enforcement and procedural codes will need to be upgraded to speed up rulings, an initiative that would likely be supported by the magistracy. *Finally*, the dissemination of Special Courts, discussed in Box 2.6, could improve the performance of the judicial system. These courts could also deal with the judicial collection of small credits.<sup>1</sup>

### **Box 2.6. Specialised courts: the experience of Rio de Janeiro**

To improve the performance of its legal system, the state of Rio de Janeiro set up specialised courts (*Varas Especializadas*) in May 2002. These courts broadened the coverage of the eight existing bankruptcy courts (*Varas de Falências e Concordatas*) to include most cases dealing with commercial enterprises and those involving the Securities and Exchange Commission (*Comissão de Valores Mobiliários*, CVM). Cases involving credit operations do not typically fall under the purview of those courts. Rio de Janeiro is currently the only state in Brazil to have set up these specialised courts. Ancillary efforts to improve efficiency in the legal system include, for example, pooling resources in courts facing a large backlog of cases and the use of productivity indicators to reward performance.

This initiative was motivated by the perception that cases involving commercial enterprises often require specific knowledge. Large enterprises also tend to rely on better prepared law firms for counsel, calling for a better match between the greater specialisation of lawyers and judges. This initiative was also encouraged by the Rio de Janeiro Stock Exchange and CVM, and is perceived as successful in promoting learning-by-doing by paralegal personnel and judges. Although judges do not have previous training prior to being assigned to these specialised courts, there is an effort to identify professionals with a vocation for the cases tried in these courts. Judges are subsequently offered additional training, often sponsored by professional associations. Although all judges are invited to these training sessions, those working in the specialised courts are required to attend. These specialised courts may also contribute to improve the technical quality, and increase the predictability, of judicial rulings.

The implementation of these specialised courts is believed to have fostered competition in the legal system. Some litigators from São Paulo are said to prefer to take cases to courts in Rio de Janeiro, where rulings are delivered more swiftly, a trend that has gained momentum with the creation of the specialised courts. However, the scope for these courts to improve the efficiency of the legal system cannot be generalised, and depends on specific problems facing the legal system in different states. The existence of a large number of corporate law cases to be judged is one example. In other states, bottlenecks in the legal system may be worse at second-instance courts.

### **NOTES**

1. Empirical evidence reinforces the importance of adequate law enforcement in fostering the use of bankruptcy legislation. See Klapper (2001), for more information.

### **BIBLIOGRAPHY**

Klapper, L. (2001), "Bankruptcy Around the World: Explanations for Its Relative Use", Unpublished document, World Bank, Washington, DC.