DISTRESSED M&A

Brazil

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Distressed M&A

Consulting editors

Thiemo Sturny, Dominik Hohler

Walder Wyss Ltd

Quick reference guide enabling side-by-side comparison of local insights, including market climate and legal framework; transaction structures and sale process; due diligence and mitigation of related risks; valuation and financing; documentation; regulatory and judicial approvals; dispute resolution; and recent trends.

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Contributors

Brazil

Renato Maggio
rmaggio@machadomeyer.com.br
Machado Meyer Advogados

Camilo T Gerosa Gomes
cgerosa@machadomeyer.com.br
Machado Meyer Advogados

Karina Ferraz Deorio
kfd@machadomeyer.com.br
Machado Meyer Advogados

Solano M D Neiva
sneiva@machadomeyer.com.br
Machado Meyer Advogados

Alessandra Takara
ahtakara@machadomeyer.com.br
Machado Meyer Advogados

MARKET CLIMATE AND LEGAL FRAMEWORK

Market climate

How would you describe the general market climate for distressed M&A transactions in your jurisdiction?

In general, as in many other countries worldwide, the effects of the covid-19 pandemic were quite severe on the Brazilian economy. In addition, several large companies and business groups were already facing financial distress, some of them under judicial reorganisation as a result of the most recent economic crisis in the country.

As a result, numerous companies were forced to seek alternative solutions to renegotiate their indebtedness with creditors, often through amendments to existing judicial reorganisation plans or filing of in-court or out-of-court reorganisations.

Although the distressed credit market in Brazil is developing and growing at great pace, the sale of assets (regardless of their nature) still stands out as the main source of funding for companies under financial distress.

In this context, changes to the Brazilian Bankruptcy Law that took place at the end of 2020 and brought several innovations were highly welcomed by investors regarding legal certainty in the acquisition of distressed assets, and are expected to boost distressed M&A activity in Brazil.

This scenario has also been strengthened by the high level of liquidity available in the global financial markets and the devaluation of the local currency against the US dollar, which makes many foreign investors interested in opportunities of this kind in Brazil, either directly or through investments in investment funds managed by local asset managers focusing on special situations.

The main players involved in these transactions range from strategic investors to infrastructure investment funds, local banks and distressed investment funds. It should be noted that financial advisors are also actively targeting the distress market and, in certain cases, joining forces with local players (banks and asset managers).

The size of the transactions also ranges from transactions with small companies (or assets and plants) to transactions involving ultra-large economic groups, such as the sales of assets that have been carried out by the Oi Group in recent years.

Law stated - 29 October 2021

Legal framework

What legal and regulatory regimes are applicable to distressed M&A transactions in your jurisdiction?

In general, the main rules applicable to distressed M&A transactions are set forth in the Brazilian Civil Code (Law No. 10,406/2002), the Brazilian Corporations Law (Law No. 6,404/1976) and the Brazilian Bankruptcy Law (Law No. 11,101/2005) .

In addition to such laws, Brazilian fraudulent conveyance rules, which are an important aspect to be analysed in transactions of this nature, are dispersed throughout several different Brazilian statutes, including labour laws and tax laws.

As for other legal aspects, such as merger control issues and regulatory matters, distressed M&A transactions will generally observe the same rules and procedures that apply to traditional M&A transactions.

If a distressed M&A transaction is carried out within a formal insolvency proceeding such as a judicial reorganisation,

the bankruptcy court overseeing the debtors' reorganisation may be required to supervise the transaction and, in certain situations, depending on the timing of the transaction (prior to or after the approval of the judicial reorganisation plan) and the type of underlying assets involved (fixed assets or non-fixed assets), the transaction must be previously approved by the bankruptcy court or by the judicial reorganisation plan (which shall be approved by the creditors). In a bankruptcy liquidation, such transaction will be conducted by the judicial administrator pursuant to the principles and rules of the Brazilian Bankruptcy Law.

Law stated - 29 October 2021

Main risk in distressed M&A transactions

Summarise the main risks to all parties involved.

In addition to typical M&A risks, from a buyer's perspective the main risks involved in distressed M&A transactions are:

- the risks of the transaction being declared null or revokable due to fraudulent conveyance issues, fraud against creditors, fraud against foreclosure and other similar provisions under Brazilian law (effectiveness or clawback risks); and
- the risk of the buyer being held liable for contingencies and liabilities of the debtor (succession risk).

Although some of these risks also exist in regular M&A transactions, they are particularly aggravated in distressed M&A transactions.

When structuring a transaction of this sort, one should consider, in view of the actual perception of such risks mentioned above, what is the best structure to mitigate or address them for each specific case. For instance, to mitigate both effectiveness risks and succession risks, a buyer would aim at such transaction to be implemented as an acquisition of an isolated productive unit (UPI) within a formal judicial reorganisation proceeding conducted pursuant to Brazilian Bankruptcy Law.

From a seller's standpoint, the most significant risk is the risk of the transaction not being implemented. Although the distressed credit market in Brazil has been growing in the last years, financially troubled Brazilian companies still rely heavily on distressed M&A transactions and sale of assets in general as a path to fund their operations and generate money to pay creditors. As a result, the failure to complete a distressed M&A transaction for a company in financial distress may also mean the end of its chance to successfully implement a restructuring.

Law stated - 29 October 2021

Director and officer liability and duties

What are the primary liabilities, legal duties and responsibilities of directors and officers in the context of distressed M&A transactions in your jurisdiction?

There are no specific rules attributing additional or increased liabilities or duties to officers or directors in the context of distressed M&A transactions or when a company nears or becomes insolvent.

The rules applied to the duties and liabilities of officers and directors in an insolvency scenario are essentially those contemplated by the Brazilian Corporations Law and the Brazilian Civil Code.

In general terms, directors and officers in Brazil owe a duty of loyalty and a duty of care towards the company and its shareholders. As a result, they must exercise the same level of care and diligence that a reasonably active and prudent individual acting in good faith would apply when managing his or her own affairs.

In addition, another important principle is that directors and officers must avoid situations of conflict between their personal interests and the company's best interests.

Based on that, when negotiating and implementing a distressed M&A transaction, directors and officers shall observe these duties – otherwise they may be held liable towards the company and its shareholders for incurred damages.

Although Brazilian Bankruptcy Law does not contemplate specific rules on the fiduciary duties of officers and directors of companies in judicial reorganisation, it provides that such individuals may be removed from office by the bankruptcy court in certain situations, such as when they have acted with wilful misconduct, simulation or fraud against the interest of the company's creditors or if they have unjustifiably decapitalised or carried out transactions that have been detrimental to the company's ordinary activities. Despite that, this matter that has not been discussed in depth by Brazilian courts since the enactment of the Brazilian Bankruptcy Law and, therefore, the parameters for its application, especially in the context of distressed M&A transactions, are still unclear in many aspects.

Law stated - 29 October 2021

Differences from non-distressed M&A

In general terms, what are the key legal and practical differences between distressed and non-distressed M&A transactions in your jurisdiction?

In general, buyers' concerns with succession risks and clawback risks tend to be higher in a distressed M&A. Therefore, the mitigation of these risks (or some of these risks) will most likely drive the structure to be adopted by the parties in the implementation of the transaction.

Outside a judicial recovery proceeding, although parties are free to negotiate, implement and close the transaction, they would hardly be able to mitigate the abovementioned risks in a distress situation.

In turn, in judicial recovery proceedings, although an M&A transaction could be exempted from clawback risks (if approved by the bankruptcy court or by the judicial reorganisation plan) or both clawback risks and succession risks (if conducted as a UPI or if a competitive process is in place), the parties need to observe the applicable rules in each case and procedures of the Brazilian Bankruptcy Law. Notably, if the transaction is purported to be performed as a UPI sale, an auction or other competitive process organised by a specialised agent is mandatory. Therefore, non-distressed M&A transactions are usually more flexible, less bureaucratic and less time-consuming than distressed M&A transactions.

Another important aspect to mention is that indemnification provisions negotiated for the benefit of buyers in distressed M&A transactions tend to be less effective in comparison to traditional M&As. Although they are usually included in the transaction documents pursuant to the same standards of typical M&A transactions, considering that sellers in distressed M&As are inevitably non-creditworthy entities, it is expected that buyers will rarely rely on simple indemnification provisions. As a result, to address specific indemnification concerns, buyers will need to pursue comfort via alternative structures, such as holdbacks, escrow deposits or third-party guarantees or collateral, just to mention some examples.

Law stated - 29 October 2021

Timing of transactions

What key considerations should be borne in mind when deciding when to acquire distressed companies or their assets?

When analysing the acquisition of distressed companies or their assets, potential investors should take into

consideration the advantages and disadvantages of each available structure, including timing, flexibility as to the implementation and the risk of competition by other potential buyers.

Outside a judicial recovery proceeding, although an acquisition can be freely negotiated, the buyer will most likely not be able to mitigate clawback and succession risks if the seller is technically insolvent or may become insolvent as result of the transaction. The buyer could pursue evidence that it is a bona fide third-party acquirer and that such a transaction would not defraud the seller's creditors (e.g., fairness opinions, important creditors' consent, among others), but Brazilian law and existing relevant precedents do not provide for a safe harbour where clawback risks are entirely eliminated in this case. Certain precedents have considered that the mere awareness by the buyer that such a transaction could potentially harm creditors should potentially be construed as fraudulent in an insolvency scenario.

Under a judicial reorganisation, a transaction could be implemented as a direct sale or as a UPI sale.

To avoid clawback risks, a judicial reorganisation direct sale must be approved by the bankruptcy court or by the judicial recovery plan (and if it involves non-current assets of the judicial reorganisation entity, such approval would be per se mandatory). The upside of this structure is the flexibility to implement it and the possibility of a bilateral negotiation between buyer and seller (potentially without competition from other potential buyers), although subject to the scrutiny of the seller's creditors (upon approval of the plan) or the bankruptcy judge (and, in practical terms, depending on the target assets, the bankruptcy court could refrain from taking a decision without an approved plan or without hearing other insolvency constituencies). Approval of a plan in a Brazilian typical judicial recovery may take a long time, but nothing prevents an acquisition agreement being entered into at any stage, as long as closing is conditioned upon such approval. The downside of a direct sale is that it would not avoid the succession risks that such a transaction may entail unless it is implemented via an auction or other competitive process organised by a specialised agent pursuant to the terms provided for in the plan. Therefore, the more a purchaser perceives (based on its due diligence exercise or the analysis of the nature of the target assets) that such a transaction is less entitled to attract seller's liabilities, the more it will be comfortable in pursuing a bilateral direct sale.

On the other hand, the main advantage of a UPI sale (or sale under the abovementioned competitive process) is that the target assets will be free and clear from succession liability risks inherent to the seller and there would be no risk of the transaction being declared null and void based on fraudulent conveyance issues if the requirements set forth in the Brazilian Bankruptcy Law are observed. A UPI sale must be expressly provided for in the seller's plan and, therefore, it could only be implemented after formal approval of the reorganisation plan by its creditors and confirmation by the bankruptcy court. Besides that, the obvious downside is that an auction or other competitive process organised by a specialised agent is mandatory. Nonetheless, some protections to certain buyers that purportedly ensured the completion of the transaction ('stalking horse' buyers) have become fairly common in the UPI sale process in Brazil, such as the right to match and break fees.

Law stated - 29 October 2021

TRANSACTION STRUCTURES AND SALE PROCESS

Common structures

What sale structures are commonly used for distressed M&A transactions in your jurisdiction? What are the pros and cons of each, and what procedures and legal requirements apply?

A distressed M&A transaction may be implemented in the context of a judicial reorganisation proceeding or outside a formal insolvency proceeding (in this case, basically whenever a company nears insolvency).

In general, a transaction performed outside an insolvency proceeding allows the parties to negotiate and execute the transaction with more freedom and flexibility considering that it does not require prior approvals by creditors or the bankruptcy court. However, an out-of-court M&A transaction does not entirely protect the buyer from clawback and

succession risks, which tend to be higher in a distressed M&A deal.

Under a reorganisation proceeding, both in a direct sale or in an isolated productive unit (UPI) sale, M&A transactions may be implemented as a sale of shares or assets of the debtor.

Despite the legal protection against succession and clawback risks, the sale of a UPI may take longer than a direct sale. The sale of a UPI must be provided for in the reorganisation plan approved by the creditors and confirmed by the bankruptcy court. The Brazilian Bankruptcy Law also requires conducting a competitive process for the sale of a UPI to grant transparency and maximise the value of the asset being sold, among other reasons. The Brazilian Bankruptcy Law also provides for an alternative competitive process organised and conducted by a specialised agent and such process shall be detailed in the reorganisation plan.

Another alternative structure for M&A transactions under a reorganisation plan that is becoming increasingly usual is the debt-to-equity swap, in particular in reorganisations with the relevant participation of international creditors and investment funds. In view of the recent amendments to the Brazilian Bankruptcy Law, creditors were granted greater comfort to approve a debt-to-equity swap structure by expressly providing that creditors shall not be held liable or successors of the debtor in the case of a debt-to-equity swap.

In Brazil, only the debtor is able to file a reorganisation plan, so the debtor remains in control of the process in the majority of the cases. The recent amendments to the Brazilian Bankruptcy Law have provided for the possibility (still untested) of creditors filing alternative plans, but only if the debtor does not file a plan within 360 days (counted from the judicial recovery filing date) or if the plan proposed by the debtor is rejected by the general meeting of creditors. Although this possibility may change the scenario – still unclear to what extent – to date, all distress acquisitions have been necessarily proposed by the debtor (or its management) or negotiated and contracted with it.

Law stated - 29 October 2021

Packaging and transferring assets

How are assets commonly packaged and transferred in a distressed M&A transaction in your jurisdiction? What procedural, documentary and other requirements apply?

Assets are commonly packaged and transferred in a distressed M&A transaction by means of the transfer of shares of subsidiaries of the seller to the buyer, or by the drop-down of assets to a special purpose vehicle (SPV) and the transfer of 100 per cent of the shares of such SPV to the buyer. While the former is most often used in distressed M&A transactions outside a reorganisation proceeding, the latter is especially used in the context of a UPI sale to enable the transfer of certain assets of the debtor or even a business unit free and clear from the liens and liabilities of the debtor.

The sale of shares of a subsidiary is usually preceded by a full due diligence of the target and negotiation and execution of a sale and purchase agreement (SPA). If the seller is under judicial reorganisation, the transaction may be submitted to the bankruptcy court's approval or, alternatively, be provided for in the reorganisation plan approved by the creditors and confirmed by the bankruptcy court. Following the recent amendment of the Brazilian Bankruptcy Law in December 2020, the sale of non-current assets of the debtor may also be approved by a creditors' meeting specially called for this purpose. The shares of a subsidiary of the debtor company may also be sold as a UPI (ie, free and clear from any liens and liabilities of the debtor) under a judicial reorganisation proceeding.

The drop-down structure requires the creation of an SPV and the execution of additional corporate acts to authorise the capital increase of the SPV and the contribution of the assets to be transferred to the SPV. Once the drop-down is completed, the shares of the SPV are transferred to the buyer by means of the negotiation and execution of a SPA. Since the drop-down structure is commonly used in the context of the acquisition of a UPI (ie, free and clear from any liens and liabilities of the debtor), the scope of due diligence is usually limited to contingencies and liabilities inherent in the acquired assets (propter rem nature obligations).

Law stated - 29 October 2021

Transfer of liabilities

What legal requirements and practical considerations should be borne in mind regarding the acceptance and transfer of any liabilities attached to the distressed company or assets?

Successor liability rules apply in the case of transfer of a business as a going concern (which may be effected regardless through the transfer of the shares of a subsidiary of the seller or through the acquisition of one or more business units of the seller or any other structure eventually adopted).

As a general rule, in the case of transfer of individual assets or properties, the buyer should not be considered a successor of the seller and therefore should not be held liable for the liabilities of the seller. However, any debt or liability inherent to the assets or properties acquired that has a propter rem nature is attached to the transferred asset or property, and the buyer shall be responsible for its payment (such as environmental damages and property taxes).

As per the transfer of a business unit (or a commercial establishment), as a general rule, the buyer is liable for the debts existing prior to the transfer. However, there are some specific rules applicable to different natures of debt (such as civil and commercial debts, labour, tax, environmental and anti-corruption debts), which are exemplified below.

- Civil and commercial debts. Article 1,146 of the Brazilian Civil Code establishes that the buyer is liable for the payment of the debts existing prior to the transfer of a business unit, provided that such debts are fully reported in the financial statements of the seller. The seller remains jointly and severally liable for such debts for a period of one year following the transfer or, if the claim is not yet due by the date of the transfer, following the due date.
- Tax debts. Article 133 of the Brazilian Tax Code provides that the buyer of a business unit that continues to engage in the same business of the seller is liable for the taxes related to the acquired business unit, due and payable up to and until the date of transfer. The buyer's liability is full if the seller ceases to engage in business following the transfer, and subsidiary if the seller continues to engage in business or initiate a new business within six months following the transfer, in the same or in a different field of activity.
- Labour debts. Pursuant to articles 10 and 448 of the Brazilian Consolidated Labour Laws, any change in the ownership or corporate structure of the company shall not affect the employees' rights. The buyer of a business unit, as the successor of the company, is responsible for the payment of all labour obligations, including those assumed before the acquisition.
- Environmental debts. Environmental debts, damages and obligations inherent in the business unit are considered propter rem obligations and the buyer is fully responsible for their payment.
- Anti-corruption debts. Pursuant to article 4 of the Brazilian Anti-Corruption Law, the liability of the company for debts arising from the Brazilian Anti-Corruption Law remains unchanged in case of a change in the corporate structure, transformation, acquisition, merger or spin-off of the company. In the case of mergers and acquisitions, the first paragraph of article 4 states that the liability of the successor is limited to the payment of penalties and the compensation for damages caused by the corrupt acts. Other sanctions provided for in the Brazilian Anti-Corruption Law (such as the declaration of lack of good standing to execute contracts with the public administration) related to acts practised before the transaction are not applicable in these cases, except in the case of fraud or simulation.

Despite the successor liability rules mentioned above, in the context of a judicial reorganisation it is possible to acquire a business unit free and clear from liabilities of the debtor (including labour, tax, environmental and anti-corruption liabilities) if the acquisition is carried out by means of a UPI, pursuant to article 60 of the Brazilian Bankruptcy Law, or upon an auction or organised competitive process according to the plan pursuant to article 66, 3rd paragraph, of such

law.

Law stated - 29 October 2021

Consent and involvement of third parties

What third-party consents are required before completion of a distressed M&A transaction? What are the potential consequences of failure to obtain these consents? In what other ways are third parties commonly involved in the transaction?

The completion of a distressed M&A transaction outside an insolvency proceeding requires the same third-party consents required as in non-distressed M&A transactions, including corporate authorisations, general third-party waivers to avoid acceleration of existing debt or termination of operational agreements and, in the case of M&A transactions performed in regulated markets, the approval of the relevant public authorities. Also, the transaction may be subject to antitrust controls.

Distressed M&A transactions performed in the context of a judicial reorganisation proceeding, in addition to the requirements mentioned above and if the transaction involves the transfer of non-current assets of the debtor (which usually is the case in M&A transactions) must be submitted to the bankruptcy court's approval or, alternatively, be provided for in the reorganisation plan approved by the creditors and confirmed by the bankruptcy court. Following the recent amendment to the Brazilian Bankruptcy Law in December 2020, the sale of non-current assets of the debtor may also be approved by a creditors' meeting specially called for this purpose.

The completion of a distressed M&A transaction as an isolated productive unit (ie, carried out free and clear from any liens and liabilities of the debtor company), in addition to the requirements mentioned above, must also observe the following: first, the sale must be provided for in the reorganisation plan approved by the creditors and confirmed by the bankruptcy court; second, the Brazilian Bankruptcy Law requires the conduction of a competitive process for the sale of a UPI. Third, the buyer shall not be related to the debtor or identified as an agent of the debtor for the purpose of defrauding succession.

Law stated - 29 October 2021

Time frame

How do the time frames and timelines for the various transaction structures differ? Can these be expedited in any way?

Regardless of the deal structure, distressed M&A transactions involve the conduction of due diligence of the target company or assets, the negotiation and execution of a sales and purchase agreement (SPA) and submission of the transaction by antitrust authorities (if applicable) and other relevant public authorities, depending on the industry. The timetable for these acts does not differ from a traditional M&A transaction.

For transactions carried out in judicial reorganisation proceedings, the timing for conclusion of the transaction also depends on meeting the requirements provided by the Brazilian Bankruptcy Law. Pursuant to such law, the transfer of non-current assets of the debtor (which usually is the case in M&A transactions) must be submitted to the bankruptcy court's approval or, alternatively, be provided for in the reorganisation plan approved by the creditors and confirmed by the bankruptcy court. The timing of the approval by the bankruptcy court may vary significantly. It may take 30 to 90 days from the date on which the debtor files a petition requesting the court's approval; however, according to the complexity of the transaction and any legal disputes arising thereto, this time frame could be extended. An in-court distressed M&A transaction usually provides as a closing condition the non-existence of appeals against the court order. If appeals are filed, a definitive decision on the matter by a Court of Appeals may take six to 12 months.

The implementation of a distressed M&A transaction under a reorganisation plan requires the approval of the plan by the general meeting of creditors and then the confirmation of the plan by the bankruptcy court. Pursuant to the Brazilian Bankruptcy Law, the debtor has 60 days following the commencement order and the meeting of creditors to vote on the reorganisation plan shall be held within 150 days from the commencement order. Despite the legal requirements, it is common that the meeting of creditors is repeatedly suspended and postponed to allow further negotiations among the debtor and creditors. If the sale is conducted by means of a UPI, free and clear from any liens and liabilities of the debtor, the sale must be provided for in the reorganisation plan and preceded by a competitive process, such as a public auction or a private competitive process organised by a professional agent. Public auction processes have typically taken 30 to 90 days from the court confirmation order.

Law stated - 29 October 2021

Tax treatment

What tax liabilities and related considerations arise in relation to the various structures for distressed M&A transactions in your jurisdiction?

In essence, two main considerations usually arise in relation to distressed M&A transactions in Brazil under a tax perspective:

1. tax treatment applicable to the taxable capital gain derived by the seller, if any; and
2. tax succession rules affecting the target company and target assets and, therefore, the buyer.

As to item (1), it is worth mentioning that groups under distress usually register significant amounts of net operating losses (NOLs). As a general rule, NOLs can be carried forward indefinitely but can only be used to offset up to 30 per cent of the taxable profits of the period. In the case of a company disposing assets (including equity stake in other companies), only 30 per cent of the taxable gain can be offset against NOLs and the corporate income taxes due on the remaining amount may require a cash disbursement, which is particularly challenging in cases of financial distress.

The changes recently implemented to the Brazilian Bankruptcy Law have addressed this issue of companies disposing assets and rights within the context of judicial recovery or bankruptcy, as authorised by the reorganisation plan or by the court: these companies are authorised to fully offset the capital gains against the NOLs and the 30 per cent cap does not apply. This is a positive legislative development towards the recovery of companies in financial distress, although the scope of the legal provision is limited to judicial sales implemented by companies under judicial reorganisation or bankruptcy.

As to item (2), it is also true that companies under financial distress are parties to several administrative and judicial proceedings related to tax liabilities, apart from the non-materialised tax liabilities. This brings a certain level of concern to acquirers under distressed M&A as to the tax liabilities that can affect the business going forward.

The general protection applicable to the disposal of isolated productive units also covers tax liabilities. Indeed, the National Tax Code sets forth that the acquirer of assets comprising a going concern within the context of a judicial sale of a UPI of a company under bankruptcy or judicial reorganisation does not inherit the tax liabilities attached to such a going concern. This protection is lifted if the acquirer is a related party to the seller.

If the acquisition of a distressed asset is not implemented under the format of a judicial sale of a UPI, general tax succession rules will apply whereby the buyer will become subsidiarily liable for the taxes inherent to the business developed with the acquired going concern if the seller continues its transactions (or new transaction) in the following six months. If the seller discontinues its activities, the buyer becomes jointly liable for the tax liabilities attached to the

going concern. Other tax succession liability rules may apply, depending on the format of the acquisition.

Law stated - 29 October 2021

Auction versus single-buyer sale process

What are the respective pros and cons of auction sales and single-buyer sales? What rules and common practices apply to each?

Pursuant to the Brazilian Bankruptcy Law, for a sale under a reorganisation proceeding to be carried out free and clear from the liens and liabilities of the debtor it must be performed as an auction or a competitive process, which provides protection for buyers against succession liabilities of the debtor. However, auction sales are typically more complex and may take longer than single-buyer sales. The auction sale must be provided for in the reorganisation plan approved by the creditors and confirmed by the bankruptcy court. Following court confirmation of the plan, the auction sale may be implemented. Before the amendment of the Brazilian Bankruptcy Law, the auction sale had to be public and preceded by the publication of court notices. After the amendment, the Brazilian Bankruptcy Law provides for an alternative competitive process organised and conducted by a specialised agent and such a process shall be detailed in the reorganisation plan, which may expedite auction sales performed in the context of reorganisation proceedings.

Law stated - 29 October 2021

DUE DILIGENCE

Key areas

What are the most critical areas of due diligence in a distressed M&A transaction?

The Brazilian Bankruptcy Law provides that in isolated productive unit (UPI) sales or sales pursuant to a public auction or other organised competitive process, the purchaser does not take on the obligations of the debtor (seller), so that the scope of the due diligence in these cases tends to be narrowed to identify liabilities that are inherent to the assets under negotiation themselves (eg, liens and ownership of the assets, propter rem obligations and, in the case of an equity deal, the liabilities of the entity being acquired itself). The due diligence should also cover contracts that are key to the business, such as financial and commercial agreements in general (clients and suppliers, including governmental authorities), as purchasers should be aware of any change of control or other provisions to be addressed as condition precedent to the closing of the relevant transaction or other aspects that could impact the acquired business.

In the case of distressed transactions carried out outside a formal insolvency proceeding, the UPI sale protections provided by the Brazilian Bankruptcy Law do not apply, so besides the full investigation with respect to the target, the due diligence should also cover sellers' and their group's liabilities to adequately assess clawback risks and succession risks.

Law stated - 29 October 2021

Searches

What searches of public records should be conducted as part of a due diligence exercise in distressed M&A transactions in your jurisdiction?

The same searches are required that a purchaser would perform in standard M&A transactions, mainly focused on court certificates on existing lawsuits, tax clearance certificates and other customary certificates (labour debts, protest offices etc.). There are other documents and information that, as a rule, may be obtained independently, such as

corporate documents filed with the Board of Trades, court records, real estate enrolment certificates issued by the Real Estate Registry Offices and collateral instruments filed with the applicable Registry of Deeds and Documents, among others. Depending on the corporate type of the involved entities, such entities may also be required to publish their financial statements in the newspapers, thus allowing the relevant accounting and financial information to be easily accessed.

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Contractual protections and risk mitigation

What contractual protections and other strategies are commonly used to mitigate diligence gaps in a distressed M&A transaction?

The same contractual protections and other strategies typically used to mitigate diligence gaps in non-distressed M&A transactions, such as representations and warranties and indemnification provisions in general, are used. However, in view of the insolvency of sellers in distressed M&As, purchasers must seek further protections to ensure that they will be indemnified for losses arising from past liabilities. Such additional protections are generally structured as escrow accounts, purchase price holdback, collaterals over sellers' remaining assets and third parties' collateral.

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VALUATION AND FINANCING

Pricing mechanisms and adjustments

What pricing methods, adjustments and protections are commonly used in the valuation of distressed M&A transactions in your jurisdiction and what are the pros and cons of each? How are they used to balance the interests of the parties?

Despite the growing practice of distressed M&A transactions in Brazil, there are no prevailing pricing methods, adjustments or protections. Any mechanisms used in non-distressed M&A transactions may also apply to distressed scenarios: M&A transactions in Brazil typically provide for locked-box structures, but structures involving price adjustments based on confirmation of the net working capital and net debt or earn-out are also used. If the parties agree on a price adjustment structure, escrow and holdback provisions are highly recommended as the seller may not have funds available to pay the adjustments to the purchaser. Earn-out provisions are most likely adopted in transactions whereby the target remains somehow dependent on sellers, so that the interests of both sellers and purchasers are aligned in reaching a certain goal, thus contributing to the growth of the business, or when there is a relevant pricing gap arising from different perceptions on future perspectives. In distressed M&A transactions within a formal insolvency proceeding, these and other terms of the purchase agreements are usually negotiated by stalking horses that will determine base offers (bidding offers) and in return will benefit from certain rights, such as break fees and right to match.

Law stated - 29 October 2021

Fraudulent conveyance

What rules govern fraudulent conveyance of distressed assets sold undervalue in your jurisdiction? How can clawback risks be mitigated when negotiating the deal price?

Brazilian fraudulent conveyance rules are dispersed throughout a number of different laws and can be summarised in

three different rules: fraud against creditors, fraud against foreclosure proceedings and fraud against tax collection.

As a general rule, creditors may be able to claw back a sale if the debtor was insolvent at the time of the sale or became insolvent as a result of the sale and buyer as intended to defraud creditors (although the mere awareness of the fact that such a transaction may harm creditors may be construed as such intention). Brazilian laws contain no specific provisions requiring that assets are sold undervalue for the purpose of considering a sale fraudulent.

Fraud against creditors is provided for in the Brazilian Civil Code and is applicable to private creditors in general. Unsecured creditors may challenge an onerous sale of assets and may be able to claw back a sale if the seller was notoriously insolvent at the time of the sale or if the buyer had reason to know the insolvent status of the debtor.

Fraud against foreclosure proceedings occur if at the time of the sale there were lawsuits pending against the debtor that could make the debtor insolvent. Any creditor (including private and labour creditors) that filed a foreclosure proceeding before the sale may challenge the transaction and request the clawback.

Fraud against tax collection is ruled by the Brazilian Tax Code and is used by the tax authorities to challenge a sale if the debtor has no other assets or revenues to pay the amount of judicially disputed tax debts (débitos inscritos na dívida ativa).

In addition to the general rules mentioned above, in case of bankruptcy proceedings, a sale performed before the bankruptcy decree is considered ineffective, regardless of the intention of the parties to defraud creditors if, as a result of the sale, the debtor remained with no other assets or revenues to pay all its debt, provided that the debtor did not obtain the approval or payment in full of all existing creditors before the conclusion of the sale. Also, any other act taken by the debtor with the intent to defraud creditors may be revoked under a bankruptcy proceeding if filed within three years from the bankruptcy decree.

Clawback risks may be mitigated under a reorganisation proceeding if the sale is either approved by the bankruptcy court or provided for in the reorganisation plan approved by the creditors and confirmed by the bankruptcy court.

Law stated - 29 October 2021

Financing

What forms of financing are available and commonly used in distressed M&A transactions? How can financing be secured?

The same structures of acquisition financing available to buyers in traditional M&A transactions may be used in distressed M&A transactions.

These types of financing are primarily provided in the Brazilian distressed M&A market by investment funds managed by alternative and distressed asset managers and the special situations desks of banks.

Furthermore, these financing transactions are usually implemented by means of collateralised debt instruments such as debentures and bank credit notes.

The type and the structure of the security requested by creditors in these transactions vary depending on the credit risk of the buyer, the size of the deal, the underlying asset, the ability of the target company or asset to generate free cash flow, the liquidation value of the target company or asset and other factors commonly examined in credit risk analyses of this nature. Despite that, these transactions are commonly secured by fiduciary liens over the acquired shares or assets, the hard assets of the target company and its receivables.

Law stated - 29 October 2021

Pre-closing funding

What provisions are typically agreed to secure pre-closing funding of distressed businesses and assets?

Companies under judicial reorganisation in Brazil may secure pre-closing funding by means of debtor-in-possession financing transactions.

Although the Brazilian Bankruptcy Law does not set forth that the debtor-in-possession financing must be necessarily approved by the bankruptcy court or the company's creditors, it does provide that the encumbrance of non-current assets of the company, which is not contemplated in the judicial reorganisation plan approved by creditors and confirmed by the bankruptcy, must be authorised by the bankruptcy court after creditors and the judicial administrator are heard.

To that extent, considering that this kind of transaction in Brazil is usually secured by these sorts of assets of the company, it is common that the collateral package of the debtor-in-possession loan must be approved by the bankruptcy court, especially in cases in which the debtor seeks financing prior to the approval of its reorganisation plan.

It has become more frequent in the Brazilian distressed M&A market for debtor-in-possession loans to be raised by companies undergoing judicial reorganisation, usually secured by the proceeds of future M&A transactions and the shares of the target company or asset, so that such companies can fund their operations before closing of such potential M&A transactions.

Law stated - 29 October 2021

DOCUMENTATION

Closing conditions

What closing conditions are commonly agreed in distressed M&A transactions? How do these differ from non-distressed transactions?

Besides the closing conditions that apply to non-distressed M&A transactions, such as the accuracy of representations and warranties, no breach of covenants, third parties' waivers (including those pf governmental authorities, such as antitrust and specific regulatory authorities), in the case of transactions conceived within judicial reorganisations as per the Brazilian Bankruptcy Law, the requirements of such law and the relevant judicial reorganisation plan should also be met. The Brazilian Bankruptcy Law provides, among others, that the legal term for the filing of any appeal must have elapsed or, in the case that an appeal has been filed, there should be no court decision still in force giving suspension effects to such appeal filed against a court decision ratifying the judicial reorganisation plan or a court decision ratifying the winning offer under the bid.

The completion of a corporate reorganisation is also commonly addressed as a closing condition in isolated productive unit (UPI) sales within formal insolvency proceedings whenever such a UPI comprises the incorporation of special purpose vehicles. Considering that the Brazilian Bankruptcy Law does not allow the sale of all the assets of debtors, the consummation of the transaction is typically preceded by a reorganisation aiming at segregating certain assets of the debtor's group.

With respect to MAC clauses, there is no consolidated market practice for negotiating such clauses in distressed M&A transactions, so these are dealt with as in any M&A transaction (including non-distressed ones). It is expected, however, that sellers would negotiate carving out credit-related issues from the MAC definition.

Law stated - 29 October 2021

Representations, warranties and indemnities

What representations, warranties and indemnities are commonly given in distressed M&A transactions?

In case of distressed M&A transactions conceived as UPI sale, the Brazilian Bankruptcy Law provides for certain protections whereby purchasers do not succeed the obligations of debtors (sellers), so although representations and warranties are negotiable as in any other M&A transaction, they may be limited to liens and ownership of the assets, propter rem obligations, and those aiming at preserving the business.

Although indemnification provisions are usually included in the transaction documents pursuant to the same standards as typical M&A transactions, considering that sellers in distressed M&As are inevitably non-creditworthy entities it is expected that buyers will rarely rely on simple indemnification provisions. As a result, to address specific indemnification concerns, buyers will need to pursue comfort via alternative structures, such as holdbacks, escrow deposits or third-party guarantees, just to mention some examples.

In the case of distressed transactions carried out with companies that are not under judicial reorganisations, the representations, warranties and indemnities are very similar to those negotiated in non-distressed M&A transactions.

Law stated - 29 October 2021

Remedies for breach

What remedies are available and commonly sought for breaches of closing conditions, representations, warranties and indemnities in distressed M&A transactions?

Besides those remedies available in any M&A transactions, such as termination of the agreement, indemnities and penalties, in case the consummation of the M&A is set forth in the judicial reorganisation plan, the breach of the provisions of the plan by the debtor (seller) may cause the debtor's judicial reorganisation to be converted into bankruptcy.

Law stated - 29 October 2021

Insurance

Is warranty and indemnity (W&I) insurance available for distressed M&A transactions in your jurisdiction? If so, what provisions and exclusions are commonly included in W&I policies?

Although available in Brazil, M&A insurances are not commonly contracted for M&A transactions (neither for non-distressed nor for distressed transactions); thus, there is no market practice established for the provisions and exclusions therein.

Law stated - 29 October 2021

REGULATORY AND JUDICIAL APPROVALS

Merger control

What merger control rules and filing requirements govern the acquisition of distressed businesses and assets in your jurisdiction? Is the 'failing firm' defence recognised in your jurisdiction?

There are no specific merger control rules or filing requirements governing the acquisition of distressed businesses and assets in Brazil – these transactions will follow the same rules and review procedure of any other M&A transactions. While the failing firm defence is recognised by the Brazilian antitrust authority (the Administrative Council for Economic Defense – CADE), it is rarely accepted by the authority – according to CADE's Horizontal Merger Guidelines (the Guidelines) the authority has been extremely cautious with the implementation of such theory, requiring the applicants to prove:

- that, in if the transaction is blocked by CADE, the company would either exit the market or would be unable to fulfil its financial obligations as a result of its economic and financial difficulties;
- that, if the transaction is blocked by CADE, the company's assets would not be kept in the market, which could result in reduction of supply, higher concentration levels in the market and reduced economic welfare; and
- that the company made efforts to seek alternatives that were less harmful to competition (eg, sale to other buyers or undergoing a judicial recovery proceeding (to avoid bankruptcy)) and the transaction submitted to CADE was the only solution that would preserve the economic activities of the company.

In addition to meeting all the requirements above, to apply the failing firm theory CADE must also have concluded that the harm to be caused by prohibiting the transaction (and of the following – likely – bankruptcy of the company) is greater than the harm to be caused by the concentration resulting from the transaction.

Law stated - 29 October 2021

Foreign investment review

Are distressed M&A transactions subject to foreign investment review in your jurisdiction? What rules, procedures and common practices apply?

Distressed M&A transactions do not differ from non-distressed ones with respect to foreign investments. The Brazilian Central Bank is responsible for regulating and overseeing the foreign exchange transactions and inflow and outflow of foreign currency in Brazil, pursuant to the guidelines set forth by the Brazilian Monetary Council, so in Brazil, certain transactions carried out between, on one hand, residents in Brazil and, on the other hand, non-residents (eg, direct investment and remittance of dividend) must be electronically registered with BACEN through BACEN's electronic system (SISBACEN).

Law stated - 29 October 2021

Bankruptcy court

What rules and procedures govern the bankruptcy court's approval of distressed M&A transactions in your jurisdiction?

If a distressed M&A transaction involves the transfer of non-current assets of the debtor (which normally is the case) it must be submitted to the bankruptcy court's approval or, alternatively, be provided for in the reorganisation plan approved by the meeting of creditors and confirmed by the bankruptcy court. Following the amendment to the Brazilian Bankruptcy Law in December 2020, the sale of non-current assets of the debtor may also be approved by a creditors' meeting specially called for this purpose.

Law stated - 29 October 2021

DISPUTE RESOLUTION

Common disputes and settlement

What issues commonly give rise to disputes in the course of distressed M&A transactions and what practical considerations should be borne in mind when seeking to settle such disputes out of court?

Companies undergoing financial difficulties frequently default in performing or fulfilling an obligation under the sales agreement. Consequently, distressed M&A disputes usually involve discussions of non-performance. Disputes may arise at all stages of the M&A transaction. In between the signing and closing, for example, it is common for disputes to arise over the non-fulfilment of conditions precedent or other contingent obligations set out in the agreement. At the pre-signing stage, on the other hand, these disputes commonly relate to alleged breaches of the agreements regulating the early stages of the deal: memoranda of understanding, letters of intent and confidentiality agreements, for example.

Disputes involving the parties' liabilities for material contingencies after the closing are also frequent, notably the ones with respect to their extent and quantification.

In settling such disputes out of court, parties must bear in mind that agreements on certain matters, depending on the specifics of the case, must be sanctioned by the insolvency court and may be subject to objections from the insolvent party's creditors, the judicial administrator and the Public Prosecutors' Office. As such, the parties should consider involving the insolvent party's creditors (and even the judicial administrator and the Public Prosecutors' Office) in the negotiations and obtain their prior approval of the terms of the settlement agreement to avoid future objections.

The sale of a distressed company or its assets can be made before insolvency proceedings are initiated. In this case, there is a risk that disputes may arise regarding the effectiveness of the transaction once the proceedings are initiated.

When insolvency proceedings are pending and the transaction occurs within the insolvency proceedings or with the insolvency court's authorisation, two types of disputes are more common: in a direct sale of a distressed company or its assets, creditors may object to the terms of the sale (alleging that it is not in the creditors' best interest, objecting to its format, value, etc) and request the court not to reject the transaction; and in the sale of an isolated productive unit (UPI) (which is subject to a bidding competitive process), creditors may also object to the deal's format and value, as well as claim that the sale did not comply with the provisions of the reorganisation plan regarding the sale of the UPI, if this is the case.

In settling such disputes out of court, parties must bear in mind that a settlement agreement must be sanctioned by the insolvency court and may be subject to objections from the insolvent party's creditors, the judicial administrator and the Public Prosecutors' Office. As such, the parties should try to involve the insolvent party's creditors (and even the judicial administrator and the Public Prosecutors' Office) in the negotiations and obtain their prior approval of the terms of the settlement agreement to avoid future objections.

Law stated - 29 October 2021

Litigation and alternative dispute resolution

What litigation forums are used to resolve disputes arising from distressed M&A transactions in your jurisdiction and what procedures apply? Is alternative dispute resolution (ADR) commonly used?

Arbitration is commonly – and predominantly – used in disputes arising out of M&A transactions in Brazil, which is viewed as an arbitration-friendly jurisdiction. There is no difference when it comes to distressed M&A transactions, but

there are certain particularities that should be borne in mind by the parties in the context of such deals.

Consistent with Brazilian courts' long consolidated case law on the subject, the changes recently introduced to the Brazilian Bankruptcy Law include express recognition that an arbitration agreement remains valid despite the commencement of judicial reorganisation or bankruptcy proceedings. Consequently, neither creditors nor insolvent parties are prevented from commencing or continuing arbitration after judicial reorganisation proceedings have been commenced or after a bankruptcy request is filed. In addition, courts cannot stay ongoing arbitrations due to a party's insolvency.

Indemnification, termination or nullification claims, and claims arising out of the non-performance of obligations provided for in the sales agreement are generally accepted to be arbitrable.

On the other hand, according to recent precedents, arbitral tribunals do not have the power to decide on certain matters regarding the disposal of assets of insolvent parties undergoing reorganisation proceedings or matters which may affect the insolvent party's ability to overcome its financial distress (eg, arbitral tribunals may not decide on the sale, freezing or seizing of assets of insolvent parties).

This is consistent with section 76 of the Brazilian Bankruptcy Law, pursuant to which bankruptcy courts have the exclusive jurisdiction to hear all lawsuits involving the insolvent's assets, interests and business with three big exceptions: labour claims, tax claims and lawsuits not directly related to insolvency issues or not governed by the Brazilian Bankruptcy Law in which the insolvent party acts as plaintiff or co-plaintiff. The vis attractiva concursus also does not extend to disputes over unquantified credits. Case law in Brazil has recently extended the prerogatives provided under section 76 of the Brazilian Bankruptcy Law to judicial reorganisation courts, and this is also in line with sections 7-A and 7-B of the Brazilian Bankruptcy Law, according to which reorganisation courts enjoy the power to suspend or even modify any seizure orders against the insolvent party's assets considered to be essential to its business.

The final decision on whether the dispute shall or shall not be subject to arbitration and submitted to the insolvency court, will depend greatly on the facts and circumstances of the case and especially on whether the outcome of the claims in the arbitration can be considered to potentially affect the insolvency proceedings directly.

It should also be noted that claims of fraud against enforcement proceedings, against creditors or any other clawback claims (brought by creditors or other interested parties) in the context of distressed M&A transactions that were closed before the existence of insolvency proceedings or without the approval of the insolvency court or creditors, will be decided by state courts.

Conciliation and mediation are now expressly encouraged before and during judicial reorganisation proceedings, at any appellate level, as per the new article 20-A of the Brazilian Bankruptcy Law. According to the Brazilian Bankruptcy Law, these proceedings may deal, for example, with disputes between the shareholders of the party in financial distress or matters involving the renegotiation of debts with creditors. Conciliation and mediation proceedings to discuss the legal nature and the classification of credits or general creditors' meeting voting criteria are not allowed.

Law stated - 29 October 2021

UPDATE AND TRENDS

Recent developments and outlook

What have been the most significant recent developments and trends affecting distressed M&A in your jurisdiction, including any notable court decisions, regulatory actions and deals? What is the general outlook for future transactions?

The reform to the Brazilian Bankruptcy Law that took place at the end of 2020 brought several innovations that were

welcomed by the market in general. One of the topics of the Brazilian Bankruptcy Law that underwent important changes relates to the sale of assets, in which relevant provisions were included aiming to:

- reinforce the absence of succession of the investor in the debtor's contingencies;
- strengthen the impossibility of declaring the transaction null and void based on fraudulent conveyance rules; and
- discourage litigation in these transactions that could delay their implementation.

In addition, Brazilian case law has been consolidating the understanding that investors that acquired isolated productive units in formal insolvency proceedings may not be held liable for contingencies of the debtor, which creates a favourable environment for distressed M&A transactions.

This favourable environment can already be seen, for example, in the recent distressed M&A transactions that have been carried out by Oi Group (one of the biggest telecommunication companies in Brazil) and Renova Group (a significant player in the Brazilian energy sector) in their respective judicial reorganisations proceedings.

The new wave of economic instability brought by the covid-19 pandemic is expected to greatly increase judicial reorganisation activity in the coming years as companies seek protection against creditors. In this context, it is possible to expect that the number of distressed M&A transactions will also rise considerably, in view of the favourable situation of this market and that the sale of assets still seems to stand out in Brazil as the main source of funding for companies financially troubled companies.

Law stated - 29 October 2021

Jurisdictions

Austria	Wolf Theiss
Brazil	Machado Meyer Advogados
Bulgaria	Wolf Theiss
Canada	Cassels Brock & Blackwell LLP
France	JEANTET
Greece	VAP Law Offices
Hungary	Wolf Theiss
Netherlands	Van Doorne
Poland	Wolf Theiss
Portugal	PLMJ
Romania	Wolf Theiss
Switzerland	Walder Wyss Ltd
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