ARTIGO

DIP FINANCE REGIME IN BRAZIL AND THE ESCHER'S DRAWINGS: A DIALOGUE WITH AURELIO GURREA-MARTÍNEZ

CÁSSIO CAVALLI
Professor da FGV Direito SP
advogado e parecerista

Dear Aurelio Gurrea-Martínez, I am glad to hear that my previous comments were helpful for your working paper.[1] It's always great to be able to contribute to your relevant work. Here follows my answers to your questions on the DIP financing Brazilian regime.

It is indeed paradoxical that unsecured DIP lenders may have a better position than secured DIP lenders under Brazilian insolvency law. From my understanding, this outcome was a severe mistake in drafting the legislation in 2005 that was reinforced by the 2020 reform, and provides good evidence that Brazilian legislator did not have the slightest idea about the functions of priorities in bankruptcy, the best international practices on financing distressed companies, and how dealing with priorities can be used to overcome agency problems resulting from a debt overhang situation. Although the declared intention of the Brazilian legislator both in 2005 and 2020 was to import the US model of DIP financing, the mere use of the acronym DIP without understanding its meaning is not enough to import the US DIP financing model to Brazilian legislation.

Since Brazilian law doesn't provide secured creditors with a priority over the proceeds of the encumbered asset (such proceeds can be used to pay general creditors, such as labor creditors, and administrative expenses first), any administrative expense will allways rank above all secured creditors. Thus, the concept of "secured creditor" pursuant Brazilian law is radically different from the concept of secured creditor under the laws of almost all other jurisdictions in the world. The expression "secured creditor" is used in a misleading way by the Brazilian law, as it refers in reality to a kind of

[1] GURREA-MARTÍNEZ, Aurelio, The Treatment of Debtor-in-Possession Financing in Reorganization Procedures: Regulatory Models and Proposals for Reform (March 28, 2022). *European Business Organization Law Review* (Forthcoming, 2023); Singapore Management University School of Law Research Paper No. 3/2022, Available at SSRN: https://ssrn.com/abstract=4067966 or http://dx.doi.org/10.2139/ssrn.4067966

CAVALLI, Cássio. DIP finance regime in Brazil and the Escher's drawings: A dialogue with Aurelio Gurrea-Martínez. *Agenda Recuperacional*. São Paulo. v. 1, n. 6, p. 1-4, mar./2023. Disponível em: www.agendarecuperacional.com.br. Acesso em:

general creditor (in the meaning adopted by the entire world, except the current Brazilian law), i.e., meaning any creditor ranking below secure creditors and administrative expenses, and above unsecured creditors. Brazilian law shuffles the terms and the ranks of general creditors, administrative expenses and secured creditors in the order of priorities.

The clearcut legal recognition of the priority of secured creditors over administrative expenses and general creditors would be the first step towards the adoption of a DIP financing regime in Brazil analogous to the US DIP financing regime. It would also be a necessary step for the adoption by the Brazilian law of the absolute priority rule in reorganization proceedings. As the legislator cannot understand the meaning of the worldwide adopted concept of secured debt, you can imagine how far the Brazilian law is from the idea of adopting rules granting priority to DIP loan and other rules such as the protection of secured creditors against cramdown. Therefore, the legal discipline governing priority of new loans (either secured or unsecured) during a reorganization are based on premises quite different from the US law and almost all jurisdictions in the world (as explored in your paper).

For the reasons above and several others, there is a sharp decline of secured debt in Brazilian financing transactions (albeit similar to the decline of secured debt in the US). The most used structure for the function of provide security to creditors is the so called "alienação fiduciária em garantia", which is a full transfer of property title of an asset (including receivables) to the creditor to secure the debt; i.e., "alienação fiduciária" is not a lien posed over a debtor's property, but a kind of securitization of assets that segregates the asset in another entity (which is the same entity providing the loan). For such reason, the asset transferred in "alienação fiduciária" before the commencement of a bankruptcy is not property of the bankruptcy estate. Therefore, the creditor holding the property title of the assets is protected by a super-absolute priority, meaning that she can individually holdout of any restructuring plan, i.e., has a super-protection against cramdown similar to the protection against intraclass cramdown conferred to secured creditors by US bankruptcy law before 1978. Therefore, "alienação fiduciária" is the most used legal structure to secure debt in Brazil, including DIP financing in reorganizations.

To provide a DIP financing with "alienação fiduciária", the estate has to transfer the property title of an asset to the DIP lender. This transfer is governed by article 66 of Brazilian law on the sale of bankruptcy property, adopted since 2005 law, including the necessity of court's authorization. (Despite dealing with the sale of property of the estate, in my opinion, article 66 was probably written based on an uneducated reading of § 364 of US law.) Anyway, in this sense, the 2020 reform did not change anything in the 2005 regime of DIP financing.

Nevertheless, here follows one more contradiction of the Brazilian law since 2005: despite treating secured creditors as general privileged

creditors (without priority and without protection against cramdown), Brazilian law provides secured creditors with an individual veto against the sale of the encumbered asset by the estate. This veto may function as a protection against the priming that would result from an “alienação fiduciária” of encumbered assets, since the secured creditor can veto the “alienação fiduciária” to the DIP lender. But such power of veto cannot prevent an unsecured DIP loan (either with or without court authorization) from priming all secured creditors!

There are other interesting provisions regarding the DIP financing. Before the reform in 2020, article 67 of the Brazilian law provided for an automatic roll-up of the pre-petition unsecured credit of the DIP lender (without court authorization) to a general privileged rank. Since the reform revoked all hyphotesis of the named "general privileged creditors" in the rank of creditors, the reform also revoked such provision. A law that doesn't understand the priority of a secured creditor (in relation with unsecured creditor, general privileged creditor and administrative expenses), the meaning of priming, and how roll-ups lead to sub-rosa strategies, is a law that leaves room for manipulation and inefficient results, both ex post and ex ante. You can imagine how capital markets assess ex ante the recovery in a liquidation scenario.

Regarding your question based on art. 69-A to F, whether court approval is required to grant an administrative expense (meaning the Brazilian super administrative expenses with automatic priming over all secured creditors) to an unsecured DIP loan, the answer is: court approval is required for unsecured DIP loan rank second in the administrative expenses list (art. 84, I-B); but is not required to grant a lower super-administrative expense under art. 84, I-E. The latter refers to any financing under article 67 extended to the debtor during the reorganization by suppliers or lenders. Such article provides for an hypothesis of DIP loan (i) to finance the regular course of business or the restructuring expenses (ii) priming all secured creditors (bold emphasis on "all") (iii) without court authorization. The only possibile conclusion is: if you look at the underlying functions of the Brazilian legal provisions, you will see a kaleidoscopic and paradoxical picture very different from the structure and meaning of rules from US and other jurisdictions governing DIP financing. Brazilian law really resembles one of M.C. Escher's drawings.

Nevertheless, one cannot deny that the Brazilian regime governing DIP financing grants the most favorable treatment to DIP lenders, since all DIP loans (except the secured ones) extended to finance either the ordinary course of business or the reestructuring of the debtor will allways prime all the secured creditors even without court authorization. Although it has resulted from thoughtless provisions, Brazilian DIP finance regime unequivocally is a "Super-strong DIP finance regime".

CAVALLI, Cássio. DIP finance regime in Brazil and the Escher's drawings: A dialogue with Aurelio Gurrea-Martínez. *Agenda Recuperacional*. São Paulo. v. 1, n. 6, p. 1-4, mar./2023. Disponível em: www.agendarecuperacional.com.br. Acesso em:

I hope my comments can be useful for your research. Thank you again for your message and good luck with your paper. By the way, I was sorry to miss Rio as well but I hope to meet you in person soon.

Abraços, Cássio

- Updated in 23.march.2023

CAVALLI, Cássio. DIP finance regime in Brazil and the Escher's drawings: A dialogue with Aurelio Gurrea-Martínez. *Agenda Recuperacional*. São Paulo. v. 1, n. 6, p. 1-4, mar./2023. Disponível em: www.agendarecuperacional.com.br. Acesso em: