CAVALLI, Cássio. A reforma da falência: primeiras impressões sobre o PL 03/2024. *Agenda Recuperacional*. São Paulo. v. 1, n. 28, p. 1-4, jan./2024. Disponível em: www.agendarecuperacional.com.br. Acesso em:

ARTIGO

A REFORMA DA FALÊNCIA: PRIMEIRAS IMPRESSÕES SOBRE O PL 03/2024

CÁSSIO CAVALLI
Professor da FGV Direito SP
advogado e parecerista

In the matter of financing distressed corporations, the keyword is only one: priority. After all, what drives away potential lenders from distressed corporations is the situation of debt-overhang. The reason for this is simple: when assessing the possibility of financing a highly leveraged corporation, the financier nurtures the well-founded fear that, as soon as she provides the loan, the other creditors will run ahead to serve themselves of the new resources contributed. Therefore, the distressed debtor will not be able to finance its assets, even if they should be financed because they have positive present value, that is, the investment is capable of benefiting both the lender and the other creditors of the corporation. Therefore, in the finance terminology, situations of debt-overhang lead to situations of underinvestment.

The fact that there is technical terminology to diagnose and solve the problem indicates that it is a problem with a known solution. And the solution is only one: priority, priority, priority. In the terminology of finance, it is said seniority. Senior is the creditor who is paid before junior creditors. Thus, to finance viable assets of leveraged debtors, it is enough to ensure the lender a priority of payment before the other creditors of the corporate debtor. Such provisions avoid that the new resources evaporate, like water on a hot plate, before irrigating the projects with a positive NPV.

It is based on this theory of finance that finance professionals who work in financial institutions, investment funds, institutional lenders and any other investors will assess opportunities for financing distressed corporations anywhere in the world. The decision to finance will depend on the finding that the corporation has projects with positive NPV and that the lender will have seniority over the other creditors. Therefore, legal institutions must be attentive to the assessement criteria used by these investors. In summary, without seniority, no financing. Therefore, to finance economically viable companies, which are those that have positive NPV, the Brazilian Bankruptcy Law must ensure to the lender a position of priority in the payment of her credit.

Nevertheless, despite the simplicity of the theory of finance and the possible legal solutions to the debt-overhang problem, it seems that the original and reformist legislator

CAVALLI, Cássio. A reforma da falência: primeiras impressões sobre o PL 03/2024. *Agenda Recuperacional*. São Paulo. v. 1, n. 28, p. 1-4, jan./2024. Disponível em: www.agendarecuperacional.com.br. Acesso em:

of the Brazilian Bankruptcy Law did not understand this lesson. Before the reform, whoever lent money to a corporation under judicial reorganization would be ranked as an extraconcursal credit (the equivalent of an administrative expense rank), in the classification that provided by the incise V of article 84 along with the article 67 of the Brazilian Bankruptcy Law. If the lender wanted to have a higher seniority, it would not help to obtain a lien over the debtors assets, since in Brazilian Bankruptcy law secured creditors are treated as true general privileged creditors, as they rank below other general privileged creditors such as the labor creditors, and the administrative expenses (which are true super-general privileges).

Thus, to obtain a higher seniority, the financier would have to obtain the property title of debtors assets (alienação fiduciária em garantia or fiduciary assignment in security) in order to rank as the holder of the right of restitution of the asset, above the administrative expenses and the general creditors. Even before the reform of the Brazilian Bankruptcy Law, it was said that the level of seniority of DIP lenders without the security interest granted by alienação fiduciária would not be enough to encourage new financing.

The recent reform of the Brazilian Bankruptcy Law included provisions in Section IV-A (articles 69-A to 69-F) so that the debtor could obtain court authorization to encumber debtor's assets (both by pledges or mortgages and by fiduciary assignment in security) in benefit of the lender. It was imagined that, with the creation of such security interest, the priority of the lender would be assured.

On one side, the position of the DIP lender without court authorization received a timid promotion of rank by the reform and passed ahead of the loan made to the bankrupt estate in liquidation, of the expenses with collection, administration, realization of the asset in bankruptcy and some other administrative costs. On the other hand, the DIP lender who obtains court authorization to encumber assets in guarantee will supposedly figure three houses above, at the level of the incise I-B of article 84 of the Bankruptcy Law. I say supposedly because, by constituting a security interest as secured creditor, the DIP lender will have a secured credit, which are located in a much lower hierarchy, at the level of article 83, II, of the Brazilian Law. Here, the legislator left a paradox. By authorizing the constitution of a security interest in favor of the DIP lender, this credit will be, at the same time, a credit with a general privilege (although named as a secured credit by the law), and an administrative expense, ranking far above. Let us see what will be the priority that the courts will recognize to the DIP lender in the cases in which the judicial reorganization is converted into liquidation. Until then, there is a serious risk of DIP lenders abstaining from financing, under the correct argument that there is legal uncertainty.

To avoid such insecurity, the reform should have restored the absolute priority rule that used to govern secured credits before the Bankruptcy Law of 2005, in the terms of what was foreseen on article 125 of the previous Bankruptcy Law (Decree-law 7.661/1945). (This is one of the greatest ironies of the Brazialian Bankruptcy Law of 2005. It was enacted under the influence of the World Bank to provide the Brazilian law with bankruptcy provisions similar to the US Bankruptcy Law. Something certainly was

CAVALLI, Cássio. A reforma da falência: primeiras impressões sobre o PL 03/2024. *Agenda Recuperacional*. São Paulo. v. 1, n. 28, p. 1-4, jan./2024. Disponível em: www.agendarecuperacional.com.br. Acesso em:

lost in translation, and, as result, the current Brazilian Law revoked the perfect old legal provisions on the absolute priority rule and did not adopt any provisions regarding such rule. As a result, there is no more absolute priority rule and the so called secured creditors are not secured creditors anymore, but in reality general privileged creditors.) The Bankruptcy Law reform of 2020 lost the opportunity to restore the dignity of the secured creditors in Brazilian law and, incidentally, to grant priority of DIP lenders to foster loans to viable corporations under judicial reorganizations.

The paradox does not stop there. There is another one, although upside down. If there is court authorization for DIP loan, the credit will rank at the administrative expense level, according to article 84, I-B, of the Brazilian Bankruptcy Law. Such provision could be construed, mistakenly in my view, in the sense of the DIP loan granted by fiduciary assignment in guarantee should also rank at the administrative expense level (article 84, I-B) and not as a restitution claim, the highst possible rank in Brazilian bankruptcy proceedings (article 85 c/c article 149 of the LRF). In my opinion, the law should be construed in favor of the seniority of the DIP lender.

It can be seen from the above that orders of priority were not the strength of the reform of the Brazilian Bankruptcy Law. These orders are also relevant even before insolvency, as they are taken into account when financing operations are originated, by projecting the hierarchy of credit in the worst possible scenario, which is the bankruptcy liquidation. In this case, by enforcing the priority of the credit as contracted in bankruptcy proceedings ensures an ex ante efficient financing. Therefore, the reform included the provision of article 69-C of the Bankruptcy Law, which says that the court will cannot authorize the creation of a lien in favor of the DIP lender over assets that are already encumbered in guarantee. This provision was included to make clear that secured creditors would not be lowered by judicial imposition. Such provision intended to say that, in the Brazilian system, unlike what happens in the US bankruptcy system, there is no possibility of creating a priming lien, that is, the judicial imposition of a new lien senior to the lines already created over the same assets. However, as the reformist legislator maintained unchanged the treatment of the secured creditor as a true general privilege, a strange situation was reached. If the DIP lender obtains court authorization to create a lien (article 69-C), the encumbered assets must be free, as there will be no priming lien by judicial imposition. However, if the DIP lender only lends the money during judicial reorganization, without court authorization, the credit of the DIP lender will rank as administrative expense (article 84, I-E), i.e., above of all secured creditors. Thus, the reformist legislator maintained an unusual norm of general priming without court authorization that does not find parallel anywhere in the world. For these and other reasons, I compared the systems of priorities in the Brazilian Bankruptcy Law, before and after the 2020 reform, to the vertiginous drawings of M.C. Escher, in which one does not know what is above and what is below.

It would be desirable that in the next reforms of the Brazilian Bankruptcy Law the legislator sought to understand the problem of financing and the legal possible solutions for incentivize financing of leveraged corporate debtors, and, even more important,

CAVALLI, Cássio. A reforma da falência: primeiras impressões sobre o PL 03/2024. *Agenda Recuperacional*. São Paulo. v. 1, n. 28, p. 1-4, jan./2024. Disponível em: www.agendarecuperacional.com.br. Acesso em:

should list the orders of priority in simple and linear provisions, and not in the kaleidoscopic norms of priority instituted in the 2005 law and perpetuated in the reform of 2020.

There are numerous other relevant problems about the financing of corporations under judicial reorganization that deserve a careful analysis, especially in view of the provisions that were inserted, or that were not, in the reform of the Brazilian Bankruptcy Law. Some, even, relate to priorities. However, I will leave to explore them in another opportunity. For today, it is enough the conclusion that, while the priority provisions in the Brazilian Bankruptcy Law are not reformed, the distressed corporate debtors will lose, because they will not be able to access new finance, along with their creditors, employees and other interested parties. Order of priorities is a serious matter and the inability to elaborate them coherently imposes severe costs to the Brazilian society.