Brazil’s new insolvency law—Law No. 11.101 of Feb. 9, 2005 (New Brazilian Bankruptcy Law or NBRL)—which became effective June 9, 2005, is designed to stimulate the rehabilitation of business enterprises, as long as minimum thresholds of viability and efficiency are met. The main objectives of the New Brazilian Bankruptcy Law are:

1. The protection of honest debtors, through a proceeding that governs the rehabilitation of the company, known as the recovery procedure (akin to U.S. chapter 11), with emphasis on negotiation between creditors and debtor so that, under its management, the enterprise is able to continue as a productive unit of the national economy;
2. The acceleration of the liquidation procedure (akin to U.S. chapter 7) of a debtor that fails to meet the requirements of the recovery procedure;
3. The adoption of protective procedures (akin to the automatic stay) such as temporary moratorium for recovery proceedings;
4. The appointment of a disinterested, independent administrator and/or a committee to oversee (but not replace) the debtor’s management in a recovery proceeding;
5. The reformulation of the judiciary’s role in the recovery procedure as a supervisor of the negotiations between creditors and debtor;
6. The reclassification of priorities of claims and credits; and
7. The establishment of a summary recovery proceeding for smaller organizations.

One of the first major tests of the New Brazilian Bankruptcy Law was the judicial recovery case of Varig, S.A. (now known as S.A. (Viacao Aerea Rio-Grandense)) and its affiliates Rio-Sul Linhas Aereas S.A. and Nordeste Linhas Aereas S.A. specifically extends to airlines the right to request judicial recovery. The Varig case is one of the first recovery proceedings of a Brazilian airline company. Prior Brazilian law disallowed recovery proceedings of a commercial airline based on the rationale that it would not be safe for the general public to the extent that aircraft maintenance could be affected by the financial instability suffered by an airline in recovery. Article 199 of the NBRL specifically extends to airlines the right to request judicial recovery.

The Varig case is also one of the first large cross-border cases of a Brazilian company with an ancillary case in the United States under former §304 of the U.S. Bankruptcy Code (the Code). The relief available to a debtor under former §304 was, essentially, a preliminary...
injunction protecting the foreign debtor’s assets in the United States and prohibiting U.S. creditors, and others subject to U.S. court jurisdiction, from taking action against the foreign debtor outside of the foreign insolvency proceeding. In Varig’s case, the debtor sought U.S. court protection principally to enjoin aircraft and engine lessors and financers from repossessing their equipment, notwithstanding that Varig was already months in arrears to these creditors in amounts that in the aggregate were in the tens of millions of dollars.

**Initial Assessment of the New Brazilian Bankruptcy Law**

This first major test of the New Brazilian Bankruptcy Law—the judicial recovery of Varig and its affiliates—demonstrates that the law may not have gone far enough to create as effective a recovery system as was intended.

The first real difficulties encountered by the lawyers working on Varig’s judicial recovery in Brazil were the limited duration of the automatic stay of post-petition claims and the very short deadline for the insolvent company to present its recovery plan. These tight timeframes are particularly pertinent in the case of a large and complex company such as Varig. Unlike other insolvency systems where debtors have years to present a recovery plan (even though other parties in interest may also have the right to do so), the debtor under the NBRL has only 60 days after the publication of the decision admitting the processing of the recovery procedure⁡ to present its recovery plan and only a six-month automatic, nonextendable stay before creditors may begin enforcing rights and exercising remedies with respect to post-petition claims.

In the United States, Varig’s lawyers were immediately faced with aircraft and equipment lessors and financers (aircraft creditors) that are accustomed to the special protections afforded to such parties under §1110 of the Code—namely, the right either to be paid current or to obtain possession of their aircraft and equipment. A basic tenet of ancillary cases under §304 was that the U.S. court would only grant comity to a foreign proceeding if, among other things, (a) the rights afforded to U.S. creditors are not prejudiced and (b) the priority of claims is “substantially in accordance with” the Code. Because the NBRL had no corollary to §1110 at the time Varig filed, the aircraft creditors argued right away that the U.S. court should not recognize the judicial recovery in Brazil because, among other reasons, the NBRL did not afford these creditors the special position they hold under U.S. law.

In addition, to be eligible for judicial recovery relief under the NBRL, the debtor must present tax good-standing certificates. This is no easy requirement to fulfill, as most companies that file for a judicial recovery relief have pending tax claims, from and against the government, that are in litigation, thus hindering the debtor’s ability to obtain the tax certificate and, in some cases, preventing it.

Furthermore, the new Brazilian bankruptcy law has a deadline of one year for labor creditors to receive payment of their claims, and it is still undetermined whether this deadline can be extended through collective bargaining agreements.

Although a comprehensive comparison of Brazilian and U.S. bankruptcy laws and practice could be presented against the backdrop of the *Varig* case, this article is narrower: How the rights of aircraft creditors were treated in the absence of special protections under Brazilian law and whether the NBRL provides debtors with the ability to sell assets free and clear of the claims and interests of creditors.

**Facts**

By 2005, Varig, the largest Brazilian and Latin American airline with flights to all major cities of Brazil and several world capitals, had been in financial turmoil for several years. On June 9, 2005, the NBRL became effective. On June 17, 2005, Varig filed for judicial recovery under the NBRL to take advantage of the several new mechanisms under the law that make it easier for debtors and creditors to negotiate reorganization plans, backed by the bankruptcy court. On that date, the Brazilian court issued an interim order—a *medida liminar*—similar to a temporary restraining order in the United States specifically to prevent aircraft creditors from seizing or interfering with Varig’s use of aircraft and equipment needed to operate its airline business. Also on that date, Varig commenced the ancillary case in the U.S. Bankruptcy Court for the Southern District of New York under §304 of the Code, and obtained *ex parte* from the U.S. court a temporary restraining order to enforce the Brazilian court’s interim order in the United States.

On June 22, 2005, the 8ª Vara Empresarial do Rio de Janeiro (8th Corporations Court of Rio de Janeiro, herein Brazilian Bankruptcy Court) granted the processing of the Judicial Recovery relief requested by Varig. On June 27, 2005, after notice and a hearing at which many of the aircraft creditors appeared in opposition, the U.S. court issued a preliminary injunction to continue the relief obtained in the temporary restraining order and to broaden it to other types of creditors.

In July 2006, creditors in Brazil voted to approve Varig’s in-court recovery plan, which contemplated a sale of the airline’s name, operating assets and business pursuant to article 60 of the NBRL after a competitive bidding process. Following two auctions, the Brazilian Bankruptcy Court determined that the prevailing bidder was Varig Logistica S.A., a former Varig subsidiary that was sold during the recovery proceedings. Following the satisfaction of certain conditions to the sale, the Brazilian Bankruptcy Court declared the sale complete on Dec. 15, 2006.

On March 19, 2007, the U.S. Bankruptcy Court issued a permanent injunction pursuant to §§304 and 105(a) of the Code, permanently enjoining actions in violation of the Brazilian recovery plan.

**Treatment of Aircraft Lessors and Financers under the New Brazilian Bankruptcy Law**

One of the principal purposes for filing Varig’s ancillary case in the United States was to extend the protective orders of the Brazilian court and render them enforceable in the United States against property and creditors subject to U.S. court jurisdiction. This was particularly critical in Varig’s case, because nearly all of the aircraft creditors were located in the United States and could have repossessed their equipment at any of the three U.S. airports where Varig landed (Los Angeles, Miami and New York) or at other airports outside of Brazil that arguably are beyond the reach of the Brazilian court.

Indeed, some aircraft creditors had already threatened to take enforcement actions against Varig’s aircraft in the United States. Varig demonstrated to the U.S. court that any such enforcement action would have immediately and
irreparably damaged Varig’s airline business and jeopardized the continuation of Varig’s efforts in the judicial recovery proceeding in Brazil. As noted above, the U.S. court granted Varig temporary and preliminary injunctive relief to allow the judicial recovery case to proceed without interference from the aircraft creditors.

The Contingency Return Plan

However, several months into Varig’s judicial recovery proceeding in Brazil and its ancillary case in the United States, Varig was unable to remain current on payments to the aircraft creditors. It became increasingly more difficult to resist the aircraft creditors’ argument that because the NBRL did not treat their claims in accordance with the priority provided by the Code, the U.S. court should order Varig immediately to return aircraft and engines.

At the same time, there was intense discussion in the Brazilian proceeding regarding the effects of the judicial recovery in Brazil and the suspension of the payment of the debts from the aircraft lease agreements for 180 days. Several repossession suits were filed by aircraft creditors in numerous civil courts in Brazil separate and apart from the judicial recovery proceeding.

At the time Varig commenced its judicial recovery proceeding in Brazil, there was a loophole in the law that was promptly amended after the filing (hence the amendment was not effective in the judicial recovery of Varig). As originally drafted and enacted, Sole Paragraph of Article 199 of the NBRL identified “mercantile” leases as being outside the judicial recovery procedure, so that the nondebtor party to such a lease (i.e., a capital or finance lease) could exercise default remedies notwithstanding the suspension of actions under the NBRL. Nevertheless, as with any other type of lease, the aircraft lease agreements are still subject to the rule of first part of §3º of Article 49 of the NBRL, providing that any assets that are leased cannot be repossessed from the debtor if it is essential to the economic activity of the company in judicial recovery.

In the absence of a Brazilian corollary to Code §1110 in the Varig case and mindful of the real possibility that Varig could run out of money and be forced into liquidation, the U.S. court devised an alternative solution—the so-called contingency return plan, which required Varig to prepare a comprehensive schedule showing the location of each aircraft and engine and their respective parts and documentation, and granting to the aircraft creditors a priority claim for damages incurred by them as a result of missing parts and missing or incomplete documentation. The U.S. court also directed Varig to seek to have the contingency return plan (including the priority claim) approved by the Brazilian court. The Brazilian court did approve the plan, giving the aircraft creditors some form of special protection.

How Article 60 of the New Brazilian Bankruptcy Law Promotes Asset Sales Free and Clear of Claims

On July 20, 2006, a judicial auction was held in the Brazilian proceeding under the auspices of the Brazilian Bankruptcy Court. VARIG Logistica (a former Varig subsidiary purchased during the judicial recovery by an entity created with the backing of U.S. private equity firm MatlinPatterson) emerged as the winning bidder. The sale to VARIG Logistica comprised substantially all of the assets and operations of Varig (referred to as the Varig Productive Unit or UPV), which is now an independent unit, including the trademark for VARIG, S.A. VarigLog, S.A. formed the company VRG Linhas Aereas S.A. (VRG) to hold and manage the UPV and to operate under the VARIG, S.A. trademark. The UPV also includes, but is not limited to, VARIG’s and Rio Sul’s Airline Authorization Certificates (CHETA), which authorizes VARIG and Rio Sul to operate their routes.

The sale did not include the trademark or CHETA of Nordeste, which, under the plan, will remain assets of old Varig. In addition, the sale excluded the old Varig’s real property assets, radio stations and the Varig Flight Training Center, which will, in part, finance certain payments to the old Varig’s creditors required by the recovery plan.

On Dec. 15, 2006, the Brazilian court issued a decision (the Dec. 15th decision) holding that pursuant to Article 60 of the NBRL, the sale to VRG was complete. The sale of the UPV to VRG pursuant to Article 60 of the NBRL was free and clear of any liens, and VARIG Logistica, as purchaser, will not be a successor to any of Varig’s obligations, including any tax obligations. Furthermore, pursuant to Article 59 of the NBRL, the plan, as amended by the restated plan, constitutes a binding novation of all debts against the foreign debtors arising prior to the commencement of the foreign proceedings. Like §363 of the Code, the effects of NBRL Article 60 are intended to allow and foster companies in financial distress to continue in business under new ownership, retain employees and continue commercial relationships with vendors and customers.

In the Varig case, after the sale of the UPV to Varig Logistica, employees of the former Varig asserted that the assets could not be sold free and clear of their labor claims, and that the labor court was the proper forum to hear their argument. Varig argued that the court presiding in its judicial recovery should decide whether the assets were sold free of or subject to the labor claims. In support of its position, Varig noted Article 3 of the NBRL, which adopts the principle of the universal judge of the judicial recovery procedure for all suits that may influence the recovery plan (as did the previous law, Decree-Law 7.661 of 1045).

Jurisdiction of Brazilian Courts on Issues Related to Sales Free and Clear of Claims

The rationale of the Universal Judge in Brazil was upheld by the Brazilian Superior Court of Justice. On April 25, 2007, Justice Ari Pargendler of the Superior Court of Justice of Brazil decided that the Brazilian Bankruptcy Court has jurisdiction to rule on issues related to the recovery plan, including a request made by labor creditors in labor court to freeze amounts to pay for labor claims:

The judicial recovery is guided by other principles, but it seems reasonable to conclude that it would be jeopardized if the assets of the company could be frozen by the labor courts.

This was the rationale for Justice Pargendler to rule on the motion of conflict of jurisdiction that was filed by the Public Attorney’s Office in the Judicial Recovery Procedure of Varig.

The issue arose when the labor court in Rio de Janeiro ordered the freezing of assets of Varig to pay labor claims against the company while, at the same time, the bankruptcy court authorized the sale of the assets free and clear. The Public Attorney’s Office filed a motion of conflict of jurisdiction at the Brazilian Superior Court of Justice.

Justice Pargendler based his ruling

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3 Article 199 was amended to provide that lease agreements (including aircraft lease agreements) are not subject to the judicial recovery, according to the first part of §3º of Article 49.
on the fact that Sole Paragraph of Article 60 and Article 141 of the New Brazilian Bankruptcy Law both provide that this type of sale is free of succession and so the bidder will not be responsible for the liabilities of the debtor, including debts for labor and tax claims.

This is one of the very first judgments of the Brazilian Superior Court of Justice on the jurisdiction of Brazilian courts to rule on issues related to the NBRL.

**Justice Pargendler's Ruling:**
*The Sale of an Independent Productive Unit Is Free and Clear of Claims*

The ruling also makes clear that bankruptcy courts presiding in judicial recovery proceedings fully understand the issues related to a recovery plan and, therefore, are the appropriate forum to hear and decide all matters affecting the plan.

Furthermore, the Brazilian Superior Court ruling supports the proposition that the rehabilitation of a financially distressed company serves a social function, since its objective is to make it viable for the company to overcome its economic social crises and consequently maintain itself as a source of jobs, as set forth in Article 47 of New Brazilian Bankruptcy Law. What remains to be seen is whether the lower courts in Brazil will also support this proposition in subsequent cases or instead try to distinguish the *Varig* case and allow separate courts to render conflicting rulings.

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