The Rise of *Precatórios*: Considerations and Recommendations for Investors in Brazilian Judicial Payment Orders

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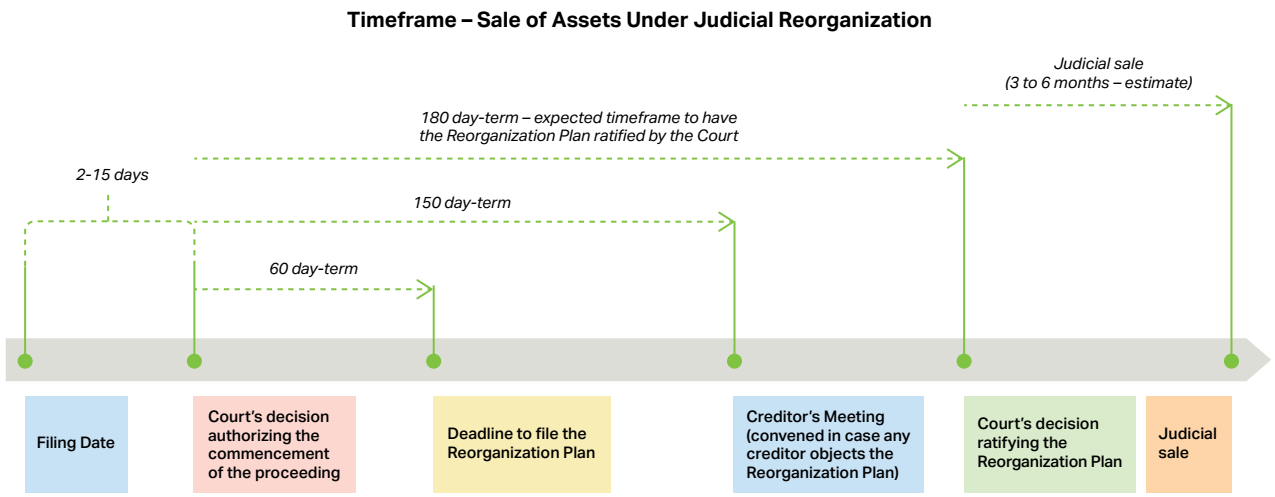
Investments in what is known in Brazil as *precatórios*, judicial payment orders arising from debts owed by the states, municipalities, federal treasury and other governmental entities in Brazil, have seen a significant boost in recent years, sustained by the increased interest of financial institutions and local and foreign investors in those assets. The market for *precatórios* today has a potential value of more than 100 billion Brazilian Reais. The economic context in which this market has developed as well as the legal framework under which *precatórios* may be acquired are important for investors to understand when investing in those assets. This article highlights the main issues to consider when investing in *precatórios* and provides our general recommendations for mitigating the risks involved.



Background

Due to the financial crisis and the corruption scandals that have affected, and continue to affect, the Brazilian economy, many companies in financial distress that hold *precatórios* and other legal claims against the Brazilian government, especially within the construction, infrastructure, energy, sugar and ethanol sectors, view the sale of those assets as a way to gain liquidity. From the investors' standpoint, such transactions require special caution and attention and must be carefully structured to avoid challenges from third parties and succession liabilities, as described below.

Out-of-Court Transactions

Generally, it is preferable for investors to acquire *precatórios* through out-of-court transactions, so as to permit them to occur in a non-regulated environment that is controlled by the investor and the seller, with terms and conditions determined by the investor and the seller, similar to any other ordinary commercial transactions. However, given the typically financially distressed situation of the seller, certain aspects should be carefully analyzed by investors prior to moving forward with such out-of-court transactions in order to avoid claims of fraudulent conveyance and/or claims of fraud upon pre-existing enforcement lawsuits filed by other creditors against the seller.

Claims of Fraudulent Conveyance

Under Brazilian law, the sale of assets by distressed companies may be challenged by the seller's creditors, especially if the seller is insolvent at the time of the transaction (the sale of the *precatório*) or becomes insolvent due to the transaction. Insolvency here means that the creditor lacks sufficient remaining assets to enable it to pay its outstanding debts. To challenge a sale transaction, an affected creditor must file a lawsuit before a competent court, evidencing that the sale was fraudulent and was detrimental to the seller to the benefit of the third party acquiring the asset. Such lawsuits may be filed within four years from the time the transaction became public.

A finding of fraudulent conveyance by the court will result in the annulment of the transaction in relation to the creditors who brought the claim. In the case of such finding, the disposed assets are returned to the debtor's property and may be used to satisfy the claims of the creditors who sought the annulment of the transaction. As a condition to the annulment, the purchaser must be reimbursed for the purchase price paid for the asset, as well as the cost of any damages arising out of the loss thereof (i.e., expenses, material damages and loss of profits). However, one should bear in mind that those indemnity claims will be advanced against a seller that is financially distressed and as such the chances of the claims effectively being satisfied tend to be very low.

Claims of Fraud Against Pre-Existing Enforcement Lawsuits

Another potential claim that could jeopardize a transaction is the risk of a determination of fraud against pre-existing enforcement lawsuits (*fraude à execução*) in cases where a transaction involving the assignment of *precatórios* may negatively affect ongoing enforcement lawsuits filed by the seller's creditors, especially tax enforcement lawsuits.

If a court finds that fraud against an existing enforcement lawsuit has occurred, it will render the transaction ineffective in relation to the plaintiff in that lawsuit in which the fraud was declared. Therefore, even though the disposed assets remain in the acquirer's property, they may be seized by the creditor in the relevant enforcement lawsuit to secure and satisfy its claim.

Naturally, due diligence on the seller's financials is important for the proper assessment of how deeply distressed the company

is and, consequently, the risk of claims of fraudulent conveyance and/or fraud upon pre-existing enforcement lawsuits. In addition, as we discuss in our recommendations, to mitigate challenges based on fraud, it is essential to evidence that the transaction was entered into at arm's length and proper consideration (market value basis) was received.

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In cases where the seller's financial situation is distressed to the point that it may impose significant risks of fraud allegations against the transaction, the appropriate alternative would be the acquisition of the assets under the seller's judicial reorganization, as analyzed below.

Precatórios and Companies Under Judicial Reorganization

Under the Brazilian Bankruptcy Law (No. 11,101, dated February 9, 2005, as amended), financially distressed companies have the option of initiating a judicial reorganization process (*processo de recuperação judicial*) aimed at renegotiating the company's debts with its creditors under a court supervised proceeding and rescuing the debtor from its financial difficulties while maintaining creditors' interests.

The assignment of *precatórios* by companies under judicial reorganization results in a more complex deal structure but at the same time provides more protection to investors, depending on the specifics of each transaction. This is the case because Brazilian Bankruptcy Law provides that the purchase of assets made under a debtor's judicial reorganization plan (as approved by the creditors and ultimately by the court and followed by a competitive bidding process conducted under court supervision) grants protection to purchasers against succession of liabilities of the debtor of any nature. Additionally, actions undertaken in the context of the reorganization plan will not be annulled nor unwound in the event of a subsequent liquidation/bankruptcy of the debtor.

Note that legal authorities and case law maintain that the protection against succession on past liabilities of the debtor is effective against all the debtor's creditors, including impaired and unimpaired claims. However, in limited instances that we will touch on, such investor protections are disregarded for the benefit of certain types of unimpaired claims. In the event that the relevant assets of the debtors are sold under a judicial reorganization proceeding and no sufficient valuable assets remain available to bear the outstanding debts owed to unimpaired creditors, the courts may render the sale transaction void in relation to the relevant creditors, allowing them to seize the assets and satisfy their claims.

As a general rule, judicial reorganization binds all pre-petition debts, even those not yet due, except for (i) tax and social security-related debts; (ii) debts related to forward foreign exchange agreements; (iii) debts arising from financial leases and fiduciary liens or transfers of property; and (iv) debts relating to real property sale agreements that have an irrevocability or irreversibility clause and purchase agreements with title retention provisions. Thus, creditors falling into any of the foregoing categories that hold unimpaired claims not subject to the judicial reorganization proceeding (*créditos extraconcursais*) may challenge any asset sale if the debtor is not left with sufficient relevant assets upon completion of such sale.

Considering that virtually all debtors that file for judicial reorganization proceedings in Brazil also have unimpaired creditors, investors should conduct due diligence on such claims for the proper verification and assessment of the risks of allegations of fraudulent conveyance or fraud against pre-existing enforcement lawsuits.

It is also worth noting that in the context of a judicial reorganization, except for any sale expressly set forth in the reorganization plan, the debtor is not permitted to sell or pledge assets or rights that comprise its fixed assets, unless the usefulness of such transaction is recognized by the bankruptcy court following consultation with the creditors' committee.

Although there is ongoing legal debate about the proper classification of *precatórios* and legal claims as "fixed assets" of a debtor, in our view, by having the assignment of such assets be governed by the reorganization plan and requiring creditor approval at a creditors' assembly, followed by ratification of the reorganization plan by the bankruptcy court, the purchaser of *precatórios* and other legal claims is protected against the succession liabilities of the debtor.

Conclusion and Recommendations

Investors interested in acquiring *precatórios* from companies in financial distress (pre-insolvency or under judicial reorganization proceedings) should take the following recommendations into consideration in order to manage the risks involved as well as to add additional layers of protection:

For Out-of-Court Transactions:

1. ***Due diligence:*** Aside from the legal and technical due diligence of the *precatórios* (legal nature and factual background, ownership, chain of assignments, inexistence of encumbrances, etc.), we also recommend that investors conduct extensive and detailed due diligence of the seller for a proper assessment of its financial situation, ongoing lawsuits and contingencies (tax, civil, labor, environmental, etc.), among other relevant matters.
2. ***Appraisal report:*** If possible, investors should carry out an independent appraisal report on the remaining assets of the seller as evidence that the seller would hold sufficient assets to pay its financial obligations even with the assignment of the *precatórios*.
3. ***Arm's length deal:*** Negotiations between the investor and the seller should be carried out on an arm's length basis.
4. ***Market value basis:*** The purchase price paid in consideration for the assignment of *precatórios* should be determined on a market value basis, which is not necessarily a simple matter considering the type of asset and its non-liquid nature. A review of the economics of prior, similar transactions and/or fairness opinions is useful for this purpose.
5. ***Contractual protections:*** Transaction agreements should include protections, such as representations and warranties to the effect that the transaction will not affect the capacity of the seller to fulfill its current obligations.
6. ***Attention to formalities:*** There are certain formalities that should be followed for the adequate perfection of assignment of *precatórios* and other legal claims, such as the execution of a public assignment instrument (*escritura pública*), registration of the applicable documents with the competent registries and communications with the competent court regarding the assignment of the *precatórios*.

For Transactions Completed in the Context of Judicial Reorganization Proceedings:

1. ***Due diligence:*** Due diligence is even more critical for companies under judicial reorganization, considering that certain creditors (e.g., those with tax claims, post-petition claims and creditors of fiduciary liens, among others) are not subject to the reorganization plan.
2. ***Competitive process:*** For companies under judicial reorganization, the organization of a competitive bidding process in which third parties are granted the opportunity to submit bids for the acquisition of the *precatórios* is material for providing proper protection to the purchaser against succession liabilities of the debtor entity.
3. ***Market value basis:*** The purchase price should be determined on a market value basis, and the competitive bidding process should evidence that the best price was achieved.
4. ***Creditors and court approval:*** For companies under judicial reorganization, investors must ensure that the assignment of *precatórios* is made based on the terms and conditions of the reorganization plan approved by the creditors at a creditors' general assembly and confirmed by the bankruptcy court.
5. ***Attention to formalities:*** The same recommendations regarding formalities for out-of-court transactions should also apply for assignments of *precatórios* made in judicial reorganization proceedings. ■

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