

# Distressed investments in Brazil: the role of private equity funds

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The new Brazilian Bankruptcy Law (Law No 11,101 of June 9 2005) significantly modified bankruptcy legislation by aligning it with the principles set out in Chapter 11 of the US Code. It revoked the previous law, Decree-Law No 7,661 of June 21 1945, which had been prepared for a different economic situation and was considered to be inadequate for the needs of the new Brazilian economy.

The overriding concern of the Bankruptcy Law is to protect production activity and create alternative proceedings for the recovery of insolvent entities, such as extrajudicial reorganisation and judicial reorganisation. Judicial reorganisation replaced the former mechanism known as *concordata*, which consisted exclusively of a moratorium and did not provide for debt restructuring. The goal of judicial reorganisation is to provide an effective solution for the debtor's economic and financial situation, thereby protecting the business and preserving jobs and the interests of creditors along the lines of Chapter 11.

It is beyond the scope of this chapter to discuss all the modifications implemented by the Bankruptcy Law. Instead, this chapter focuses on the opportunities created by the capital markets to invest in distressed companies.

## Use of investment funds in distressed companies

Distressed funds are funds that invest in the stock or debt of companies in pre-bankruptcy or in reorganisation, often at a significant discount. The attractive feature of this form of investment is that distressed companies are often undervalued, as shareholders and creditors often overreact to the imminence of bankruptcy. This gives the investment fund the prospect of achieving attractive returns once the company emerges from reorganisation.

Although the Brazilian capital markets offer investors a wide range of products, distressed funds are a relatively new concept. Investors were hesitant to participate in reorganisation proceedings because of the risk that they could be held liable for the company's debts. There was also substantial legal uncertainty as the law did not provide for an adequate vehicle for distressed investments.

This uncertainty remained until the Brazilian Securities Commission (CVM) enacted Regulation No 391 of July 16 2003, regulating *fundos de investimento em participações* (FIPs), the preferred investment vehicle for private equity funds. The purpose of a FIP is to acquire stock, debentures, warrants and other types of securities convertible or exchangeable for stocks issued by publicly or closely held companies. It is a condition of any investments made by FIPs that they have effective participation in the management of the company in which they are investing, for instance through the appointment of directors.

The FIP may participate in the decision-making process of the company by:

- holding shares that are part of the controlling block;
- entering into shareholders' agreements; or

- taking any other measures that assure the effective influence of the FIP in the company's management or strategic policies.

The regulatory framework for FIPs is flexible. There are few requirements on how FIPs should be managed and operated: the company has substantial flexibility in choosing how to regulate minimum net equity requirements, investment policy, capital calls, distribution of proceeds and terms of investment. Public offerings of FIPs are subject to flexible registration requirements, since FIP investors are deemed sophisticated enough to assess the prospects and risks associated with this form of investment.

Regulation No 391 allows FIPs to invest in companies under reorganisation by using assets or credits to purchase shares. The regulation requires that such assets or credits be evaluated through an expert appraisal report and that they be connected to the company's restructuring process. Creditors can therefore use their credits to invest in the company, a feature that has dramatically changed the landscape for relations between creditors and investors in distressed companies.

### **Benefits of using FIPs**

Creditors that share common interests may pull their credits together and invest in companies through FIPs, reaching a number of votes sufficient to influence the company's management decisions. In a judicial reorganisation plan, different types of FIP may be created to accommodate different classes of creditor, such as creditors holding labour-related claims, secured claims and unsecured claims.

In general, FIPs are managed by third parties in order to:

- maximise the financial return of creditors that will receive shares of the funds as payment for their claims; and
- give more credibility, transparency and security to the reorganisation plan.

Through this structure, creditors which share common interests may enhance their negotiating position and play a more meaningful role during the reorganisation of the company, enabling them to receive their claims and increase their gains through dividends or the sale of the recovered company.

Thus, the use of FIPs when dealing with a distressed company may bring significant advantages and benefits to all those involved in the reorganisation process.

For example, the creditors of a company under reorganisation may acquire FIP shares through the assignment of their claims against the company or even assets connected to the reorganisation process. There are also creditors that may wish to sell some or all of their claims to investors that wish to take part in the reorganisation process in order to achieve results greater than those currently effective in the market.

Strategic investors that wish to take control over the company can invest funds in the FIP. They will allocate those funds for the capitalisation of the company and play a prominent role in the governance structure of the fund.

Furthermore, goods and equipment suppliers and service providers may transfer their goods, equipment and credits to the FIP. This measure would allow the production unit which is going through the recovery process to have a cash flow compatible with its economic and financial situation, while enabling those parties to maximise their gains.

### **Conclusion**

The new FIP structure provides a valuable alternative to the reorganisation prospects of distressed companies, while bringing benefits to the Brazilian capital market and allowing the Brazilian private equity industry to become stronger and more developed. FIPs are an important mechanism to accommodate creditors' interests and to recover distressed companies.