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# AIRLINE REORGANIZATION UNDER THE NEW BANKRUPTCY AND RESTRUCTURING LAW OF BRAZIL

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**D**ELTA Air Lines and Northwest Airlines declared bankruptcy on September 14, 2005.<sup>1</sup> Currently, four of the seven largest U.S. airlines are now operating under Chapter 11 federal bankruptcy protection.<sup>2</sup> More than 100 U.S. airlines have entered into bankruptcy over the past twenty-five years.<sup>3</sup> Chapter 11 bankruptcy protection provides the airlines with the opportunity and time to restructure and renegotiate with their creditors.<sup>4</sup> By filing for this protection, the airlines benefit from cost savings, allowing them to offer customers lower fares.<sup>5</sup> But although bankruptcy protection in the United States does not offer a permanent solution to the increasing costs and increasing debts plaguing the airline industry, the Brazilian government recently adopted a revised bankruptcy code similar to the U.S. Chapter 11 code to assist the Brazilian airline industry.<sup>6</sup>

Chronic inflation and a foreign debt of more than \$100 billion pose severe problems to Brazil's economy, and these problems have begun to impact Brazil's major airline companies.<sup>7</sup> The airline industry in Brazil is in debt due to long-standing failures to control costs and currency depreciation.<sup>8</sup> Although these airlines would be considered bankrupt in other countries, Brazilian "air transportation companies are protected by law

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1. See Chris Isidore, *Delta, Northwest file for Bankruptcy*, CNN MONEY.COM, Sept. 15, 2005, [http://money.cnn.com/2005/09/14/news/fortune500/bankruptcy\\_airlines/index.htm](http://money.cnn.com/2005/09/14/news/fortune500/bankruptcy_airlines/index.htm).

2. *Id.*

3. Jerry Knight, *Airlines Hide Out in Bankruptcy Court*, WASH. POST, Sept. 19, 2005, available at <http://www.washingtonpost.com/wp-dyn/content/article/2005/09/18/AR2005091801611.html>.

4. See 11 U.S.C. §§ 1101-1146 (2005).

5. Patty Davis, *US Air Files for Bankruptcy*, CNN MONEY.COM, Aug. 12, 2002, <http://money.cnn.com/2002/08/11/news/companies/usair/index.htm>.

6. See Aloisio Araujo & Bruno Funchal, *Past and Future of the Bankruptcy Law in Brazil and Latin America* 50 (Graduate Sch. of Econ., Getulio Vargas Found. (Brazil), Econ. Working Papers (Ensaio Economicos da EPGE), Paper No. 599, 2005), available at <http://epge.fgv.br/portal/arquivo/1922.pdf>.

7. *Brazilian Airlines Varig, TAM Delay Merger*, AIRWISE NEWS, Feb. 10, 2004, <http://news.airwise.com/stories/2004/02/1076449503.html>.

8. *Id.*

from bankruptcy.”<sup>9</sup> Three major airlines dominate the internal routes in Brazil: Viacao Aerea Rio-Grandense (VARIG), Viacao Aerea Sao Paulo (VASP), and Transportes Aereo Marilia (TAM).<sup>10</sup> In 2004, several of these Brazilian airlines faced large debts and were threatened with bankruptcy and liquidation of assets.<sup>11</sup> Due to the enactment of a new Brazilian bankruptcy law in 2005 that resembles the U.S. Chapter 11 bankruptcy protection law, the two airlines have met different fates, as the VASP airline has been permanently grounded and VARIG has retained its assets and is currently restructuring.<sup>12</sup> As the Brazilian bankruptcy law goes through this transitional period, the future of the Brazilian airline industry hangs in the balance.

### I. BANKRUPTCY LAW OF BRAZIL PRIOR TO 2005

Prior to June 9, 2005, debtors considering filing for bankruptcy in Brazil faced harsh consequences. Brazilian corporations facing bankruptcy dealt with an ineffective and fragmented bankruptcy law that had been in place since 1945.<sup>13</sup> Under the bankruptcy law, known as Decree Law No. 7,661 of June 21, 1945, only merchants were eligible for bankruptcy protection.<sup>14</sup> A Brazilian corporation in financial distress was subjected to one of three types of proceedings: insolvency, bankruptcy, or concordata.<sup>15</sup> Under insolvency and bankruptcy proceedings, all of the debts of the corporation were accelerated, and assets were collected and sold. The court would appoint a trustee (sindico), working under the supervision of the bankruptcy judge, to manage the liquidation and distribution of the debtor’s assets.<sup>16</sup> Under this system, the court had absolute authority in every aspect of the bankruptcy, from appraisals of assets to how the assets would be distributed. Similarly, under concordata proceedings, although the affected corporation was permitted to continue conducting business, the corporation conducted its business under complete judicial supervision.

Bankruptcy proceedings in Brazil often took decades to conclude.<sup>17</sup> Creditors faced the high risk of never being paid and increased their lend-

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9. *Protected from Bankruptcy, Brazil’s Carriers Get No Help*, AVIATION DAILY, Jan. 3, 2003, available at 2003 WLNR 3240860.

10. *See Travel-International: Brazil*, COLUMBUS WORLD TRAVEL GUIDE (2003), [http://www.worldtravelguide.net/country/39/international\\_travel/South-America/Brazil.html](http://www.worldtravelguide.net/country/39/international_travel/South-America/Brazil.html).

11. *Brazilian Airlines Varig, TAM Delay Merger*, *supra* note 7.

12. *Id.*

13. Araujo & Funchal, *supra* note 6, at 46.

14. Francisco A. Laguna, *Brazilian Insolvency and Bankruptcy Law*, BUS. CREDIT 1, May 2003, available at <http://www.allbusiness.com/legal/laws/545209-1.html>.

15. Fay Hansen, *Brazil Rewrites Its Bankruptcy Laws*, BUS. CREDIT, Oct. 1, 2004, available at 2004 WLNR 11668780.

16. Araujo & Funchal, *supra* note 6, at 2.

17. *Id.* at 47.

ing charges to compensate for these risks.<sup>18</sup> The Brazilian economy suffered negative consequences as debtors and creditors faced expensive credit rates.<sup>19</sup> Additionally, provisions of the Brazilian bankruptcy code prevented airlines from negotiating with creditors and fighting insolvency in court.<sup>20</sup>

Under the old bankruptcy law, any debtor who failed to pay a liquid debt was technically obligated to petition for bankruptcy.<sup>21</sup> But voluntary bankruptcies were a rare event, and often the creditor would file for bankruptcy for the debtor, supporting their filing with evidence of a prior protest for nonpayment of matured debt.<sup>22</sup> As soon as the court declared the debtor bankrupt, the debtor was divested of its business and all of the debtor's obligations were accelerated.<sup>23</sup> A court-appointed trustee would assess the debtor's assets, and liquidate and distribute the debtor's remaining assets.<sup>24</sup> Trustees were poorly paid public officials, and bankruptcy management was often inefficient and hindered by the highly bureaucratic procedures.<sup>25</sup> The bankruptcy law in Brazil ensured that upon liquidation of a bankrupt corporation's assets, workers were paid first.<sup>26</sup> Under this law, taxes were paid after payments were made to workers, and creditors were paid out of any remaining assets. A company facing bankruptcy would not have the opportunity to retain control of its company and reorganize or restructure, and creditors would not have the opportunity for maximum recovery of their debts. Brazilian bankruptcy laws hindered the development of an efficient credit market in Brazil.<sup>27</sup>

In 2002, General Electric Corporation (GE) made a bankruptcy claim against a small Brazilian airline, Transbrasil.<sup>28</sup> There were expectations that the two companies would come to an agreement regarding Transbrasil's \$20 million debt to GE.<sup>29</sup> Transbrasil was expected to present a recovery plan to the Brazilian federal government in June of 2002, and in its plan it was to demonstrate that it had capital infusion lined up, as well as the name of an investor.<sup>30</sup> But Transbrasil faced such severe financial difficulties that it declared bankruptcy in 2002 and has since ceased its operations.<sup>31</sup>

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18. ORGANIZATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT, OECD ECONOMIC SURVEY OF BRAZIL 2005: REFORMING BRAZIL'S BANKRUPTCY LEGISLATION (2004), available at <http://www.oecd.org/dataoecd/12/12/34427462.pdf>.

19. *Id.*

20. *Id.*

21. Araujo & Funchal, *supra* note 6, at 2.

22. *Id.*

23. *Id.*

24. *Id.*

25. *Id.* at 7.

26. *Id.*

27. *Id.* at 11.

28. *Airlines Remembered: Transbrasil*, <http://www.ruudleeuw.com/rem-transbrasil.htm>.

29. *Id.*

30. *Id.*

31. *Protected from Bankruptcy, Brazil's Carriers Get No Help*, *supra* note 9.

Founded in 1933 by the regional government of Sao Paulo, VASP was Brazil's fourth-largest airline.<sup>32</sup> In early 2000, evidence emerged that VASP was struggling financially as it returned some aircraft to its lessors and stopped services to Europe.<sup>33</sup> Since VASP was unable to pay its debts of more than \$3 million, on October 7, 2004, VASP creditors GE Celma and GE Varig Engine Service petitioned a bankruptcy judge to declare VASP insolvent.<sup>34</sup> VASP contested this claim in an effort to buy itself time. But on November 26, 2004, a hotel also requested VASP be declared bankrupt.<sup>35</sup> Had a court ruled in favor of the petitioners, the assets of VASP would have been liquidated and distributed to its creditors. The company was unable to pay its employees their salaries, and thousands of employees of VASP airline signed a petition and visited the country's presidential palace to ask the Brazilian government to allow the airline to reorganize its debt.<sup>36</sup> The Brazilian government forced VASP to produce a debt payment plan or be grounded.<sup>37</sup> VASP was able to buy itself some time by paying off a portion of its debt.<sup>38</sup> But VASP began canceling flights, violating an airline rule that a major problem must exist for a flight not to take off.<sup>39</sup> After months of speculation and canceled flights, VASP airline was forced to ground its fleet for good on January 26, 2005.<sup>40</sup>

## II. NEW BANKRUPTCY AND RESTRUCTURING LAW OF BRAZIL (NBRL)

On December 14, 2004, eleven years after its initial proposal, the Brazilian House of Representatives approved the NBRL (Bill of Law 4376/93).<sup>41</sup> The NBRL went into effect on June 9, 2005.<sup>42</sup> The goal of the NBRL is "to enhance the chances of restructuring distressed businesses, as well as by the need to optimize the results of bankruptcy proceedings, enhancing credit recovery and enabling bankrupt companies to be sold as

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32. *Airlines Remembered: VASP*, <http://www.ruudleeuw.com/rem-vasp.htm>.

33. *Id.*

34. *Brazil's Vasp Airline on the Brink of Collapse*, AIRLINE INDUSTRY INFO., Oct. 7, 2004, available at <http://www.allbusiness.com/operations/shipping-air-freight/227180-1.html>.

35. *Shares of Brazil's Vasp Suspended from Trading*, AIRLINE INDUSTRY INFO., Nov. 29, 2004, available at [http://www.findarticles.com/p/articles/mi\\_m0CWU/is\\_2004\\_Nov\\_29/ai\\_n7580602](http://www.findarticles.com/p/articles/mi_m0CWU/is_2004_Nov_29/ai_n7580602).

36. Raymond Colitt, *VASP Employees Lobby Brasilia for More Help*, FIN. TIMES, Oct. 14, 2004, available at [http://www.il-rs.com.br/ilingles/informative/novembro\\_2004/informative\\_vasp.htm](http://www.il-rs.com.br/ilingles/informative/novembro_2004/informative_vasp.htm).

37. *Brazil's Vasp Airline on the Brink of Collapse*, *supra* note 34.

38. VASP, PROPOSAL FOR THE FINANCIAL RESTRUCTURING OF VASP IN THE AMBIT OF THE COMPANY'S JUDICIAL RECOVERY PROCESS 8 (2005), [http://www.vasp.com.br/arquivos/minutaplano\\_eng.pdf](http://www.vasp.com.br/arquivos/minutaplano_eng.pdf).

39. *Id.*

40. *Airlines Remembered: VASP*, *supra* note 32.

41. Thomas Benes Felsberg, Troy F. Petit & Andrea Acerbi, *Brazil: New Bankruptcy Law Ready for Signing*, INTER-AM. TRADE REP., Dec. 2004, at 2, available at <http://www.natlaw.com/bulletin/2004/0412/trdec04.pdf>.

42. *Id.*

going concerns.”<sup>43</sup> Proceedings under the NBRL are analogous to Chapter 11 proceedings under the U.S. Bankruptcy Code, with the purpose of permitting the corporation to negotiate with its creditors and avoid liquidation.<sup>44</sup> The debtors are permitted, under the NBRL, to retain control of their businesses and assets, while creditors are prohibited from enforcing their claims against the debtors.<sup>45</sup> In order for a corporation to effectively reorganize, the corporation must be permitted to retain its assets.<sup>46</sup> By allowing corporations in financial distress to restructure, cooperation between the debtor corporation and creditors is encouraged, and the corporation in distress has a chance of recovery.<sup>47</sup>

To file a petition under the NBRL, the debtor corporation must submit an initial application to the Brazilian Court.<sup>48</sup> The Brazilian Court shall then order a stay of proceedings for up to 180 days, to prevent creditors from enforcing their claims against the debtor corporation, while the debtor corporation files a plan for restructuring.<sup>49</sup> The plan for restructuring must be approved by 51 percent of the creditors and sanctioned by the Brazilian Court.<sup>50</sup> If the plan is not approved by the creditors, the company will be declared bankrupt. If the plan is approved by the majority of the creditors, the Brazilian Court will ratify the plan and approve the judicial reorganization.<sup>51</sup> The Brazilian Court will then appoint a judicial administrator to ensure that the debtor is acting in compliance with the plan.<sup>52</sup> Unlike the Brazilian bankruptcy law prior to the NBRL, the judicial administrator does not override the management of the debtor's business. Instead, the judicial administrator simply oversees the debtor's activities and provides reports on them to the Brazilian Court.

The creditors are the primary beneficiaries of the NBRL. Unlike the old Brazilian bankruptcy law that gave priority of payment to workers and tax revenues, the NBRL gives priority to creditors and limits payments to workers.<sup>53</sup> This change in the law provides the creditors with much greater chances for recovering their payments.<sup>54</sup> Additionally, interested creditors are able to participate in and supervise the bankruptcy processes for the debtor corporation.

VARIG is one of Brazil's largest airlines and the largest airline in Latin America.<sup>55</sup> Founded in 1927, VARIG is one of the oldest airlines in the

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43. *Id.*

44. ORGANIZATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT, *supra* note 18.

45. Felsberg, Petit & Acerbi, *supra* note 41.

46. *Id.*

47. *Id.*

48. *Id.*

49. *Id.*

50. *Id.*

51. *Id.*

52. *Id.*

53. Araujo & Funchal, *supra* note 6, at 7.

54. Felsberg, Petit & Acerbi, *supra* note 41.

55. *Viacao Aerea Rio-Grandense, S.A.*, HOOVER'S IN-DEPTH COMPANY RECORDS, Mar. 28, 2007, available at 2007 WLNR 5845116.

world, flying throughout Brazil and to twenty countries worldwide.<sup>56</sup> VARIG maintains a fleet of eighty-seven aircraft and employs approximately 11,456 full-time workers.<sup>57</sup> VARIG dominates Brazil's international and domestic airline markets and is a member of Star Alliance, a partnership of the world's leading airlines.<sup>58</sup> The airline possesses no fixed assets, and each of its airplanes is operated under leases from companies including GE, Boeing Company, and Goodrich Corporation.<sup>59</sup> VARIG's single largest creditor is the Brazilian state.<sup>60</sup>

The Brazilian government heavily regulates the airline.<sup>61</sup> For example, the Brazilian government must approve all acquisitions of aircraft by VARIG.<sup>62</sup> It must also approve of any increase in the number of flights on existing routes and the opening of any new routes.<sup>63</sup> The Brazilian government regulates the fares that Brazilian airlines, such as VARIG, may charge for its domestic routes.<sup>64</sup> The government bases these fares on political, social, and economic factors over which VARIG has no control.<sup>65</sup>

Despite the Brazilian government's high level of control over VARIG, many of VARIG's foreign competitors are owned, either wholly or by majority, by foreign governments and have access to greater financial resources.<sup>66</sup> Additionally, most of VARIG's debts are in U.S. dollars. VARIG's revenues are in Brazilian currency, the real, which has been losing value. These factors have contributed to VARIG's debts, which have climbed to over nine billion reals, equivalent to U.S.\$4 billion.<sup>67</sup>

VARIG's controlling shareholder is the Ruben Berta Foundation, a nonprofit trust that has consistently vetoed any financial plans for the airline that would entail giving up control over the airline's management.<sup>68</sup> The Ruben Berta Foundation has been blamed for VARIG's financial problems, as an airline analyst stated that "[t]he lack of money is a consequence of bad management. I don't want to pass judgment on the foundation, but the numbers show that they simply haven't done a good

56. See *Background and Description of Varig*, VARIG BANKR. NEWS, June 18, 2005, at § 00001, available at <http://bankrupt.com/varig.txt>.

57. *Id.*

58. VARIG Brasil, [http://portal.varig.com.br/us/varig/index\\_html](http://portal.varig.com.br/us/varig/index_html) (last visited Oct. 6, 2005).

59. Geraldo Samor, *International: Brazil's Not-So-Favored Airline*, WALL ST. J ABSTRACTS, at A18, available at 9/14/05 WSJ-ABS A18 (Westlaw).

60. *Id.*

61. *Background and Description of Varig*, *supra* note 56.

62. *Id.*

63. *Id.*

64. *Id.*

65. *Id.*

66. *Id.*

67. *Id.*

68. Peter Muello, *Brazilian Airline's Main Shareholder to Give up Control in Restructuring Plan*, AP WORLDSTREAM, Sept. 13, 2005, available at 9/13/05 APWORLD 00:06:13 (Westlaw).

job running the company.”<sup>69</sup>

VARIG has been operating under its large debt since 1994.<sup>70</sup> In 1994, the government required VARIG to restructure its debt.<sup>71</sup> This restructuring did not reduce the debt overall, but simply deferred the debt. VARIG was again required to restructure its debt in 1999.<sup>72</sup> VARIG’s financial difficulties became increasingly evident following the terrorist attacks of September 11, 2001. In 2001, VARIG laid off 10 percent of its workers and reduced its fleet.<sup>73</sup> The Brazilian government introduced measures including tax exemptions and reductions, as well as debt relief.<sup>74</sup> The government considered temporarily nationalizing the company. In February of 2003, the airline’s debts affected passengers when American International Group, an aircraft leasing company, seized a VARIG Boeing 777 at Paris’s Roissy-Charles de Gaulle Airport for unpaid lease payments by VARIG.<sup>75</sup> Another aircraft leasing company, GE Capital Aviation Services, seized a VARIG Boeing 767 at Miami International Airport.<sup>76</sup> In April of 2003, cash-flow problems within VARIG forced the company to delay paychecks to employees.<sup>77</sup>

In early 2005, Brazilian airline VARIG was facing a debt of over \$4 billion, and was unable to pay its aircraft lease payments.<sup>78</sup> On June 17, 2005, VARIG became the first company in Brazil to file a request to restructure its company under Brazil’s new bankruptcy law, the NBRL, enacted only eight days prior.<sup>79</sup> Without Brazil’s new bankruptcy law, creditors would have liquidated VARIG’s assets and VARIG would have been unable to continue operating.<sup>80</sup>

Prior to enacting the NBRL, the Brazilian government examined options to ensure that VARIG would not collapse under its \$4 billion debt.<sup>81</sup> Brazilian President Luis Inacio Lula da Silva publicly declared that the company could not be written off and needed to be kept operating.<sup>82</sup> He stated that VARIG is a national resource and a business with seventy-five years of history.<sup>83</sup> The president directed his chief of staff, Jose Dirceu, to create a committee to draw up a bailout plan for the air-

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69. Todd Benson, *Brazil Sifting Through Ideas for Rescuing Flagship Airline*, N.Y. TIMES, Aug. 24, 2004, at W, available at 2004 WLNR 5435667.

70. *Background and Description of Varig*, *supra* note 56.

71. *Id.*

72. *Id.*

73. *Id.*

74. *Id.*

75. *Creditors Release Varig’s Boeing 777 Aircraft*, AIRLINE IND. INFO., Feb. 3, 2003, available at <http://www.allbusiness.com/operations/shipping-air-freight/448097-1.html>.

76. *Id.*

77. *Background and Description of Varig*, *supra* note 56.

78. *Id.*

79. *See Samor*, *supra* note 59.

80. Felsberg, Petit & Acerbi, *supra* note 41.

81. Benson, *supra* note 69.

82. *Id.*

83. *Id.*



line.<sup>84</sup> As Brazil's government is one of VARIG's largest creditors, it is committed to saving VARIG.<sup>85</sup> But by creating the NBRL, they ensured that VARIG would have the opportunity to continue to operate. On June 17, 2005, just eight days after the NBRL was enacted, VARIG was the first company to file for bankruptcy under the new law.<sup>86</sup>

On June 17, 2005, Judge Alexander dos Santos Macedo of the Commercial Bankruptcy and Reorganization Court issued an interim order in compliance with the NBRL.<sup>87</sup> Under this interim order, VARIG's twenty-nine aircraft lessors were prohibited from repossessing or interfering with VARIG's leased aircraft.<sup>88</sup> As seizure of VARIG's leased aircraft would force VARIG to cease its operations, the interim order permitted VARIG to continue operating while restructuring.<sup>89</sup>

VARIG presented its restructuring plan to a state judge in Rio de Janeiro on September 12, 2005, detailing its plans to renegotiate its debt and cut staff by 13 percent.<sup>90</sup> Additionally, VARIG plans to create a new company, sell shares of the new company, and use the proceeds from the sales to pay debts and to invest in new businesses.<sup>91</sup>

The reforms to the Brazilian bankruptcy law will likely bring about positive changes to Brazil's economy, as large corporations in financial distress will be provided an opportunity to continue to operate while developing a plan for restructuring or reorganizing.<sup>92</sup> Prior to the reforms in the Brazilian bankruptcy law, the corporation's assets would be liquidated immediately upon filing for bankruptcy. While an airline's assets will continue to have a higher value if the airline is permitted to continue to operate, the effect of filing for reorganization ripples to each of the airline's competitors.<sup>93</sup> Reorganization allows the airline to lower its fares, which forces the airline's competitors to lower its fares.<sup>94</sup> Members of the airline industry continually debate as to whether bankruptcy protection while restructuring provides bankrupt airlines unfair operating advantages, contributing to the overall demise of the airline industry.<sup>95</sup>

The airline industry in the United States has not prevailed under the Chapter 11 bankruptcy protection, as many airlines in the United States declared bankruptcy as a means to keep operating while repudiating their obligations and negotiating lower payment options to their debtors.<sup>96</sup>

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84. *Id.*

85. Samor, *supra* note 59.

86. *See Background and Description of Varig, supra* note 56, at § 00001.

87. *Id.* § 00002.

88. *Id.*

89. *Id.*

90. Muello, *supra* note 68.

91. *Id.*

92. Felsberg, Petit & Acerbi, *supra* note 41.

93. *See* Mark C. Mathiesen, *Bankruptcy of Airlines: Causes, Complaints, & Changes*, 61 J. AIR L. & COM. 1017 (1996).

94. *Id.*

95. *Id.*

96. *See* Justin Fox & Kate Bonamici, *Three Cheers for Bankruptcy*, *FORTUNE*, Oct. 17, 2005, at 33, available at 2005 WLNR 16004796; *Bankruptcy May Not Save Airlines*,

Now that the NBRL has gone into effect, time will show whether the airline industry in Brazil will mirror the airline industry in the United States, and VARIG's competitors, budget airline Gol Linhas Aereas Inteligentes and Brazil's largest airline, TAM Linhas Aereas, will survive.<sup>97</sup>

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AIRWISE NEWS, Sept. 15, 2005, available at <http://news.airwise.com/story/view/1126766104.html>.

97. See Benson, *supra* note 69.

