How the increasing number of insolvencies in Brazil may affect arbitrations

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Brazilian companies have increasingly chosen arbitration as their preferred method for resolving domestic and international disputes.[1] Now the impact of COVID-19 in Brazil has caused a sharp increase in insolvencies, and there is no expectation of a quick turnaround in the next months and, possibly, years to come. What, then, are the potential effects of Brazilian insolvency proceedings on arbitrations in Brazil and abroad?

Are arbitration agreements affected by the opening of insolvency proceedings?

No. The opening of insolvency proceedings – either judicial reorganization or liquidation – does not affect arbitration agreements executed beforehand. These agreements remain valid and enforceable by or against the insolvent company.

Care should be taken, however, when negotiating new arbitration agreements with an insolvent party. Companies in liquidation are represented by a court-appointed trustee, who has exclusive capacity to contract on behalf of the insolvent estate, and concluding such contracts may be conditional on receipt of bankruptcy court approval. Companies in judicial reorganization (Brazil's equivalent to a US 'Chapter 11' bankruptcy protection regime) are not subject to this rule, since neither their capacity or representation is directly affected by the insolvency regime.

Are arbitrations suspended as a result of insolvency proceedings?

Differently from the U.S., where an automatic stay is triggered by the opening of insolvency proceedings, in Brazil insolvency has no standard effect on arbitrations. Parties can expect ongoing arbitrations to proceed, and new arbitrations may be filed by or against insolvent parties. Agreements to arbitrate remain valid and enforceable.

Do bankruptcy courts have jurisdiction over matters under arbitration?

Insolvent parties have often tried to induce the bankruptcy courts to accept jurisdiction over disputes covered by arbitration agreements. However, in a leading case decided in 2018, Brazil's Superior Court held – in a majority decision – that arbitrators, and not bankruptcy courts, have jurisdiction over matters covered by arbitration agreements.[2]

Although deference is given to an arbitral tribunal's jurisdiction, the enforcement of orders issued by such a tribunal is still subject to review by bankruptcy courts. In this review, the courts assess the potential impacts of enforcement on the debtors' restructuring framework and may control the implementation of enforcement measures (e.g. creation of judgment liens in assets, foreclose on property, etc.)

Are arbitral awards and settlements subject to the outcome of insolvency proceedings?

Yes. Arbitral awards arising out of pre-petition claims are subject to the outcome of the insolvency proceedings.[3] Post-petition claims are also subject to the liquidation regime. If the debtor is in judicial reorganization, arbitral awards must be enforced under the aegis of a reorganization plan. This may affect, in particular, any economic aspect of the award (e.g. by imposing haircuts, different forms of payment, payment schedules or applicable interest rates, etc.). In any event, payment of pre-petition claims outside the insolvency proceeding is unlawful, meaning no voluntary performance is allowed. If the debtor is in liquidation, enforcement must respect the established order for priority of payments.[4]

The same rules apply to the settlement of pre-petition claims. Notwithstanding the fact that an agreement has been reached to settle a dispute, this arrangement will then be subject to the insolvency proceedings (court approval may be required) and any resulting financial changes pursuant to a reorganization plan or the priority of payments under a liquidation regime.

How does a lack of resources impact a party's access to arbitration?

Lack of funds may impede an insolvent party from commencing or continuing an arbitration claim that could lead to a significant recovery.

A possible way of circumventing this problem is to seek third-party litigation funding. Third-party funders (often specialized funds) can finance the costs of an arbitration (including legal and expert fees, arbitrator costs and other disbursements) on a non-recourse basis, in exchange for payment that is contingent on the arbitration leading to a successful award.

Such payment is usually calculated as a proportion of the amount awarded or a multiple of the funder's costs investment. Obviously, a third-party litigation funder will insist on having first call on the proceeds of an award. Consequently, an insolvent claimant will need to seek bankruptcy court approval before concluding an agreement with a third-party funder.

Increasingly, arbitral tribunals are requiring that funded parties declare the existence of a funding agreement to their counterparty in an arbitration. This can, in turn, increase the likelihood of an application by respondents for security for costs.[5] In commercial arbitrations, tribunals will often consider a claimant's insolvency as a ground, in itself, for granting security for costs. This means that insolvent claimants and their funders may need to budget for the cost of providing such security or to show the tribunal that they have purchased 'After the Event' insurance to cover the risk of an adverse costs award. It is rarer for tribunals in investment treaty cases to issue security for costs orders. This is often because claimants can argue that their impecuniosity is the alleged result of respondent State measures at issue in the arbitration.

How insolvency proceedings affect the confidentiality of arbitrations?

Arbitrations do not take place in open court, meaning that information about disputes will not be publicly available as a matter of course. This does not mean, however, that an arbitration is automatically confidential. Brazilian Law requires that the parties conclude an express confidentiality agreement (or agree to submit to express confidentiality terms in terms of reference or through a procedural order) in order to prevent wider dissemination of information about the dispute.

However, Brazilian Bankruptcy Law requires an insolvent company to make public the existence of a dispute, which may give room for discussions where an express confidentiality obligation is in place.[6] More importantly, bankruptcy courts may lift confidentiality where an arbitration becomes relevant to the insolvency proceedings. This may happen, for example, when the expected proceeds of an arbitral award are assigned to one or more creditors. In such cases, the bankruptcy court may grant access to documents filed in the arbitration to creditors, minority shareholders or other interested parties.

Any dissemination of information or documents covered by confidentiality agreements must be carefully framed, particularly due to the lack of clear statutory guidance on the issue. First, it should be limited to parties with an interest in the dispute itself or indirectly in the effect the outcome of arbitration will have on the insolvency proceedings. Secondly, any lifting of confidentiality cannot lead to disclosure of information that is extremely sensitive (e.g. trade secrets) or protected by legal privilege (e.g. client-attorney communications). Parties in an arbitration should closely monitor the insolvency proceedings and, where necessary, appear before the bankruptcy court to resist any attempts to obtain unreasonably broad disclosure of information or documents that would otherwise be protected by confidentiality,

What are the possible consequences for international arbitrations?

An arbitral tribunal seated outside Brazil is not directly subject to the rulings of the Brazilian courts. However, where a respondent is an insolvent Brazilian company, a foreign arbitral award will likely need to be enforced against the company in Brazil.

Foreign arbitral awards are enforceable in Brazil under the New York Convention, but first require recognition (homologação) before the Brazilian Superior Court. Among other grounds, Article V (2) (b) of the New York Convention allows States to deny enforcement of a foreign arbitral award deemed to be contrary to the public policy of the enforcing country. Although the Brazilian Superior Court rarely interferes with the enforcement of foreign awards, it has refused to enforce awards found to be absolutely incompatible with the Brazilian legal system. Consequently, the need to ensure the smooth enforcement of an award issued outside Brazil is another reason why a claimant should closely monitor, and be represented in, proceedings before the Brazilian bankruptcy court.

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Footnotes:

[1] International Chamber of Commerce – ICC. ICC Dispute Resolution 2019 Statistics, p. 21.

[2] Oi S.A. v Juízo de Direito da 7ª Vara Empresarial do Rio de Janeiro, Tribunal de Justiça do Estado do Rio de Janeiro, Juízo Arbitral da Câmara de Arbitragem do Mercado de São Paulo (Superior Tribunal of Justice – STJ, Case n. 157.099-RJ), Final Award on Conflict of Jurisdiction, 30 Oct 2018.

[3] Pre-petition credits are credits existent at the date of which the insolvency petition was filed, regardless of whether the credit was due or not (see Articles 49 and 77 of Brazilian Bankruptcy Act). Accordingly, pre-petition claims are claims arising out of facts occurred prior to the insolvency petition. See Grupo de Comunicação Três S.A. – Em Recuperação Judicial v William Roberto de Campos (Superior Tribunal of Justice – STJ, Case 1.447.918-SP), Final Award on Special Appeal, 07 April 2016.

[4] See Article 83 of the Brazilian Bankruptcy Act.

[5] In summary, security for costs is a bond posted as a guarantee for the risk of the funded party being unable to pay the costs of the proceedings if ordered to do so, such as if it loses the claim.

[6] See Articles 6, §6, II and 51, IX of the Brazilian Bankruptcy Act.