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Reforming Insolvency Systems in Latin America

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Argentina, Colombia, Costa Rica, and Peru have recently revised their insolvency laws. The Argentine reforms are of special note because they have been complemented by labor law reforms. But reforms are still on the drawing board in many other countries in Latin America—including the big economies of Brazil and Mexico—where the laws tend to be very old, formalistic, not enforced, out of touch with today's business practices, and heavily skewed to favor preserving the enterprise to protect employment at the expense of creditor protection. Moreover, judicial decisionmaking is unpredictable, and corruption is rampant. In some countries anticreditor political pressures appear to have stalled the reform process. This Note assesses the weaknesses of insolvency law in Latin America and proposes some common solutions.

Conflicting interests

Most insolvency systems share two prime objectives: allocating risk among participants in the economy in a way that is predictable, equitable, and transparent, and maximizing the value of the insolvent firm for the benefit of all interested parties and the broader economy. Disputes usually center on how to maximize value—whether through liquidation or reorganization, whether with the existing management or under new management, and at whose expense. Once this is settled, the dispute then becomes a matter of hierarchy—who gets paid, how much, and when.

Where to strike the balance between the rights of debtors and creditors is a political decision. In Latin America the balance has historically favored preserving the enterprise to protect employment. While the consequences of a policy favoring preservation of the enterprise have not been studied closely in Latin America, one possible effect is a tendency to provide overly short-term credit. This is shown by an analysis of the French insolvency system, which emphasizes keeping firms in operation and preserving employment. To minimize the risk of being trapped in bankruptcy cases, French banks provide mostly short-term credit, renewing the loans only if the risk of bankruptcy over the next period is low. Yet this short-term financing increases the risk of bankruptcies caused by transitory decreases in firms' cash flows.

In the absence of an effective avenue for collection and a viable insolvency system, creditor banks have turned to the state for bailouts—sometimes billions of dollars worth. After the 1994 financial crisis in Mexico, for example, the state responded to banks' request for a bailout by creating special vehicles to purchase troubled loans. Mexican bankers resorted to the government in part out of a feeling that the insolvency system is ineffective in controlling credit losses.

Weak creditor protection may also deter banks from lending. One legal practitioner observes that Brazilian *concordata* (reorganization) and bankruptcy laws enable solvent debtors, without showing compelling need, to obtain a moratorium on their debt, allowing them to repay it in depreciated currency, or to have part of their debt extinguished. In both cases unsecured creditors run the risk of substantial losses, and even secured creditors can suffer losses. With sophisticated lenders clearly understanding these risks, conventional, unsecured lending may not take place.

Current problems

There are five main categories of problems. First, many of the current insolvency laws are rigid, formalistic, and old. In Mexico few *suspensíon de pagos* proceedings (suspension of payments proceedings, the closest thing in Mexico to a reorganization) succeed. And in Brazil as well as Mexico many of the insolvency provisions are simply theoretical or are not followed in practice. Both countries have insolvency schemes that date from the 1940s, with provisions still on the books that were designed to accommodate the difficulty of communicating before telecommunications. While age alone is no reason to reform a law, most of the region's economies have changed radically in recent years, while the laws have not.

Second, the high degree of judicial discretion increases uncertainty and financial risks and encourages corruption (though in Argentina recent reforms have diminished this discretion). Judges have the power to make such critical decisions as selecting the trustee and deciding contested issues of fact and law. In some cases they can decide what is in the best interests of all concerned. Some observers have accused the courts of having a paternalistic and interventionist perspective that values the general interest over the collective judgment and interest of the stakeholders.

Third, corruption is rampant. References to the "mafia" that works the bankruptcy field are common. The sense is not that organized crime is somehow endemic in the system, but that a core group of players control the field and exact kickbacks and bribes in exchange for favorable treatment. While opinions about the severity of the problem vary, they vary within a narrow range, with some observers believing that the problem in their jurisdiction is less virulent than it once was.

Fourth, a "rescue culture"—where creditors' interests are protected—is unlikely to thrive in the region without better enforcement. Skepticism—if not cynicism—about the functioning of the current systems is pervasive. Regardless of the text of the law, faith in the system is unlikely where creditors find, for example, as they have in Mexico, that the executive branch at the state level has refused to give the police the power to execute judgments out of political concerns over the public's reaction to enforcement. Such skepticism is widespread among general counsels of Mexican banks, which face a large backup of collection cases. Their view is that creditors have little chance of collecting on their debt in the current political environment and that judges do whatever they can to prevent collection. One bank alone is reputed to have 35,000 collection cases pending. This situation has led some to observe that in Mexico the issue is less the lack of a rescue culture than the existence of a culture of nonpayment.

That the absence of a rescue culture creates needless losses is borne out by current practice. In Mexico secured creditors regularly accept settlements worth far less than the value of their collateral, recognizing that a court process is likely to bring only delay and even lower value. Across Latin America creditors tend to lose all expectation of a meaningful recovery once a debtor enters the insolvency process, deterring them from getting involved with the system. Instead, creditors tend to write off a debt once a borrower is in bankruptcy. In Brazil a "white concordata" process has developed in which creditors agree to accept payouts below the statutory minimums once a debtor threatens to file for *falençia* (liquidation).

Fifth, as noted, there is a powerful, explicit bias in favor of labor. In Brazil, Mexico, and Venezuela labor claimants receive a high degree of preference and protection. For example, labor claimants in Mexico are not affected by insolvency moratoriums, are free to pursue their claims outside the bankruptcy court, and effectively have priority over secured creditors.

New priorities

A common set of essential reforms can be prescribed for all countries in Latin America, although the priority and sequencing of reforms in a country will depend on its circumstances.

Crack down on corruption. The widespread corruption in the insolvency system—not only among some judges but also among the core players (trustees, debtors, creditors)—calls for a multipronged strategy:

- Requiring disclosure of behind-the-scene dealings (such as collusive bidding or wrongful transfers of value from debtors to creditors).
- Creating incentives for ferreting out corruption.
- Setting rules of conduct—emphasizing transparency, accountability, and conflict of interest—for trustees in insolvency cases.
- Fostering associations of insolvency professionals to help improve knowledge, standards, and practice through education, peer pressure, and political influence (as in Canada).

Delink criminal and bankruptcy issues. Many Latin American countries have laws that classify bankruptcies by different degrees of fault (with no differentiation between the business and the businessman), some of which can result in criminal sanctions and bar insolvency relief (as in Mexico). By mixing the business and criminal aspects of insolvency, these laws deter owners and managers of failing businesses from seeking outside help early. Criminal conduct should not preclude insolvency relief to a business in crisis.

Foster transparency. To ensure that all participants in the insolvency process have accurate and timely information, priority should be given to maximizing transparency.

- Current statutes should be revised to require meaningful disclosure of information, particularly financial information.
- Trustees and other stakeholders should be given greater power to investigate debtors' past dealings, particularly with regard to transfers, collateral arrangements, and the like.
- Trustees should also be given greater power to recover assets wrongfully transferred, particularly overseas, through better procedural provisions, both domestic and international.

Help preserve going-concern value before and during insolvency. To aid the preservation of going-concern value, insolvency laws in most Latin American countries need to be revised to provide for more timely and predictable relief, by:

- Defining more precisely the standard to be met before insolvency relief can be granted (such as failure to pay a fixed number of creditors within a certain period).
- Permitting and encouraging insolvency relief so that it is more broadly available (as in the Costa Rican reform), not just for extreme financial disaster.
- Fixing a definite period, prior to a bankruptcy filing, within which a judge or trustee can void transactions that may be fraudulent or harmful to other creditors (probably 3 to 12 months).
- Revising avoidance statutes to encourage resolutions before petitions are filed. (Under the new Argentine law a mortgage or lien is not avoidable if the unsecured debt had matured, encouraging commercial banks to grant concessions during a workout.)
- Providing protection for postpetition creditors to encourage the granting of credit during insolvency proceedings.
- Eliminating provisions that needlessly drive toward liquidation (such as those prohibiting the sale of assets before they are appraised, or making creditors that, as a group, have voted for a debtor to stay in business liable to third parties if the debtor cannot perform).
- Providing for exits other than liquidation if a debtor fails to obtain the required consents from creditors to a proposal. (In Argentina shareholders' interests can be sold to third parties.)

Protect collateral. To give workouts a real chance of success, secured creditors could be barred from pursuing mortgage claims for a reasonable period during a nonliquidation proceeding. But the debtor should compensate the creditors appropriately for the value of the collateral that it consumes.

Reduce delay in bankruptcy proceedings. While promptness is a virtue in nearly all judicial proceedings (as long as quality is maintained), bankruptcy proceedings in particular demand rapid resolution because of the costs of delay to a firm's going-concern value and its underlying assets. Judges should be educated about these costs, and needless legal impediments that slow insolvency proceedings should be eliminated. These include the procedures for proof of claims, the ability to routinely appeal decisions, and the need for personal validation of claims in court hearings.

Enhance flexibility in reorganization. Current insolvency statutes have excessively formalistic and rigid requirements for reorganizations. Flexibility should be built into the relevant laws to:

- Allow for more than just a predetermined payout schedule (as in Brazil and Mexico).
- Allow for capital restructuring, including debt-to-equity conversions.
- Make adequate provisions for executory contracts (for example, contracts that are only partially completed).
- Address the setoff of debts in financial contracts.
- Provide for insolvencies of groups of affiliates (not permitted in Brazil and Mexico).
- Provide for the special needs of small and medium-size businesses, for example, by simplifying insolvency procedures for them (as is now done in Argentina).

Promote cooperation in cross-border insolvencies. Latin America has long adhered to the "territoriality" principle in cross-border insolvency cases, with each state asserting sovereignty. With the globalization of investment bringing about more joint ventures and other transactions that cross national boundaries, there is a growing need to harmonize bankruptcy and reorganization proceedings across borders. Those involved in cross-border bankruptcy proceedings want the same results that they would seek in a domestic case: reasonable notice, access and participation, predictability, enforcement, and fair and transparent distribution of assets.

Conventions ensuring cross-border cooperation have been difficult to achieve. But recent initiatives on several fronts may be promising. In the private sector Committee J of the International Bar Association has prepared a concordat providing procedures and administrative arrangements for cross-border court cooperation, which has been successfully implemented in a case involving U.S. and Canadian courts. Probably more important for Latin American countries is the model law on cross-border insolvencies developed in 1997 by the United Nations Commission on International Trade Law (UNCITRAL) to foster procedural and administrative coordination among courts. This law should be adopted by Latin American countries as a useful starting point for effective collaboration across borders.

Provide specialized courts and training. The complexities of insolvency exacerbate the problems of inadequate judicial training in Latin America. Special training on bankruptcy and insolvency law is essential for judges, along with training on business concepts such as accounting, derivatives, netting, and interest and exchange rates.

The specialized nature of bankruptcy law also requires specialized bankruptcy courts. Such courts have been successfully piloted in several countries in the region. Where specialized courts are not feasible in the near term because of a lack of resources or qualified judges, insolvency cases could be routed to designated commercial law judges. Another possibility is to use nonjudicial mechanisms to resolve cases, as in Colombia, or formal alternative dispute resolution programs, which could be annexed to courts or free-standing.

This Note is based on Malcolm Rowat and José Astigarraga, *Latin American Insolvency Systems: A Comparative Assessment* (World Bank Technical Paper 433, Washington, D.C., 1999).

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