Insolvency in Colombia: Regulatory Change or Cultural Change?

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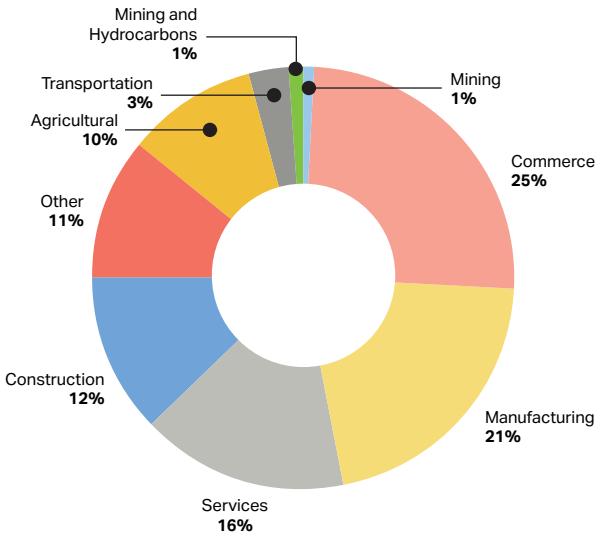
The recent avalanche of businesses seeking insolvency in Colombia, both through restructurings and formal insolvency proceedings, has led the various actors involved in Colombian insolvency processes to ask how to make this process more efficient and ensure that stakeholders receive maximum value. Over the past year, the Superintendence of Companies in Colombia (the "Superintendence") has led and encouraged discussion on this issue with a view towards transforming its insolvency procedures and generating a cultural change around the process to be further supported by regulatory changes.

The insolvency process in Colombia has evolved significantly over the last 25 years. In 1995, Decree Law 222 was enacted, and subsequently, in 1999, Law 550 was enacted with the purpose of addressing the economic crisis that the country suffered in the late 1990s. Law 550 specifically established an expedited system for restructuring of debtors. In 2006, Law 1116 was enacted to create a structural framework that would protect creditors while simultaneously safeguarding a company undergoing insolvency as a unit of economic development and source of employment under the criterion of value aggregation (Art. 1). In 2012, Law 1564 was enacted to regulate the insolvency of natural persons. Both corporate and personal insolvency processes in Colombia are administered by the Superintendence.

More than 10 years have passed since the most recent legal change to the insolvency process in Colombia. During this period of time, about 2,400 insolvency agreements have been executed, consisting of 1,100 restructuring agreements and 1,300 settlement agreements. In terms of industries affected, roughly 68% of these insolvencies were concentrated in 4 main sectors: commerce, manufacturing, agriculture and construction.

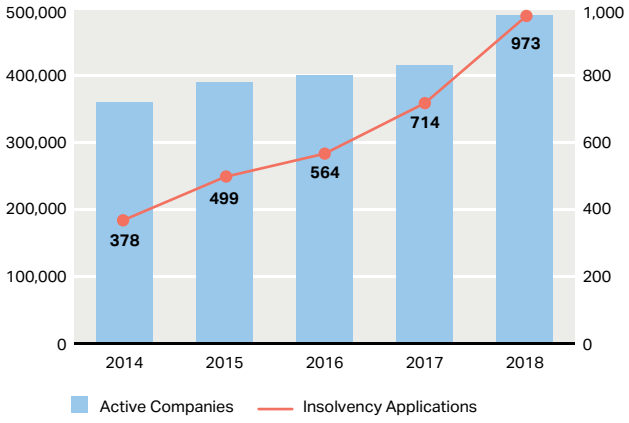
Insolvency Agreements by Sector
(2007–July 2019)



Source: Superintendence of Companies, Colombia, author calculations

Most recently, in the last 5 years, there has been a significant growth in the number of companies and individuals that benefit from the insolvency process, as evidenced by the following graph:

Active Companies vs. New Insolvency Applications



Source: Superintendence of Companies, Colombia, author calculations

In 2014, there were 378 insolvency applications submitted to the Superintendence and roughly 360,000 active companies in existence. In 2018, there were 973 insolvency applications submitted and roughly 490,000 active companies in existence. In terms of growth, while the number of active companies grew in the five-year period at an annual average rate of 8%, the insolvency process applications were made at a rate of 27% per year, a little more than three times the growth rate of active companies. As of the six months ended June 2019, the Superintendence had received 656 insolvency applications, which amounted to 67% of what it received in total during the year 2018.

These trends have created several challenges for the Superintendence. The first one is the need for a separate and expedited mechanism for the insolvency process of natural persons. Insolvency applications by natural persons currently make up 31% of the applications received during the year 2019, but only represented 18% of the total assets of restructurings under the insolvency law during the same period. Despite their lower asset value, insolvency applications by natural persons require the same amount of effort in terms of human resources and time spent on the cases as corporate restructurings, which represent 82% of all assets under restructurings under the insolvency law. In other words, the Superintendence invests the same significant resources in reviewing natural person insolvencies as it does addressing company insolvencies that are, on average, two times larger than those of natural persons. When considering that, on average, 80% of insolvency applications for natural persons are rejected due to defects in the application or because they do not meet the admissibility requirements, it is clear that resources spent on defective natural persons insolvency applications could be better spent by the Superintendence to improve the insolvency process of companies. Under this context, a regulatory change that reduces the pressure on the Superintendence from the natural person insolvency process and maximizes the efficient use of its resources is necessary.

Additionally, with respect to the insolvency process for companies, the new administration of the Superintendence that was appointed by the new government in Colombia at the end of 2018 has expressed the need to transform the insolvency ecosystem from a litigious process to a more transactional process. The aim is for the restructuring and liquidation process to become a timely and efficient solution so as to guarantee the protection of creditors and the recovery and conservation of the company as an unit of economic development, consistent with the objectives of the insolvency law. In this regard, the Superintendence has initiated a two-pronged effort: (1) a cultural change in the different actors facing insolvency, and (2) a regulatory

change to achieve a timely and efficient solution for companies in distress.

With regards to the cultural change, the Superintendence has created a space to discuss and disseminate the need for both debtors and creditors to take appropriate measures to address early insolvency warnings and consider the application for admission in a process of restructuring in a timely manner. The main warning sign for potential insolvency is a decrease in liquidity to meet a company's payment obligations to third parties, such as timely payments to suppliers, the payment of financing obligations or the payment of taxes and payroll. Other early warning signs include a decrease in profit margins and a limitation in access to credit. In the discussions mediated by the Superintendence, it has been argued that, due to cultural customs in Colombia, debtors generally make the decision to begin an insolvency process too late. This is due to lack of knowledge, embarrassment before the industry and stakeholders, fear of losing funding sources or simply due to the optimistic belief that the situation will somehow improve in the short term. In this context, simply acknowledging these factors and providing a space for public discussions on the matter is creating the awareness needed to cause debtors to begin an insolvency process at the appropriate time. Nevertheless, the process for such cultural change takes time and the results can only be seen in the long term.

The Superintendence's second line of effort, a regulatory change, is relatively easier to manage because it is a tangible task for which concrete metrics can be established. In particular, the current administration of the Superintendence has launched several working groups in April of 2019 to establish an intersectional and multidisciplinary dialogue. These working groups were based on the joint efforts and participation of multidisciplinary actors and experts in the insolvency industry and academia, and discussed the current issues and obstacles in insolvency law that require regulatory modification. As a result of these working groups, the Superintendence is now preparing new bills to modify the current regulations, which will be presented to Congress during the next legislative period in 2020. The main issues discussed by these groups were: (i) the development of an investment ecosystem to insolvent companies for the promotion and protection of credit under restructuring agreements; (ii) the balance in the distribution of voting powers for the approval of a restructuring agreement between the different types of creditors (labor, tax, secured and unsecured, internal and external); (iii) update of the rules for small companies insolvencies and natural persons and (iv) the role of the trustee (*promotor*) and business plans under the restructuring agreements.

Next we will highlight the two main changes that, in the authors' opinion, must be made to the existing regulations: (i) granting of post-filing financing (such as DIP financing) or financing under the restructuring agreements and (ii) the role of the trustee (*promotor)*.

Most companies enter into the restructuring process because they face serious liquidity problems that hinder them from meeting their payment obligations to third parties. In these cases, entering a restructuring process through which financial debt is restructured does not necessarily imply that the debtor automatically has sufficient liquidity to continue operating the company. Law 1116 establishes that the credit granted to the debtor by third parties (financial entities or others) after the execution of the restructuring agreement are considered administrative expenses during restructuring and consequently, have priority over any other obligation prior to the application for admission and that is within the framework of the restructuring agreement. Notwithstanding this priority in payment, the regulation applicable to financial institutions in Colombia obliges these entities to rate the debtor in a high risk category, creating a high reserve (between 60 and 100%) of the relevant obligation, which is why local financial institutions have no incentive to grant financing to rescue these companies. To overcome this barrier, a regulatory change is required. On the other hand, given that the insolvency ecosystem has been developing in Colombia and that there is an explicit priority in the regulations to meet the debt service of post-law loans, there is an opportunity for the development of the distressed financing market in Colombia. So far, this has been a local market focused on individual investors who have seen an opportunity to acquire the obligations of debtors at a discount under restructuring agreements with financial institutions and then inject resources to implement the turnaround in the insolvent company. However, most recently, with the aforementioned changes, local parties

have taken an interest in seeking foreign funds specialized in distressed debt to develop the Colombian market. Thus, we are beginning to see an influx of foreign investment toward this type of investment.

Finally, the role of the trustee (*promotor*) in the context of the restructuring process, both in practice and based on the provisions of the law, has been limited to the organization of the company's financial information to establish the votes and the ranking of the creditors for the restructuring agreement. In this context and to the extent that the objective of the insolvency law is the recovery and conservation of the Company as a unit of economic development, the proposal of a more robust role for the trustee (*promotor*) would include expanding its powers to validate the business plan for the insolvent Company, lead the negotiations with creditors and execute the restructuring agreement. The assignment of new functions seeks to align the role of the trustee (*promotor*) to that of a trustee under U.S. Chapter 11, as the party in charge of managing the debtor's assets once the process begins and the judge appoints it. In Colombia, the trustee (*promotor*) can be the same legal representative of the company and is not required to be an independent third party with the necessary expertise to carry out a restructuring agreement. If the role of the trustee (*promotor*) is to be strengthened and its functions expanded within the restructuring process, then ideally the trustee (*promotor*) should be different than the legal representative of the insolvent company. To successfully implement a restructuring process, an independent view of the situation and specialization in distress management are required. If the trustee (*promotor*) is the same person as the legal representative of the insolvent Company, the execution of the restructuring measures are less transparent and the recovery and conservation of the Company as a unit of economic development and generating source of employment, which is the ultimate goal of the restructuring process in accordance with the law, is put at risk. In the authors' opinion, this is definitely a required change in current regulations to ensure the success of the restructuring process. However, once this regulatory change is in effect, the Superintendence and the actors in the insolvency system must work on the cultural change to further develop a market of trustees (*promotores*) with the necessary skills required to manage companies in distress.

The challenges faced by the Superintendence and the actors in the insolvency industry in Colombia are not insignificant. However, the current administration in Colombia has taken an important first step by creating a dialogue about the cultural and regulatory changes that must take place in this industry and developing new opportunities for different actors such as providers of DIP financing and trustees (*promotores*). ■

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