Costa Rican Bankruptcy Rules: What Every Investor Needs To Know

By **ANDRÉS LÓPEZ**

Introduction

Costa Rican law on insolvency and bankruptcy creates a fairly reliable system that offers stability and solutions for creditors in Costa Rica and abroad. However, there are certain issues and complexities that foreign investors and professionals need to bear in mind.

From a general stand point, Costa Rican law contains specific rules and procedures designed to (1) restructure or reorganize the outstanding obligations of the debtor when there are viable solutions to its difficult financial situation or (2) liquidate the debtor's assets and pay its creditors when there is no viable remedy available.

Under Costa Rican law, commercial debtors (i.e., corporations, commercial entities) are subject to bankruptcy rules while individuals and organizations not formed for a pecuniary profit or commercial purpose are subject to insolvency rules. The rules on bankruptcy are stringent and reserved for the liquidation of assets owned by commercial debtors that have ceased payments on their obligations and are in financial

distress. Meanwhile, insolvency rules are designed to orderly liquidate the assets of individuals and non-commercial organizations through a relatively more simple process.

This article focuses on bankruptcy proceedings, the provisions governing such proceedings and the advantages and challenges they might present.

General Overview

The Costa Rican bankruptcy system may be described as more creditor-friendly due to its robust protections of creditors' rights. However, depending on the case, bankruptcy proceedings can be slow and difficult due to the existence of several codes and laws and also due to an overburdened court system. In addition, the satisfaction of creditors' interests depends on the availability of assets of the debtor. If the debtor does not have sufficient assets to satisfy each claim, then the creditors will be paid proportionally and up to the value of the assets available.

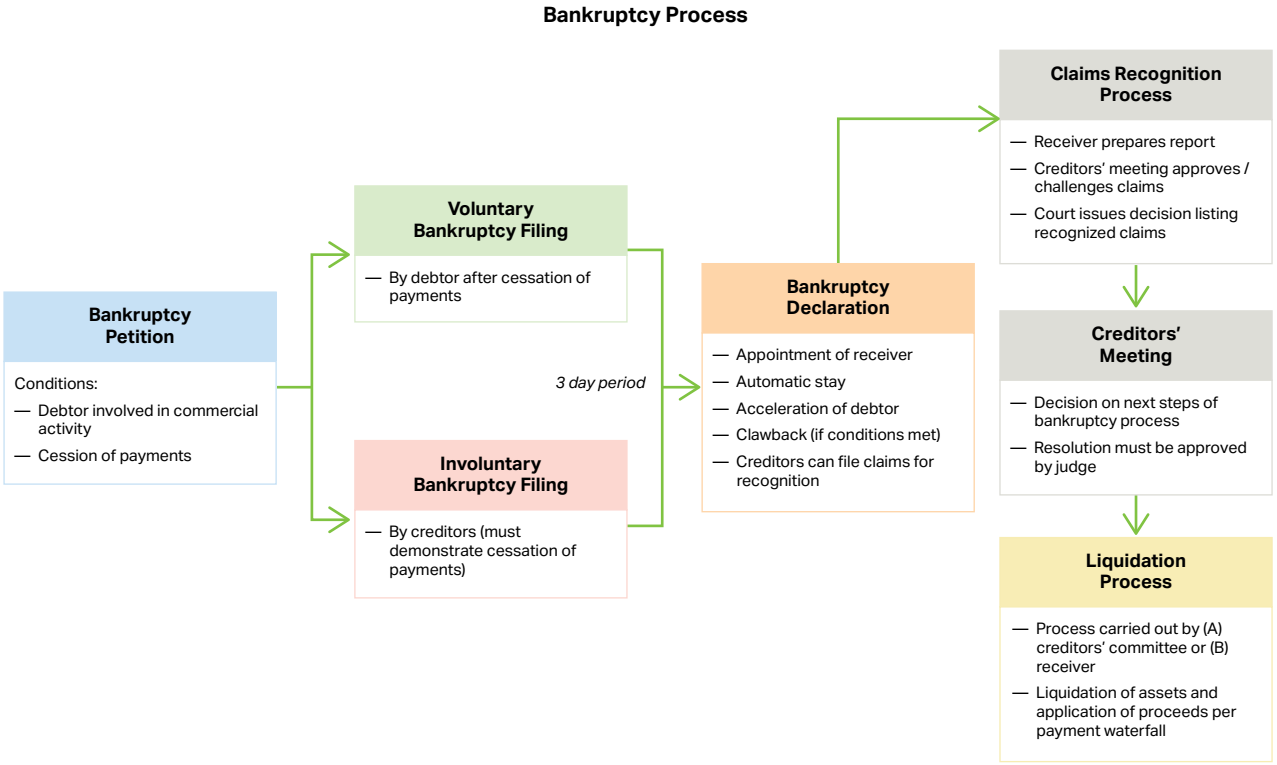
A bankruptcy proceeding is triggered by the inability of the debtor to pay its outstanding obligations. Bankruptcy cases are therefore related to a debtor's cessation of payments (and not to the debtor's possession of sufficient assets).

The Bankruptcy Proceeding

In order for a court to declare a debtor bankrupt, there are two requirements that must be met. First, the debtor must be involved in a commercial activity. Known as the subjective element (*elemento subjetivo*), this is the classic characteristic of bankruptcy proceedings. According to applicable law, all Costa Rican companies are deemed to be commercial entities by nature. In addition, individuals, local or foreign, and foreign companies that perform any type of commercial activity shall also be eligible under the bankruptcy rules.

Furthermore, the other relevant element that must be present in order for the court to declare the debtor bankrupt is the objective element (*elemento objetivo*), which is evidence of a cessation of payments. As mentioned before, sufficiency of assets is not relevant under Costa Rican bankruptcy law. The factor that triggers the bankruptcy is the inability of the company to pay its debts in a timely manner. Costa Rican case law has interpreted such cessation of payments as a condition of the debtor, meaning that it is a general situation of non-compliance with the entity's payments that is presumably not reversible.

The bankruptcy petition may be filed by the creditors but also by the debtor. Once the petition is filed by a creditor, the court in charge of the proceeding will issue a resolution and



give the debtor a three-day period to either pay the debt in full or to provide enough assets to secure its obligation with the creditor. If the debtor fails to pay or provide sufficient assets as requested, the court hearing the case will declare the debtor bankrupt and the proceeding will move forward regardless of the opposition of the debtor.

Upon the declaration of bankruptcy, all obligations of the debtor become due and payable. In the case of executory contracts, the receiver (appointed by the judge, as described below) may permit the debtor to continue with its obligations under such contracts. The receiver will then take over the rights and obligations the debtor under the contract. If the judge, after obtaining the receiver's and the creditors' input, does not permit the debtor to continue with its obligations under the executory contract, then the contract will be terminated and the counterparty of such contract will be able to file all available claims against the debtor.

In the resolution declaring the bankruptcy, the judge must appoint a receiver (the creditors do not participate in such appointment). The judge chooses the receiver from a list of pre-authorized attorneys that is prepared and managed by the court. Among the expenses related to the bankruptcy process, the fees of the receiver are easily the highest as they are based on a percentage (typically 5%)of the total liquidated value of the assets of the debtor.

The receiver is in charge of the management of the debtor company and its assets, and must produce a complete inventory of its assets and liabilities. The debtor company may dispose of assets through the receiver, but must have the previous authorization of the judge in charge of the bankruptcy.

Following the appointment of the receiver by the judge, there is the liquidation and appreciation of assets in accordance with the waterfall according to the priority rules described further below.

Out-of-court liquidation proceedings are possible and normally implemented through a trust or in a mediation proceeding. However, in order to implement an out-of-court proceeding of this kind, all parties must agree. Such alternative may not be imposed to any party because the access to an insolvency proceeding at court is a right that both creditors and debtors have. This is the reason why such out-of-court solution are not so common.

Although there are very detailed rules that deal with bankruptcy, they are not consolidated in one specific law or code. Instead, Costa Rica has both procedural and substantive rules spread across different laws, particularly in the Civil Code, the Commercial Code and the Civil Procedures Code. This is a situation that has added a level of complexity to bankruptcy cases over the years, because the court has had to issue resolutions that intend to harmonize and integrate the rules from various separate legal codes. There are several aspects of our bankruptcy legislation that need to be updated and modified, but a modern, comprehensive and exclusive bankruptcy law is certainly one the main issues we need to address.

Creditors' Rights

The effect of the declaration of bankruptcy on the debtor's assets is that the assets are from that point on seized for the benefit of creditors. This means that the assets are reserved to be liquidated and the proceeds of such liquidation will be used to repay the creditors' outstanding obligations. Therefore, the assets cannot be sold, transferred or encumbered unless the court determines that it is for the best interest of the creditors.

The procedures established by law are designed to treat all creditors equally within their specific classification (*par condicio creditorum principle*), including foreign creditors. This means that when two or more unsecured creditors benefit from the same level of protection, no one creditor may be paid a higher percentage of their claim than other creditors and if funds are not enough to pay them all, they should be paid proportionally to the amount of their pending debt.

For the purpose of approval and payment of the bankrupt obligations, creditors are classified as follows, in order of priority:

— Creditors having a rights over specific assets of the debtor:

- The federal government and the several municipal governments for certain taxes owed in connection with the relevant asset
- Creditors secured by a mortgage (real estate)
- Creditors secured by a pledge or movable asset guarantees
- Creditors that have the right to withhold the assets from the debtor
- The lessor of real estate for any lease payments due

— Employee creditors

— Creditors of the bankruptcy proceeding itself (this refers to any obligations acquired by the bankruptcy estate/receiver on behalf of the bankrupt debtor after the bankruptcy order issued

— Unsecured creditors

Creditors whose debt is secured by a real assets guarantee may continue collecting on such security. Depending on the security and the status of collection procedures, the creditor may initiate an independent claim against the debtor or may be called to initiate or continue collection procedures with the same bankruptcy judge.

Extension of Bankruptcy Protections to Companies in the Same Economic Interest Group

Although there is no specific provision in the bankruptcy laws, based on civil procedure rules governing reorganization proceedings, Costa Rican case law has recognized the extension of bankruptcy protection to all companies belonging to the same economic interest group (*grupo de interés económico*), which may include companies outside Costa Rica.

In order to obtain an extension from the court, companies consider the following factors (which are neither exclusive nor dispositive):

— be considered one business and economic unit

— have similar or common words shared in their names

— have common representatives and shareholders

— have the same domicile

— the direction of the companies is exercised by one person or group that is common to all of them

In this case, there is an element that case law has accepted as clear evidence of the existence of the same economic interest group, and that is the express acceptance of such existence by the companies of the group.

The extension of bankruptcy protection to companies of the same economic interest group has proven to be important for foreign investors, as it is customary for groups of companies to distribute funds or assets amongst their subsidiaries and affiliates, making it difficult for their creditor to pursue those assets or funds when collecting their debts as there is a separation of assets due to the individuality of each company.

Several court resolutions have dealt with the recognition of the economic interest group within bankruptcy proceedings, but there is one resolution issued in 2006 that presents the basics of the arguments that have supported this thesis. Resolution 985-F-2006 issued by the First Chamber of the Costa Rican Supreme Court established:

> *"These groups are usually formed by several independent legal entities. They arise in the context of economic models in which the expansion of markets, thanks to globalization, promotes unions, creation or integration of a complexity of subjects, usually corporations, to meet the needs of consumers, increasingly less simple. Thus, they can respond to the most diverse reasons, but all of them, usually operative, among which can be cited a wide variety, from the specialization by activities, to the exploitation of specific geographical areas. The intra-organic relationship can be of direction, with an entity at the head and several subordinates, or, of coordination, between legal persons with similar decision-making power. To create them, a variety of mechanisms are used, such as business agreements (contracts) or acquisition of shares. This form of organization, absolutely legitimate as it responds to the exercise of the autonomy of the will, freedom of commerce and freedom of association, however, should not be used in fraud of law. Therefore,* ***the majority of doctrines states that the legal independence held by the members of the group cannot constitute a screen to cause harm to the principle of patrimonial responsibility****. Imagine, for example, a group of economic interest constituted, for instance, by a directing legal entity that also owns all the assets of the group and also owns the capital, which decides to constitute a series of subordinated companies with insufficient capital, with the purpose of acquiring obligations through them, in such a way that in case of non-compliance, only the assets of the latter are subject to liability, protecting their real operating assets from third parties. However,* ***this fraud of law is avoided through the declaration of existence of a group of economic interest, which is justified in the fact that it functions as a single economic entity and, therefore, must respond accordingly.***"

Look Back Period

Among the variety of rules that deal with bankruptcy, there are provisions that establish a look back period mainly as a protection for creditors. The look back period protects creditors from any action by the debtor which adversely impacts its patrimony by diminishing its assets and/or increasing its liabilities before the declaration of bankruptcy. Therefore, during the lookback period, all extraordinary actions of the debtor are suspicious and therefore may be challenged by the receiver or the creditors and eventually be annulled by the judge.

The judge sets the date in which the look back period starts when the declaration of bankruptcy of the debtor is issued. In this resolution, the judge applies the effects of the bankruptcy declaration back in time until the date in which the debtor became insolvent. This date is set preliminarily, because the order is issued very early in the process, but may be changed later as the judge gets more information.

The judge may set that date of insolvency up to three months back from the time of the declaration of bankruptcy. Upon request of the receiver or any of the creditors, the date of insolvency may be changed going back up to a maximum of six months from the time of the bankruptcy.

Similar rules apply when there are fraudulent transfers or the creation of security interests by the debtor when the cessation of payments occurred or even when it was imminent. In such cases, the receiver and the creditors might challenge disposition of assets or payment of debt for longer periods than those described in the previous paragraph.

This is another issue that must be taken into consideration by foreign investors, especially when coming into the bankruptcy proceedings late in the game.

Foreign Bankruptcies Involving Costa Rican Assets

A foreign bankruptcy process may seek to adjudicate for assets located in Costa Rica, but a preliminary liquidation process in Costa Rica must take place first, as such assets are held by the law as a preferred guaranty for the local creditors. Creditors in Costa Rica are protected before bankruptcy proceedings pending in other countries.

The law specifically requires that before adjudicating for local assets, a foreign bankruptcy must establish a partial liquidation procedure in which local creditors are convened to officially recognize their claims under law and be paid against the debtor's assets, before the foreign liquidation proceeding may dispose of those assets. If there are no local creditors or when there are, after they are duly paid, the judge will allow access to the foreign receivership to dispose of the debtor's assets.

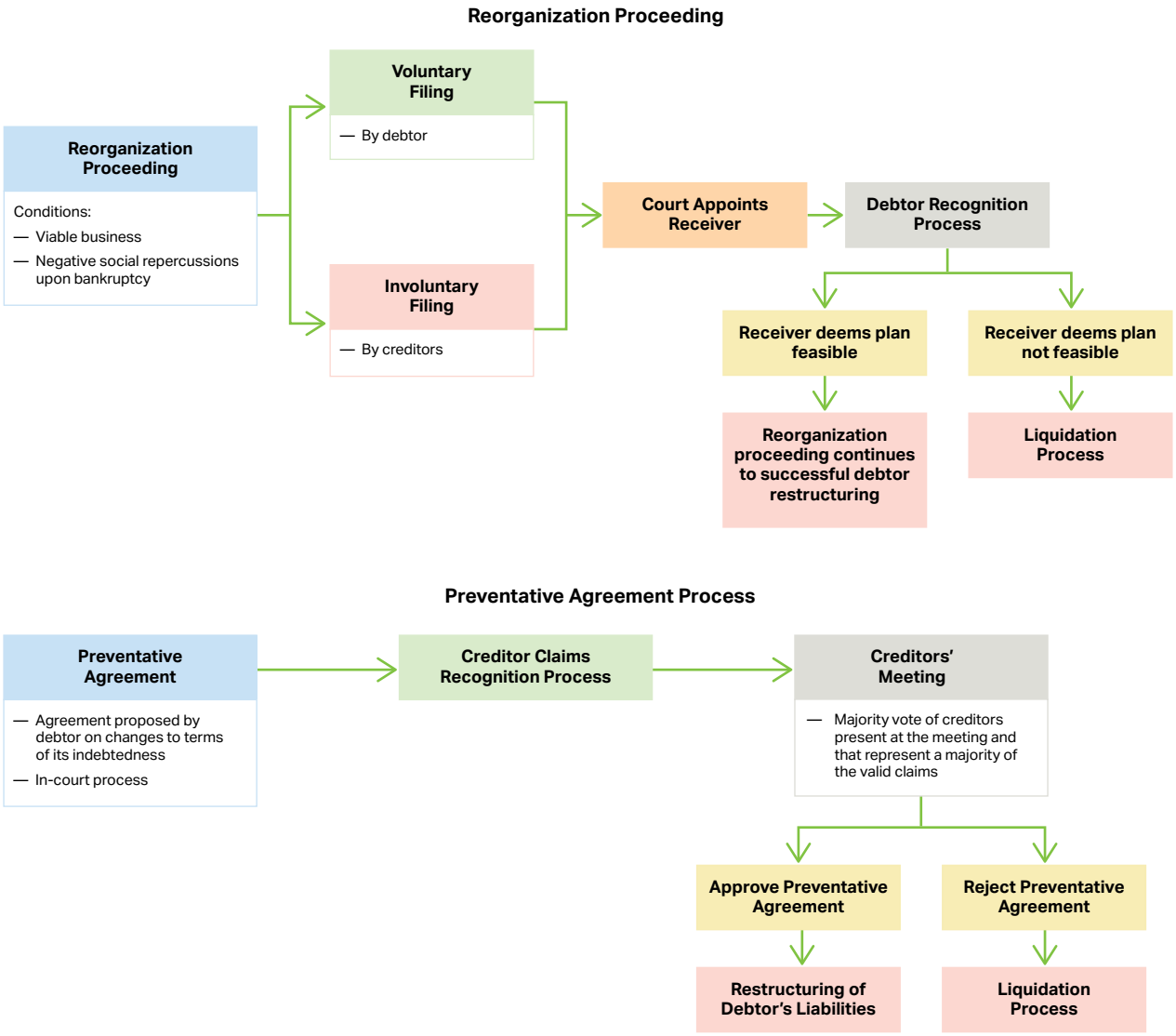
Alternatives to Bankruptcy: Rehabilitation Mechanisms

Under Costa Rica law, there are two alternative legal measures which are intended to avoid the liquidation for commercial debtors. However, they still need improvement in order to be viable remedies to rescue the financial situation of the debtor.

This first is an in-court reorganization proceeding, which may be initiated by either the debtor or a creditor. The rules governing this proceeding are reflected in the Civil Procedures Code of Costa Rica. In order to take advantage of this option, the court must determine that there exist the following two main requirements: (1) the debtor must still have a viable business and (2) in the event the debtor declares bankruptcy, there will be negative social repercussions (e.g., significant job losses, detrimental effects to creditors or providers of the company). Once the proceeding begins, the judge will appoint a receiver to take control of the debtor's business. However, before that occurs, the debtor must present a reorganization plan and the receiver must determine that the plan is feasible. The creditors may also opine on the plan but the judge will at the end decide, with all the elements of the case, if the plan is acceptable or not. If the plan is feasible, the proceeding will continue, otherwise, the reorganization will convert into liquidation. Among other advantages, the debtor can obtain a reduction in principal and interest payments on loans if the process is successful. This procedure is not attractive for debtors in general, because of the complexity of the requirements, especially the reorganization plan, and also because if the plan is not accepted, there is a possibility that the company will go into bankruptcy.

The second measure is an in-court proceeding whereby the debtor may propose before the court a "preventative agreement," providing specific changes to the terms and conditions of its outstanding indebtedness to obtain some relief from its payment obligations. Creditors will then present their claims before the court so that they and their claims are recognized before the law. If approved, such creditors will convene a creditors' meeting and the creditors' meeting may approve or deny by a majority vote the agreement presented by the debtor. If the agreement is rejected, then the debtor must pursue a liquidation proceeding under the bankruptcy rules. This measure is also not that popular, mainly because the continuity of the debtor lays in the hands of the creditors.

As discussed, the preventive measures described above are not that attractive to debtors in Costa Rica. That is clearly confirmed by the fact that between 2015 and 2017 only 3 of reorganization and 4 of preventive agreement have been filed, in contrast with 73 cases of bankruptcy filed within the same period of time.



Conclusion

There are certainly more issues worth analyzing in the Costa Rican bankruptcy system, but we believe those set out here are relevant for foreign companies, business executives and attorneys. Based on what has been laid out here, we can come to the following conclusions:

— Costa Rican law has structured a reliable system regarding bankruptcy of commercial debtors, covering relevant issues such as creditor rights, foreign bankruptcies, economic interest groups, etc.

— Nevertheless, the complex structure of codes and laws and judicial delay in attending the cases make procedures slow and cumbersome.

— In addition to the losses incurred in bankruptcy proceedings, creditors need to consider if there are other relevant expenses to bear such as the receiver's fee.

— Preventive measures intended to avoid the liquidation of a debtor whose difficult financial situation may be resolved exist, but present certain inconveniences that make them unattractive.

— There is definitively room for improvement in the Costa Rican insolvency and bankruptcy system, especially in regards to the simplification and modernization of the tools to restructure companies in financial difficulties, the efficiency of court offices dealing with these cases, the expenses that users must incur when involved in these kinds of proceedings and the availability of measures to assist debtors with financial difficulties but with a viable business. ■

Key Indicators – Costa Rica Bankruptcy and Insolvency Regime

Experience Level: Some established precedents of successful in-court restructurings involving international bond or bank debt or multiple established precedents but mostly occurring more than 10 years ago.

KEY PROCEDURAL ISSUES	
Can bondholders/lenders participate directly (i.e., do they have standing to individually participate in a proceeding or must they act through a trustee/agent as recognized creditor?)	Yes
Involuntary reorganization proceeding that can be initiated by creditors?	Yes
Can creditors propose a plan?	No
Can a creditor-proposed plan be approved without consent of shareholders?	No
Absolute Priority Rule?	No
Are ex parte proceedings (where only one party participates and the other party is not given prior notice or an opportunity to be heard) permitted?	No
Are corruption/improper influence issues a common occurrence?	No
Viable prepackaged proceeding available that can be completed in 3-6 months	No
Secured creditors subject to automatic stay?	Yes
Creditors have ability to challenge fraudulent or suspect transactions (and there is precedent for doing so)	Yes
Bond required to be posted in case of involuntary filing or challenge to fraudulent/suspect transactions?	No
Labor claims can be addressed through a restructuring proceeding	No
Grants super-priority status to DIP financing?	No
Restructuring plan may be implemented while appeals are pending?	Yes
Does the restructuring plan, once approved, bind non-consenting (or abstaining) creditors?	Yes
Does the debtor have the ability to choose which court in which to file the insolvency proceeding (or is it bound to file where its corporate domicile is)?	No
Other significant exclusions from automatic stay?	No
Prevents voting by intercompany debt?	No
Strict time limits on completing procedure?	No
Management remains in place during proceeding?	No

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Mr. López's practice focuses on banking and finance transactions. He has represented lenders and borrowers in a wide range of transactions for over 20 years. He also has broad experience in real estate and corporate transactions, civil and commercial litigation and arbitration. He has participated as legal advisor in many national and international transactions in which he has been responsible for coordinating with several participants, including parties from other countries such as United States of America, Panama, Grand Caiman, United Kingdom, Netherlands and Germany.

Mr. López became a member of the Costa Rican bar in 1996. He is an arbitrator at the International Center of Arbitration and Conciliation of the Costa Rican-American Chamber of Commerce. He is also Vice President of the Costa Rican Chamber of Commerce and Vice President of the Costa Rican chapter of the International Chamber of Commerce.

He received a law degree from the University of Costa Rica in 1996 and a post-graduate degree in commercial law from the University of Costa Rica in 2000.