Assessing a New Evolution in Chile: In-Court Reorganization Proceedings

By **FRANCISCO JAVIER ILLANES** *and* **SERGIO BALHARRY**

Chile enacted a new insolvency law (*Ley de Reorganización y Liquidación de Activos de Empresas y Personas, or the "New Insolvency Law"*) that went into effect in October 2014. Several novelties were introduced, including the introduction of special insolvency proceedings for individuals, the inclusion of the UNCITRAL Model Law on cross-border insolvency, and a new Agency of Insolvency and Recommencement. The New Insolvency Law also purports to correct the long duration of insolvency proceedings under the previous law.[1] However, the most important development is a new in-court reorganization proceeding (*procedimiento concursal de reorganización*), which is somewhat comparable to a Chapter 11 proceeding of the U.S. Bankruptcy Code.

Scenario before the New Insolvency Law

The previous insolvency law included the possibility of avoiding bankruptcy through a "Preventive Judicial Agreement" (*Convenio Judicial Preventivo*). By means of an in-court proceeding, the debtor would be able to obtain an agreement that would be binding on its creditors. This procedure had several shortcomings for the debtor. Possibly the most relevant of these deficiencies were:

a. **The agreement was only binding on unsecured creditors**. Secured creditors could only participate and vote in the relevant creditors meeting, and become a party to the agreement, if they waived their preferred ranking status. In practice, secured creditors normally preferred to keep their preferred ranking status to be able to enforce their collateral, so it was not common that the Preventive Judicial Agreement was binding on this class of creditors. This meant that in spite of Preventive Judicial Agreements, secured creditors could enforce their collateral. But, if the assets granted as collateral were deemed to be essential for the debtor's normal operation, the enforcement of the collateral would make it very difficult for the debtor to continue with its operations and comply with its obligations under the Preventive Judicial Agreement.

b. **Collection and enforcement proceedings against the debtor continued**. During the proceeding to obtain a Preventive Judicial Agreement, creditors could still initiate collection proceedings against the debtor or enforce collateral granted to secure their credits. The collection and enforcement proceedings were only suspended if the debtor had presented the agreement proposal with the support of two or more creditors representing more than 50% of the total debts. Therefore, prior to the initiation of the proceeding to obtain a Preventive Judicial Agreement, the debtor would need to negotiate to obtain creditors' support, but without any protection against possible legal actions during that period. This resulted in an important risk that the debtor's assets and operations would be adversely affected during the negotiation with its creditors.

The New Reorganization Proceeding

One of the main innovations of the New Insolvency Law is a new in-court reorganization proceeding,[2] focused on allowing viable businesses to overcome temporary periods of financial distress. When the bill to modify the previous bankruptcy law was presented in May 2012, the President indicated that the project "is based on promoting and encouraging, in the first place, the effective reorganization of viable enterprises, that is, to allow that an enterprise that has the possibility to subsist and flourish may overcome the transitory difficulties in which it is, with help from its creditors and in pursuit of continuing as a productive unit."

Of Bankruptcy, Insolvency and Criminal Offenses

The objective of the New Insolvency Law to promote the continuation of viable businesses is not only embodied by the inclusion of the new in-court reorganization proceeding, but it also becomes apparent through several other legal provisions.

For example, the New Insolvency Law abolishes the term "bankruptcy", replacing it with the terms "insolvency", "reorganization" or "liquidation", depending on the case. The idea behind this change was that the term "bankruptcy" was perceived too negatively. The view was that a debtor involved in a bankruptcy carried a sort of "social stigma", which reduced the possibilities of reinserting that debtor as a productive business unit. The new wording would be perceived as more "technical" and less "disgraceful", thus making it easier for debtors to make use of the insolvency proceedings provided under the New Insolvency Law to effectively reintroduce themselves in the economy.

Another example is the modification of the rules about insolvency criminal offenses. Under the previous insolvency law, a debtor was subject to criminal penalties if its bankruptcy was considered guilty or fraudulent. The law did not include a definition of "guilty" or "fraudulent" bankruptcy. Rather, it described several conducts that were legal presumptions of a guilty or fraudulent bankruptcy. This legal technique considered by some as confusing and outdated, so the New Insolvency Law replaced it with a description of specific conducts that constitute crimes in the context of an insolvency, but without considering the insolvency itself as a crime. Also, under the previous law, a debtor that failed to request its own bankruptcy within a short term from the date of suspension of payments could be exposed to criminal liability. This sanction was eliminated under the New Insolvency Law.

The new reorganization proceeding deals with the main shortcomings of the Preventive Judicial Agreement:

a. For example, the New Insolvency Law does not require that a secured creditor waive its preferred ranking status to become subject to the reorganization agreement. A debtor may now submit a reorganization plan that includes provisions binding on unsecured creditors as well as secured creditors. If the reorganization plan proposed by the debtor is approved by its creditors, with certain voting thresholds that need to be met by each class of creditors, the reorganization agreement becomes binding for both secured and unsecured creditors. This allows the debtor to effectively continue its operations, as secured creditors would not be able to enforce their collateral and should only request payment in accordance with the terms of the reorganization agreement. Secured creditors, however, tend to have a negative view of this aspect of the law, as the effectiveness of their collateral is reduced in comparison to the previous law.

However, the reorganization agreement is not necessarily binding for all secured creditors. Creditors with collateral over assets that are not essential for the operation of the debtor's business are not affected by the reorganization agreement, and their credits are not considered for purposes of calculating the quorums required for the approval of the reorganization plan. This allows those creditors to enforce their collateral regardless of the terms of the reorganization agreement. As the objective of the reorganization proceeding is to allow a debtor to continue its operations, the law did not limit the possibility of creditors to obtain liquidity through the sale of assets that are not necessary for the continuation of debtor's business. The problem with this approach is the difficulty to determine if an asset granted as collateral is essential or not. The New Insolvency Law initially grants the debtor the opportunity to determine which of its assets are essential for its business, at the time of filing for the reorganization proceeding. Afterwards, creditors have a period of time to contest the "essential" condition of an asset, in which case it will ultimately fall on the court to decide on whether the relevant asset is essential or not for continuing the debtor's business.

Creditors Related to the Debtor

It is possible, and to a certain point quite common, for debtors to have related party creditors. The New Insolvency Law provides special rules applicable to those credits, starting with a list of persons that are considered "Related Persons" to the debtor, such as:

— certain relatives of the debtor or of its representatives;

— parent or subsidiary companies of the debtor;

— directors, managers, administrators, principal executives or liquidators of the debtor, and certain relatives of those persons, as well as any entity controlled, directly or through others, by any of them; and

— persons who, on their own or with others with whom they have joint action agreements, may designate at least one member of the management of the company or control 10% or more of the equity or voting capital.

Creditors who are considered related persons do not have the right to vote in reorganization proceedings, and their credits are not considered for purposes of calculating the quorums required for the approval of the reorganization plan.

However, their credits are treated as any other credit for purposes of the reorganization agreement, and those creditors would be paid in accordance with the terms and conditions of the agreement. Yet, in certain cases the credits of related persons are subordinated to the payment of the credits of unsecured creditors, such as when the credit of a related party is not properly documented at least 90 business days prior to the initiation of the reorganization proceeding.

b. The debtor that requests the initiation of a reorganization proceeding benefits from a stay period, which is triggered by a court resolution promptly after the filing once the debtor has submitted additional documents, without needing creditors' prior support. This stay period is called "*Protección Financiera Concursal*". During this stay period, no execution or enforcement procedures may be initiated against the borrower. If these legal procedures had commenced before the stay period, they will be suspended. Also, the event of the initiation of the reorganization proceeding cannot be claimed as grounds for: (i) the unilateral termination of agreements entered into by the debtor; (ii) the acceleration of debts; and (iii) the enforcement of collateral granted by the debtor. The debtor continues to manage its business during this stay period, but the debtor is subject

Stay Period

The stay period lasts, initially, 30 business days. However, there are several cases in which this period may be extended with creditors' support:

1. With the support of two or more creditors representing more than 30% of the total debts, excluding credits from related parties, the stay period may be extended for up to 30 additional business days.
2. With the support of two or more creditors representing more than 50% of the total debts, excluding credits from related parties, the stay period may be extended for up to 60 additional business days, or for 30 additional business days if the stay period was extended according to number 1) above.
3. At the end of the stay period, a creditors' meeting will determine if the reorganization plan is approved or not. If the reorganization plan is not approved, a liquidation proceeding against the debtor would normally be initiated. However, the creditors may agree on giving the debtor a chance to present a second reorganization plan, in which case the stay period is extended for 20 business days. The quorum required in this case is two-thirds of the total debts with right to vote.
4. The creditors' meeting that needs to decide on the reorganization plan may also agree on suspending the meeting to decide on the reorganization plan at a later date. The suspension may last for up to 10 business days, during which the debtor still benefits from the stay period. This suspension needs to be approved by the absolute majority of the total debts with right to vote.

Local lawyers have also been able to extend the stay period without the need of obtaining the support of creditors, at least on a limited basis. They do so by applying general provisions of the civil procedure rules, specifically the possibility of requesting a prejudicial injunction (*medidas prejudiciales precautorias*) from the courts. Through the prejudicial injunction proceeding, the debtor informs the court that it will initiate a reorganization proceeding, to obtain a court resolution prohibiting specific creditors from unilaterally terminating agreements that are essential for the debtor's business. This protection lasts for a limited time (between 10 and 30 business days), and is only effective against creditors that are a party to the prejudicial injunction proceeding. However, this mechanism has helped debtors to obtain extra days to be able to prepare the documents required to request the initiation of a reorganization proceeding, to prepare a better reorganization plan and to try to obtain the support of creditors for the plan.

to certain limitations, and an overseer (*veedor*) is appointed by the court to oversee the reorganization process, with supervision authorities over the management of the debtor.

Reorganization Proceedings in Practice

It is still early to determine whether the New Insolvency Law will be successful in allowing viable enterprises to overcome periods of financial distress. However, a timely question might be whether debtors are using this new mechanism.

According to data provided by the Agency of Insolvency and Recommencement (*Superintendencia de Insolvencia y Reemprendimiento*, or the "Agency"), 53 reorganization proceedings were initiated during 2016. During the same period, 701 liquidation proceedings were initiated. Although debtors may be more inclined to use reorganization proceedings in the future, from these numbers it is apparent that reorganization proceedings are, for now, still far from replacing liquidation proceedings.[3] One possible explanation for this relatively low number is that a majority of the enterprises that initiated insolvency proceedings simply were not economically viable entities: debtors in financial distress may have undergone liquidation proceedings if they considered that a reorganization proceeding was not a feasible option. Another reason may be that debtors prefer to reach private agreements with their financial creditors without using the reorganization proceeding, and therefore those private agreements would not be reflected in the data of the Agency. This is usually the preferred first choice for larger debtors.

Under the prior insolvency law, it was common practice that debtors, whose creditors were mainly banks, did not file for a Preventive Judicial Agreement, but instead negotiated with their financial creditors a private agreement restructuring its debt. This normally involved term extensions and granting of collateral, rather than debt haircuts. In these cases, the financial creditors generally acted as a group to negotiate with the debtor and reach an agreement. It is possible that both creditors and debtors are still accustomed to this practice and use it instead of a reorganization proceeding, which may be perceived as a last resort because a liquidation proceeding would normally be initiated if the reorganization plan is not approved. Also, it seems that local banks consider that

The Agency's View on the Use of Reorganization Proceedings[4]

The New Insolvency Law is an important regulatory development with respect to the prior insolvency law. First, it distinguishes between different types of debtors, by creating proceedings designed specifically for legal entities and those for individuals. Regarding the proceedings applicable to legal entities, and following international best practices, the New Insolvency Law seeks to distinguish between proceedings for debtors with an economically viable business and those in an unsustainable business. For the first group of debtors, it provides a flexible and transparent reorganization proceeding, and for the second group, a fast and efficient proceeding to liquidate assets. The New Insolvency Law also introduces the proper incentives in each proceeding, so that creditors and debtors may decide between one and the other by using as sole criteria the real possibility of obtaining the recovery of the business.

In this regard, the Agency communications campaign about the New Insolvency Law resulted in widespread promotion of insolvency proceedings as a possible solution to the over indebtedness of Chileans. Under the prior insolvency law, there were an average of 143 bankruptcy proceedings and 11 restructurings per year, while under the New Insolvency Law, there have been an average of 512 liquidation proceedings and 49 reorganization proceedings per year between 2015 and 2016.

Reorganization proceedings take an average of 84 business days from the date of filing to the date of the creditor's meeting that needs to decide on the reorganization plan, which is less than the originally expected term of four months. In addition, 51% of the debtors are large-size companies, while 26% are medium-size companies, 10% small companies and 13% micro-enterprises. With respect to the business activity of these debtors, 22% conducted commercial activities, followed by construction with 21% and non-metallic industries with 15%.

Based on the data mentioned above, it seems that this tool is used mostly by large companies, unlike liquidations proceedings that normally apply to medium and small companies and micro-enterprises. As a comparison, until July 2016, the total debt recognized in liquidation proceedings was an average of USD 237,000,[5] while in reorganization proceedings the average was of approximately USD 23.7 million.[6]

According to data provided by the Chilean tax authority, in 2015, 96% of Chilean companies were either small companies or micro-enterprises. Thus, the fact that the majority of the debtors filing for reorganization proceedings are large companies is caused, to a greater or lesser extent, by several entry barriers provided by the law, which are the costs and formalities related to the initiation of the reorganization proceeding. According to studies by the Agency, the average fee of the overseers (*veedores*) is approximately USD 16,720. This cost is increased by the fees of the debtor's counsel and of the independent auditor that must issue a certificate of the debtor's situation under the proceeding. Only considering the costs involved, the proceeding becomes a barrier that is difficult to overcome for smaller companies in financial distress.

reorganization proceedings represent an improvement of the debtor's negotiating position. Therefore, these creditors may still prefer to avoid that their debtors initiate reorganization proceedings. This may vary on a case-by-case basis, as creditors may also be interested in restructuring the debtor's debt through a reorganization agreement, for example, to avoid the possibility of claw-back actions that could affect a private restructuring agreement.

Also, in certain cases, in-court reorganization proceedings have not been used as originally intended. Local legal practice has sometimes used these proceedings as an alternative way to liquidate the debtor's assets to pay its creditors, instead of using it as a way to allow the debtor to continue its operations. In these cases, creditors try to achieve the liquidation of the assets of the debtor in an organized manner. The debtor and its creditors would still be required to agree on a reorganization agreement, but the contents of the agreement would refer to the way the debtor should operate its business and liquidate its assets. Unlike a "regular" liquidation proceeding, in which the debtor's business is managed by a court-appointed trustee, and unlike a "regular" reorganization proceeding, in which essential assets are not liquidated to allow the continuation of the debtor's business, in this "liquidation reorganization agreement" the debtor continues to manage the company, but only to liquidate all of its assets in the manner agreed with its creditors.

Claw-back Actions

The New Insolvency Law amends the former claw-back period rules such that, generally, any transfer, encumbrance or other transaction executed or granted by the debtor during the term of two years prior to the commencement of the reorganization or liquidation proceedings, may be rendered ineffective if it is proved before the court that such transfer, encumbrance or transaction: (i) was entered into with the counterparty's knowledge of the debtor's poor business condition; and (ii) caused damages to the bankruptcy estate (e.g., that the transaction has not been entered into under terms and conditions similar to those prevalent in the market at the time of its execution) or has affected the parity that shall exist among creditors.

Similarly to the previous insolvency law, the New Insolvency Law also provides certain cases in which transfers, encumbrances or other transactions executed or granted during the term of one year prior to the commencement of the insolvency proceedings (extendable to two years in certain events) are deemed ineffective, based on objective grounds, such as pre-payments, payments with terms different than as originally agreed to by the parties and creating security interests to guarantee pre-existing obligations.

Some Underused Mechanisms of Reorganization Proceedings

The New Insolvency Law includes several mechanisms related to reorganization proceedings, which have not yet received much practical application, such as:

1. Out-of-court reorganization proceedings (which are somewhat comparable to a pre-packaged bankruptcy under U.S. Chapter 11).
2. Insolvency arbitration.
3. Cross-border insolvency proceedings.

Positive Experiences

There are several successful experiences with reorganization proceedings, some of which include important local companies. Examples of companies that have successfully undergone reorganization proceedings include *Transportes Tamarugal Limitada* ("Tamarugal") and *Caja de Compensación de Asignación Familiar La Araucana* ("La Araucana"):

a. **Tamarugal** is one of the major players in the mining transportation industry, with more than 40 years of business experience. Because its main focus was providing services to mining companies, a drop in the price of mining commodities and the subsequent suspension or cancellation of mining projects had a serious impact on Tamarugal's business. In 2014, it reported losses for approximately USD 16 million, and a debt-to-equity ratio of 17.5. By the time it requested the initiation of a reorganization proceeding, its total debt was approximately USD 120 million, involving approximately 500 creditors which included banks, factoring companies and suppliers.

   As the amount of the total debt was relevant, and the number of creditors high, it was not easy to reach an agreement. And it was not possible to agree on the reorganization plan within the standard 30 business day stay period. The stay period was extended two times (each time for additional 30 business days) before the reorganization plan was approved by the creditors. Overall, the proceeding lasted for about six months until the reorganization agreement entered into effect.

   Approximately one year after the approval of the initial reorganization agreement, Tamarugal asked its creditors for a modification of the terms of the agreement. Some reasons to request this modification included that several projections discussed with its creditors to approve the initial reorganization agreement could not be met, and that the covenants assumed by the debtor limited its ability to renew its vehicle fleet. The modification of the reorganization agreement proposed by debtor, including a new business plan, was successfully approved by its creditors.

b. **La Araucana** is a major non-profit private entity that manages social security benefits for its members and their families. This type of legal entity is subject to special legal rules and regulations. Prior to the initiation of the reorganization proceeding, La Araucana became subject to an "intervention", mainly because of its failure to fulfill certain requirements made by the Chilean Social Security Agency (*Superintendencia de Seguridad Social*). Therefore, management was replaced by an independent controller appointed by the Chilean Social Security Agency. The independent controller decided to initiate a reorganization proceeding, as La Araucana was unable to fulfill its obligations in due time. At the time of the initiation of the reorganization proceeding, its total debt exceeded USD 600 million, with creditors that included banks and holders of notes issued under Chilean law.

Similar to the Tamarugal case, it was not possible to reach an agreement quickly. The stay period was extended one time, for an additional 60 business days period, before the reorganization plan was approved by the creditors. Overall, the proceeding lasted approximately four months until the reorganization agreement entered into effect. La Araucana recently obtained the approval of its creditors for a modification of the reorganization agreement, which, in summary, allowed it to extend the payment terms of its debt.

In both cases, because of the short amount of time passed since the approval of the reorganization agreement and its modifications, it may be too soon to know if Tamarugal and La Araucana will be able to pay their restructured debt. But from a legal perspective, the New Insolvency Law provided adequate mechanisms to allow debtors to negotiate with their creditors under a judicial proceeding that gave them much needed "breathing space" in the form of a stay period. Both cases show that, despite the relatively low use of the reorganization proceeding so far, the New Insolvency Law has the potential to be an effective tool to help debtors and creditors reach an agreement that is acceptable for the creditors and feasible for the debtor. The fact that Chile improved from position 110 to position 55 in the ranking on the ease of resolving insolvency according to the data collected the World Bank (Doing Business 2012 and 2017 reports), also shows that the changes introduced by the New Insolvency Law are in the right direction. ■

The Agency's View on Successful Reorganization Proceedings.[7]

Based on the experience gained from the first years of the New Insolvency Law, it is possible to confirm that the debtors that have a higher possibility of undergoing a successful restructuring are those that meet certain characteristics. First, they need to have their accounting books up to date, as this would allow making cash flow projections to determine the future payment capacity of debtors. This analysis allows debtors to determine if positive cash flows, with real profit, are possible; if strategies to reduce operational expenses are required; if certain economic activities that do not generate profits should be closed; along with other measures that may allow the repayment of the restructured debt.

Second, it is important for the debtor to have a good management team and an internal structure consistent with its financial and economic situation, or that such management team and structure are established in the reorganization agreement, including payment control policies and internal auditing to make the restructuring viable. These types of measures give support to the performance of the payment calendar proposed by the debtor.

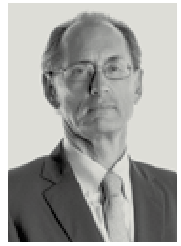
Finally, the possibility of a successful restructuring is also related to debtor compliance with labor obligations as of the date of filing. If a company has a high level of unpaid labor obligations, it is exposed to labor claims that may disproportionally increase its total debts and that may, in the end, hinder the fulfillment of the restructured debt.

1. According to data collected by the World Bank Group's Doing Business 2012 report, resolving insolvency in Chile took an average of 4.5 years, in comparison with 1.5 years in the United States and 1.3 years in Colombia.
2. The reorganization proceeding is applicable mainly to legal entities, but the New Insolvency Law also includes a special "renegotiation proceeding", that is applicable exclusively to individuals.
3. However, the renegotiation proceeding applicable to individuals has been relatively more successful than the reorganization proceeding. During 2016, a total of 944 renegotiation proceedings have been filed, against a total of 1.175 liquidation proceedings against individuals.
4. This excerpt has been provided to the authors exclusively by the Agency of Insolvency and Recommencement for purposes of this article.
5. Average amount based on a sample of liquidation proceedings completed through June 2017.
6. Average amount based on a sample of reorganization proceedings completed through June 2017.
7. This excerpt has been provided to the authors exclusively by the Agency of Insolvency and Recommencement for purposes of this article.

Scorecard of Chile's Insolvency Regime

Experience Level: Limited established precedents of successful in-court restructurings or significant cultural resistance to resolution of insolvency through court proceedings

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?	No
Can creditors propose a plan?	No
Can a creditor-proposed plan be approved without consent of shareholders?	No
Absolute priority rule?	Yes
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	Yes
Secured creditors subject to stay period?	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?	Yes, though limitations apply
Restructuring plan may be implemented while appeals are pending?	Yes
Does the restructuring plan, once approved, bind non-consenting (or abstaining) creditors?	Yes, with exceptions
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 the stay period?	Yes
Prevents voting by intercompany debt?	Yes
Strict time limits on completing procedure?	Yes
Management remains in place during proceeding?	Yes (for reorganization proceedings) No (for liquidation proceedings)



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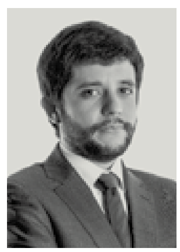

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