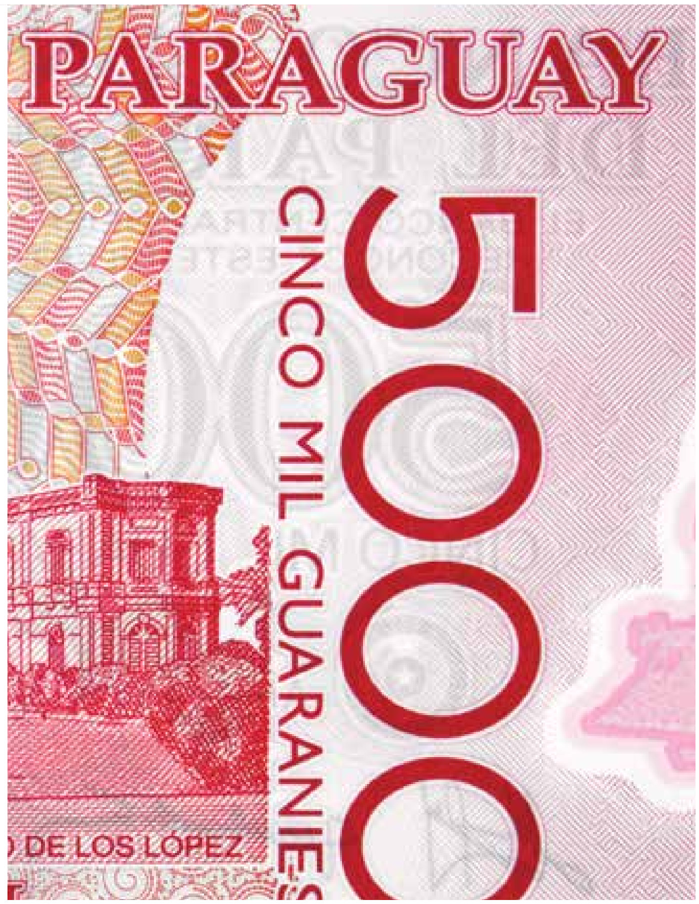
Insolvency of Financial Institutions under the Laws of Paraguay

By SIGFRIDO GROSS BROWN



For years, Paraguay's bankruptcy law enacted in 1969 (*Ley de Quiebras 154/69*, or the "Bankruptcy Law") has been the legal framework under which any insolvency situation affecting individuals and private entities has been handled. Other than private contract, there were no other legal avenues at that time to deal with an insolvent entity. The bankruptcy law was drafted and enacted at a time when the Paraguayan economy remained small and there was really no risk of systemic damage by the fallout of insolvencies in a given sector.

However, unexpected and extraordinary situations can expose the underlying limitations that the law may have as well as the limited tools that the law may avail itself of in these situations. This was the case in Paraguay with its financial sector, which had grown into a systemically relevant group of poorly regulated and in many cases badly managed banks and similar financial entities. When a string of banking and financial entities failed simultaneously, the regulator and the courts were ill-prepared to adequately handle the mass failures and the corresponding economic and social implications.

This article analyzes the legal and regulatory framework that was created as a result of the financial crisis resulting from the bank failures from 1995 through 1998. A background of the general bankruptcy legal framework and the banking crisis is given, followed by an analysis of the new financial restructuring laws and regulations, which have been particularly useful measures in the subsequent years of the country's history marked by stable economic growth and its ability to cope with other larger and more developed markets.

Background

The Bankruptcy Law is the current law that regulates the insolvency proceedings of every business activity, whether by segment (i.e., retail, banking, agriculture, industrial, etc.) or by volume or size of the assets involved, with the exception of those relating to Paraguayan public entities and, as mentioned above, financial entities.

The Bankruptcy Law has three main components. The first concerns the process of voluntary insolvency with the objective of obtaining a settlement with creditors through a restructuring of debts (with payment extensions of periods up to four years and a discount on amounts owed to creditors of up to 75% in certain circumstances). A settlement is reached with votes by the required creditors calculated by (i) the number of creditors and (ii) the amount of debt owed to each creditor. The second component refers to the bankruptcy process itself, with rules on (i) the limitations over a debtor's ability to manage and dispose of their assets in general and (ii) the liquidation of assets for the payment to creditors. This process is directed by the bankruptcy judge with the direct participation of a receiver or trustee, who is primarily in charge of supervising the debtor's conduct, inspecting the debtor's mail and documents and approving actions that would impact the debtor's assets and financial condition in general. Finally, the third component consists of specified procedural rules related to the insolvency process, which means the Bankruptcy Law is "self-containing" and does not need to rely on the general Code of Civil Procedure.

The Financial Crisis

In the decades after the enactment of the Bankruptcy Law, the Paraguayan economy in general and certain sectors, such as the financial sector, in particular underwent a significant level of growth and sophistication. However, while regulated, the financial sector suffered from insufficient regulatory oversight that led to a severe economic recession. Starting in 1994, a group of banks, many related through interlocking ownership and management, became insolvent through mismanagement and, in some instances, outright appropriation of clients' funds.

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Both the sector's regulatory authority (*Banco Central de Paraguay*, or the "Central Bank") and the courts did not have the necessary regulatory and legal power and tools to handle the bank runs and insolvencies that followed and led to both an economic and social crisis. This crisis had a steep economic and social cost with many companies closing and people losing their life savings as well as their jobs.

The New Financial Restructuring Framework

As a result of the financial crisis, the Government passed three new laws which had the objectives of (i) properly regulating the Central Bank's constitutional mandate of managing monetary policy and supervising the financial sector (Law 489/95 of the Central Bank), (ii) creating a comprehensive legal framework for the private financial sector (Law 861/96 of Financial Entities) and (iii) granting additional legislative and regulatory powers to the Central Bank to supervise and intervene in an insolvency of financial entities to rapidly ensure either its recovery or winding-up and liquidation (Law 2334/03 which creates the Deposit Guarantee).

At first, Law 861/96 of Financial Entities included specific sections which covered the supervision, intervention and finally liquidation procedures for financial entities. These sections were superseded and abrogated by the newer Law 2334/03, when it was determined that the process of forced liquidation and bankruptcy of unhealthy financial entities required a comprehensive and separate set of legal rules.

The new laws mentioned in the previous section reinforce three key concepts: (i) the supervisory and disciplinary role of the Central Bank over the financial sector, (ii) the scope of what is a financial entity under such supervision and (iii) the interplay between the Bankruptcy Law and the regulatory powers of the Central Bank in the event of insolvency of a financial entity.

By constitutional mandate, the Central Bank is charged with overseeing the country's monetary policy and the financial system. This mandate is developed by Laws 489/95 and 861/96, which give the Central Bank a more comprehensive set of oversight and disciplinary powers over financial entities. The definition of "financial entities" under Law 861/96 is based on the activity of "financial intermediation," requiring that any legal person which receives deposits from the public and lends those funds (combined or not with such legal person's own funds) be licensed by the Central Bank as a financial entity (subject to the satisfaction of various other financial and regulatory requirements).

Finally, Law 2334/03 develops a legal structure that gives the Central Bank wide regulatory powers to oversee financial entities in insolvency or in the proximity thereof. The policy behind this law was to avoid the scenario that had already unfolded with the bankruptcy of several banks which resulted in an economic recession of significant proportions. With the powers granted by the new law, the Central Bank would be up-to-date on the financial situation of each entity and would be endowed with sufficient powers to intervene with respect to those entities signaling distress before any significant damage occurred. The new law also prohibited shareholders and administrators of financial entities from filing for bankruptcy or calling a creditors' committee, superseding the former rule under the Bankruptcy Law. This decision would now be available solely to the Central Bank.

Law 2334/03 is comprised of three main components to protect a distressed financial entity from insolvency: (i) the creation of a Deposit Insurance Guarantee which guarantees deposits for a minimum amount per person, (ii) the creation of a remedial process to regulate financial entities exhibiting signs of financial disorder and (iii) the creation of an orderly process for the winding up, liquidation or bankruptcy of financial entities. This framework ensures that only once all obligations with the Central Bank, depositors and the financial system in general are satisfactorily met, the insolvent financial entity may enter a bankruptcy proceeding.

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The Deposit Insurance Guarantee

To restore investor confidence and minimize the social impact of a bank failure, Law 2334/03 created the Deposit Insurance Guarantee to cover savings from small depositors, which likely would have most if not all their savings covered by this guarantee. The Deposit Insurance Guarantee is a fund created by Law 2334/03 through mandatory and periodic contributions by both public and private financial sectors. The fund is managed by the Central Bank, though it is expressly separated from the Central Bank's balance sheet. The fund's purpose is to protect (at least in part) the savings of the financial system. It provides a guarantee for deposits equivalent to 75 minimum wages (approximately USD 26,600 at the time of this article's publication) per person (including both individuals or entities), regardless of nationality. Each person may receive up to the mentioned limit net any amounts owed by such depositor to the insolvent financial entity.

The guarantee is paid to the depositors of financial entities which have been declared insolvent by the Central Bank pursuant to the resolution process described in section 5 of this article. The guarantee, however, is activated by the Central Bank only as a last recourse, in the event the restructuring or assets sale alternatives of the resolution process may not be implemented or do not sufficiently cover the losses of depositors. If this occurs, the depositors who are repaid with funds disbursed by the Deposit Guaranty benefit from a special privilege over any other creditors over any remaining assets of the insolvent entity.

The Remedial Stage: Initial Central Bank Intervention

As a next step in the management and containment of insolvent financial entities, Law 2334/03 created procedures of moderate intervention (or enhanced supervision), whereby financial entities exhibiting signs of economic distress are subject to additional scrutiny. Upon occurrence of these red flags (described below), such financial entities are obligated to present a regularization plan to the Central Bank that is subject to review and approval by a department within the Central Bank responsible for supervision of financial entities called the Superintendence of Banks (*Superintendencia de Bancos*).

Among others, the law includes the following grounds for a financial entity to either voluntarily initiate a regularization plan or for the Superintendence of Banks to impose one:

1. Insufficient mandatory funds deposit as determined by the Central Bank through regulation (financial entities are obligated to reserve a certain minimum amount of funds which may not be used in its ordinary course of business);
2. Revenue losses in the entities' operations for two consecutive quarters;
3. Failure of meeting the minimum threshold under the solvency index, as determined by the Central Bank through regulation;
4. Requesting funds from the Central Bank as lender of last recourse;
5. Reiterated breach of Central Bank regulations;
6. Remittance of false or fraudulent information to the regulator;
7. Offering rates on deposit which are markedly superior to the market average;
8. External auditors withholding their opinion or issuing a negative one; or
9. The Superintendence of Banks determines that the financial entity poses a risk to the financial system (such a determination to be reasonably supported).

The Regularization Plan

If a regularization plan is necessary, the plan must address the causes that motivated the regularization process, as well as the remedial measures to be undertaken by the financial entity to remedy such causes. Among the measures that may be proposed by the entity are (i) capital increases, (ii) the sale of non-core assets, (iii) a plan of reduction of costs and expenses, (iv) merger or spin-off alternatives, (v) the implementation of external audits, (vi) the suspension of expansion plans in new branches and (vii) a restructuring program of its liabilities.

The plan must be approved no later than five business days by the Superintendence of Banks, which will also determine the milestones and duration of the plan. It will also be tasked with supervising the compliance with the plan by the financial entity. The plan includes a report issued by the Superintendence of Banks to the Board of Directors of the Central Bank, providing its conclusions on the expected results of the implementation of the regularization plan. Based on its report, the Central Bank will decide whether to allow the financial entity to continue operating in the financial system or order the cancellation of the entity's operating license and the winding-down of its business under the "resolution" process.

Aside from the plan, financial entities are also subject to enhanced information reporting obligations. The Superintendence may as well require guarantees (personal or in rem) from the financial entity's shareholders and its board members to secure adequate compliance with the commitments undertaken under the plan.

The "Resolution" or Central Bank Administrative Takeover

The "resolution" process is the mechanism established by Law 2334/03 to wind-up and liquidate a financial entity. Unlike other corporations, financial entities may not call a creditors' committee for an out-of-court debt restructuring or file for an in-court bankruptcy proceeding under the Bankruptcy Law. Only the Board of Directors of the Central Bank may request that a bankruptcy judge declare the financial entity bankrupt after the conclusion of this resolution process.

The Board of Directors of the Central Bank will order the initiation of a resolution process for a financial entity when:

1. The entity's solvency index falls below 50% of the required legal minimum;
2. The regularization plan is either not presented to the Superintendence of Banks or it is not approved;
3. The entity's license to operate in the financial system is permanently revoked by the Central Bank; or
4. Based on the information provided by the Superintendence, the Board of Directors determines that the financial entity is insolvent, i.e., the entity is unable to meet its obligations as they mature.

Effects of the Resolution Process

Removal of Directors and Management

Once the Central Bank orders a resolution process, the Superintendence of Banks will appoint trustees (*interventores*) from the Central Bank to effectively take over the financial

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entity and its management. During the intervention, such trustees will physically take over the offices, management and employees of the financial entity. The legal and managerial powers of the board of directors and those of management of the financial entity are suspended, as are shareholders' rights for the duration of the resolution process.

The powers of the Central Bank's trustees are limited to (i) acts to preserve the assets and business of the financial entity, (ii) collecting payments, as deposit operations (i.e., accepting deposits from the general public) are suspended during this process and (iii) certain acts expressly authorized by the Central Bank.

Identifying the Entity's Assets
The trustees also have the task of identifying the financial entity's assets and generating a new balance sheet of its assets and liabilities from the last balance sheet submitted to the Superintendence. In this new balance sheet, the Central Bank trustees will identify and cancel all pending employment-related and benefits obligations (such as mandatory social security and any private pension or retirement obligations) of the entity to high-level management because the law takes the view that the entity's directors and officers are responsible for the entity's financial insolvency, and as such, they should not be able to extract any other benefits from the entity. The cancellation of these obligations affect only high-level management; other employees are entitled to their legal employment and social security benefits in full.

As required by the Central Bank, the trustees will also prepare a shorter version of the balance sheet described in the previous paragraph. The *balance de exclusion* lists only those assets necessary to complete the resolution process. It will also list the following liabilities (in order of priority): the outstanding deposits entitled to payment under the Deposit Guarantee, cash deposits, public administration entities' deposits, amounts owed to the Central Bank and tax obligations.

Judicial Proceedings and Liens
Law 2334/03 requires that all judicial terms and conditions in proceedings filed by or against the insolvent financial entity be suspended from the initiation of the resolution process until its conclusion. During this period, no liens on the entity's assets will be allowed. The objective of this legal provision is safe guarding the public policy interest of availing the Central Bank of all leeway possible in disposing of assets to satisfy the law's end of terminating the entity's legal existence as efficiently as possible and maximizing the transfer of its business or assets.

Implementation Alternatives of the Resolution Process

The optimal scenario for the Central Bank is to transfer the insolvent entity's business as a going concern to another healthy financial entity. Therefore, the primary alternative resolution mechanism is the transfer of the insolvent entity's assets and liabilities listed on the *balance de exclusion*, which assumes the cancellation of certain liabilities by the Central Bank, to the financial entity that offers the Central Bank the best terms for these items (such terms include the extent to which the successor entity agrees to assume the insolvent entity's business and whether the acquiring entity will decline the assumption of certain obligations or impose additional terms or conditions).

The transfer of such assets and liabilities will be done at no cost to the successor entity. Since under Paraguayan law, contract must have a "cause," which typically would be the purchase price, the cause in this special purchase and sale agreement is the law and the Central Bank's administrative authority. In this scenario, (i) the insolvent entity's clients, deposits and other operations are transferred to the successor entity and (ii) the successor entity maintains the insolvent entity's employees (or as many as the dissolving entity has offered to the Central Bank), but without the obligation of assuming their seniority or necessarily respecting their current salaries (i.e., being able to negotiate their salaries to incorporate them to their structure). The transaction is expressly released from any taxes that would ordinarily apply.

As a second alternative, the Central Bank may (i) order the transfer of depositor's accounts to an interested and acceptable financial entity, (ii) securitize the income generated by the insolvent entity's assets and (iii) sell the corresponding securities. This scenario involves the direct liquidation of the financial entity, with the Deposit Guarantee being the first creditor for any payments it has disbursed to the insolvent entity's depositors.

As of the date of this publication, there have been less than three regularization processes executed to completion by the Central Bank. This highlights the success of the additional regulation and laws that have been enacted, and the satisfactory role in this respect of the Central Bank. The author of this article has advised the Central Bank in one of those regularization processes involving the insolvency of Agrofinanciera Chaco S.A. The interesting fact of the Agrofinanciera Chaco's regularization process was not caused by an insolvency event but, rather, because the entity was unable to continue operating as a result of serious administrative mismanagement. In fact, the entity was solvent and had sufficient assets to pay back all depositors and remaining obligations. However, the entity was not complying with its contractual and regulatory obligations due to a serious disorganization by management. This process in particular was concluded in six months, with the Central Bank ordering (i) the transfer of the *balance de exclusion* to Financiera Río S.A., another financial entity in the market, (ii) the permanent cancellation of the intervened entity's license to operate and (iii) the winding-up and liquidation of Agrofinanciera Chaco.

Legal Effects

Upon implementation of any of the resolution mechanisms described above, the insolvent entity's creditors are barred from claiming a violation of creditor parity or of otherwise attacking the legality of the transfer of assets. The assignment of credits (owed by the insolvent entity) does not require the authorization of the insolvent entity as may be otherwise mandated by law or agreed by way of private contract.

Conclusion of the Resolution Process

Once the resolution process authorized by the Central Bank concludes, the Superintendence of Banks issues a report to the Board of Directors of the Central Bank, detailing all aspects of the process. The Board of Directors will then approve the process undertaken, revoke the insolvent financial entity's operating license (if it has not done so before), order the winding-up of the financial entity and notify the bankruptcy court of the remaining assets and liabilities to finalize the liquidation of any such remaining assets and payment of creditors.

At this time, the bankruptcy proceedings are reinstated, and creditors may continue their claims in-court, but only against the remaining assets of the insolvent entity. This means that the transfer of assets, assignment of debts and any other acts undertaken by order of the Central Bank during a resolution procedure may not be impugned by creditors or any other interested parties.

Scorecard of Paraguay's Current 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, but creditors can vote and counter-propose alternatives to proposals in the debtor's plan in a negotiation
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?	Yes
Viable prepackaged proceeding available that can be completed in 3-6 months	No
Secured creditors subject to automatic stay?	No
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	Yes
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?	Yes
Strict time limits on completing procedure?	No
Management remains in place during proceeding?	Yes

Conclusion

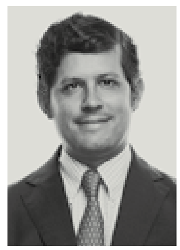
In Paraguay, the banking crisis of the 1990s generated by the collapse of several financial entities and the insufficiency of a legal and administrative framework to deal with this situation prompted the enactment of laws and their corresponding administrative regulation to prevent another collapse of the banking sector.

The new banking laws have strengthened the Central Bank's authority, clarified the obligations of financial entities and created a framework to protect depositors and prevent or manage the insolvency of a financial entity. This process involved the partial abrogation of the Bankruptcy Law, leaving the insolvency and liquidation of financial entities under the sole purview of the Central Bank. However, since the enactment of these new laws, there have been no legal challenges to the additional powers assigned to the Central Bank.

Paraguay's general bankruptcy rules should be improved even further in order to stay ahead of the curve and not only be a reactive tool in the face of a crisis. The continuous growth of Paraguay's financial and economic development and the drive towards industrialization and expansion of commercial and financial consumption has created certain new risks for which the current Bankruptcy Law is unsuited to handle. The weak link among Paraguay's regulatory institutions is the judiciary branch. The greatest shortcomings of the judiciary are the pervasiveness of corruption and the massive delays in the continuation of judicial proceedings (litigation, foreclosures, civil and criminal suits, etc.). In the context of insolvency proceedings, creditors' committees and bankruptcy trials may take years without conclusion. For example, there are cases that have taken more than fifteen years to resolve. These delays only extend the uncertainty for the parties involved and decrease the value of the bankruptcy estate as a result of higher legal costs, defeating the purpose of the in-court debt restructuring or the bankruptcy liquidation.

Clearly, a reform of the Bankruptcy Law is required to address these shortcomings. There are currently proposals from lawmakers to improve the judicial insolvency process, which include among others a more efficient use of the receiver institution and the creation of steering committees to guide the asset management and restructuring negotiation process.

This author believes that Paraguay should avoid the fate of jurisdictions such as Spain, which had to amend its bankruptcy law more than five times in the past five years to manage its financial crisis. To do so, the legal framework should incorporate the possibility of out-of-court restructuring arrangements involving parties outside of the financial sector with the protection of the Bankruptcy Law (as opposed to merely private contracts which may be overturned in bankruptcy court), among other changes to the Bankruptcy Law to make in-court bankruptcy process more efficient. This out-of-court restructuring framework should be available to business or commercial debtors (as opposed to private non-commercial insolvencies), including small- and medium-sized companies (which make up the bulk of the country's entrepreneurial fabric), and would facilitate credit to debtor by granting incentives to banks to provide fresh credit to those companies facing temporary difficulties but with sound business models. This option would reduce the caseload of courts and would be a faster, more convenient alternative to creditors' committee or in-court bankruptcy proceedings, which as described involve lengthy proceedings and higher costs. ■



▼ **Sigfrido Gross Brown** is Partner in the corporate and finance groups of Estudio Jurídico Gross Brown. He rejoined the firm after ten years practicing in the United States and Spain, at firms such as Shearman & Sterling LLP (New York), and Freshfields Bruckhaus Deringer LLP (Barcelona). He has a strong M&A practice, including share and asset purchase, as well as joint ventures. In his role as a senior lawyer for major international firms, Sigfrido has regularly lead teams in cross border transactions both as deal counsel and as local counsel. Sigfrido received his law degree from the Universidad Católica de Asunción in 1999 and his LLM from Harvard Law School in 2001.