Is Debtor-In-Possession Financing Even Possible in Peru?

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In Peru, providing financing to companies undergoing insolvency proceedings ("DIP financing") is highly uncommon. In most cases, this lack of financing makes it difficult to continue operating what makes up the core value of many insolvent companies. As a result a debtor is often forced to liquidate and subsequently exit from the market.

Indeed, for more than a decade, insolvency proceedings in Peru have been characterized as being more prone to liquidate rather than to reorganise. Liquidations are the most common fate of insolvent debtors, and therefore creditors have usually no interest in participate actively in insolvency proceedings in Peru.

According to 2014-2015 statistics published by the National Institute for the Defense of the Free Competition and the Protection of Intellectual Property (*Instituto Nacional de Defensa de la Competencia y de la Protección de la Propiedad Intelectual* or INDECOPI),[1] 92 creditors' meetings (*junta de acreedores*)[2] were held in 2015 in order to determine the fate of insolvent debtors. In all of these meetings, the creditors agreed to liquidate the insolvent debtor. Similarly, in 2014, creditors decided to liquidate the relevant debtor in 136 out of 145 cases, and only in nine cases creditors opted to restructure the insolvent company. Liquidation is in fact the most common alternative for creditors when it comes to determine the fate of insolvent companies.

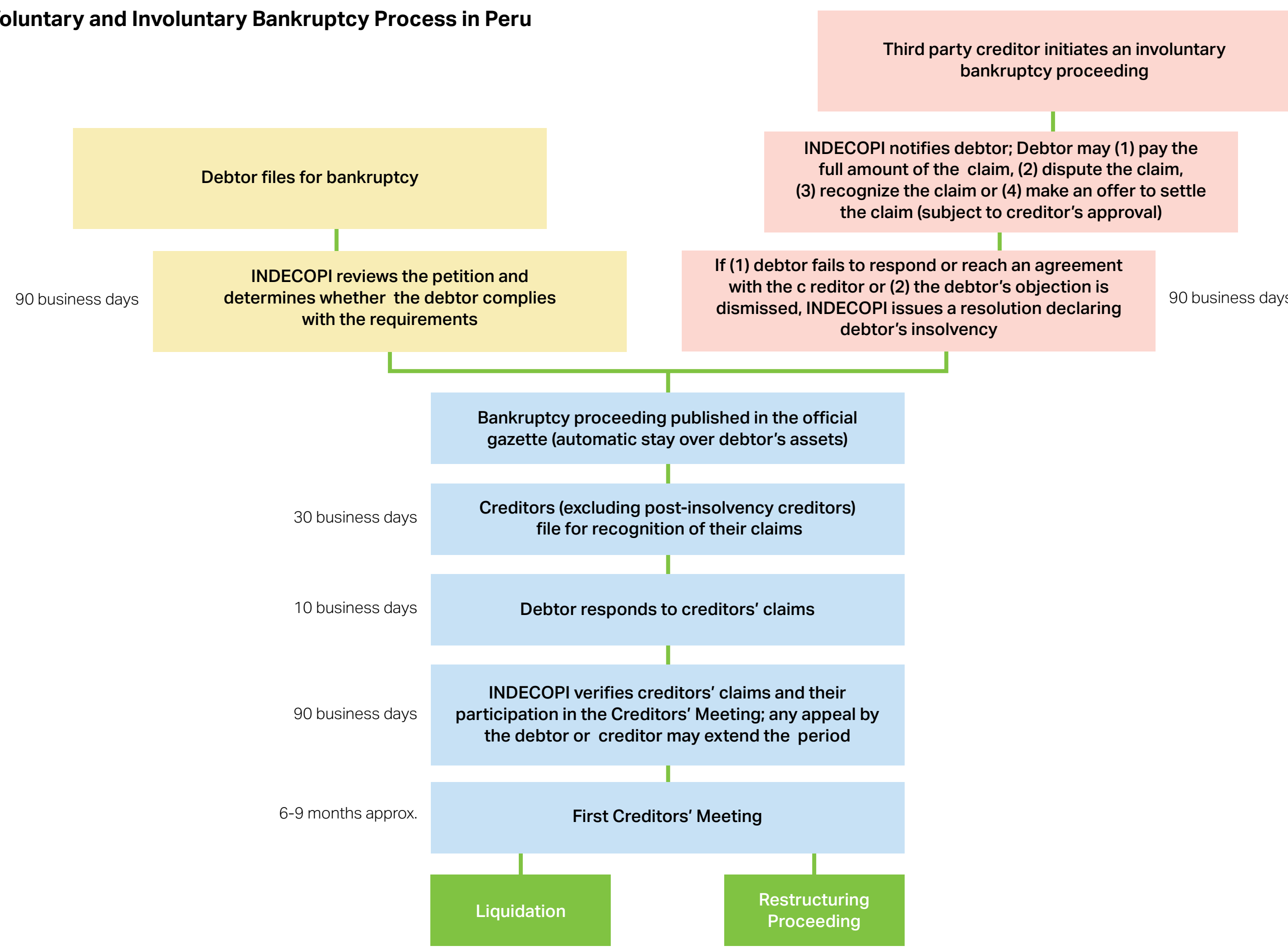
It is reasonable to assume that creditors would decide to liquidate the debtor if the market value of the debtor's assets was higher than the value of the cash flows that the debtor (as an ongoing business) could generate. Nevertheless, if that was the case, one would assume that creditors should prefer the debtor to continue running the business and preserve the value of such business in order to recover their claims.

In light of the INDECOPI statistics, we could assume that in Peru the market value of the debtor's assets is (almost always) higher than the value of the insolvent debtor as a going concern. It would seem that the losses suffered by creditors involved in an insolvency proceeding would always be less in a liquidation scenario rather than in a reorganization.

However, in our experience, creditors are usually not interested in analyzing the pros and cons of restructuring or liquidating an insolvent company in Peru. In fact, there are very few cases in which creditors hire independent consultants to assess the possibility of restructuring the business and, therefore, the future of the debtor is focused entirely on the prompt recovery of the business' remaining value (even if only partially) rather than in identifying an alternative strategy that could offer more value for all creditors, even if such value were to be obtained in the long run. Peruvian insolvency laws do not require creditors to hire independent consultants to decide about the fate of the debtor and, for the reasons explained further below, creditors are not willing to incur in the costs of hiring these specialists, even though they may provide with a more accurate assessment of what the best economic option is (liquidation vs. reorganization).

One of the reasons that could explain the massive liquidations of insolvent debtors is that reorganizing an insolvent business could be considered by creditors as an expensive and risky decision given the features of the Peruvian insolvency regime. In fact, such features usually prevent insolvent companies from obtaining the financing and working capital they need to keep carrying their business, as further explained below.

Voluntary and Involuntary Bankruptcy Process in Peru



Financing Insolvent Companies in Peru

Under Peruvian insolvency laws,[3] the financing granted to a company once the beginning of its insolvency proceeding has been published in the Peruvian official gazette does not require the approval of creditors or the INDECOPI and is not subject to rules governing payment of claims part of an insolvency proceeding. This means that such financing is repaid per the terms agreed between the debtor and the lender (i.e., post-insolvency financing is not affected by the automatic stay enforced over the debtor's assets once the proceeding has commenced).

Peruvian insolvency laws do not expressly prohibit insolvent debtors to grant security interests over their assets in order to secure post-insolvency financings such as DIP financings. As such, if the debtor does not pay the amount due, a DIP lender should be able to enforce the security interest and get paid with the proceedings obtained therefrom.

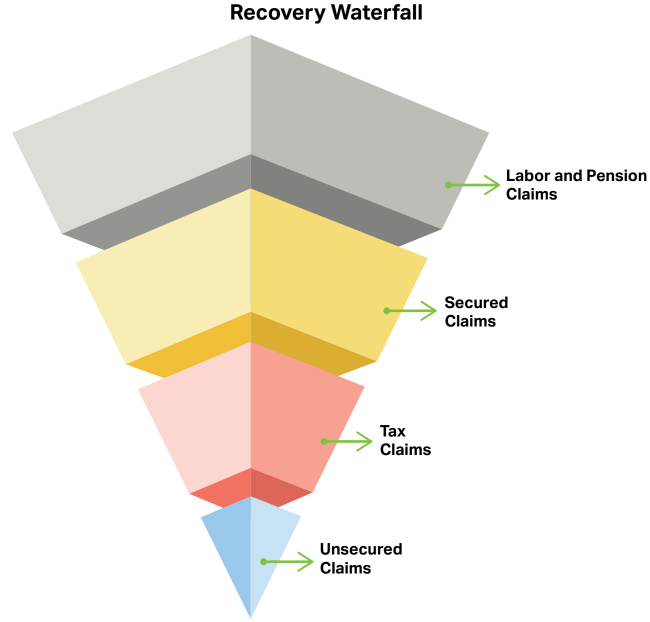
Given these features, one would think that post-insolvency financing benefits from favorable treatment under Peruvian insolvency laws and therefore the Peruvian DIP financing system is effective. Nonetheless, the situation is not as flexible as it appears to be. Peruvian insolvency laws provide that if the creditors' meeting decided with a two-thirds majority vote to liquidate the debtor, all claims against the debtor will be subject to the insolvency proceeding and paid off pursuant to the priority rules set forth by law. This provision applies to all claims regardless of whether such claims originated before or after an insolvency proceeding was published in the Peruvian official gazette. Therefore, post-insolvency creditors will have to verify their claims before INDECOPI in order to take part of the creditors' meeting and approve the corresponding liquidation agreement.

In this context, post-insolvency financing is risky given that creditors have the right to liquidate the insolvent company at any moment during the insolvency proceeding. Moreover, only creditors have the right to determine whether or not the debtor will liquidate the business, which means the creditors can choose to liquidate even if they had initially decided to restructure the business.

Hence, if creditors decide to liquidate the debtor, any post-insolvency claims will be subject to the insolvency proceeding. This means that the automatic stay will apply to these liabilities; therefore, post-insolvency creditors will no longer be paid pursuant to the original terms, and the collateral granted to secure these claims could no longer be enforced. Instead, post-insolvency indebtedness will be treated as any other claims subject to the rules of the insolvency proceeding, and creditors would be paid pursuant to the mandatory provisions set forth in Peruvian insolvency laws and in the liquidation agreement approved by the creditors' meeting.

Pursuant to Article 42 of the Peruvian Bankruptcy Law (*Ley No. 27809*), secured debt ranks second in priority of payment in a liquidation scenario—right after labor and pension debts. Unsecured debts rank fourth (and last) in said priority—after labor and pension debts, secured debts, and tax claims. Consequently, post-insolvency creditors benefitting from collateral securing their debt may believe they will rank second in the recovery waterfall; however, Peruvian insolvency laws require that the security interest be registered in the relevant Public Registry office by the time the insolvency proceeding is published in the Peruvian official gazette in order to benefit from the second rank priority. Given that post-insolvency indebtedness is issued after the insolvency proceeding is announced, in most cases, these types of claims will be ranked by INDECOPI last in the priority payments under a liquidation scenario, regardless as to whether they were secured or not.

Recovery Waterfall



All things considered, DIP lenders will likely think twice before granting any financing to insolvent debtors: financing the business of a company undergoing an insolvency proceeding may be very risky given that the likelihood of payment depends entirely on whether the creditors' meeting decides to liquidate the debtor or not. Consequently, DIP lenders may prefer not to enter into a financing agreement with the insolvent company, even if they could obtain higher interest rates, disbursement commissions or other benefits.

Peru's insolvency system, unlike other insolvency regimes of countries like the U.S. or Canada (which have a super priority rule under which DIP financing is preferred over all other existing debt, equity and other claims), does not protect or incentivize the financing of companies undergoing insolvency proceedings. The Peruvian regime unfairly penalizes investors willing to finance the activities of insolvent companies by putting them in an equal or worse situation than those creditors who granted financing before the declaration of insolvency, and who decided to remain safe during the insolvency proceeding by not providing any additional financing to the debtor.

If the justification for the Peruvian current system is to prevent post-insolvency creditors such as DIP lenders from affecting pre-insolvency creditors, then Peruvian insolvency laws may well be amended to grant the creditors' meeting the authority to approve or reject any new financing by the insolvent debtor, along with the preferred payment provisions applicable to such new financing. In fact, some limitations and other specific provisions may be included when such new financing is granted by a related company or by a lender who already holds the majority of the verified claims in the creditors' meeting.

As explained above, insolvent companies in Peru seeking to restructure face several difficulties in getting new financing and, therefore, need legal mechanisms to mitigate the risks of a liquidation scenario.

However, Peruvian insolvency laws are not the only factor causing to the lack of DIP financing in Peru. Banking regulations contribute as well to this situation by imposing higher costs on banks that are willing to finance insolvent companies.

Worst Case Scenario for a DIP Lender

1. Company undergoes an insolvency proceeding
2. At the Creditors' Meeting, creditors decide to reorganize the debtor
3. DIP lender grants new financing to the company with expectation to be paid before all other creditors with attractive interest
4. Creditors subsequently decide that the reorganization plan is no longer feasible and will not succeed and to liquidate the business
5. The DIP financing granted to the company under the terms of the failed reorganization plan becomes subject to the liquidation proceeding and will most likely be last in line for recovery

Post-Insolvency Financing under Peruvian Banking Regulations

Peruvian banking regulations consider loans to an insolvent company in the risk category of (i) "potential problems" (*peligro potencial*) only if the previous risk category was "normal" (*normal*) and (ii) "deficient" (*deficiente*) if the previous risk category was "doubtful" (*dudosa*) or a "credit loss" (*perdida*). Consequently, banks providing financing to insolvent companies may have to record general provisions (*provisiones por cobranza dudosa*) in order to cover the risk of default of such financing. This means banks are required to set aside reserves to pay for the anticipated losses coming from these loans.

This means that banks face additional costs for funding companies undergoing a restructuring proceeding. Hence, banks avoid these costs and simply do not grant financing to insolvent companies. These additional costs may be linked to how post-insolvency loans are treated in the event of liquidation. If the Peruvian insolvency laws were amended to allow preferences for authorized post-insolvency financing (such as DIP financing), banking regulations would likely be amended accordingly in order to reflect the lower risk involved in this type of financing.

Liquidation of Companies as "Going Concerns"

Peruvian insolvency laws allow companies to liquidate at their "going concern" value. This occurs when creditors believe they will obtain a higher value by selling the assets of the debtor altogether as an operating business to a single buyer rather than selling the assets individually to different buyers.

Usually, these liquidations have to be completed within two years from the date the creditors' meeting decided to liquidate the debtor as a "going concern." Nevertheless, Peru's Congress recently enacted a law extending such two year term for up to two additional years for the specific case of Doe Run Peru[4] (one year with the approval of the creditors forming part of the creditors' meeting, and one more year with the approval of the President of Peru).

Liquidations of companies as going concerns are rare in Peru. Mostly due to the lack of clear rules for the treatment of financing obtained by the debtor during the sale process. This situation is worsened by the fact that Peruvian insolvency laws provide that if the sale of the business is not completed within the time limit described above, then the debtor has to cease activities and the liquidation has to be performed through the default sale of individual assets.

Nevertheless, Peruvian insolvency laws have provisions dealing with the indebtedness issued by the debtor in order to implement the liquidation as a going concern. Pursuant to these provisions, this type of indebtedness is not pooled into the insolvency proceeding and, therefore, shall be paid when due pursuant to the terms agreed with the relevant lender. However, there remains some uncertainty in the interpretation of the laws about what claims qualify as "debt assumed by the debtor in order to implement the liquidation as the sale of a going concern."

INDECOPI issued a binding administrative resolution in 2016 interpreting the scope of these provisions.[5] Resolution No. 0226 clarifies that not all indebtedness issued during the liquidation proceeding is excluded from the insolvency proceeding, but only debt that was necessary to keep the business running during the sale process. If the post-insolvency claims comply with such purpose, then they are not pooled into the insolvency proceeding and have to be paid when due and with priority over the claims subject to the insolvency proceeding.

In our opinion, new financing of working capital or financing granted by suppliers of goods and services should fit within the definition of this binding precedent. Conversely, unpaid fines and financing obtained to acquire a new line of business would not be regarded as claims excluded from the insolvency proceeding.

Resolution No. 0226 is a step forward in clarifying the rules governing the financing of companies undergoing insolvency proceedings. With such rules, creditors will be able to better assess the true risk of providing financing to insolvent companies by determining whether such financing would qualify or not as an "excluded credit" from the insolvency proceeding.

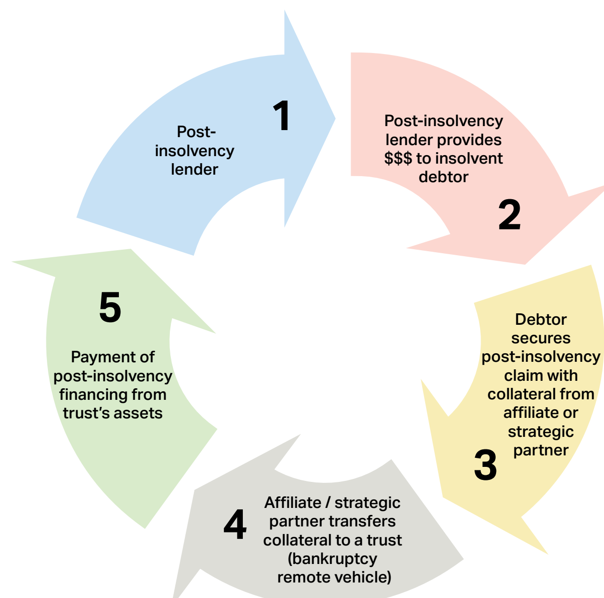
Furthermore, we believe the liquidation agreement may set forth further details about the specific claims that will qualify as "excluded debts" so that it is clear that there will be two types of claims to be paid out with the proceedings coming from the liquidation: (i) claims assumed by the insolvent debtor for the continuance of the business during the liquidation, which will be paid on their due date, and (ii) claims which are included within the scope of the insolvency proceeding (i.e., indebtedness assumed by the debtor before the filing of the insolvency proceeding along with claims assumed by the debtor thereafter which do not qualify as necessary for the continuance of the business during the liquidation), which will be paid pursuant to Peruvian insolvency laws and as set forth in the liquidation agreement.

Creation of Alternative Structures to Ensure Post-Insolvency Financing

Given that Peruvian insolvency laws do not incentivize the financing of companies undergoing insolvency proceedings, investors may have to use alternative structures to protect DIP financing and preserve the operating value of the insolvent company.

For example, companies affiliated to the debtor or strategic partners that are interested in preserving the business of the debtor as a going concern may provide collateral for securing any post-insolvency financing to be provided to the debtor. Alternatively, affiliates and strategic partners may be able to obtain the financing directly in order to redirect these funds to the insolvent debtor's business through joint ventures or other modality of business association.

Alternative structure to protect post-insolvency financing



These structures aim to mitigate the risk of liquidation that any lender willing to provide financing to an insolvent debtor faces in Peru. As such, these structures provide these lenders with a different recourse entity for any claim for payment of the post-insolvency financing in the event the debtor is liquidated.

The collateral to be posted in order to secure this financing may be structured through the incorporation of trusts (*fideicomisos*) to provide lenders with a bankruptcy remote vehicle in the event that these related companies and strategic partners face insolvency as well. Indeed, once the statute of limitations of the avoidance actions (*accion revocatoria*)[6] have expired, the trust estate is isolated from any risk affecting the debtor and/or any third party.

Conclusions

While there are some provisions regulating DIP financing in Peruvian insolvency laws, lenders face several risks which may deter them from providing such financing. In fact, if the creditors vote to liquidate the debtor, all claims outstanding at the moment the creditors take such decision are brought into the proceeding, the original terms governing the post-insolvency financing are no longer binding on the parties, and such financing will be paid pursuant to the mandatory provisions set forth by law and the rules agreed on the liquidation agreement. As shown by INDECOPI statistics, these risks have led to a situation in which restructurings are very rare and liquidations are the rule when creditors have to determine the fate of the insolvent debtor.

Lenders face a somewhat better scenario if the debtor is liquidated as a "going concern." In this case, post-insolvency financing which qualifies as "debts required for the continuance of the business during the liquidation" are excluded from the insolvency proceeding and, therefore, they are paid when due pursuant to the terms agreed on by the debtor and the lender.

Peruvian insolvency laws should be amended in order to provide DIP (post-insolvency) financing with a super priority similar to the priority granted to DIP financing under U.S. rules. In most cases, the restructuring of the debtor depends on the ability of the debtor to obtain further financing in order to continue running its business. In Peru, restructurings are not an option most likely because of the costs and risks involved in granting financing to a company undergoing an insolvency proceeding. As such, we believe that this new feature (super priority of post-insolvency financing) will allow creditors to have a real choice when deciding whether to liquidate or restructure an insolvent debtor.

Super-priority should be granted to any post-insolvency claims that is duly approved by the creditors meeting (in the absence of a judicial insolvency authority in Peru), in order to avoid this new feature to be abused by investors acting in collusion with insolvent debtors. ■

1. "*Anuario de Estadísticas Institucionales 2015*" and "*Anuario de Estadísticas Institucionales 2014*" both published by INDECOPI. INDECOPI, which began in November 1992, is the governmental (administrative) agency in charge of monitoring insolvency proceedings in Peru.
2. The meeting of creditors is comprised of all creditors of the insolvent debtor who have had their claims verified by the administrative court. In order to take part in the meeting, creditors must verify their claims before INDECOPI within 30 days after the insolvency proceeding is published in the Peruvian official gazette (*El Peruano*). This creditors' meeting replaces the shareholders meeting for all decision-making purposes and decides whether to liquidate an insolvent company or not. Usually, the first creditor's meeting takes place approximately 9 to 12 months after the insolvency proceeding is published in the Peruvian official gazette. All the creditors hold the same voting and preferential rights in each meeting. However, the voting threshold may vary depending on the representation of creditors affiliated with the insolvent company.
3. Law No. 27809 (the General Bankruptcy Law), enacted in August 2002 and related amendments including Law No. 28709, enacted in April 2006, Legislative Decree No. 1050, enacted in June, 2008, Legislative Decree No. 1170, enacted in December 2013, Legislative Decree No. 1189, enacted in August, 2015 and Law No. 30502, enacted in August 2016.
4. This law was enacted in connection with the liquidation of Doe Ron Peru SRL, a smelting company located in La Oroya. DRP is a company undergoing a liquidation proceeding (as a going concern) that owns a metallurgic center in the town of La Oroya, Peru. Currently, the liquidation proceeding of DRP is suspended because no binding offers for the acquisition of DRP were submitted. This law aims to give more time for this liquidation to be completed successfully in order to avoid social unrest in La Oroya - most of La Oroya's population work or are in some other way dependable on the continuation of DRP' business.
5. Resolution N°0226-2016/SCO-INDECOPI, published in the Peruvian Gazette "El Peruano" on May 25, 2016. This is binding administrative resolution that was issued in connection with the Doe Run Perú SRL proceeding.
6. Avoidance actions grant creditors of a company the right to revoke the transfer of assets made to a trust if such transfer was made by the company with the intention to hinder the rights of said creditors. The statute of limitations for avoidance actions is six months from the date the incorporation of the trust was last published in the Peruvian official gazette.

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