You Have Options: The Use of Alternative Dispute Resolution in Insolvency Proceedings

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Latin America is once again a volatile region – political uncertainty in both mature and emerging economies, the threat of changes to the terms of trade, commodity prices that have yet to recover and wild swings in foreign exchange rates are just some of the issues that debtors are struggling with. It is no surprise, then, that restructuring activity is beginning to pick up, from the corruption-related work-outs in Brazil to the construction industry slump in Mexico. When debtors in these markets look at how to implement a restructuring, they come across two imperfect and competing options. Debtors can file for bankruptcy locally and bind 100% of their impaired creditors (in most cases), but with this option they will face courts that move slowly, are often unfamiliar with international financing structures and in some cases are susceptible to outside influence. As a second option, debtors can conduct an out-of-court restructuring through an exchange or tender offer, but with this option, they won't be able to bind 100% of creditors and very often will remain in technical default even after a successful transaction.[1]

There is, however, another alternative, which to date remains largely untested in the region: a local bankruptcy proceeding, with some or all of the case handled through arbitration proceedings. With this option, debtors could have the certainty of a full and final resolution of their restructuring, but with the flexibility to use arbitration and mediation procedures that in many circumstances provide for a quicker resolution of the case by arbitrators that are more familiar with the sorts of issues that arise in international financial contracts and that are less susceptible to judicial corruption. This article looks at the option of using arbitration and mediation in bankruptcy proceedings in three jurisdictions where such an option is available – Peru, Chile and the United States – and outlines a modest proposal to expand the use of arbitration and mediation in other jurisdictions that are considering reforms to their bankruptcy laws.

Peru

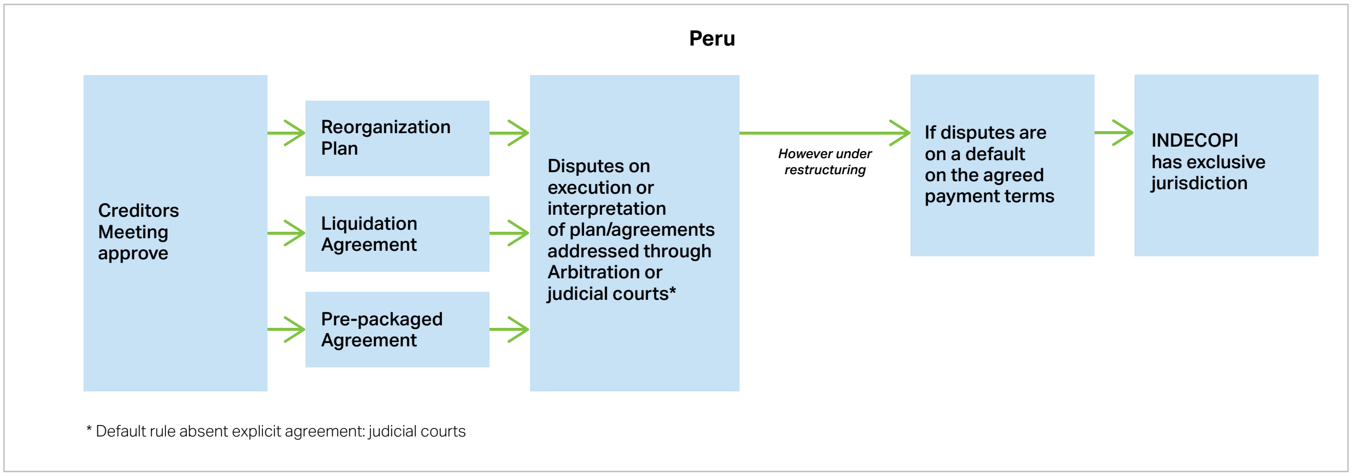
Unlike most jurisdictions in Latin America, where bankruptcy proceedings are handled by judicial courts, Peru employs solely administrative bankruptcy proceedings and judicial courts have limited jurisdiction.[2] All Peruvian bankruptcy proceedings are handled and supervised by a specialized administrative agency, the National Institute for the Defense of 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"). However, the creditors' committee is empowered to make the principal decisions within the bankruptcy proceeding, such as the approval of the restructuring plan, pre-packaged plan or the liquidation agreement.

Pursuant to Articles 73 and 79 of the General Bankruptcy Law of Peru, one option that creditors have is to decide that all disputes arising from the reorganization plan or liquidation agreement will be subject to arbitration. If the creditors' committee elects to use arbitration, they may select an arbitrator from the location where the bankruptcy proceeding takes place. If the creditors' committee does not elect arbitration, disputes related to a liquidation agreement or restructuring plan will be heard in judicial courts.

Because Article 73 of the General Bankruptcy Law of Peru does not specify or limit the disputes that may be addressed through arbitration, a broad range of situations may qualify. For instance, a conflict related to a new guarantee by a debtor as agreed in a reorganization plan, a controversy arising from a liquidator's default under a liquidation agreement, or any dispute associated with the interpretation of a pre-packaged plan are examples of disputes that may be arbitrated pursuant to Article 73. However, the law does not contemplate the administration of bankruptcy proceedings themselves through arbitration. Thus, under the Peruvian insolvency system, the bankruptcy proceedings themselves, and ancillary matters (such as recognition of credits and ranking of claims) cannot be handled through arbitration.

In addition, INDECOPI has exclusive jurisdiction to determine whether a default under a reorganization plan has occurred, which triggers a liquidation of the debtor. In a binding administrative resolution issued in 2013, INDECOPI stated that because it has a duty to declare the liquidation of the debtor to protect the interest of the creditors in the bankruptcy proceeding, the existence of a default under an ordinary reorganization plan cannot be arbitrated. Consequently, in the Peruvian insolvency system, the ability of creditors to elect arbitration under a restructuring proceeding is limited to controversies that are not related to a default on the payment terms set forth in the plan. However, creditors may be able to elect to have disputes related to defaults under pre-packaged and liquidation agreements resolved through arbitration. With pre-packaged agreements, since the proceeding before INDECOPI is "terminated" with the approval of the plan by the creditors' committee, the jurisdiction of INDECOPI is no longer applicable. Therefore, in the case of any dispute related to the execution of the pre-packaged agreement, including the debtor's default, the creditors or the debtor have the right to choose arbitration as the mechanism for resolution of such disputes. Likewise, for disputes arising from the interpretation or execution of a liquidation agreement there are no limitations on the ability of creditors to choose arbitration.

Another scenario where arbitration might be used in connection with bankruptcy proceedings is a dispute relating to post-petition claims (*créditos post-concursales*). INDECOPI has clarified that post-petition claims will not be subject to a bankruptcy proceeding if (i) claims were generated during the implementation of the liquidation as an ongoing concern, and (ii) claims arise from debts required to keep the debtor's operation as an ongoing concern. Peruvian lawyers José Jiménez and Daniel Gonzáles consider that a new financing of working capital or a post-petition financing granted by suppliers of goods and services should fit within this criteria.[3] This suggests that creditors may choose to use arbitration for disputes arising from this sort of "debtor-in-possession" financing, which may be particularly advantageous for creditors, since under Peruvian law, if a creditor receives an arbitration award, it will receive the payment of that award with priority over all insolvency claims.



Notwithstanding the potential for greater use of arbitration to resolve disputes in connection with insolvency plans in Peru, there is no evidence that creditors have opted into this system so far. Although there do not appear to be any obvious or downsides to the use of arbitration, creditors may simply not choose arbitration because reorganization remains relatively unusual in Peru and thus there are fewer precedents for its use.

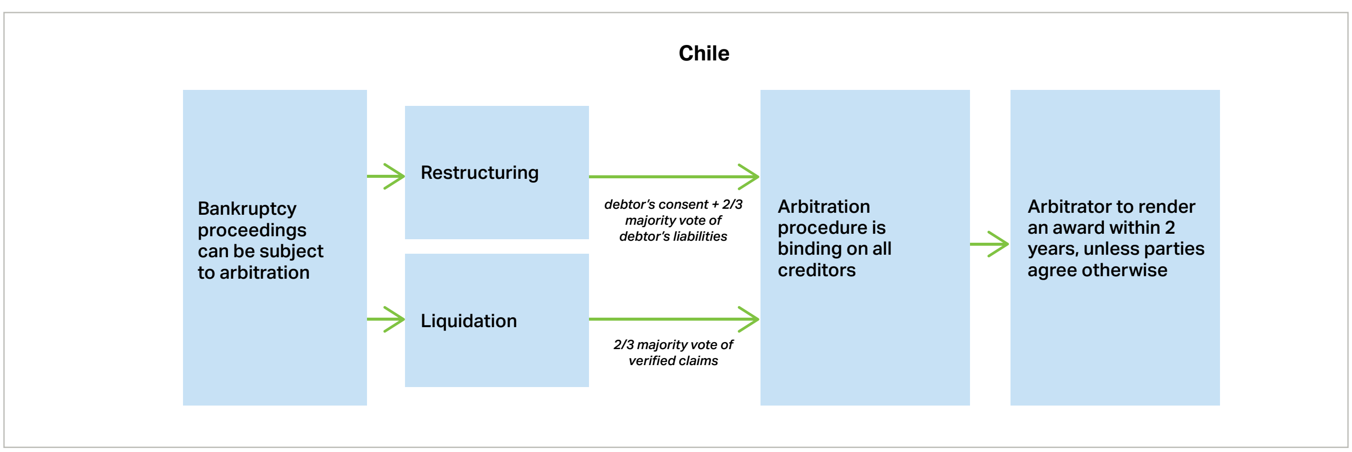
Chile

The new Chilean insolvency law[4] was enacted to promote reorganizations as an alternative to liquidations. Several reforms were introduced to the prior bankruptcy regime with the goal of simplifying and shortening the time frames for reorganization and liquidation proceedings, promoting greater participation by creditors, facilitating the financing of insolvent companies, and creating specialized insolvency courts.

In addition to specialized insolvency courts, Chapter VII of the insolvency law, titled "Insolvency Arbitration" (*Del Arbitraje Concursal*), provides for the possibility to arbitrate both liquidation and reorganization proceedings. In short, arbitration can be chosen by a debtor and its creditors, and the arbitrator's purview is broad enough to include the entire proceeding. In a reorganization proceeding, arbitration can be chosen with the consent of the debtor and two-thirds of the debtor's liabilities.

On the other hand, in a liquidation proceeding, the debtor's consent is not needed, and only a two-thirds majority vote of the verified claims (*Quórum Especial*) is required, to elect arbitration for the proceeding. In both cases, once approved, the arbitration procedure is binding on all creditors, including the non-consenting creditors.

In both reorganization and liquidation proceedings, the sole arbitrator must be chosen by the creditors from a "Roster of Insolvency Arbitrators" prepared by Chile's Insolvency and Reorganization Superintendency, which must approve all arbitrator candidates. In order to qualify, arbitrators are required to have at least 10 years of legal experience and to be well trained in bankruptcy law. Liquidators and Trustees (*Veedores*) are banned from serving as insolvency arbitrators pursuant to the insolvency law. Once the arbitrator accepts this commitment



the arbitrator must render a decision on any matter within a two-year term from his or her designation, unless all parties involved in the arbitration process agree on a different term.

Insolvency arbitrators are entitled to admit any kind of evidence, to have access to all the books and records where the operations, acts, and agreements of the debtor have been registered, and to order evidentiary hearings. Furthermore, arbitrators have the power to analyze all available evidence under the rules of "healthy criticism" (*sana crítica*), with broad powers to consider or not consider all the evidence before them. Finally, an insolvency arbitration decision may be appealed, unless the parties agree otherwise. It is important to mention that although appeals are permitted, appeals on the merits are not possible, and appeals on the process are possible only if the parties to the arbitration have agreed in the arbitration agreement to subject such appeal to other arbitrators.

Despite the adoption of this alternative to the insolvency law, to date liquidation and reorganization proceedings continue to be heard primarily, if not exclusively, by Courts and there are no known insolvency proceedings in Chile involving international creditors that have elected to use arbitration; just as in Peru, it is likely this is a result of the relatively few reorganization cases that have been heard.

United States

In the United States, insolvencies are governed by the Bankruptcy Code, which is generally administered by specialized bankruptcy courts. These courts have jurisdiction over "all civil proceedings arising under [the Bankruptcy Code], or arising in or related to cases under [the Bankruptcy Code]." 28 U.S.C. § 1334. This language is sweeping and provides bankruptcy courts with jurisdiction over almost all aspects of a bankruptcy proceeding. In general, arbitration, mediation and other forms of alternative dispute resolution may not be used to administer or adjudicate matters that are before a Bankruptcy Court. Despite this broad jurisdiction and power, however, alternative dispute resolution mechanisms, such as mediation and arbitration, have been used in particular circumstances arising in insolvency cases in the United States.

Mediation

In large, complex insolvencies, there may be thousands of claims filed against a debtor. In order to ease the burden on the Bankruptcy Court and to ease the financial strain on the debtor of litigating these claims, the court, pursuant to its broad powers, may require parties to mediate disputes arising in connection with an insolvency. In many cases, parties have questioned the court's power to require such mediation. However, courts have held that ordering mediation is part and parcel of managing the claims filed before the court and is a way of providing a procedural framework for the consensual resolution of claims through streamlined procedures that do not bind participating parties unless they choose to be bound.

In the OSG Shipholding Group insolvency proceeding, for example, over 7,000 claims were filed against the debtor. Among the claims asserted were thousands of asbestos exposure related claims, as well as personal injury claims. Absent consent by all of the parties, the Bankruptcy Court lacked the authority to rule on these types of claims — but at the same time, without settling the claims, OSG would have had a very difficult time emerging from bankruptcy. Certain claimants argued that the court lacked authority to force the parties to mediate. The court, however, found that although it may not have the authority to rule on the merits of the claims (or to force the parties to resolve the claims through the mediation process), it had the authority to require the parties to mediate and attempt to reach a resolution. Ultimately, in the OSG case, this power to force mediation proved useful, as OSG was able to settle many of its claims in a more efficient manner, and it has just recently emerged from bankruptcy.

Arbitration

In the United States, there is a tension between a legal presumption in favor of the enforceability of arbitration agreements and the broad jurisdiction that bankruptcy courts have over all proceedings arising in, under, or related to the Bankruptcy Code. Thus, for example, if a contract dispute arises between a debtor in bankruptcy (also called the "estate") and a third party, and there is a provision of the contract stating that any dispute arising under the contract must be arbitrated, bankruptcy courts often look to four factors to decide whether to enforce an arbitration clause or retain jurisdiction and decide a dispute itself: (1) whether the parties agreed to arbitrate; (2) the scope of the agreements; (3) whether Congress intended the claims to be nonarbitrable; and (4) if some claims are arbitrable, the court must decide whether to stay proceedings pending the outcome of the arbitration.

However, even if the four criteria mentioned above are satisfied, bankruptcy courts may choose to retain jurisdiction (and thus decline to let the parties arbitrate a dispute) for institutional legitimacy reasons such as a desire to uphold the authority of the bankruptcy courts to oversee bankruptcy matters and the right of the debtor to file for bankruptcy. Thus, if the claim to be arbitrated is a claim that arises solely because the debtor is in bankruptcy (so-called "core proceeding"), most courts will not enforce an arbitration clause; this type of proceeding usually takes the form of claims against the estate, the sale of estate assets, and the recovery of assets by the estate, among others. If, however, the claim exists outside of the debtor's bankruptcy (so-called "non-core proceeding"), courts are more likely to enforce the arbitration agreement. These "non-core proceedings" involve, for example, the personal injury claims that were at issue in the OSG case, as well as certain pre-bankruptcy contracts.

For example, in *In re Pisgah Contractors, Inc.*,[5] a contractor in bankruptcy had one major asset, a pre-bankruptcy account receivable. The contract underlying the account receivable included an arbitration clause. If an account receivable was a "core proceeding," the Bankruptcy Court could have decided not to enforce the clause; however, pre-bankruptcy accounts receivable are generally not considered to be core proceedings. Reversing the Bankruptcy Court, the court hearing the appeal held that the Bankruptcy Court had no discretion and should have enforced the arbitration agreement because the account receivable in question was not a core proceeding.

Thus, the United States' approach to the use of arbitration and mediation in bankruptcy proceedings is more akin to that of Peru – although arbitration cannot be used to process an insolvency, it can in many instances be used to resolve disputes that are related to a debtor in bankruptcy or to make a court-supervised bankruptcy process more efficient.

Key Questions When US Courts Decide to Enforce Arbitration Clause

1. Did the parties agree to arbitrate?
2. What is the scope of the arbitration agreement?
3. Did Congress intend the claims to be arbitrable or not?
4. Will the main proceedings be stayed while the arbitration is pending?

A Modest Proposal

Given that arbitration is being increasingly favored by commercial counterparties in international transactions, it is worth considering whether jurisdictions in emerging markets could encourage further use of arbitration in insolvency proceedings. As indicated above, some jurisdictions (such as Peru and the United States) have already taken small steps towards the use of arbitration in ancillary disputes, and at least one jurisdiction (Chile) has permitted the use of arbitration in core bankruptcy matters (although to date there is no evidence that this mechanism has been used). One potential reason for the limited use of arbitration – in addition to those discussed above for each jurisdiction – is that choosing arbitration when (or after) an insolvency is initiated may not be the most opportune time to do so. At that time, creditors and the debtor are suspicious, if not completely hostile to each other, which makes choosing something as material as a forum a complicated process. In addition, choosing arbitration or mediation on a bilateral basis – in contracts or other arrangements – can lead to conflicting jurisdictional claims and a chaotic proceeding.

An alternative would be to amend insolvency laws to permit companies to choose arbitration in their bylaws. In that scenario, the decision to use arbitration would be taken at the outset of a commercial relationship, rather than the end. In addition, the decision would be transparent and available to all creditors who asked for a copy of the company's constitutive documents. Creditors could still play a role in the decision – they could insist on a company amending its bylaws to permit (or not permit) arbitration as the forum for a future insolvency proceeding, much as counterparties choose the governing law and dispute resolution forum for their contract. Some matters would need to be reserved for future agreement – for example, it would likely not be possible for parties to choose the specific arbitrator in advance. However, as in Chile, countries could maintain a roster of insolvency arbitrators and could provide for a mechanism to decide on the arbitrator (if parties are unable to do so) when the insolvency is filed, just as many jurisdictions do with an overseer or bankruptcy trustee.

Advocates in some countries might object that using arbitration – a mechanism typically reserved for sophisticated counterparties – is not appropriate for a bankruptcy that involves employee or trade creditors, who may not be able to afford the sophisticated legal advisors that typically accompany these proceedings. However, many insolvency cases involve impairment only of institutional financial creditors, such as bondholders or banks, and it may be reasonable to limit the use of arbitration if a debtor wishes to impair other creditor classes. Likewise, advocates might object that absent a strong procedural framework, arbitrated insolvencies could drag on indefinitely while the appropriate mechanisms are worked out. However, it should certainly be possible to publish a model insolvency procedure for arbitrators (much in the way that the UNCITRAL model law on cross-border insolvency has served as a template for many countries), and that model could differ by region or country, depending on the nature of local practices. Parties could agree in advance to use (or modify) this model framework for a future insolvency arbitration.

Even with these modifications, the ability to elect arbitration in insolvency proceedings could be a significant improvement to restructurings in emerging markets – it has the potential to result in speedier and more transparent proceedings, higher recoveries and greater certainty as to outcomes. And it would align insolvency regimes with the overall trend towards alternative dispute resolution in commercial markets. Countries involved in insolvency reforms should consider whether this would help their access to credit markets – and creditors should consider whether these reforms would be beneficial to them as well. ■

You Have Options: Takeaways

1. Include insolvency optionality in bylaws
2. Create and maintain a roster of insolvency arbitrators by jurisdiction
3. Form a model insolvency procedure for arbitrators

1. A third option, to file for bankruptcy in a mature market like the United States, Canada or the United Kingdom, is often not viable because of the need to impair local creditors that refuse to participate in an extra-territorial proceeding.
2. Judicial courts in Peru are able to hear challenges by creditors against any final decisions from INDECOPI's administrative tribunal as well as clawback actions, among others.
3. José Jiménez and Daniel Gonzáles, *Is Debtor-In-Possession Financing Even Possible in Peru*, Emerging Markets Restructuring Journal. Issue No. 2 – Fall 2016, 40-45.
4. The Law No. 20.720, Law for Reorganization and Liquidation of Assets for Companies and Individuals (Ley No. 20.720, Ley de Reorganización y Liquidación de Empresas y Personas), has been in force since October, 2014.
5. *In re Pisgah Contractors, Inc.*, 215 B.R. 679 (W.D.N.C. 1995).

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