

Proceeding with caution

Incoming reforms will improve Chile's outdated insolvency regime. But lawmakers have not overcome their scepticism of in-court reorganisations

Over the last decade, most of Latin America's leading economies – including Mexico, Brazil, Argentina, Peru and Colombia – have updated their insolvency laws to respond to the challenges of reorganising troubled businesses. Late last year, Chile joined its neighbours by passing a new *Ley de Reorganización y Liquidación de Activos de Empresas y Personas*. The number of Chilean high-yield issuers and borrowers in the international markets experiencing stress, in part due to the peso's 15% depreciation since mid-2013 and falling commodity prices, means it may be just in time. But both debtors and creditors may face difficulties navigating the new regime when it takes effect in October 2014.

The old law

The problems with the existing regime, created in 1982, are well known to distressed debtors and creditors alike. This year the World Bank ranked Chile the 22nd best country in the world for starting a business – but 102nd in resolving an insolvency. While the old regime may have emphasised the orderly and timely payment of creditors, there were no real incentives to bring a debtor with a viable business to the table. First, although a debtor could theoretically propose a so-called *convenio judicial preventivo*, filing the proposal was a cumbersome process. The debtor had to publish the proposal in the *diario oficial*, an expensive proposition that was also unlikely to reach creditors. In

addition, a debtor that filed a *convenio judicial preventivo* remained vulnerable to attack by creditors because no automatic stay was imposed on creditor actions unless a majority of creditors consented to it. Even if a debtor could find supportive creditors, the 1982 law failed to deal with managing the debtor as an ongoing business during the proceedings. For example, a debtor that proposed a *convenio judicial* could not pledge or dispose of assets, and debtor in possession (DIP) financing was not a realistic option. Prepackaged bankruptcies – *acuerdos extrajudiciales* – were of even less utility. The *acuerdo* only bound creditors that agreed to it and not those that dissented. Liquidations were also unfavourable. The debtor's approval was needed to sell a group of assets or the entire business in any way other than through a public auction. This hampered the ability to sell businesses as going concerns. Even the language of the *Ley de Quiebras* created a stigma against its use – only seven percent of financially troubled companies identified themselves as *el fallido* (the one who failed) and initiated proceedings under the old regime. For those few distressed debtors that did enter liquidation, the result was a lengthy process with low recovery for creditors. According to the World Bank's Doing Business study, a creditor should expect a process that takes 3.2 years and returns 29.1 cents on the dollar.

PescaChile's recent proceedings illustrate the system's flaws. After a year of court proceedings triggered by the insolvency of its Spanish parent company, the process to liquidate the company as a going concern has stalled. Among other matters, fights over the recognition of debt, as well as intercreditor battles among the parent's creditors (which have a guaranty from PescaChile)

and direct creditors of PescaChile have left the bankruptcy trustee with little recourse but to seek frequent guidance in court. The challenges faced by PescaChile show why most companies and creditors have typically eschewed Chile's in-court bankruptcy system in favour of negotiated restructurings – albeit without the ability to cramdown dissenting creditors.

New benefits

Recognising the inefficiency of the old regime, the Chilean Congress approved the new *Ley de Reorganización y Liquidación de Activos de Empresas y Personas* in October 2013. The law will enter into full effect in October 2014. Debtors and creditors are already starting to take note of its advantages – and some of its flaws.

The improvements begin with a detailed process for judicial reorganisation. A stay on most creditor actions is automatically imposed within five days of the debtor filing for judicial reorganisation. This automatic stay lasts for 30 days beginning after the court orders the appointment of the trustee (*veedor*), which must happen within five days of the reorganisation filing. This stay can be extended for up to 30 days with the support of two or more creditors representing 30% of liabilities, or up to 60 days with the support of two or more creditors representing a majority of liabilities. In addition, Chile joins Mexico and Brazil in permitting DIP financing – a debtor can incur new financing representing up to 20% of its total debt during a proceeding without the consent of creditors. This financing has priority status in any future insolvency. Similarly, a debtor can sell up to 20% of its total assets without requiring creditors' consent. In both cases, the 20% threshold can be exceeded with the support of creditors representing a majority of the liabilities. Another new feature is the preferential treatment of pre-petition debt from certain ordinary course suppliers and international trade financing counterparties that continue to provide services to the debtor during the bankruptcy proceedings. Together, these changes underscore the new law's focus on preserving debtors with viable businesses.

The new law also allows for prepackaged bankruptcy plans which, with the support of two or more creditors representing three-quarters of the debtor's liabilities, are binding on all creditors once approved by the court. This is a big improvement on the old law, in which a prepackaged plan bound only those creditors that had approved it. Upon approval by the

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requisite creditors, the Chilean court is required to render a sentence approving the plan within ten days.

The new law includes several important new features regarding alternate proceedings. For example, it will be possible to submit a debtor's bankruptcy proceeding to arbitration, as opposed to Chilean court proceedings, with the support of creditors representing an absolute majority of the debtor's liabilities. Under the new arbitration provisions, the arbitrator is accorded broad powers that encompass all matters necessary to adjudicate the debtor's bankruptcy proceeding. Importantly, the law also provides for a proceeding similar to a US Chapter 15 recognition and based on the UNCITRAL model law on cross-border insolvency. This should help facilitate multi-jurisdictional restructurings involving Chilean companies. Chilean companies that have cross-border operations, or that continue to use insolvency proceedings in other countries, will particularly benefit from a stay imposed on creditor enforcement actions upon the recognition of a foreign proceeding as a 'foreign main proceeding'.

The new insolvency law also includes a number of enhancements to creditor protections. For example, both creditors and the bankruptcy trustee can bring clawback actions for certain transactions within one year of the bankruptcy filing. This includes preferential prepayments, payments-in-kind, and the provision of additional security. Clawback actions can also be brought for contracts or payments made within a two-year period prior to the filing, but only if the beneficiary of the contract or payment was 'aware' of the debtor's economic state, or the contract or payment prejudiced creditors because it was not made on market terms. These actions can be brought by creditors or the trustee within one year of a court's appointment of the bankruptcy trustee. If successful, creditors or the trustee are permitted to seek reimbursement for the costs of bringing the avoidance action, including legal fees.

Perhaps the most revolutionary developments of the new insolvency law relate to the transparency of proceedings. Insolvency proceedings in Latin America have a long history of being opaque to creditors. Filings are often only available on paper in a public registry, and hearings are sometimes held on an *ex parte* basis. Chile appears to have turned these traditions on their head. The new law provides that all filings and proceedings in a judicial reorganisation will be recorded in

a *boletín concursal*, an online portal freely accessible to the public.

New challenges

Despite all its advantages, the new law contains some limitations that may make it less useful for large multinational insolvencies. First, only the debtor can file for judicial reorganisation. Although creditors can bring a liquidation proceeding that may be converted into a reorganisation proceeding, the initiation and control of a reorganisation process remains firmly in the hands of shareholders. Likewise, only the debtor can propose a reorganisation plan. And with no absolute priority rule, creditors may face the choice of accepting a debtor-proposed plan that benefits shareholders, or having to recover through a potentially lengthy liquidation process in which any going-concern value is likely to be lost.

While the new law has strict and short deadlines to expedite proceedings (delay being a significant problem under the old law), at times it appears to do so at the cost of creating a user-friendly law. For example, from the date that the court orders the appointment of the bankruptcy trustee, creditors only have eight days to verify the existence of their claims (apart from those included in a schedule of debts submitted by the debtor in its filing). The law does not specify the type of evidence required. But for companies with complex capital structures or capital markets debt, it may be difficult for individual bondholders acting outside of a trustee to present the required evidence in time. Further, although the new law improves upon the old law by allowing for an automatic stay, its 90-day limit may hamper the debtor's ability to reach a consensual agreement with creditors, unless it started negotiations before filing for reorganisation.

Exclusions from voting and participating in proceedings may make it harder to successfully restructure. Any creditor who has acquired its claim within 30 days of the commencement of insolvency proceedings is prohibited from participating. This may restrict investors wishing to acquire distressed claims from Chile to a more limited set of investment options, such as acquiring interests through a total return swap or participation in which the original

claimholder continues to hold record and beneficial ownership to the claim. And much like the Brazilian *recuperação judicial* proceeding, Chile excludes a number of claims – such as labour claims – from the stay. This could make it difficult for companies in need of operational restructuring to take advantage of the new law. The new law allows secured creditors to participate in the proceedings where the old law previously excluded them, but some elements of the treatment of secured claims remain unclear. Claims secured by property deemed by the court to be 'essential' to the business of the debtor are subject to the bankruptcy plan, but it appears that a creditor with security deemed 'non-essential' would have the right to not participate in the bankruptcy process and may be able to foreclose on its collateral notwithstanding the automatic stay. These and other areas of the law that remain unclarified – such as the effect of



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insolvency filings by corporate groups (a major issue in the recent PescaChile insolvency proceedings), some of which were reflected in Mexico's recent reform to its *concurso* law – demonstrate that there is still room for Chile's insolvency regime to develop.

Looking forward

Overall, the new insolvency law appears to be an important step forward. It provides a stronger process than beforehand and more transparency than any other Latin American jurisdiction. Nevertheless, the law seems rooted in a philosophy of caution when it comes to the benefits of reorganisation proceedings. Whether Chile can step forward and allow an efficient and cost-effective means of recovering credits will be determined by the next wave of restructurings.

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