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Latin American Insolvency Systems

A Comparative Assessment

Malcolm Rowat
José Astigarraga

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FOREWORD

Bankruptcy policy focuses both on the exit of firms from the market where profitability cannot be regained through restructuring measures as well as on the rehabilitation/reorganization of firms where the opposite is true. In the former case, firms are allowed to fail, particularly those that had survived on subsidies and other kinds of largesse, thereby freeing up more market space for more viable firms. In the latter case, timely financial restructuring, changes in ownership/management and so on can ensure that better economic use can be made of scarce resources. Specifically, when a loan contract is breached in a market economy, debt collection laws provide the basis for protecting creditors' rights through foreclosure on collateral, self-help, and/or court remedies such as breach of contract suits to seek redress. However, where multiple creditors have a stake in the business as financiers of a corporate entity, there will be, in the absence of an effective and equitable bankruptcy/reorganization framework, a tendency to grab assets (the so-called "common pool" problem) that could lead to sub-optimal results whose impact, though difficult to measure, can be substantial.

An effective legal framework requires the balancing of the rights of creditors and debtors with due regard to the social costs and the effects on credit and capital markets. However, there are no best-practice models available that can provide guidance in this as to how countries should proceed in their reform efforts in this area, and in many cases they are completely different.

This report, the first of its kind, provides a set of recommendations of both a legal and institutional nature for bankruptcy reform for the Latin American region, with the caveat that sequencing and priorities will vary from country to country. The report is based on a detailed study of four case studies (Argentina, Brazil, Mexico and Venezuela), an overview of the legislation of the remaining countries in the Latin American region, and draws on the extensive experience of bankruptcy reform in OECD countries as appropriate.

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ABSTRACT

Modernization of commercial legal systems is one of the essential "second-generation" reforms now underway throughout much of Latin America designed to underpin economic regimes based on market forces. While many specific commercial legal reforms are underway in the Region particularly in the areas of competition policy and capital market development to improve the operation of market forces, one relatively neglected area has been bankruptcy or insolvency reform dealing with the appropriateness and timing of the "exit" of firms from the market place.

When a loan contract is breached in a market economy, debt collection laws provide the basis for protecting creditors' rights through foreclosure on collateral, self-help, and/or court remedies such as breach of contract suits to seek redress. However, where multiple creditors have a stake in the business as financiers of a corporate entity, there will be, in the absence of an effective and equitable bankruptcy/reorganization framework, a tendency to grab assets (the so-called "common pool" problem) that could lead to sub-optimal results whose impact, though difficult to measure, can be substantial. In effect, bankruptcy policy focuses both on the exit of firms from the market where profitability cannot be regained through restructuring measures and on the rehabilitation/reorganization of firms where the opposite is true. In the former case, firms are allowed to fail, particularly those that had survived on subsidies and other kinds of largesse, thereby freeing up more market space for more viable firms. In the latter case, timely financial restructuring, changes in ownership/management and so on can ensure that better economic use can be made of scarce resources.

In either scenario, an effective legal framework requires the balancing of the rights of creditors and debtors with due regard to the social costs and the effects on credit and capital markets. When dealing specifically with an insolvency, two of the primary objectives are how to maximize the size of the "pie" as well as determine who gets what piece of the pie (and who pays). Answers to such questions are complex and country-specific. Indeed, there are no best-practice models available that can provide guidance in toto as to how countries should proceed in their reform efforts in this area and in many cases, the approaches are completely different (e.g. France and Germany). However, this has not prevented a number of countries, both developed and developing, to institute significant reforms in recent years focusing on the particular needs of their own jurisdictions. Within Latin America, Argentina, Costa Rica, Peru and Colombia have recently modernized their bankruptcy legislation, though room for further improvements remains in all jurisdictions.

The beginnings of reform in the region have also coincided with a radical change in the mix of capital flows that is now predominantly private to private compared to the public to public pattern of a decade earlier. This implies that to deal with potential downstream project failures, a viable bankruptcy regime needs to be in place in addition to the sovereign debt workouts of an earlier era. Bankruptcy reform also implies reforms in other tangentially related areas such as

secured financing, labor laws, and financial sector regulation, which also need to be addressed as part of a reform package.

This report provides a set of recommendations for bankruptcy reform in the Latin American region, both legislative and institutional, recognizing that the sequencing and priorities will vary from country to another, particularly since some countries have yet to begin the process of reform. The report is based on a detailed review of four case studies (Argentina, Brazil, Mexico and Venezuela) as well as a broad overview of the remaining countries in the Latin American region. It also draws on the extensive experience of OECD countries, as appropriate, in bankruptcy reform. The report, however, does not cover the special bankruptcy/reorganization issues of financial institutions which are normally handled separately (usually involving the central bank) in most countries.

EXECUTIVE SUMMARY

Modernization of commercial legal systems is one of the essential "second-generation" reforms now underway throughout much of Latin America designed to underpin an economic regime based on market forces. While many specific commercial legal reforms are underway in the Region particularly in the areas of competition policy and capital market development to improve the operation of market forces, one relatively neglected area has been bankruptcy or insolvency reform dealing with the appropriateness and timing of the "exit" of firms from the market place.

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The recommendations are grouped into ten broad categories:

1. Foster Judicial Reform

   As a general proposition, courts in Latin America are stretched beyond capacity due to a lack of equipment and infrastructure as well as from inadequate training for all levels of court personnel including judges. In addition, however, the special complexities of bankruptcy exacerbate the problems of inadequate judicial training. As a result, special training programs beyond traditional skill enhancement that are focused on bankruptcy/insolvency law would be essential for judges in addition to training programs on business concepts (accounting, interest and exchange rates, derivatives and netting, etc.).

2. Create Specialized Bankruptcy Courts

   Linked to the first recommendation is the notion that the specialized and complex nature of bankruptcy law and problems requires judicial specialization which has been successfully attempted on a pilot basis in a number of countries in the region. Where this is not feasible in the near term due to lack of resources or sufficiently qualified judges, consideration should be given to channeling insolvency cases to designated commercial law judges. A related recommendation concerns the possibility of using non-judicial mechanisms for resolution such as the special administrative arrangements operating in Colombia or the use of formal ADR programs that could be court-annexed or free-standing.

3. Crack Down on Corruption

The prevalence of corruption of all the major participants in the bankruptcy system is undisputed by most observers. This includes not only certain judges but also the core group of players (trustees, various debtors and creditors etc) who manipulate the system and exact improper payments in exchange for favorable treatment. To remedy this, a multi-pronged attack is required that should: (a) elevate insolvency corruption in the prosecutorial scheme of priorities; (b) require disclosure of behind-the-scene dealings that would provide the predicate for prosecution if found to be false; (c) create private causes of action that would incentivize parties to ferret out insolvency corruption and make such cases prosecutable in an expedited fashion and (d) promulgate rules of conduct for trustees in insolvency cases; and (e) foster the formation of professional associations of insolvency professionals, as such groups can help to elevate the level of knowledge, standards, and practice through education, peer pressure and political influence.

4. De-link Criminal and Bankruptcy Issues

Many Latin American countries deter businesses from resorting to outside help early by virtue of having legislation that classifies bankruptcies by various degrees of fault, some of which can result in criminal sanctions and bar insolvency relief. By mixing the business and criminal aspects of insolvency, the law discourages managers and owners of failing businesses from seeking timely outside assistance. The existence of criminal conduct should not alone preclude insolvency relief to the business in crisis.

5. Foster Transparency

In order to ensure that all participants in the bankruptcy process have accurate and timely information, priority should be given to maximize transparency. (a) Current statutes should be reviewed and revised to require meaningful and effective disclosure of pertinent information; (b) the power of trustees and other stakeholders to investigate meaningfully the debtor's past dealings should be enhanced; and (c) the power of trustees to recover assets wrongfully transferred should be enhanced.

6. Facilitate Preservation of Going Concern Value Before and During Bankruptcy

Legislation in most Latin American countries needs to be streamlined to provide for more timely and predictable relief through changes to (a) define better the standard to be satisfied before insolvency relief can be granted (e.g., suspension of payments may be too strict and vague); (b) permit and encourage insolvency relief before it is too late; (c) fix a definite reachback date for avoiding transactions; (d) revise avoidance statutes to facilitate pre-petition resolutions (e.g. a mortgage or lien is not avoidable if the unsecured debt had matured); (e) provide a framework for granting of credit during insolvency proceedings where warranted (through the protection of post-petition creditors); (f) identify and eliminate those provisions that needlessly militate toward liquidation (e.g. creditor liability to third parties after the debtor is voted to stay in business but cannot subsequently perform; and (g) provide for other exits besides liquidation upon a debtor's failure to obtain the required creditor consents to a proposal (sale of shareholder interests to third party).

7. Protect Collateral

Consideration should be given to having a reasonable period of 'stay' in a non-liquidation proceeding barring secured creditors from pursuing real and chattel mortgage claims to ensure that a work-out has a genuine chance of success. However, appropriate compensation should be provided while the debtor is using and consuming the value of the collateral.

8. Reduce Delay in Bankruptcy Proceedings

While promptness is a virtue in nearly all judicial proceedings (assuming quality is maintained), bankruptcy proceedings particularly demand rapid resolution given the costs of delay on the going concern value of a business and its underlying assets. For that reason, judges should be educated (in addition to the points raised in recommendation No. 1) about the costs of delay on a firm in financial crisis. Secondly, there is a need to identify and eliminate needless impediments built into existing laws that hinder the flow of insolvency proceedings such as the procedures for proof of claims, the routine appealability of decisions, the need for personal validation of claims at a court hearing, etc.

9. Enhance Flexibility in Reorganization Proposals

Current statutes have excessively formalistic and rigid requirements for reorganizations. Flexibility should be built into the relevant legislative provisions to: (a) allow for more than just a predetermined payout schedule; (b) allow for capital restructurings including debt to equity conversions; (c) make adequate provisions for executory contracts; (d) address the setoff of debts in financial contracts; (e) provide for insolvencies of groups of affiliates; and (f) provide for the special needs of insolvencies of small and medium-sized businesses.

10. Promote Cooperation in Cross-Border Insolvencies

The globalization of investment actively resulting in joint ventures and other multi-party transactions that transcend national boundaries requires focus on bankruptcy/reorganization harmonization across national boundaries. The parties engaged in a cross-border bankruptcy proceeding desire the same result that they would seek in a domestic bankruptcy case - namely reasonable notice, access and participation, predictability of results, enforcement of bankruptcy court judgments and the equivalent distribution of estate assets. However, in practice, this has been historically difficult to achieve, the one notable exception being the Inter-Nordic Insolvency Convention, though the European Union recently completed negotiations for a cross-border bankruptcy convention. The Latin American region has long adhered to the "territoriality" principle (each state asserts sovereignty) in cross-border insolvency cases, the basic exception being the Treaty of Montevideo (1940) involving four South American countries which has, however, been ineffective.

Faced with this difficulty, initiatives have been taken on several fronts aside from the above-mentioned treaties and conventions. To begin with, the private sector (Committee J of the International Bar Association) has successfully prepared and implemented a Concordat providing procedures and administrative arrangements for cross-border court cooperation (e.g., between the U.S. and Canada). In addition, and probably most important for Latin American countries is the recently approved UNCITRAL (United Nations Commission on International Trade Law) "model law" designed to foster procedural and administrative coordination amongst courts dealing with cross border insolvencies (not substantive legal harmonization of laws) which should be adopted by Latin American countries as a useful starting point for effective collaboration across borders.

Conclusion:

A review of existing insolvency legislation would be timely. Many of the region's insolvency regimes are antiquated, and not useful for minimizing the losses from financial crises of private sector modern enterprises. There is also scope for additional empirical work to ascertain the degree of delay in liquidation/restructuring proposals and its effects on collateral recovery in addition to the broader impact on cost of credit and economic growth. In any event, an adequate insolvency system is vital to promote investment and avoid needless losses.

I. INTRODUCTION.

> "The progress of legal institutions is clearly shown simply by comparing the inhumane procedures that the primitive Roman law authorized for use against the insolvent debtor, with the benignity of modern laws in the field of bankruptcy, benignity that has converted bankruptcy into one of the most popular forms to which unscrupulous merchants resort to carry out their frauds."[3]

While even that writer was not advocating a return to the Roman law from which most Latin American systems are drawn (with its provisions permitting the enslavement of the debtor), deep frustrations exist today on all sides of the insolvency process in Latin America. This study, believed to be the first of its kind, assesses Latin American insolvency systems in light of existing practice. Although this study focused on four countries, it also reviewed the insolvency laws of nearly all other Latin American countries.

The four focus countries, Argentina, Brazil, Mexico and Venezuela, were deemed to be a good sampling of the region: Argentina because it recently modernized its insolvency law, Venezuela as a country coursing a difficult economic period and representing the northern tier countries in South America, Mexico because of its NAFTA links with the United States and Canada, and Brazil because of the size of its economy and age of its insolvency law. In addition, each of these four countries, by virtue of their commercial links and globalizing economies, has to one degree or another experienced cross-border insolvencies.

A brief summary of the commercial insolvency laws of each of the four countries is attached as Appendices A though D.[4] This study, however, is based not only on an analysis of the letter of each county's laws, but as well on extensive interviews with parties involved in Latin American insolvency issues, including appellate and lower court judges, business executives, accountants, debtors' lawyers, creditors' lawyers, labor union representatives, United States, European and Latin American banks and other financial institutions. For an introduction to

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[3]Eduardo Pallares, Tratado De *Las Quiebras*, 11 (Jose Porrua E Hijos Publishers) (1947) (authors' translation).

[4]Translation of legal terms is a risky proposition, for the possibility exists that the translation will import into the phrase unintended nuances or meanings. For that reason, the text for the most part uses the untranslated terms, save for certain exceptions, such as "trustee" for "síndico," which are used despite the inexactitude of the translated term and the attendant risk.

Risk is attendant as well whenever a statute, especially one that is part of a broader statutory scheme, is interpreted or summarized. An affirmation of a statute's meaning will of necessity often omit important exceptions. And so, this report's synthesis of any statute is not intended to suggest that the stated principle is without exceptions or qualifications.

bankruptcy issues in the Mercosur countries, see Malcolm Rowat, et al "Competition Policy and Mercosur", World Bank, 1997.

As discussed more fully below, many insolvency law issues are uniquely national in nature. The resolution of issues such as the priority to be given to worker, tax and non-tax government claims, the role of government, including the judiciary and administrative agencies, in the insolvency process, among others, involves choices that can be made only in light of the unique circumstances facing the national policy makers. This study revealed two things pertinent here, though.

First, some countries in the region and elsewhere have adopted creative measures in efforts to address the problems that plagued their insolvency system. Given the commonality of some of the problems, such measures are worth consideration by policy makers in the region.

Second, even though many issues are uniquely national in nature, the assessment detected a sense by all stakeholders that current systems are not working, with the proviso that Argentina's recent revision is still too new to evaluate. Not surprisingly, debtor-representatives, labor and creditors identified differing reasons for why the current systems are not working, but some common complaints, discussed below, were found.

In light of those two findings, this study presents ten recommendations for reform in the region. The recommendations are intended to provide topics for the policy maker's initial agenda, not a detailed proposal for specific reform in any specific country.

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II. BANKRUPTCY POLICY.

The 1980's saw major economic restructurings in Latin America, driven in part by default on sovereign debts. The capital flows occurring in Latin American today, however, are markedly different from those of the past. Where capital flowed to and from the public sector before, much of the flow today is largely from private party to private party. While public sector debt does not depend on a national insolvency system for resolution, the adequacy of the insolvency system impacts private sector debt directly and therefore the magnitude of the resultant losses to the national economy. Events in Asia, Mexico, the "Tequila Effect" and other factors have recently imposed substantial economic pressure on Latin American businesses. This study was born from the World Bank's interest in assuring the existence of adequate methods for resolving private sector financial crises without needless losses, and its belief that such methods can be optimized only in the context of an adequate bankruptcy policy.

Bankruptcy policy impacts the marketplace, including daily decisions taken by managers, debtors, bankers, suppliers and others who engage in business.[5] More study is needed to measure empirically the impact of bankruptcy policy on the marketplace. Some work has been done. For example, Atiyas reported that Colombia's reform to its bankruptcy laws resulted in a higher percentage of consensual resolutions as well as quicker proceedings.[6] The precise effect of such improvements on the national economy as a whole requires further study, but common sense and feedback from those interviewed both support the proposition that an efficient, reliable insolvency system would increase predictability for both debtors and creditors and thus facilitate investment and the flow of capital.

The question of what losses are or are not "needless" is at the heart of a bankruptcy policy. As stated by one commentator, "[i]deally, bankruptcy policy should encourage the reorganization of companies whose liquidation value is smaller than their value as a going concern, and the liquidation of companies for which the opposite is true."[7] One difficulty in effectuating such a policy is that value, like beauty, is often in the eye of the beholder. So, "creditors sometimes fail to take into account the social costs associated with bankruptcies, such as job losses and other disruptions of economic relations,"[8] and evaluate only the cost to themselves, leading to possibly inefficient liquidations. On the other hand, a bankruptcy policy that unduly weighs the social consequences exacts a high cost, too:

> [A] bankruptcy regime should promote the flow of credit in an economy by protecting creditors and serving as a final stage of debt collection. A well-designed bankruptcy process takes control over financially-distressed firms before

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5 For a detailed treatment of the economic debate concerning the tradeoffs involved in the bankruptcy reform, see Oliver Hart, "Firms, Contracts and Financial Structure," Chapter on "Bankruptcy Procedures", Clarendon Press, 1995

6 Izak Atiyas, "Bankruptcy Policy," The World Bank, PSD Occasional Paper No. 14, p. 40 (February 1996).

7 Izak Atiyas, Bankruptcy Reform -- Breaking The Logjam in Colombia, VIEWPOINT, The World Bank, September 1995, at n. 51.

8 Bruno Bias & Jean François Malécot, Incentives and Efficiency in the Bankruptcy Process: The Case of France, The World Bank, Private Sector Development Department, Occasional paper No. 23, April 1996, at 1.

> all assets have been misused or dissipated, and it gives creditors the information and power to direct the use of the remaining assets to maximize the potential for debt recovery (either by improving the firm's performance via reorganization or by liquidating the firm and satisfying creditors' claims . . . out of sale proceeds). By thus giving creditors the confidence that debts can be collected, bankruptcy processes . . . facilitate the role of banks and other creditors in funding and monitoring investment in an economy and in exerting influence over enterprise managers. Without the ability to collect debts, banks will either refuse to lend at all . . ., or they will turn to the state for support when loans turn bad.[9]

The possibility that banks and lenders will turn to the state for support in the absence of a meaningful avenue for collection and a viable insolvency system is real. According to more than one observer interviewed, Mexican banks have turned to the state to bail them out of bad loans, and the state has responded with the creation of government programs such as the Unidad Coordinadora para el Acuerdo Bancario Empresarial (UCABE) and the purchase of troubled loans by the Fondo Bancario de Protección al Ahorro (FOBAPROA). While the banks' resort to the Mexican government has more than one explanation, Mexican bankers uniformly felt the existing insolvency system is not a viable option for controlling credit losses.[10]

Similarly, the possibility that banks "will not lend at all" is, within limits, real, too. Commenting on Brazil's law, one practitioner observes:

> As currently written, Brazilian concordata and bankruptcy laws are a major deterrent to the development of an efficient and dynamic domestic credit market. Together, these laws, in effect, make it possible for solvent debtors who have failed to demonstrate a compelling need to either obtain a moratorium and thereby repay the debt in depreciated currency or to have some part of their debt extinguished. In either event, unsecured creditors run the risk of substantial losses. Obviously, these risks are understood by sophisticated lenders and, for this reason, conventional, unsecured lending does not take place with the resultant economic consequences. Unless these anomalous results are eliminated by changes in the law, the development of a normal credit system, with banks as financial intermediaries, will be impeded if not foreclosed.[11]

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[9] Izak Atiyas, Bankruptcy Policies: A Comparative Perspective, Regulatory Policies and Reform, 36 (Claudio Frischtak, ed.) (1995)

[10] For a discussion of the UCABE program, see Mike Lubrano, Practical Difficulties in Mexican Workouts and Bankruptcy, N. AM. CORP. LAW., Vol. III, No. 3 (1996).

[11] Antonio Mendes, A Brief Incursion Into Bankruptcy and the Enforcement of Creditor's Rights in Brazil, 16 J. INTL. L. BUS. 107, 115 (Fall 1995) (emphasis added).

The consequences of a policy that favors preservation of the enterprise have been studied. In the view of some, such a policy results in, among other things, a tendency to provide too short term credit. In analyzing the French insolvency system, which has as a main objective the continuation of firms in operation and the preservation of employment, Biais and Malécot found that:

> Banks tend to provide too short term credit, which increases bankruptcy risk [meaning liquidation]; creditors [in France] have only limited bargaining power and obtain only limited repayment in bankruptcy cases. This reduces their incentives to lend . . . . To minimize the risk of being trapped in bankruptcy cases, banks provide mostly short term credit, which they renew only if the risk of bankruptcy over the next period is low. Such short term financing, however, increases the risk of bankruptcies generated by transient decreases in cash flows.[12]

To be effective, then, bankruptcy policy must address the goal of avoiding needless losses from financial crises on several levels. It must balance both the social costs as well as the effect on credit and capital markets, among other factors, for

> a legal framework that emphasizes rehabilitation ends up providing excessive bargaining power to the owners and managers of the debtor enterprise, and grossly violates the creditors' bargain. One that aims at protecting the creditors' rights, on the other hand, is likely to encourage substantial losses in going concern values.[13]

In striking this balance, policy makers must deal with at least two dimensions of an insolvency: first, how to maximize the size of the "pie" and second, who gets what size of helping.

Few, if any, constituencies in an insolvency proceeding, save an occasional competitor, dispute that the debtor-enterprise's value should be maximized. As expressed by one commentator,

> The role of insolvency law is to organize collective action in such a way that the value of the debtor's assets will be maximized and everyone involved will be better off than without such action . . ..[14]

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[12]Bias & Malécot, supra note 5, at 2-3. These findings were made in relation to France's pre-1994 insolvency legislation. France modified its legislation in 1994.

[13]Atiyas, supra note 6, at 36.

[14]Dr. Manfred Balz, Market Conformity of Insolvency Proceedings: Policy Issues of the German Insolvency Law, 23 BROOK. J. INT'L L. 171 (1997).

Rather, the dispute centers on how that maximization can be achieved: whether through a liquidation or a reorganization, whether with the existing management or under new management, and at whose expense.

Second, even if the value is maximized, the dispute becomes a matter of hierarchy: who gets paid what when. Thus, the term "needless" losses does not address the question of who will bear the losses that do occur, including those that are not the result of an inefficient or ineffective insolvency legal system.

How such issues (how to maximize, who pays, who gets) are resolved is a function of choices made in light of national political and economic realities. The question is not whether to favor liquidations versus reorganizations in a national policy -- that answer flows from the national resolution of the aim of bankruptcy policy. If the aim is to preserve employment and the firm, the details of the regime take one direction; if the aim is to serve as a debt collection mechanism of last resort, they take another, with policy makers in each instance needing to balance power appropriately among the stakeholders.

As in most things political, the answers are often the product of compromise and accommodation. Even systems that favor, say, preservation of employment and the firm and reduce the power of creditors will often build in compensating checks, such as an empowered judge, to balance the process. So France, with its expressed objective of preserving the firm and employment, limits the rights of creditors, but "allocates most of the power to the judge . . . [with] the idea that, as an independent third party, the judge should be able to ascertain whether the firm should be liquidated or not, and in taking this decision, to internalize the interests of all stake-holders, i.e., not only creditors but also shareholders, workforce, suppliers, etc."[15] In contrast, the new German legislation provides for a unitary proceeding (liquidation vs. reorganization, involuntary vs. voluntary), and leaves the determination of what is the best solution primarily in the hands of the creditors:

> . . . [T]here is no normative hierarchy [in the German law] (as it exists, for example, in the French law) of outcomes in bankruptcy. Most of all, reorganization is not preferred over liquidation, and an orderly liquidation with a sale of entire business units is not generally preferred over the piecemeal liquidation of the debtor's assets. It is primarily for creditors to decide which solution serves their interests best and to impose that solution upon the debtor and the equity holders.[16]

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[15]Bias & Malécot, supra note 5, at 1.

[16]Balz, supra note 11, at 173.

Insolvency law reform is occurring throughout the world. Germany,[17] France, the United States, Colombia, Costa Rica, Argentina, India, Canada and Hong Kong are just a few of the countries that have undertaken significant insolvency law reform in recent years. The debate over whether rehabilitation or liquidation, should be favored, over the rights of secured creditors, over the priority to be accorded to labor and tax claims has been resolved in a variety of ways. But in the eyes of one observer, "[i]t is possible to detect a tendency in bankruptcy reform efforts across countries to enhance the possibility of maintaining going concern values without granting bargaining power to the owners and managers of debtor firms."[18] As will be seen, this tendency is manifesting itself in Argentina and elsewhere in Latin America.

In considering reform, two points should be kept in mind.

First, insolvency cuts across many national laws. Insolvency law directly impacts and is impacted by the nation's laws for secured financing. Issues such as the operation of a stay, perfection of lien rights, the right of other creditors (such as workers) to prime or surcharge a lender's lien to collect their claims are all intertwined. Bankruptcy laws impact a society in a multitude of other ways. A worker's ability to collect an unfunded retirement pension, whether or not estate assets will be used to the exclusion of other creditors to clean up environmental contamination, the right of landlord to repossess premises occupied by a debtor not paying rent are but a sampling of ways in which bankruptcy law, policy and systems impact citizens.

Insolvency reform in a vacuum, then, while better than nothing, is incomplete. To be fully effective, reform must also address other linked laws:

> [B]ankruptcy reform should be carried out in parallel with reform of other types of regulatory policy that have an impact on bankruptcy outcomes. . . . [T]he supervision and regulation of the financial system, accounting and disclosure rules, and regulations that restrict the mobility of labor and capital should occupy top positions on the reform agenda. A general improvement in loan documentation and legal registries is also key. Without an improvement in the relevant regulatory environment, bankruptcy reform is bound to have only a muted effect.[19]

Second, the "reform" in question might start with statutory reform, but that is only a first step. Effective solutions for a business in financial crisis depend on a system, not simply a law.

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[17]Germany reformed its insolvency law in 1994: Insolvenzordnung, v. 5.10.1994 (BGBI. I S.2866); Einfuhrungsgesetz zur Insolvenzordnung, v. 5.10.1994 (BGBl. I S.2911).

[18]Atiyas, <u>supra</u> note 3, at 49.

[19]Atiyas, <u>supra</u> note 3, at 164.

That system requires an infrastructure not only of functioning courts, but as well upon private sector functions. A corps of trained professionals, credit bureaus, collection agencies, and skip-tracing services all play important roles in the debt adjustment process. Insolvency reform should address as well the need to foster the growth of these services.

III. SEVEN THRESHOLD OBSERVATIONS ABOUT THE INSOLVENCY ENVIRONMENT IN LATIN AMERICA.

First, many of the current insolvency laws in the region are deemed woefully inadequate. Mexico's *Ley de Quiebras y Suspensión de Pagos* ("LQSP") has been called "the worst law that has been ever enacted in the history of Mexico."[20] Although no statistics were presented, observers asserted that few *suspension de pago* (the closest thing in Mexico to a reorganization) proceedings ever really succeed. Many of the provisions in the LQSP were deemed simply theoretical or "*letra muerta*" (dead law) not followed in practice.

Such criticisms are based in part on the law's rigidity and formalistic requirements. Brazil's law is subject to many of the same complaints: "Brazilian bankruptcy law, as currently written, is very inflexible and only authorizes the liquidation of the debtor's assets. Moreover, whatever assets may be marshaled will be sold at auction, generally under conditions which will preclude obtaining maximum value."[21]

The laws are old. Mexico and Brazil both have insolvency schemes that date from the 1940's. The advanced age of insolvency statutes is evidenced by still-on-the-books provisions made to accommodate the difficulty in communicating before the era of telecommunications: the Venezuelan Code fixes the date by which domestic creditors must file their claims by adding one day for each 30 kilometers that the creditor is located away from the court, and establishes a sliding scale for foreign creditors, ranging from three months to six months depending on how far away the creditor resides (e.g., Colombia, the Americas, Europe or elsewhere).[22]

While age alone is not reason to reform a law, most of the region's economies have changed radically in recent years and the laws have not. For example, the Venezuelan *atraso* proceeding might have been adequate for the small business owner ("*el comerciante*") whose

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[20]Cervantes Ahumada, R., Derecho de *Quiebras* 261 (Editorial Herrero, S.A., Tercera Edicion 1981), as cited by Lubrano, supra note 7.

[21]Mendes, supra note 8, at 134.

[22]Venezuelan Commerce Code, Art. 959. Not to mention other indicants of age, such as Venezuela's prohibition upon women serving as trustees. See Venezuelan Commerce Code, Art. 970 (hereafter "Venezuelan Code").

business was the norm when the *atraso* procedures were devised. The statute requires the debtor to present, among other things, all its business books regularly kept, its balance sheet, its inventory, dated not more than thirty days before, a listing of accounts receivable and other debts, a listing by name and address of all its creditors indicating the amount and nature of each credit owed, and the consent of at least three creditors, all at the time of filing.[23] The procedures for *atraso* relief, then, do not accommodate themselves well to the complex financial affairs of any meaningful-size business.

Second, the judiciary plays an important role in the insolvency process in Latin America (but the role has been diminished under Argentina's recent revision). Although their precise duties vary, the judges have power to make critical decisions such as selection of the trustee and deciding contested issues of fact and law. In some instances they are vested with discretion to decide what is in the best interests of all concerned. Some[24] have accused the courts as having a "paternalistic, interventionist" perspective that values the "general interest" over the collective judgment and interest of the stakeholders. For example, in one much criticized instance under Section 61 of the prior Argentinean insolvency law [Ley 19,551], the judge refused to validate a restructuring agreement in the Sasetru S.A. case, despite the agreement's approval by a majority of the creditors, on the grounds that the creditors would fare better in a liquidation than under the agreement.[25] Even after the appointment of a trustee, the judges do not serve merely an administrative role, as they adjudicate disputes between the trustee and creditors, among other issues.

Third, a rescue culture is not likely to thrive in the region currently. Skepticism, if not cynicism, about the functioning of the current systems is pervasive. Regardless of the text of the law, faith in the system is not likely where creditors find, for example, as they have in Mexico, that the executive branch at the state level has refused to lend the police power to execute judgments on account of political concerns over the citizenry's reaction to dispossession of the debtor or execution of the judgment.

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[23]Venezuelan Code, Art. 899.

[24]Julio Cesar Rivera, Instituciones De Derecho Concursal, Tomo I, 109 (Rubinzal-Culzoni eds.) (1996).

[25]See Julio Cesar Rivera, Instituciones De Derecho Concursal, Tomo I, 81 (Rubinzal-Culzoni eds.) (1996). When he proposed the current Argentinean law to the Congress, President Menem cited the need to limit the power of judges to evaluate the merits or convenience of solutions agreed upon by a debtor and its creditors. *Mensaje del Poder Ejecutivo*, 12 May 1994, Section I, signed in Buenos Aires, Argentina, by Hon. Carlos Menem, Jorge L. Maiorano, and Domingo F. Cavallo. Whereas under old Law 19,551, an Argentinean judge had the power to deny bankruptcy relief in the "general [public] interest," the judge now is entitled to deny relief only if the specified statutory legal requirements are not satisfied. See Appendix A.

To cite experiences in just one of the countries studied, creditors in Brazil perceive a system that is biased in favor of debtors, bent on preserving jobs at all costs, without regard to the overall economic cost. Cited as examples were instances in which notwithstanding a statutory scheme that permits the attachment of assets in collection of a debt, the courts had recently ruled that cash could not be seized if the effect would be to shut down the debtor's business. Banks even considered ceasing business in one of the northern states of Brazil where the courts are perceived to have blatantly favored debtors, in one instance entering judgment against one bank for $250 million for dishonoring a $256 check.

In Mexico, general counsels of banks attested to the large back up in courts for collection cases. Their perspective is that the creditors have little chance of success in the current political environment and that judges do whatever they can to prevent collection. One bank alone is reputed to have 35,000 pending collection cases, leading some to observe that in Mexico the issue is not so much the lack of a rescue culture, but rather the existence of a "culture of non-payment."

That the absence of a rescue culture creates needless losses is borne out by current practice. In Mexico, secured creditors regularly accept discounts far below the value of their collateral in recognition of the delay and the deterioration in value that are likely to ensue if the court process were to play itself out. In each of the countries studied, a tendency existed among creditors to lose all expectation of a meaningful recovery on a debtor that entered the insolvency process, resulting in a disincentive for getting involved with the system. Repeatedly, creditors indicated that they tended to write off a debt once in bankruptcy rather than continuing to invest time and effort in its collection. In Brazil, a "white concordata" process has developed in which creditors agree to accept payouts below the statutorily-mandated minimums on threat by the debtor to file for *falençia* (liquidation).

Fourth, jurisdictions in the region evidence a powerful bias in favor of labor claimants.[26] In Mexico, Brazil and Venezuela labor claimants are given a high degree of preference and protection.[27] For example, as discussed more fully below, labor claimants in Mexico are not stayed by an insolvency moratorium, are free to pursue their claims outside the bankruptcy court, and have, in effect, a super-priority that primes even secured creditors.

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[26]That was the case in Argentina until recently, but is less so now.

[27]Other countries also give priority to certain labor claims. But unlike countries such as the United States where the labor claims given priority are capped at a certain amount, that is not the case in the cases studied. In fact, under some of the region's labor laws, the worker claims entitled to priority go beyond simply wage claims. Mexican workers are entitled to substantial (in proportion to wages) severance and pension benefits that are rarely funded. If a company is liquidated, the claims for these benefits can amount to a multiple of the annual wage bill and consume all estate proceeds.

Fifth, all four systems provide for at least two forms of relief, a liquidation procedure and some form of arrangement that permits the debtor to survive in operation. The arrangement procedures are not akin to United States Chapter 11 proceedings, although Argentina's recent reform has some similar features.

Sixth, corruption is the most resounding complaint in the region. References to the "Mafia" that works the bankruptcy field were common in the field interviews. The sense is not that organized crime is somehow endemically involved in the system, but rather that a core group of players control the field and exact kickbacks and other improper payments in exchange for favorable treatment. While opinions about the severity of the problem varied, they varied within a narrow range, with some observers believing that the problem in their jurisdiction is not as virulent as it once was.[28]

Finally, insolvency reform is on the agenda of countries in the region. In 1994, the Ministry of Commerce in Mexico prepared a revised insolvency law for commercial debtors. After the crisis broke out in December of that year, the project stalled and seemingly for political reasons has not been advanced. Brazil similarly has several insolvency reform proposals under study, but they are not deemed to have a high likelihood of passage because of perceived anti-creditor political pressures.

If such proposals are perceived to be simply pro-creditor, the likelihood of success in the current environments that include such elements as organized militant pro-debtor groups, will be diminished. Reform is needed not simply because current systems do not serve to recover loans effectively, but as well because current systems do not provide debtors with effective means to restructure their balance sheets and preserve the going concern value of their businesses. A Brazilian concordata, for example, does not bar secured creditors and permits only a predetermined payout amount that must be paid out within the predetermined statutory period. A revised law would ideally provide more flexibility.

Any such reform entails a balancing of interests. In formulating a bankruptcy policy, that will in turn define the national insolvency system, Latin American policy makers must address the basic choices in light of current market realities, including the mobility of capital and competition for jobs among industrializing countries worldwide.

This tendency is evidenced in Argentina's recent reforms. Argentina revised its insolvency law in 1995.[29] In transmitting the proposed law to the Congress,[30] President Menem

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[28]For example, some in Mexico felt that trustee corruption became less severe once Mexico required, starting in 1987, that only banks and chambers of commerce be appointed to serve as trustees, eliminating the prior practice under which any "comerciante" was eligible to serve as trustee.

[29]Ley 24,522, sanctioned 20 July 1995, known as "Ley de Concursos y *Quiebras*"

cited thirteen objectives, including:

- Increasing the flexibility of the *concurso* process, with the intent of providing a wide range of solutions for a business in crisis;

- Incorporation of the creditor body through a more active role in the search for solutions;

- Providing a means for creditors or third parties to salvage the enterprise by assuming the risk and paying a "real price for the value of the business" upon a debtor's failure to overcome its crisis;

- Treatment of labor relations with the aim of simplifying procedures for claims recognition and an exclusive forum,[31] and providing for more flexibility in labor negotiations for businesses in crisis;

- Limiting the power of judges to evaluate the merits or convenience of solutions agreed upon by a debtor and its creditors;

- Reduction of time periods and simplification of procedures in liquidations in order to avoid the deterioration of the value of assets of the debtor or its business; and

- The reduction of the cost of *concurso*s and liquidations.[32]

President Menem's proposal then was intended to address some of the problems cited above.

(hereafter "Argentina Revision").

[30]Mensaje del Poder Ejecutivo, 12 May 1994, Section I, signed in Buenos Aires, Argentina, by Hon. Carlos Menem, Jorge L. Maiorano, and Domingo F. Cavallo (hereafter "Mensaje del Poder Ejecutivo").

[31]The new law provides that the opening of a *concurso* proceeding effects a "radicación" (conceptually speaking, the "relocation") of all pending lawsuits to the court handling the *concurso* with specified exceptions. Argentina Revision, Art. 21(1). The wording of the provision has led to questions about its implementation such as whether outlying courts should transmit their files to the *concurso* court, with some courts doing so, and others not. See also, note 77, infra.

[32]All thirteen objectives are not listed here, nor does this listing purport to be a *verbatim* recitation of President Menem's message.

IV. TEN RECOMMENDATIONS.

As noted, many issues fundamental to the possibility of reorganizing a business in crisis, such as the priority to be given to worker claims, are singularly domestic and politically-sensitive issues. In its recent effort to draft a model cross-border insolvency law, United Nations Commission on International Trade Law (UNCITRAL) law encountered a host of issues on which no agreement could be reached. Any regional-level recommendations, then, risk irrelevance.

On the other hand, certain shortcomings are problems no matter what national resolution is given to the singularly domestic and politically-sensitive issues. Inadequate court systems, corruption among the players in the game, the lack of transparency, and needless statutory inflexibility impede the salvaging of the value of a business in crisis, no matter what the national philosophy on insolvency. Debtors, lenders, workers and other creditors alike get cheated by a dysfunctional system, as do ultimately, the taxpayers who must pay for higher social costs as well as higher credit costs caused by needless loss of value in the national economy.

That said, an initial assessment of the region's systems yields ten recommendations for reform:

1. Reform The Judiciary.
2. Create Specialized Insolvency Courts.
3. Crack Down On Corruption.
4. Delink Criminal and Insolvency Issues.
5. Foster Transparency.
6. Facilitate Preservation of Going Concern Value.
7. Enhance Protection of Collateral.
8. Reduce Delay.
9. Enhance Flexibility In Reorganization Proposals.
10. Promote Cooperation In Cross-Border Insolvencies.

An insolvency system is a multi-component means of dealing with an enterprise's financial problems -- by definition the system has multiple elements or pieces that affect its functioning. The challenges facing insolvency systems in the region are so fundamental that fixing one element will not adequately meet the need. As will be seen, problems exist across much of the spectrum of the region's insolvency systems and are interlinked. Because the problems are interlinked, so are the recommendations. Ranking the ten recommendations, then, is difficult, although surely issues such as corruption and inadequate judiciary and infrastructure are foremost.

1. Judicial Reform.

The refrain that the principal problem is not an inadequate law but inadequate application of the law resonates throughout the region. As one observer put it, "a bad law in the hands of a good judge is better than the reverse." The complaints included the delays of years[33] that it takes to resolve a case, judicial incompetence, as well as outright corruption.

In each of the countries studied, the judiciary is stretched beyond capacity. For one, the judges by and large lack the equipment and infrastructure necessary to function effectively. The court's staff do not provide the level of support needed to process the multitude of cases burdening the court, and often, are not qualified to carry out their administrative functions.[34] Visits to the courts' facilities reveal judges and staff laboring in cramped quarters under piles of over-stuffed files. Through a variety of projects, the World Bank is actively facilitating the modernization of judicial infrastructures in the region. Such projects should include components to modernize the insolvency system's infrastructure in such countries.[35] The needs range from computer equipment and software to track cases and rulings, to additional staff, to training for existing staff, to basic office equipment, to know-how for better management of filings and case files, and even efficiency studies to determine how to streamline the flow of paper.

Many practitioners complain that the judiciary in general are not adequately trained and lack the experience gained from years in practice. While excellent judges exist at every level, judicial positions, especially at the lower level, are often regarded as a career track for less talented law graduates.

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[33] In each of the countries studied, observers cited their respective extreme examples of the case that had been pending 10, 15 or 20 years, in one case explaining that the judge had hosted, hopefully in an attempt to inject humor into an otherwise sorry situation, an 18th birthday party for the file.

[34] One suggestion made was to require a mandatory court apprenticeship or clerkship ("pasantía obligatoria") for all law students, thereby replacing existing inadequate court support staff.

[35] See M. Dakolias, The Judicial Sector in Latin America and the Caribbean - Elements of Reform (1996).

Such a statement and the suggestions of corruption made in the next section run the risk of slighting the many fine judges and professionals who diligently and competently labor every day in the region's judicial systems. No such slight is intended. Particularly the judges who were interviewed in connection with this assessment were thoughtful, competent and demonstrated professionalism and dedication under challenging circumstances. The assertions set forth here regarding the judiciary's competence, in the next section about corruption, and others reported elsewhere in this assessment are distilled from dozens of private interviews with participants in the region's insolvency systems who spoke candidly but in confidence about their perceptions of their system. While no pretense is made that the sampling has statistical significance, the themes resounded enough to warrant reporting.

Apart from concerns about the judiciary's general lack of training, most observers believed that the judiciary specifically lack training and knowledge about their country's insolvency law. This concern was not as acute in those jurisdictions in which specialized courts have been established or judges have been assigned to handle all the insolvency cases for the district or locality. The concern was especially acute in relation to judges outside the country's major commercial centers, where a judge might only infrequently handle an insolvency case. That lack of familiarity results in judges postponing decisions and not taking action to avoid making mistakes.

The lack of training is not confined to issues of law. Many members of the judiciary lack knowledge of basic business notions, notions that are key to evaluating the viability of a business in crisis. Examples cited included a lack of understanding of foreign exchange, credit terms, and even how to calculate interest.[36]

The question of what should be the qualifications to become a judge (i.e., should the non-appellate judiciary be a career track for less qualified law students) is another of those peculiarly domestic political issues. The training of judges, whomever they might be, should be a high priority, at least for any state seeking to establish a functioning, independent commercial law judiciary. The quality of the national insolvency system, regardless of what policy choices it reflects, will be improved if judges administering the system better understand it, better understand the business concepts necessary to make informed decisions about the fate of a company, and have the resources necessary to consider and make such decisions in an orderly and timely way.

Several countries have the mechanisms in place (such as Brazil's "Escuela de Magistratura" or magistrates' school) to administer such a training program, albeit that they would need additional resources. This recommendation, then, is two-fold:

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[36]In lieu of training, courts could be empowered to appoint independent expert advisors on business and economic issues. While such a practice might be helpful in a highly complex case or serve as a band-aid solution to inadequate training of the judiciary, it carries a meaningful risk of creating unaccountable shadow judges were it to become widespread.

1(a). <u>Design and Implement a Program to Train the Existing Judiciary on the Law of Insolvency.</u>

The training on insolvency law should include both substantive insolvency law as well as procedural law. Observers in each of the four countries commented on the complexity of the interplay between substantive insolvency laws and applicable procedural rules. By way of example, Mexico's main insolvency law, the LQSP, provides some rules of procedure, in other instances the *Código Federal de Procedimientos Civiles* controls, and in other instances, the non-federal local law governs procedure.[37]

1(b). <u>Design and Implement a Program to Train the Existing Judiciary on Business Concepts.</u>

All judges, whether they be insolvency judges or not, would benefit from an understanding of basic principles of business and economics. But, many judicial decisions in non-insolvency contexts do not require knowledge of such concepts. Disputes about criminal acts, personal injuries, breach of contract or administrative law do not necessarily implicate business notions or market principles. In contrast, many insolvency disputes implicate precisely those notions and principles. Insolvency judges ultimately are being asked to make a judgment about how to maximize the value of an enterprise, or stated differently, about how to avoid needless economic losses. To make such judgments, insolvency judges need an adequate base of knowledge. Apart, then, from any policy that the entire judiciary generally should be trained in these fields, there is a specific need to so train insolvency judges.

The curriculum should include such subjects as the calculation of interest, exchange rates, indexation, financial instruments (equity shares, bonds, and securitization) as well as an understanding of financial statements and the local equivalent of generally accepted accounting principles. To the extent that training on all such subjects is deemed unnecessary for judges outside of commercial centers, the curriculum can be tailored toward more basic business concepts. Similarly, as markets become more sophisticated, consideration can be given to such subjects as derivatives and netting, given the likelihood that insolvencies in major commercial centers may well include such instruments and issues.[38]

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[37]<u>See</u>, <u>e.g.</u>, LQSP, Disposiciones Transitorias, Art. 6.

[38]Such training programs need not depend on the public sector's willingness to subsidize them. Local bar associations as well as chambers of commerce and other private sector organizations could undertake such programs.

2. Specialized Courts.

2(a). Evaluate and Elevate Qualifications for Judges Adjudicating Insolvency Cases.

The widely-held view that lower level judgeships often serve as a career track for less able law graduates raises a broader question about what qualifications should be required to serve on any sector of the judiciary. That broader question (what should be the required qualifications to serve as a judge) goes beyond the narrow needs of insolvency stakeholders and involves more basic questions about a nation's governance system beyond the scope of this study. But, special qualifications to judge an insolvency case can justifiably be required, given the sophistication of the issues involved in such proceedings.

2(b). Channel Insolvency Cases to Specialized Courts or Designated Judges.

While a training program will help most judges, it cannot substitute for the experience gained from having to adjudicate a steady flow of insolvency cases, each of which brings variations on repeat issues. Channeling bankruptcy cases to designated judges would enhance the sophistication of the courts, better familiarize them with the insolvency laws, facilitate training and on-the-job learning about business concepts (interest, financial statements, etc.), and create greater accountability.

One advantage of channeling cases to specialized courts would be the courts' ability to devote attention to priority cases. While to each debtor and its creditors theirs is the most important of all cases, courts have limited time to devote to their duties. Large or complex insolvency cases require fast attention to minimize the risk that value will be needlessly lost. A specialized court should be able to manage its docket better so as to focus on such cases as needed, in contrast to general jurisdiction courts that will have a variety of important matters vying for its attention.

This solution is not without substantial issues, ranging from Constitutional questions about the structure of the judiciary to practical questions about the outlying regions of a country that lack enough volume to warrant a judge dedicated full-time to bankruptcy. Such issues appear superable. Some jurisdictions have already implemented some variation of this suggestion, at least on a limited basis. In Mexico, for example, two judicial chambers in Mexico City have been designated to handle all bankruptcies filed in the district. Brazil similarly has implemented such a system in major commercial centers. Specialized courts have been established in some provinces in Argentina, such as in Mendoza and Córdoba.

The creation of a specialized insolvency courts would require careful definition of the court's jurisdiction. Some areas of jurisdiction are easily defined as being within the court's jurisdiction (such as a petition for insolvency relief). The difficulty arises when defining the outer limits of the jurisdiction. Should the insolvency court have jurisdiction over disputes among creditors? Over claims against officers, directors, accountants or other professionals who are not creditors of the estate? Over the claims of government and labor, both of which are often not subject to the constraints of current Latin American insolvency laws? The need to define the jurisdiction's outer limits does not undercut the benefit from establishing a specialized insolvency court.

This proposal is not intended to suggest that the insolvency courts should be independent or isolated from the country's ultimate judicial authority. Given the overlap between a country's bankruptcy and non-bankruptcy laws, a means of assuring a coherent interpretation of both such bodies of law is important, and absent unique national circumstances, the country's supreme judicial body should have say over decisions of even specialized insolvency courts.

2(c). **Consider Alternative or Supplementary Bodies to Administer or Aid in the Insolvency Process.**

Other jurisdictions have devised non-judicial solutions. Beset by many of the same problems diagnosed in this assessment, Colombia modified its law: before undertaking reform in 1989, Colombia provided a good example of the kinds of problems and inefficiencies that arise when debtors are granted excessive power, multiple forums deal with different aspects of a bankruptcy, and the judicial system suffers from a lack of skills and limited processing capacity. The reform introduced an innovative institutional solution to these problems: it shifted the bankruptcy procedures from the traditional judicial system to a credible administrative agency with more expertise in handling workouts. The result was a process with more authority, more flexibility, and more speed.[39] Peru has charged the supervision of insolvency proceedings to the *Comisión de Salida del Mercado* ("Commission for Exit from the Market"), an arm of the INDECOPI, the *Instituto Nacional de Defensa de la Competencia y de Protección de la Propriedad Intelectual* ("National Institute for Defense of Competition and Protection of Intellectual Property").[40] The procedure has received at least some positive comment.[41]

If reform of the judicial system is too daunting a task, insolvency policy makers should consider the possibility of using non-judicial administrative bodies to aid in the resolution of insolvencies. Colombia's reform provides a workable model for other countries suffering from congested courts.

While the establishment of administrative agencies outside the judicial system entails substantial expense and major overhauling of the existing systems, small steps can be taken as

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[39]Atiyas, supra note 3, at 1.

[40]*Ley de Reorganización del Patrimonio*, Legislative Decree No. 845 (October 1996) (hereafter "Peru Revision")

[41]See, Noya De La Piedra, Ismael & Cauti Barrantes, Augusto, "Peru Eases Path Toward Reorganization," International Financial Law Review (June 1997), 41.

well. Mediation and other forms of alternative dispute resolution can help reduce the number of disputes that insolvency courts must adjudicate. Although mediation and ADR are not yet widespread in the region, they are being considered by the bar and others in countries such as Argentina. Similarly, arbitration can be effective especially where the dispute is between two parties, such as the debtor and a creditor. Even where no pre-bankruptcy contract requiring arbitration exists, parties can voluntarily submit a dispute to arbitration. Insolvency courts or policy makers could establish sanctioned arbitration programs to encourage parties to extract their disputes from overloaded courts.

3. **Crack down on Corruption.**

As noted, corruption is a major, if not the major, issue plaguing the region's national insolvency system. The "corruption" cited was multi-dimensional and not limited to judicial corruption. Instances cited included trustees who demanded kickbacks[42] in exchange for agreements to sell estate assets to an interested buyer, debtors who paid trustees in exchange for trustee support during the proceedings, rigged auctions of estate assets in which bidders extorted hush money from prospective bidders in exchange for not driving up the bid price at auction[43] and the fabrication by debtors of phony creditors designed to manipulate the voting in a *concurso*. Secret and side agreements between debtors and creditors and among creditors are widely known to exist.[44] Other examples cited included collusion between a debtor and labor to skim assets "off the top" using labor's high priority claims.

As one Brazilian lawyer put it, "it is very difficult to be decent in this environment." No matter how good the substantive bankruptcy law, the system will fall short of its potential if the field is not level. In such an environment, creditors needing their claims adjudicated and debtors needing their businesses saved lose faith in the system's ability to resolve their controversy fairly, bidding is chilled, and ultimately, values are not maximized.

The devil is in the details.

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[42]More than one observer independently remarked that "getting the trusteeship of a sizable business is a sure way to get rich."

[43]Participation in such schemes often involves more than just an outlaw bidder. For example, bank employees participating in the scheme will issue the extorting bidders facially valid cashiers' checks which are required to bid. The bidder will show these checks to legitimate bidders as evidence of the bidder's ability to carry out the threat.

[44]See, e.g., Rivera, supra note 21, at 140. Instances cited by other observers included inflation by debtors of their alleged liabilities to suppliers in an effort to curry favor with suppliers and circumvent the Argentinean principle of *pars condictio creditorum*.

3(a). Elevate Insolvency Corruption In The Prosecutorial Scheme Of Priorities.

The criminal justice system in much of the region is just as taxed as the insolvency courts, and is itself as corrupt as the insolvency system. Given the importance to the national economies of adequately adjusting debts, a case can be made that "bankruptcy crimes" (being those crimes which directly undercut the adjustment of debts and disposition of estate assets in accordance with the national laws) should be elevated in the prosecutorial schemes of priority.[45] Creditors regularly complained of instances in which the criminal authorities failed to prosecute debtors who falsified financial statements or otherwise defrauded creditors.

3(b). Require Disclosure of Behind-the-Scenes Dealings.

All of the activities cited should be illegal under the law. But, dependence on state prosecution of bankruptcy corruption is not likely to be enough. Private causes of action, if effective, would create an additional deterrent. The focus should be on facilitating efficient and effective prosecution of such private causes of action.

To facilitate civil as well as criminal prosecution and encourage debtors, creditors and other interested parties to rely on insolvency systems, the systems should require disclosure of any agreements that restrain the operation of the market forces, such as collusive bidding and direct or indirect transfers of value, from the debtor or its principals to a creditor. With such a requirement, the offense should be less difficult to prosecute as it would be not merely an "omission" or failure to disclose, but rather an affirmative misstatement.

Whether an affirmative requirement of disclosure would deter someone willing to collude is a fair question. Someone willing to engage in an illicit transaction will be willing to file a false disclosure to boot. But, a statement or disclosure by any party receiving a benefit from the estate, such as a trustee or buyer of estate assets, certifying that it neither paid nor received any non-disclosed benefit or value and that all terms of the transaction in question have been disclosed would create the predicate necessary to punish any false declaration by disgorgement of any assets or other value received from the estate and forfeiture of any further right to recovery. While the disclosure, then, might not in and of itself deter, it will aid in the prosecution of both civil and criminal claims for improper dealings.

Such a law should require disclosure of value or benefits received from third parties as well as from any parties to the transaction. In each of the jurisdictions studied, instances occurred in which the debtor or its principals secretly executed a purchase of estate assets

[45]Enactment alone of laws outlawing bankruptcy corruption will not be enough. Some legislation already exists, but is not meaningfully enforced. For example, the Venezuelan Code prohibits a creditor from trading its vote at the expense of the estate assets, yet that is regularly done. Venezuelan Code, Art. 921.

through a supposed "third party."

3(c). Create Private Causes of Action that would Incentivize Parties to Ferret Out Insolvency Corruption.

Private causes of action entitling the estate as well as creditors to prosecute efficiently private causes of action against perpetrators of insolvency corruption would provide some further brake. Generally speaking, a trustee currently has power to seek return of estate assets. The issue here goes beyond simply recovering estate property. Corruption in this context damages stakeholders because the value of the estate is not maximized by virtue of rigged bidding, diverted business opportunities, or other secret means. The need, then, is to provide stakeholders with an effective and speedy mechanism that incentivizes parties to ferret out such conduct. A regime prohibiting "insider"dealing would be even more effective if parties were incentivized to prosecute violations by, for example, an entitlement to share in any benefit to the estate resulting from the party's successful exposure of insolvency corruption. Any legislation creating such causes of action would need to provide for an adequate statute of limitations period to allow adequate time to discover the occurrence of any improper dealings.

Finally, in some jurisdictions such as the United States, trustees are regarded as fiduciaries owing duties of care to the estate and interested parties. The scope of that duty is fleshed out on a case-by-case basis under the United States common law system. While such open-ended judicially-defined duties are not typical under Latin legal systems, the imposition of statutory duties and civil liability upon trustees is worth consideration.

3(d). Make Such Causes of Action Prosecutable in an Expedited Fashion.

Simply creating private causes of action prosecutable as general civil claims in the general jurisdiction courts is not likely to succeed given the cost and protracted length of time it takes to prosecute civil causes of action in the region. The deterrent effect of civil causes of action would be enhanced if such causes were to be litigated within the context of the insolvency proceeding itself or some other forum on an expedited basis.

3(e). Enact Rules of Conduct for Trustees in Insolvency Cases.

Confidence in the system and therefore the system's ability to foster a rescue culture is affected not only by outright corruption but even by subtler issues affecting the marketplace's perception of the system's impartiality. For example, there do not appear to be clearly announced rules relating to a trustee's conflicts of interest, and so, concerns were voiced about a trustee's ability to carry out duties while also, for example, advising a competitor of the debtor.

If the courts and the office of trustee are to be effective, they must be perceived as impartial, and conflicts of interest, as well as the *appearance* of conflicts, must be avoided. A code of conduct for trustees, drafted with these principles in mind, would be a useful step.

Beyond that, fair questions exist about the ability of interested parties to serve as trustees. What is perceived as a disqualifying partiality varies from country to country. For example, in Brazil, the role of trustee is to be offered first to the top three creditors.[46] Such a provision was not uniformly regarded as problematic, and in fact, some even suggested that as the stakeholders with the most at risk, creditors should be the trustees. (That perception might be influenced by the fact that few creditors accept the role.) Local culture, mores, and rules of the marketplace all affect perceptions about fairness and impartiality, and any proposed code of conflict of interest will need to account for local perspectives. On the other hand, as a basic proposition, the concept that a trustee should be disinterested and obligated to protect the interest of all creditors would help diminish the perception that the system is biased. A committee of creditors, such as an enhanced committee of creditor "interventores" or overseers as exists in Mexican procedure, might assuage concerns that the principal stakeholders do not have enough say.

Similarly, policy makers should consider whether trustees should be licensed. In a context where trustees are regarded as not reliable, the notion of legal standards and licensing of trustees has much to commend it. On the other hand, some jurisdictions such as Mexico have made the problem of trustee corruption less grave by requiring that trustees be either banks or chambers of commerce.[47]

Apart from rules of conduct, the laws should be revised to eliminate needless incentives to commit bankruptcy crimes. For example, under current Brazilian legislation, a trustee must normally await the end of the case to be paid. As a practical matter, trustees do not wait to get paid. Trustees often cut side and secret deals rather than wait years for their compensation. The statutes should permit interim compensation to trustees.

3(f). Foster the Growth of Associations of Insolvency Professionals.

The lack of trained professionals knowledgeable in the field is a factor that has, among other things, facilitated the continuing control by a small cadre of practitioners. In Brazil, for example, professionals with the global accounting firms do not serve as trustees; many involved in trying to locate debtors' assets are not familiar with measures such as 11 U.S.C. §304 that are available to them in the United States in aid of their proceedings; and accountants who are named to help trustees unravel a debtor's financial operations are often regarded as too unsophisticated for the task.

Unlike jurisdictions with more developed insolvency systems, countries in the region do not have comprehensive associations of insolvency professionals. Professional associations

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[46]Federal Decree No. 7.661, 21 June 1945, Article 60 (hereafter "Brazilian Bankruptcy Law").

[47]LQSP, Art. 28.

could help deal with a number of the problems identified in the region. As discussed above, corruption, including self-dealing by trustees, is a major issue in the insolvency field in the region. Strong professional associations of insolvency lawyers, trustees and other professionals could bring social pressure to deal with the problem as well as political influence to promote legislation. A model code of ethics adopted by such associations could help. Associations of insolvency judges similarly would be beneficial.

The development and establishment of professional associations could also play important roles in the continued education of judges, trustees, and other bankruptcy related professions. Public institutions as well as non-governmental organizations could foster the development of a broader corps of trained professionals through educational programs.

4. De-link Criminal and Bankruptcy Issues.

Given the recommendation that bankruptcy corruption be prosecuted more vigorously, a recommendation that bankruptcy relief be de-linked from the criminal issues might seem paradoxical. The de-linkage is suggested to eliminate a deterrent existing in current systems which causes the management of legitimate debtors to vacillate before reaching out for help.

Under many systems in the region, bankruptcies are classified into levels of fault, ranging from "fortuitous" to"culpable" to "fraudulent." Bolivian law declares that a fraudulent bankruptcy occurs when the debtor fraudulently reduces its net worth (*"patrimonio"*), including by hiding its property or falsifying its debts.[48] In Chile, a fraudulent bankruptcy is presumed where the debtor paid a creditor to the detriment of others while in a state of "cessation of payments," stopped keeping records, or hid assets.[49]

Each of these countries provides for criminal sanctions for at least bankruptcies deemed "fraudulent." In Colombia, the penalties range from 2 to 8 years in prison.[50] In some jurisdictions, such as Ecuador, the debtor is subject to arrest if there are serious indicia of a fraudulent bankruptcy, and even in the absence of a detention, the debtor may not leave the district without the court's permission.[51]

The classification of a bankruptcy has important consequences. Mexico classifies its bankruptcies as "fortuitous," "culpable," and "fraudulent." LQSP Article 101 provides that the

[48]Bolivian Code, Art. 1657.

[49]Chilean Code, Art. 219.

[50]Colombian Code, Arts. 1993-98.

[51]Ecuadorian Code, Art. 521.

debtor's management (officers, directors, etc.) responsible for the culpable or fraudulent acts in question shall be personally responsible. Under the LQSP, culpable *quiebra* results from acts contrary to good commercial management that cause or worsen the cessation of payments. Acts qualifying a bankruptcy as fraudulent include the failure to keep the required books and records, material falsification or destruction of records that makes impossible the ascertainment of the true state of affairs, or the making of payments or granting of security to a creditor during the reachback period to which the creditor was not entitled.[52]

The Mexican standard for a fraudulent bankruptcy, then, includes actions that might be taken in good faith (such as the making of a preferential payment), given that the reachback period is set by the court after the fact. The risk of incurring criminal liability from a bankruptcy deemed "fraudulent" is one reason not many liquidations are filed in Mexico. As noted by one commentator, "[t]he disutility of being subject to such an investigation [criminal in nature], and possible losses of reputation generates unwarranted costs for the debtor, makes bankruptcy liquidation less attractive, [and] possibly aggravates pre-bankruptcy agency problems that encourage excessive risk taking."[53] To complicate the matter even more, as a result of creditors' frustration with the ineffectiveness of the Mexican insolvency system, creditors are beginning to use the criminal system to pressure debtors, in effect, criminalizing the bankruptcy remedy.

Apart from the deterrent or disincentive effect created by the possibility of criminal sanctions if a bankruptcy is deemed fraudulent, classification has other important effects as well. Under Venezuelan law, only debtors who are illiquid for unforeseen or otherwise excusable reasons may request *atraso* relief.[54] Denying a business all relief other than liquidation because it has had crooked management seems to make the creditors and workers victims twice over.

Professor Ignacio Arroyo of the Universidad Autónoma of Barcelona advocates for the differentiation between the "business and the businessman."[55] More than one observer remarked that Latin America is known for its "rich business owners and their poor businesses." De-linking criminality or fault from the rescue of the business is not likely to cause otherwise honest, albeit imperfect, debtors to turn crooked. Under existing law, the debtor who has not run a perfect shop can be legitimately concerned that good faith actions taken in the course of a crisis will be second-guessed and turned into criminal accusations for purposes of either leverage or revenge.

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[52]LQSP, Art. 96.

[53]Atiyas, supra note 4, at 37; see also, Atiyas, Bankruptcy Policy, supra note 3 at 32.

[54]Venezuelan Code, Art. 898.

[55]Ignacio Arroyo, La Disciplina de Los Procesos Concursales, 1018 II JORNADAS (INTERNACIONALES) DE DERECHO MERCANTIL (Universidad Católica Andrés Bello Facultad de Derecho) (1989).

That risk of vindictive prosecution will exist whether or not the bankruptcy court concerns itself with the culpability of the debtor. But, a debtor can feel that the risk of a vindictively-inspired prosecution is lesser if the forum is separate and the issue is not automatically on the agenda.

More importantly, the question of the debtor's fault or lack of fault has little to do with the future of the business and its then current and potential value. If fraudulent acts automatically preclude reorganization or rehabilitation relief, "fraudulent behavior by management may result in liquidations even when the firm itself has higher value under continuation."[56] While a business' history and trajectory are a vital part of the economic and financial analysis that must be done to determine whether and when to liquidate, operate, and so on, the question of whether the management was so corrupt that they should be prosecuted simply serves to distract the insolvency court and parties and divert otherwise scarce judicial resources.

5. Foster Transparency.

Inherent in any reorganization process is the need of the debtor, creditors and the court to make a variety of decisions. Among other decisions, the trustee must determine whether any estate assets have been diverted, creditors must decide whether to accept restructuring proposals, the court must decide whether to allow management to continue in control, and a debtor needs to know whether creditors, the trustee or others are colluding to keep asset sales prices down.

5(a). Review and Revise Current Statutes to Require Meaningful and Effective Disclosure of Pertinent Information.

Current systems in the region do not foster the dissemination of information needed to make informed decisions. On this topic, the dichotomy between actual practice and the law's theory was evident once again. In Mexico, a debtor is required to file its books and records with its initial petition.[57] In practice, some debtors turn in books and records and then immediately request leave to withdraw them for use in the business, or else provide the information in a computer disk that then cannot be read.

The issue of effective disclosure of material information is further complicated because in some cultures debtors maintain more than one set of books and often resist providing material financial information when applying for credit or other transactions, much less when involved in a bankruptcy process. As the region's markets and economies grow in sophistication, this phenomenon is likely to change; currently, major creditors in the marketplace are now more often requiring independently audited financial statements from counterparties and other borrowers in substantial transactions. Some creditors identified the need for accurate financial information as

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[56] Atiyas, supra note 3, at 37.

[57] LQSP, Art. 6.

the most pressing.

Apart from affirmative provisions empowering trustees and creditors to ferret out financial information, statutes impeding such investigations should be reviewed to determine whether they are needlessly obstructing the search for assets. For example, in Brazil, bank secrecy laws have impeded the ability of trustees and creditors to delve into the debtor's financial affairs.

5(b). Enhance the Power of Trustees and Other Stakeholders to Investigate Meaningfully the Debtor's Past Dealings.

According to practitioners, an effective mechanism for ferreting out fraud and information relating to a debtor's pre-petition operations is not available. For example, although under Article 67(III) of the LQSP the "interventores" or creditor representatives are entitled to ask the court to compel the debtor to answer questions about the bankruptcy, practitioners advise that the mechanism is not effective. The same complaint was voiced in the other countries. The questioning by and large is formalistic in nature. Through hyper-technical objections made in a judicial system that gives much weight to matters of form, defense lawyers are able to obstruct efforts to ferret out facts. Procedural reform to empower trustees and creditors to investigate meaningfully the debtor's past dealings should enhance the ability to recover assets that rightfully belong in the estate.

5(c). Enhance the Power of Trustees to Recover Assets Wrongfully Transferred.

As well, trustees have limited tools at their disposal for ferreting out and recovering illicit transfers of assets. For example, the Brazilian Bankruptcy Law provides for the avoidance of acts in fraud of creditors, [58] but the law has procedural limitations that limit its effectiveness. In Brazil and each of the other countries studied, creditors repeatedly cited instances in which debtors and their principals had transferred assets overseas with trustees and creditors having no effective means to pursue and avoid the transfers. Effective tools are needed to empower trustees to recover transfers of funds abroad, including express authority to seek the aid of foreign courts in recovering estate assets.

To some degree the issue is not the lack of legal procedures to reach assets, but the sophistication of trustees and their lack of knowledge about the means and tools at their disposal for tracking assets and debtors down, especially in cross-border cases. In the course of the interviews, it became clear that many participants in the insolvency processes in the region are unaware of such provisions as 11 U.S.C. §304 which allows foreign trustees to seek the help of United States bankruptcy courts. An educational program aimed at trustees, their counselors, accountants and judges would help.

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[58] Brazilian Bankruptcy Law, Arts. 52-53.

6. Facilitate Preservation of Going Concern Value Before and During Bankruptcy.

A number of features of existing laws hinders the preservation of a business' going concern value.

6(a). Better Define the Standard to be Satisfied Before Insolvency Relief Can Be Granted.

The definition of the test for eligibility for insolvency relief, whether voluntary or involuntary, is important. In a financial crisis, as in so many other fields, "timing is everything" or if not everything, a lot. If the trigger is pulled too soon, the debtor's efforts to salvage its business could be thwarted -- if pulled too late, the creditors could suffer a deterioration in the values of the assets in the estate.

Some systems in the region have conditioned relief on one or another state of "insolvency" rather than on an economic or financial crisis. Relief is often not available until a business is in a state of "*suspensíon*" or "cessation" of payments. In Argentina, a debtor may petition for *concurso* relief only if it is in a such a state.[59] Some statutes require a debtor's management to petition for relief within a defined period after such a state is reached.[60]

The standards for eligibility for insolvency relief are important not so much in the context of voluntary petitions for relief, but rather in cases where creditors seek such relief over the debtor's objection. Significant amounts of time, energy and resources have been spent litigating over whether a debtor is or is not in a state of *suspensíon*/cessation of payments. One banker identified the need for a clearer definition of "*suspensíon* de pagos" as one of the top four modifications that should be made to the Mexican insolvency law, suggesting that, for example, it be defined as non-payment to a specified number of creditors. An objective test, such as the failure of the debtor to pay a debt or a specified number of debts within a fixed number of days after a written demand for payment, would be measurably simpler than existing requirements that for example entail the "protest" of debt by registering it with an officer of the judiciary who in turn makes demand upon the debtor.[61]

6(b). Permit and Encourage Insolvency Relief Before it is Too Late.

Some systems create needless barriers to insolvency relief. Under the Venezuelan Code, a debtor is not eligible for *atraso* (non-liquidation) relief unless three creditors consent to the

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[59] Argentina Revision, Art. 1.

[60] See, e.g., Venezuelan Code, Art. 925.

[61] See, e.g., Brazilian Bankruptcy Law, Art. 11.

filing.[62] In Brazil, a debtor becomes ineligible for concordata relief once one of its debts has been protested.[63] In Venezuela, *atraso* relief is not available if the debtor has a negative net worth.[64] Liquidation becomes the only relief available in Venezuela to a business that has crossed the threshold from a positive to a negative net worth (subject to some minor exceptions).[65]

While the businesses most likely to resort to the insolvency system are those in *suspension* of payments and with a negative net worth, the law should facilitate resort to the system before the financial crisis is irremediable and value still exists in the estate. As explained by Professor Arroyo:

> To overcome the problem, it is necessary to intervene in time and without hesitation. The success of every insolvency system that seeks rehabilitation as its primary objective requires, as is the case in treating a patient, the utmost brevity in starting the treatment.[66]

Some legal systems have recognized the importance of facilitating relief without reference to technical issues of insolvency or *suspension* of payments. Costa Rica's new statute, for example, provides that insolvency relief is available to any debtor which finds itself "in a difficult economic or financial situation," without regard to whether it is in a state of cessation of payments or not.[67] While in some legal systems such definitional nuances might seem trivial, the distinctions can make a difference in the context of more formalistic civil law systems in the region. Absent a sound policy reason to condition relief on satisfaction of some threshold statutorily-defined state of "insolvency," states might better serve the objective of rehabilitation by focusing instead on the existence of an economic or financial crisis.

6(c). Fix the Reachback Date for Avoiding Transactions.

A business in crisis needs many things, among them, usually an infusion of cash. In a rescue culture, a business in crisis with a realistic chance of reorganizing would benefit from the

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[62]Venezuelan code, Art. 899.

[63]Brazilian Bankruptcy Law, Art. 158.

[64]Venezuelan Code, Art. 898.

[65]Venezuelan Code, Art. 899.

[66]Arroyo, supra note 52, at 1014.

[67]Costa Rican Code, Arts. 709, 851.

ability to borrow, both before and during a bankruptcy proceeding.

But, a borrower's request for concessions during a pre-petition financial crisis creates a creditor's dilemma. If the creditor does not cooperate with its debtor it risks pushing the debtor into bankruptcy; if it does cooperate, it risks weakening its financial position vis a vis other creditors. Often, the creditor's decision hinges on its ability to make an informed decision as well as its ability to protect itself against a deterioration of its position if the concessions prove futile and the debtor ultimately fails; so a creditor might be willing to grant a concession if its up-to-then unsecured position is collateralized or its collateral is enhanced.

Many systems provide that a grant of additional collateral operates to prefer a creditor at the expense of other creditors and are avoidable if made within a certain period before the bankruptcy proceeding is filed. Such rules of transfer-avoidance are not problematic, as they are recognized and accepted in the marketplace. The difficulty arises because under some systems in the region, the reach back period is not pre-determinable. The courts are given the discretion to reach back and avoid transfers that take place long before the filing. In Mexico, the court has the power to declare the date of "retroacción" or retroactive-effect date.[68] Although in practice the date is normally within 6 months of the petition date, the statute declares no limit, and significantly longer periods have been set. This problem is compounded by provisions specifying that the court has the power to change the retroactive date up until the date that credits or claims are validated in the proceedings.[69] In other statutes, a maximum reachback period is specified, but the court is given the discretion to set the reachback date at any point within that period.[70]

This uncertainty in determining the reachback period was identified by banks as one impediment to loan restructurings, citing their inability to determine when liability for a potential avoidable transfer would end as a factor impeding the work-out of loans and the granting of concessions. Such undefined demarcation points impede the ability of creditors to make informed decisions on whether to grant concessions. The laws defining reach back periods should be reviewed to determine whether fixing the reach back as a defined number of days before the filing of a bankruptcy would enhance the ability of debtors and creditors to workout their credits and other transactions. In other jurisdictions such as Argentina, the reach back is capped, but at two years is regarded by some as too long.

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[68]LQSP, Art. 15(IX).

[69]LQSP Art. 118. See also, Art. 121.

[70]In Argentina, the court can reach back a maximum of two years. Argentina Revision, Art. 116. In Panama, the reachback period varies, depending on the nature of the transaction in question, but can range from up to 4 years. Panamanian Code, Arts. 1581-82.

6(d). Revise Avoidance Statutes to Facilitate Pre-petition Resolutions.

Argentina's recent revision to its doctrine of avoidable transfers is worth consideration. Under Ley 19,551, a mortgage or lien granted during the reach back period to secure an unsecured credit was avoidable.[71] Other jurisdictions, such as Venezuela, have similar provisions.[72] Argentina revised its avoidable transfer law to provide that a mortgage or lien is avoidable if the unsecured credit had not yet matured, but is not avoidable if the debt had matured.[73] Argentinean bank lenders cited this revision as an important step in getting banks to grant concessions during loan workout negotiations with borrowers in crisis.[74]

6(e). Provide Framework for Granting of Credit During Insolvency Proceedings Where Warranted.

Issues impacting a debtor's ability to raise funds during a bankruptcy proceeding exist as well. As noted in connection with Mexico, "the lack of available credit for an insolvent business makes the Mexican equivalent of a reorganization difficult to accomplish."[75] In most if not all jurisdictions studied, a debtor in possession is not considered a "subject of credit." Almost by definition a debtor in bankruptcy is deemed unworthy of credit. On the other hand, a debtor will usually need additional funds in order to survive during bankruptcy. Existing systems in the region do not facilitate the granting of credit or concessions during a proceeding.

While some laws provide that the debtor may petition the court for authority to take acts outside the ordinary course of business, and some even refer to authority to grant chattel mortgages,[76] few of the statutes deal adequately with the issue of post-petition financing. The need for credit is often acute given that, for example, in Argentina, the court will in practice first adjudicate creditors' claims before resolving the disposition of estate assets, resulting in

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[71]Ley 19,551, Art. 122(4).

[72]Venezuelan Code, Art. 945.

[73]Argentina Revision, Art. 118(3).

[74]On the other hand, the Argentina Revision does not provide for avoidance of preferential transfers in *concurso* proceedings, only in liquidations. Id.; Hon. Adolfo A. N. Rouillon, Regimen de Concursos y *Quiebras*, 153 (Editoreal Astrea De Alfredo y Ricardo Depalma S.R. 6th ed. 1996).

[75]John A. Barrett, Jr., Mexican Insolvency Law, 7 PACE INT'L. L. REV. 431, 436 (Spring 1995).

[76]Argentina Revision, Art. 16; LQSP, Art. 411.

substantial delays before a debtor can emerge from a proceeding. Debtors will build war chests in the months and weeks before filing for relief, a tactic not unknown even in those jurisdictions that do facilitate postpetition credit. The tactic in places such as Argentina results in a debtor's deliberate over-extension on credit to stockpile inventory.

Even though often credit granted to a debtor will come from its existing lenders, the ability of a debtor to stay in operation would be enhanced if it had the ability in an appropriate case to borrow during a proceeding. Since a debtor will usually have difficulty borrowing, especially on an unsecured basis, the codes should authorize the debtor to grant protections to a post-petition lender, provided the court approves.

6(f). <u>Identify and Eliminate those Provisions that Needlessly Militate Toward Liquidation.</u>

Those provisions that drive the process toward shutting down a business, perhaps needlessly, should be examined. For example, the Venezuelan Code authorizes the continuation of a debtor's business upon a vote of 75% of the creditors, but on the condition that those creditors be liable personally to those third parties with whom the trustee contracts if the estate cannot perform.[77] Such a provision has a chilling effect on a creditor who genuinely believes there is greater value in the going concern, and perhaps is needless given the third parties' ability to perform their own analysis of the risk of contracting with a trustee and of whether the estate will be able to perform its end of the postpetition bargain. In Brazil, assets cannot be sold before they are appraised, often resulting in needless delay.

6(g). <u>Provide for Other Exits Besides Liquidation upon a Debtor's Failure to Obtain the Required Creditor Consents to a Proposal.</u>

Statutes currently provide, for the most part, that upon a failure of a debtor to obtain creditor approval of a proposed *atraso* or *convenio* agreement, the court shall order bankruptcy (liquidation). Argentina's revision provides another out, short of liquidation: *salvataje.* Sometimes called "cramdown" (literally) in Argentina,[78] *salvataje* is not "cramdown" in the U.S. sense of the word. Under 11 U.S.C. §1129, a debtor can "cramdown" on dissenting creditors a restructuring proposal, subject to court approval and compliance with the statute's requirements. Under Argentinean "cramdown" or *salvataje,* creditors (or a even third party) can preserve the debtor's going concern value by "cramming down" a proposal for restructuring on a non-consenting debtor that fails to obtain timely the creditors' consent to its own proposal. Whereas under Ley 19,551, the failure of a debtor to achieve a *concurso* agreement with its creditors

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[77] Venezuelan Code, Art. 967.

[78] President Menem's report to Congress referred to salvataje as "cramdown." <u>See</u> Mensaje del Poder Ejecutivo, Part II, subpart 4.

resulted in the conversion[79] of the *concurso* to a liquidation proceeding,[80] the Argentina Revision provides that upon such failure in the cases of specified entities (generally speaking, including business corporations), the court shall not convert the proceedings to a liquidation but rather shall authorize a *salvataje* procedure as specified in Article 48.

That article contains a detailed set of deadlines and procedures for effectuating *salvataje*. The Argentina Revision grants the debtor a period in which it exclusively can present proposals for the restructuring of the enterprise.[81] If a debtor fails to achieve a consensual resolution with its creditors within the exclusivity period, creditors or third parties are then given a period ("*el periodo de salvataje*") to offer proposals to the creditor body. If the proponents obtain the required approvals from the creditors, then notwithstanding the objection of the debtor or the debtor's shareholders, the proposal can be approved and ownership of the restructured enterprise transferred in accordance with the proposal. In keeping with curtailment of judicial discretion effected by the Argentina Revision, the court is obligated to approve the first compliant proposal accompanied by the necessary creditor approvals.[82]

The complaints about the Argentina Revision's *salvataje* provisions include suggestions that the statutory deadlines are unrealistically short and that the procedures for effectuating a *salvataje* are otherwise deficient. Imperfections and all, *salvataje* represents an effort to salvage going concern value of an enterprise in crisis. Whether the details are right or not, the innovation commends itself for study by other policy makers reviewing the all-or-nothing propositions imposed by other existing insolvency regimes.

7. <u>Protection of Collateral.</u>

7(a). <u>Adjust the Scope of the Stay in Relation to National Policy.</u>

The scope of a moratorium or stay (be it automatic or not) in a non-liquidation insolvency proceeding similarly merits consideration. For example, under Argentinean law, the court can

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[79]There is some academic debate about whether the ensuing liquidation proceeding is part of the same insolvency proceeding or is regarded as a separate, independent proceeding. The term "conversion" is used for the sake of convenience with no intent to weigh in on the issue. Under the Revisión, a *concurso* agreement results in a novation and the failure to perform a *concurso* agreement does not revive the creditors' pre-*concurso* claims. <u>See</u> Argentina Revision, Art. 55. <u>See also</u>, Rivera, <u>supra</u> note 21, at 142.

[80]Ley 19,551, Art. 62.

[81]Argentina Revision, Art. 43.

[82]Argentina Revision, Art. 48(4).

enjoin a secured creditor for not more than 90 days from executing upon personalty securing the credit.[83] In contrast, under Venezuelan procedures, an *atraso* proceeding does not stay a secured creditor.[84] A secured creditor is stayed from prosecuting real and chattel mortgage claims through judgment by a Mexican *suspensíon de pagos* proceeding,[85] and a concordata does not bar secured creditors in Brazil.[86] While the differences are understandable given the different philosophies, (for example, an *atraso* is intended simply to allow time to liquidate assets to pay off liabilities), reorganization or restructuring will often be difficult if the secured creditors are, figuratively speaking, able to take their collateral and go home.

7(b). Balance the Protection of the Stay By Compensating for its Effects.

On the other hand, a moratorium against executions would be prejudicial to creditors if a debtor were permitted to stay execution while continuing to use and consume the value of the lender's collateral. Argentinean law takes a small step toward addressing this concern by providing that interest accruing during a stay is payable as high priority *concurso*-estate expenses.[87] In contrast, Mexico makes no express provision for what is known under U.S. law as "adequate protection" payments to compensate the secured creditor for the diminution in the value of its collateral resulting from the debtor's use. In Mexico, a lessor's remedy for the debtor's continued use of leased personalty without payment is to request the "separation" of the leased asset from the rest of the estate and its return to the lessor.[88] Although a debtor operating its business is in theory obligated to perform its contracts during the pendency of a proceeding,[89] a dichotomy exists between current practice and the provisions of law. The actuality is that the debtors do not pay and the lessor typically experiences much difficulty and delay in obtaining the return of the leased good, and the asset is substantially deteriorated by the time it is returned, if returned at all. Reform should make provision to compensate for or prohibit the deterioration of

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[83]Argentina Revision, Art. 21(2), 21(4), 24. Some debate exists as to scope of the stay. See Rivera, supra note 21, at 232, 235. Debate existed as well about whether the law operated to "attract" or transfer to the insolvency court actions to execute upon chattel mortgages. Id. The Argentinean Supreme Court has ruled that such actions do not transfer. See Casesa S.A. v. Saiegh, S.A., April 2, 1996; Hercules, S.A. v. Pedro y Jose Martin, S.A., July 1, 1997.

[84]Venezuelan Code, Art. 905.

[85]LQSP, Art. 126.

[86]Brazilian Bankruptcy Law, Art. 147.

[87]Argentina Revision, Art. 24.

[88]LQSP, Art. 159(VI)(a).

[89]LQSP, Art. 140.

collateral during the course of a proceeding.

The balance to be struck between debtors and creditors and among classes of creditors is one of those singularly national issues. The outcome in the Mexican-lease example, though, is not reflective of a national policy favoring lessees over lessors, but is the result of manipulation by debtors of procedural and other devices (such as appeals). Once domestic law (read: policy makers) makes choices, the insolvency systems ought not to permit abusive manipulation of procedural devices to alter that balance or effect some other outcome.

8. Reduce Delay.

While justice delayed may be justice denied in most contexts, delay is especially damaging in insolvency proceedings, in which fleeting assets must be quickly pursued and the going concern value as well as the value of collateral depends on prompt decisions.

8(a). Educate the Judiciary About the Effect of Delay on a Firm in Financial Crisis and on its Creditors.

A recurring complaint in all jurisdictions is the delay inherent in the region's insolvency systems. A combination of factors accounts for the delays. As noted above, the judiciary is over-burdened and lacks the resources to administer effectively its caseload. Some element of the delays plaguing the current systems could be reduced through education, through sensitizing the judiciary to the prejudice caused by delay. Underqualified judicial personnel contribute as well. As noted, in some instances judges procrastinate to avoid delving into the unfamiliar field of insolvency law or to avoid an unpopular decision such as shutting down a source of local jobs. Training should include a review of the effects of delay.

8(b). Identify and Eliminate Needless Impediments Built Into Existing Laws that Hinder the Flow of the Insolvency Proceedings.

Other delays are created by substantive and procedural features in the existing legal schemes, features exploited by debtors and other interested parties for advantage. Observers complained of the excessive emphasis given to matters of form over substance, such as, for example, to powers of attorney in Mexico. Proof of credits or claims is a formalistic process subject to technical objections, in a system that provides few disincentives for frivolous or specious objections. While no suggestion is being made that procedures more fitting for judicial systems that rely on oral advocacy be adopted in Latin America, practitioners there criticized the undue emphasis given to matters of form, often at the expense of fairness and justice.

Another such feature is the routine appealability of decisions rendered in the course of a case. Regardless of whether such appeals operate *de jure* to stay the lower court proceedings, the *de facto* effect is to slow down the progress greatly. Appeals become a weapon to delay the outcome. A review and curtailment of appellate remedies would expedite administration of the estate.

On the other hand, observers underscored a vitally important point: legal reform based on systems that work in jurisdictions that enjoy more reliable judicial systems with greater resources would be ill-advised in countries lacking a comparable, independent judiciary. While curtailing appellate recourse might be workable in a jurisdiction having experienced, trained insolvency judges with original jurisdiction, appellate remedies in Latin American insolvency proceedings are an important tool for compensating for the system's current shortcomings. Such a curtailment absent judicial reform and a crackdown on insolvency corruption might do more harm than good since an appellate tribunal provides some measure of protection against lower court corruption and incompetence.

In other instances, the conditions precedent to a disposition of assets precludes an expeditious adjudication or disposition of estate assets while the business still has a going concern value. For example, the disposition of estate assets or a *convenio/concurso* proposal should not have to await the adjudication of all creditor claims. The claims-validation process often takes years. By then, the debtor's business has often ceased to exist.

The requirement that a credit or claim be validated in person at a court hearing, as occurs in Venezuela, results in a multitude of hearings, often being continued from month to month, requiring the presence of the claiming creditor at the validation hearing as well as subjecting other claiming creditors to the inconvenience of sitting through the validation proceedings of other creditors until the claiming creditor's claim is reached.[90]

While undoubtedly any bankruptcy proceeding needs a logical order of events, observers do not feel that events are optimally sequenced under existing statutes. Again, the precise order of events is affected by national bankruptcy policy choices, but many procedural features of current laws impede the preservation of value in the estate and hinder the ability to restructure a business' financial affairs. A review of the procedural sequence existing under current laws to eliminate needless delay would be beneficial. In fact, a recurring complaint in all four countries, but especially in Venezuela and Mexico, was that the rules of procedure applicable to insolvency proceedings do not work smoothly in an insolvency, are unclear, complex, and for that matter at times in conflict.[91]

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[90]Consider as well the risk created by the free-for-all in which creditors are each objecting to each other's claims.

[91]In Mexico, for example, the LQSP itself provides some rules of procedure, in other instances Código Federal de Procedimientos Civiles controls, and in other instances, the non-federal local law governs procedure. <u>See</u> LQSP, Disposiciones Transitorias, Art. 6.

9. Increase Flexibility in Reorganization Proposals.

9(a). Allow More than Just a Predetermined Payout Schedule.

For the most part, current statutes do not contemplate "reorganization" in the sense that workout specialists, lenders and investment bankers use the word. Current laws are rigid in the restructuring schemes they permit, and are more in the nature of pre-approved, fixed payout schedules, than they are "reorganization" schemes. In Mexico and Brazil, for example, a debtor's proposal *(a convenio or concordata)* must pay the specified statutory minimum percentages of creditors' claims over the specified maximum period of time. Under the letter of those laws, a debtor does not have the flexibility to propose a plan that does not conform to the statutorily-mandated payout schedule, even with the consent of a majority of its creditors.[92]

9(b). Allow for Capital Restructurings, Including Debt to Equity Conversion.

The laws are not by and large designed to deal with the advent of capital markets. As more and more companies turn to capital markets, Latin American debtors are likely to have more complicated and sophisticated capital structures, including publicly-held debt, shares and other securities. To compensate for inadequate laws, markets are improvising, cutting solutions out of whole cloth with little comfort that they will hold up and be protected from future collateral or even direct attack..

9(c). Make Adequate Provisions for Executory Contracts.

Existing laws do not adequately address disposition of executory contracts. Peru's recent revision specifies that future enactments will define the conditions under which pre-petition contracts can be avoided.[93] Inadequate provisions for executory contracts impact capital markets in particular. For example, Mexican law is not clear on whether a trustee can accept part of a contract and reject or refuse the rest. The question is important in the context of "financial" contracts, as noted by the American Law Institute's draft Statement on Mexican Bankruptcy Law:

> . . . the question was raised in connection [with] a master agreement covering

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[92]Other jurisdictions are more flexible. For example, Venezuela provides that in an *atraso* proceeding, a debtor may reach any arrangement, including forgiveness of interest and reductions of principal and longer repayment periods, even over the objection of the statutory minority of creditors. Such arrangements must assure that the dissenting creditors receive at least as much as they would receive in a liquidation. Venezuelan Code, Art. 906. No suggestion is made here that a statute ought not stipulate minimum protections for a dissenting minority, of course. The point is that the Mexican and Brazilian statutes mandate a payout schedule.

[93]Peru Revision, Art. 13.

> transactions and rescind losing ones, or would the Sindico have to affirm or rescind the contract as a whole. There is no judicial precedent to provide guidance, but in probability it could be argued that each single derivative or foreign exchange transaction is a contract by itself, separate from the other transactions, since . . . a master agreement . . .only . . . establish[es] common provisions for the same type of transactions done repeatedly over a period of time and does not represent a transaction contract in and by itself . . . .[94]

If that is so, a trustee could "cherry pick" among individual transactions effectuated under a master contract, affirming profitable ones and rejecting the others. In view of the growth of derivatives, foreign exchange operations and other financial contracts, reform should delineate clear rules for the assumption or rejection of such operations.

9(d). <u>Address the Setoff of Debts in Financial Contracts.</u>

Under Mexican law, setoff of mutual debts is prohibited once the court "declares the bankruptcy" (subject to some exceptions).[95] Such a rule is of vital importance to a financial intermediary, which would want to setoff or "net" any mutual liabilities existing between it and a bankrupt debtor, so that the liability in question would be only the net difference; the intermediary would want to preclude a trustee from affirming the profitable derivatives transactions or other financial contracts existing between the two institutions while simultaneously rejecting the unprofitable ones.

The permissibility of setoff generally in an insolvency context should be analyzed separately from the question of setoff in mutual financial obligations. If local markets are to benefit fully from derivatives, repos and other new (at least to the region) financial products, insolvency laws will need to provide the conditions necessary to protect providers of such products, by, for example, permitting netting. Organizations such as Emerging Markets Traders Association (EMTA) and the International Securities Dealers Association (ISDA) are endeavoring to foster such modifications to existing laws.

9(e). <u>Provide for Insolvencies of Groups of Affiliates.</u>

Complaints that current laws might have been adequate for economies comprised of small merchants but are inadequate for Latin America's increasingly sophisticated markets are borne out in a variety of other ways as well, including inadequate provisions for the insolvency of groups of affiliated companies. By virtue of Mexico's corporate law provisions specifying that

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[94] American Law Institute, International Statement of Mexican Bankruptcy Law (Preliminary Draft No. 2) 43, n. 135.

[95] LQSP, Art. 128 (IV).

each company is a separate legal being, Mexican bankruptcy law does not permit affiliated Mexican companies to file as a group. Observers in Mexico cited the example of a bankruptcy lawyer currently being prosecuted for filing a consolidated petition for relief on behalf of affiliated companies. The lawyer's offense: "*simulación*," essentially a charge of simulating falsely what is not true.

Brazilian law similarly does not permit group filings. The example cited by Brazilian observers resulted in the appointment of 19 different trustees for 19 affiliated companies, with the attendant duplication and conflict inherent in such an arrangement. In relation to Argentina's prior law, Julio Cesar Rivera noted

> . . . [concurso proceedings] for groups of affiliated companies would arise with certain frequency, and generally involved companies of certain significance. The prior judicial decisions revealed generally unsatisfactory solutions, particularly because the concursos were processed individually and with distinct trustees, all of which complicated the process and above all generated significant expense. On another front, the prior law's regimen inhibited some preventive solutions that involved the group as owner of a single proprietary equity, and finally would leave matters unclear if the preventive situation failed for one of the group members but was accepted for the others.[96]

In contrast, Argentina's new law makes detailed provisions for insolvencies of groups of affiliated companies.[97] The law provides that insolvency relief may be sought jointly when only one of the group's members is insolvent (as used here, meaning in a state of "*cesación de pagos*") if such condition can affect the rest of the group members.[98] The law authorizes the appointment of a single trustee for the whole group, as well as the presentation of a unified plan for the whole group that classifies each group member's creditors in classes with creditors of the other group members.[99] Given that Argentinean law permits the approval of a plan over the objection of dissenting creditors if enough other creditors approve, this provision for what is in effect a substantive consolidation of affiliates' estates might become an attractive feature to forum-shopping debtors. Given the possibility that such companies will have operations in other countries, the notion of harmonization and provisions for cross-border insolvencies, as discussed below, take on added importance. Reform of insolvency laws, then, should provide for insolvency of groups of affiliated companies.

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[96]Rivera, supra note 21, at 348.

[97]See Argentina Revision, Arts. 65-68.

[98]Argentina Revision, Art. 66.

[99]Argentina Revision, Art. 67.

9(f). <u>Provide for Insolvencies of Small and Medium Businesses.</u>

While provisions that take into account the heightened sophistication of modern day marketplaces are important, reform should also address the needs of small business. Argentina's new law makes special provisions for small and medium businesses, otherwise known as "PYMES" (for "pequeñas y medianas empresas"). If a business has liabilities of less than 100,000 Argentine *pesos*, less than 20 unsecured creditors, or less than 20 workers, it qualifies for the statute's simplified procedures.[100] A qualifying small business debtor is exempted from having to present statements from a certified public accountant, creditors' committees are made optional and the *salvataje* provisions for forced sale of the debtor's assets do not apply.[101] As a result of these exemptions, the "filing of a preventive concurso is simpler (and cheaper) . . . ."[102] Venezuela, too, makes special provisions for small businesses (debtors owing less than 10,000 Bolivares), but the provision has been annulled as a practical matter by virtue of devaluation (10,000 Bolivares approximate US $20).[103] Such provisions will provide needed flexibility in helping small businesses in financial crisis.

Important questions of national bankruptcy policy and constitutional rights must be resolved when determining the degree of flexibility to incorporate into an insolvency scheme. For example, should a reorganization proposal be authorized over the objection of a class of creditors, and if so, under what circumstances? Under Argentinean procedure, a court may approve a *concurso* agreement over the objection of a creditor. Similarly, a Mexican court can approve a *convenio* over the objection of creditors, provided the statutory minimum percentages are met. But, in contrast to rights granted under the laws of other countries to dissenting creditors such as the requirement that the proposal grant the dissenting creditor at least as much as the creditor would receive in a liquidation,[104] the Argentinean and Mexican laws have no such protection. On the other hand, the Argentinean law requires the approval of all classes of creditors[105], unlike the U.S. system which permits approval of the proposal even over the objection of an entire class.[106]

Most current statutes in the region do not adequately provide for a variety of other issues

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[100]Argentina Revision, Art. 288.

[101]<u>Id.</u>

[102]Rouillon, <u>supra</u> note 71, at 316.

[103]Código de Comercio de Venezuela, Art. 1.069 *et seq.*

[104]Brazilian Code, Art. 143; Venezuelan Code, Art. 906; 11 U.S.C. §1129(a)(7)(a)(ii).

[105]Argentina Revision, Art. 45.

[106]11 U.S.C. §1129(b)(1).

important to modern-day businesses, such as the licencing of intellectual property, subordination, and differences among classes of creditors. Again, a policy-based reform should deal with these issues.

10. Promote Cooperation In Cross-Border Insolvencies..

While the call for the harmonization of national insolvency regimes has been a long-standing one with initiatives going back to the early part of the century, the more recent impact of globalization on national economic regimes has provided a strong impetus to consider radical reforms. Specifically:

> The rapid growth in international economic relationships at both company and governmental levels has led to a substantial increase in the number and complexity of cross-border insolvency situations. Insolvency proceedings now often affect investment and commercial interests well beyond the state in which they take place. These economic effects in turn trigger changes in trade patterns as well as creditors' lending and investment decisions. Existing insolvency laws of many states provide conflicting rules on access to proceedings, priorities for claimants, protective rights for certain parties, and other related matters, all of which make efficient settlement very difficult, costly, and often disruptive for future commercial activities. The history of international insolvencies indicates that despite a lack of consensus concerning the most effective means to promote global harmonization of bankruptcy laws, creditors long have recognized that failure to cooperate in the resolution of immediate financial crises will adversely affect the potential for recovery of their claims...
>
> The parties involved in a cross-border bankruptcy proceeding desire the same outcome as they would seek in a domestic bankruptcy case - namely, reasonable notice, access and participation, predictability of results, enforcement of bankruptcy court judgements by foreign courts, and equivalent distribution of estate assets.
>
> Beyond the common factors, however, the interests of the parties diverge widely. Debtors typically need relief from individual creditors and, when appropriate, the potential for rescue or rehabilitation. Secured creditors seek recognition and enforcement of their interests, and exclusion of such interests from the general estate. Unsecured creditors seek to maximize return by preventing exclusion of secured interests, and by beating other unsecured creditors in the race to the court house, before a stay may be imposed. Employees need "an insolvency law system that provides [the] greatest opportunity for survival of continuing employment prospects," or alternatively, enforcement of priority rights for wages and benefits due. Governments of the states in which the debtor has assets seek to interpose their claims as priority, and thereafter to preserve going concern value so as to encourage capital investment and employment. Administrators of the insolvency

proceeding often seek a reliable, predictable, and efficient framework within which to operate. Another factor that must be taken into account is the close relationship between economic results and legal solutions in this field; this relationship leads to an important role for corporate accountancy, for which harmonization of international accounting is also needed. Differences in the valuation of assets and of going concerns among different states make equitable cross-border distribution difficult. All these factors are compounded when two or more states with distinctly different procedures, priorities, or economic legal goals are involved.[107]

Aside from ad hoc approaches, cross-border insolvency usually involves either the 'universal' approach (one control proceeding in the home country), the 'unity' approach (principal administrator coordinating the action of other fora on the assumption of similar legal systems) or the 'territorial' approach (each state asserts the sovereignty of its system).

10(a). Treaties and Conventions.

Not surprisingly, given the complexity of cross-border transactions and the strong tendency towards "territoriality" as a solution in the majority of jurisdictions around the world, progress in the form of treaties and/or conventions based on public initiatives has been quite limited.

One notable exception has been the Inter-Nordic Insolvency Convention that dates back to 1933 and incorporates Denmark, Finland, Iceland, Norway and Sweden, all with similar legal systems. The Convention has three main principles:

a) a bankruptcy declared in one country automatically includes all property and liabilities contained in other member countries.

b) the trustee appointed in the "opening" country can sign for the estate for each transaction in any of the five countries.

c) a framework for choice of law rules.[108]

For over 60 years, the Convention has worked reasonably well in practice, though it has not been called upon to deal with a large number of cases during this period.

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[107] Harold Burman, Harmonization of International Bankruptcy Law: A United States Perspective, FORDHAM L. REV., May 1996, at 1, 2-3.

[108] L. O. Svensson, The Inter-Nordic Insolvency Convention, 24 INT'L BUS. LAW. 226 (May 1996).

By contrast, the European Union, with a larger and more diverse (and overlapping membership) took 30 years of tough negotiation to arrive at a draft convention which provided for both primary and secondary proceedings, which is expected to be ratified in the near future.[109]

10(b). <u>Model Laws.</u>

Amongst the most important "public" initiatives to develop a cross-order insolvency system was the recently adopted "model law" prepared by a working group on insolvency law (spurred by the efforts of INSOL, an international association of insolvency practitioners as well as the American Bankruptcy Institute) of the United Nations Commission on International Trade Law (UNCITRAL) in May, 1997. It was adopted without a vote by the Sixth (Legal) Committee of the General Assembly under Resolution 52/158 on December 15, 1997.

The Law's primary objectives include:

a) cooperation between the courts and other authorities of the state and foreign states involved in cases of cross-border insolvency;

b) greater legal capacity for trade and investment;

c) fair and efficient administration of cross-border insolvencies that protects the interests of all creditors and other interested persons, including the debtors;

d) protection and maximization of the value of the debtor's assets; and

e) facilitation of the rescue of financially troubled businesses, thereby protecting investment and preserving employment.[110]

However, the model law does not constitute an effort to harmonize the substantive portion of insolvency legislation nor does it cover all types of insolvency such as those involving banks and insurance companies which are normally treated under separate systems at the national level.

Nevertheless, it is a significant step forward in attempting to foster greater cooperation in

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[109]For a brief summary of the major features of the Convention, <u>see</u> O. Borch, <u>The Convention on Insolvency Proceedings: A Major Step Forward</u>, 24 INT'L BUS. LAW. 224-225, 228.

[110]United Nations Commission on International Trade Law (UNCITRAL), Model Law on Cross-Border Insolvency, Preamble

insolvency cases across jurisdictions.

In summary, when an insolvency proceeding involves more than one country, the model law should produce essentially the following satisfactory results: creditors, regardless of country, will receive equal, non-discriminatory treatment; courts and representatives of insolvency estates will communicate and cooperate with each other to coordinate the administration of such estates and the conduct of concurrent proceedings involving a common debtor; and persons or bodies authorized to administer reorganizations or liquidations will have expeditious access to foreign courts and to the relief they need to protect the assets of the debtor or the interests of creditors.[111]

For this to have an impact, it is recommended that, given the approval by the General Assembly, it be adopted at the national level by as many countries as possible in Latin America.

10(c). Private Sector Response.

In addition to various public initiatives, the private sector has been actively involved in addressing solutions to cross-border insolvency issues. For example, the International Bar Association (IBA) endorsed in June 1989, the Model International Insolvency Cooperation Act (MIICA), prepared under its auspices for adoption as domestic legislation by national states. The Act covers the duties of the local court to assist foreign insolvency proceedings, procedures for providing such assistance and insolvency treaty override of the Model Act.[112] The Model Act has been considered in several countries that have been examining reforms in their national bankruptcy regimes.

More recently, Committee J of the IBA prepared a concordat on cross-border insolvency that was approved by the Council of the Section on Business Law in September 1995. This covers a broad number of principles particularly focused on a series of procedures and administrative arrangements that have been successfully implemented particularly between Canada and the U.S., most recently in the Everfresh Beverages, Inc. case, an integrated multinational manufacturer and distributor with headquarters in the United States, but operating in both the U.S. and Canada. Using the concordat as a framework, courts in New York and Toronto cooperated extensively to produce on the same day a reorganization plan that was satisfactory to creditors, suppliers, etc. on both sides of the border with little delay and reduced expenses.

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[111] D. Glosband, "The UNCITRAL Model Law on Cross-Border Insolvency" (June 1997) (unpublished paper delivered at the International Bar Association meeting in New York City).

[112] T. Powers & R. Mears, The Model International Insolvency Cooperation Act *in* CURRENT ISSUES IN CROSS-BORDER INSOLVENCY AND REORGANIZATION 238 (B. Leonard & C. Besant eds. 1994).

10(d). Latin American Harmonization Prospects.

The Latin American region has had a long history of adherence to "territoriality" as the guiding principle in cross-border insolvency cases. The one notable exception to this practice has been the Treaty of Montevideo (1940) involving Argentina, Uruguay, Paraguay, and Bolivia which includes a number of provisions for dealing with cross-border insolvencies (Acts 40-41, 45-48) of a rudimentary nature. However, in practice even these provisions have not been followed.

However, the impact of subregional integration could provide an impetus for enhanced harmonization efforts. For example, in the context of NAFTA, the American Law Institute (ALI) has been undertaking a review of the insolvency regimes of the three NAFTA countries with a view to identifying recommendations, in the absence of comprehensive treaties or harmonization of substantive laws, that could be implemented by private parties and the courts. A number of draft reports have been prepared for each jurisdiction, with the final work to be completed sometime in 1998.

By contrast, the countries of MERCOSUR (Argentina, Paraguay, Uruguay, and Brazil[113]) have made no effort to date to harmonize or coordinate their insolvency regimes despite the fact that Argentina has a different insolvency system than the other 3 countries. Within the respective national legislation, only Argentina (Art.4) refers to the possibility of reciprocity with respect to international cooperation but stops well short of a comprehensive cross-border insolvency arrangement (e.g., including 'national treatment' for foreign creditors) which is obviously difficult to undertake unilaterally.[114] A first step, however, for the range of Latin American countries may be the implementation of the UNCITRAL Model Law to foster greater cooperation in the insolvency area in the Region.

V. CONCLUSION.

As acknowledged at the outset, many issues affecting insolvency are singularly national and politically sensitive. Whatever the policies underlying the national system in question,[115] a review of existing legislation and practice to determine whether those policies are being well served would be beneficial.

Such a review should encompass even those issues not addressed by this report for being

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[113]Bolivia and Chile are associate members.

[114]For a discussion of the need for harmonization of insolvency laws in MERCOSUR, see A. Kleidermacher, "Una ley concursal uniforme para El MERCOSUR" (1997) (unpublished).

[115]For a succinct discussion of bankruptcy policy, see generally, Atiyas, supra note 3.

too local in nature. By way of example, any system seeking to facilitate business credit and capital investment must provide for the protection of such infusions. Lenders in Mexico and Brazil expressed a reluctance to extend secured credit given the priority accorded to labor and government claims to the proceeds of a lender's collateral.[116]

Other issues are especially important to Latin American states as they transition the privatization process. Should labor claims be adjudicated outside the insolvency court and proceeding, as they are in Mexico, or should they be centralized as they are in Argentina? Are and should wholly or partially state-owned entities be eligible for relief? Argentina says yes,[117] Venezuela, apparently not.[118]

Given how politically charged they are, such issues are difficult to resolve. On the other hand, insolvency laws that do not accommodate the needs of modern economies and financial markets will not facilitate development. In a globalizing economy with acute needs for capital investment, a national government could reasonably conclude that the allocation of rights made years ago by now antiquated bankruptcy laws is not serving the national interest.[119] Much as the

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[116]Argentina revised its law in 1995 to restrict the priority given to worker claims. Venezuela provides a priority privilege to worker claims. *Ley de Privilegios de Los Créditos de Los Trabajadores del 14-07-61, Artículo Unico,* as do Mexico, Labor Law, Art. 113-14, 892, 979, and Brazil. Brazilian Bankruptcy Law, Art. 102.

[117]Argentina Revision, Art. 2.

[118]See generally, José Muci-Abraham, *¿Son aplicables a Petróleos de Venezuela, S.A., y a sus Empresas Filiales, las disposiciones del Código de Comercio relativas a la Quiebra?*, REVISTA DE LA FACULTAD DE CIENCIAS JURÍDICAS Y POLÍTICAS, No. 79 (Universidad Central de Venezuela). See also, María Auxiliadora Pisano Ricci, La *Quiebra*, Derecho Venezolano 47 (2d ed. 1996).

[119]One example of issues policy makers must confront was provided by the region's period of high, and in some instances, hyper, inflation. As a result of insolvency law provisions that fixed the amount of a creditor's claim as of the date of the filing, stopped the accrual of interest, and did not provide for indexation, debtors were able to use the effects of inflation to pay off their debts in greatly reduced currency. Insolvency proceedings during that inflationary period were principally a means of refinancing credits. With the waning of hyper inflation, insolvency proceedings will unfold in a more normalized context.

Even apart from the effects of inflation, though, this continues to be an issue for creditors owed debts in foreign currency. For example, in Mexico, by court ruling and practice, the amount of a foreign creditor's claim is converted to local currency as of the date insolvency relief is ordered. Brazil has a similar rule. Brazilian Bankruptcy Law, Art. 213. Given the duration of proceedings, often many years, creditors are at risk for all intervening currency devaluations.

United States has created a national commission to review its bankruptcy law, national commissions in the countries in the region might well discover important improvements that could enhance the operation of the bankruptcy system.

Some countries in the region have taken the reform initiative: Costa Rica[120], Colombia[121] and Perú,[122] in addition to Argentina, have all amended their insolvency laws recently. Proposals to modify existing insolvency laws are being considered or advanced in each of the four subject countries. If the modifications result from an *ad hoc* process or take place in the absence of a meaningful debate that considers the competing interests and defines the desired national bankruptcy policy in light of modern-day economic realities, the reforms will likely not create the framework necessary to minimize needless losses when businesses encounter future financial crises.

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[120]Ley No. 7643, *Reforma del Título del Código Procesal, 28 de octubre de 1996.*

[121]Decree No. 350 of 1989.

[122]*Ley de Reorganización del Patrimonio,* Legislative Decree No. 845 (October 1996) (hereafter "Peru Revision").

APPENDIX A
Argentina's Insolvency System

Argentina revised its insolvency law in 1995.[123] In transmitting the proposed law to the Congress, President Menem cited thirteen objectives,[124] including:

- Increasing the flexibility of the *concurso* process, with the intent of providing a wide range of solutions for a business in crisis;

- Incorporation of the creditor body through a more active role in the search for solutions;

- Providing a means for creditors or third parties to salvage the enterprise by assuming the risk and paying a "real price for the value of the business" upon a debtor's failure to overcome its crisis;

- Treatment of labor relations with the aim of simplifying procedures for claims recognition and an exclusive forum,[125] and providing for more flexibility in labor negotiations for businesses in crisis;

- Limit the power of judges to evaluate the merits or convenience of solutions agreed upon by a debtor and its creditors;

- Reduction of time periods and simplification of procedures in liquidations in order to avoid the deterioration of the value of assets of the debtor or its business; and
- The reduction of the cost of *concursos* and liquidations.[126]

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[123]Ley 24.522, sanctioned 20 July 1995, known as "*Ley de Concursos y Quiebras*" (hereafter "Argentina Revision").

[124]*Mensaje del Poder Ejecutivo*, 12 May 1994, Section I, signed in Buenos Aires, Argentina, by Hon. Carlos Menem, Jorge L. Maiorano, and Domingo F. Cavallo (hereafter "Mensaje del Poder Ejecutivo").

[125]The new law provides that the opening of a *concurso* proceeding effects a "radicación" (conceptually speaking, the "relocation") of all pending lawsuits to the court handling the *concurso* with specified exceptions. Argentina Revision, Art. 21(1). The wording of the provision has led to questions about its implementation such as whether outlying courts should transmit their files to the *concurso* court, with some courts doing so, and others not.

[126]All thirteen objectives are not listed here, nor does this listing purport to be a *verbatim* recitation of President Menem's wording.

Although the law is basically untested, particularly because no substantial number of major insolvencies has occurred since its enactment, the revision is regarded by most observers interviewed as an improvement. Some complain that the *concurso* process has been "privatized,"and as noted below, complaints about the law's specifics are surfacing.

Under both the old[127] and new laws, Argentina permitted two basic forms of insolvency proceedings: *concursos preventivo* and liquidations.[128] *Concursos* are not akin to U.S.-style Chapter 11 reorganization proceedings, although some features are similar. Liquidations contemplate the disposition of estate assets and a prorata distribution of the proceeds in a specified order of priority.

One concept of the Argentina Revision is to limit the power of judges over the insolvency proceeding, in effect privatizing some aspects of the restructuring. For example, whereas before, an Argentinean judge had the power to deny bankruptcy relief in the "general [public] interest,"[129] the judge now is entitled to deny relief only if the specified statutory legal requirements are not satisfied.[130]

The judges' power is limited as well in the course of another Argentinean innovation, the *salvataje*. Sometimes called "cramdown" (literally) in Argentina,[131] salvataje is not "cramdown' in the United States sense of the word. Under 11 U.S.C. §1129, a debtor can "cramdown" on dissenting creditors a restructuring proposal, subject to court approval and compliance with the

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[127]Ley 19,551, effective July 1, 1972, sanctioned 4 April, 1972.

[128]Argentina Revision, Titles II and IV. The Argentina Revision also authorizes "extra-judicial agreements" among a debtor and its creditors, which can be submitted to the court for approval. Id., Art. 69. Because such an agreement is not binding on dissenting creditors, it is not considered an insolvency remedy in the same sense that *concursos* and liquidations are.

[129]Ley 19.551, Art. 61. In one much criticized instance under Section 61 of the prior law [Ley 19,551], the judge refused to validate a restructuring agreement in the Sasetru S.A. case, despite the agreement's approval by a majority of the creditors, on the grounds that the creditors would fare better in a liquidation than under the agreement. See Julio Cesar Rivera, Instituciones De Derecho Concursal, Tomo I, 81 (Rubinzal-Culzoni eds.) (1996). Many observers noted that in reality judges did not freely exercise their power to reject creditor-approved agreements. See, e.g., supra.

[130]See Argentina Revision, Art. 13. See also, Adolfo A. N. Rouillon, *Regimen De Concursos Y Quiebras, Ley 24.522* 39 Textos Legales Astrea, Buenos Aires, Argentina, (6th ed.).

[131]President Menem's report to Congress referred to salvataje as "cramdown." See *Mensaje del Poder Ejecutivo,* Part II, subpart 4.

statute's requirements. Under Argentinean "cramdown" or *salvataje,* creditors (or a even third party) can preserve the debtor's going concern value by "cramming down" a proposal for restructuring on a non-consenting debtor that fails to timely obtain the creditors' consent to its own proposal. Whereas under Ley 19,551, the failure of a debtor to achieve a *concurso* agreement with its creditors resulted in the conversion[132] of the *concurso* to a liquidation proceeding,[133] the Argentina Revision provides that upon such failure in the cases of specified entities (generally speaking, including business corporations) the court shall not convert the proceedings to a liquidation but rather shall authorize a salvataje procedure as specified in Article 48.

That article contains a detailed set of deadlines and procedures for effectuating *salvataje.* The Argentina Revision grants the debtor a period in which it exclusively can present proposals for the restructuring of the enterprise.[134] If a debtor fails to achieve a consensual resolution with its creditors within the exclusivity period, creditors or third parties are then given a period ("*el periodo de salvataje*") to offer proposals to the creditor body. If the proponents obtain the required approvals from the creditors, then notwithstanding the objection of the debtor or the debtor's shareholders, the proposal can be approved and ownership of the restructured enterprise transferred in accordance with the proposal. In keeping with curtailment of judicial discretion effected by the Argentina Revision, the court is obligated to approve the first compliant proposal accompanied by the necessary creditor approvals.[135] The complaints about the Argentina Revision's *salvataje* provisions include suggestions the statutory deadlines are unrealistically short and that the procedures for effectuating a *salvataje* are otherwise deficient.

In an effort to provide flexibility in structuring solutions, the Argentina Revision empowers debtors to classify creditors into distinct classes. Article 41 specifies that a debtor must present a proposed classification and grouping scheme, keeping in mind such factors as whether the credits are unsecured, the amounts of the claims, and any factor that could reasonably bear on its classification or grouping with an eye to facilitating tailored proposals.

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[132]There is some academic debate about whether the ensuing liquidation proceeding is part of the same insolvency proceeding or is regarded as a separate, independent proceeding. The term "conversion" is used for the sake of convenience with no intent to weigh in on the issue. Under the Revisión, a *concurso* agreement results in a novation and the failure to perform a *concurso* agreement does not revive the creditors' pre-*concurso* claims. See Ley 24,522, Art. 55. See also, Rivera, supra note 126, at 142.

[133]Ley 19,551, Art. 62.

[134]Argentina Revision, Art. 43.

[135]Argentina Revision, Art. 48(4).

This provision modifies the pre-existing notion under Argentinean law of *pars condictio creditorum* (equal treatment of similarly situated creditors) that was more honored in the breach than in reality.[136] To circumvent Ley 19,551's principle of equality among creditors, debtors would inflate their alleged liabilities to suppliers in an effort to curry favor with that important source of much needed post-*concurso* credit. When transmitting the proposal to Congress, the executive branch acknowledged that proposed Article 41 modified the doctrine of *pars condictio creditorum,* but asserted that the doctrine was a generic concept suited for an ideal situation, which should not be followed when in reality different types of creditors, such as workers, suppliers, institutional lenders, and large and small creditors, represent different species that could justify different treatment.[137]

In a *concurso* proceeding, the debtor is to present a proposal for consideration by its creditors. The proposal must offer at least 40% of the pre-*concurso* unsecured debts.[138] Much as is the case under United States law, the debtor is given a period in which only it is entitled to make a proposal.[139]

The new law creates two panels of trustees, Panel "A" comprised of firms of *contadores* (university-certified accountants) and panel "B" comprised of individual *contadores,* the former intended for major businesses in financial crisis, the latter for medium and small businesses.[140] The dichotomy was intended to avoid the repetition of situations in which unqualified trustees had been appointed to oversee the insolvency of major businesses. The court is to appoint trustees from the "A" panel in insolvencies that are both "complex" *and* "large-scale."[141]

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[136]Some suggest that the Argentina Revision does not violate the equal treatment principle at all, but rather is simply recognition that "dissimilar" creditors (such as a small incidental claimant and a substantial bank lender) should not be treated the same, and have called Ley 19,551's purported adherence to absolute equality "absurd." Rivera, supra note 126, at 140.

[137]*Mensaje del Poder Ejecutivo*, 12 May 1994, Section II, par. 3.

[138]Argentina Revision, Art. 43. Although a debtor's proposal must offer at least 40%, a third party or creditor proposal pursuant to the forced restructuring provisions (*salvataje*) of Article 48 need not offer such minimum. Id.

[139]Id.

[140]Argentina Revision, Art. 253.

[141]Argentina Revision, Art. 253(5). The Argentina Revision also makes special provisions for small business bankruptcies (those businesses having less than 20 unsecured creditors, 20 workers or $100,000 Argentinean pesos in liabilities). Argentina Revision, Art. 288. Although panel "B" is not intended solely for these small business bankruptcies, there is some view that the panel "A" trustees are indicated for any insolvencies that do not fall within

Argentina Revision, Art. 253(5). The theory has not yet been borne out in practice. According to some, not enough trustees with the sophistication necessary to oversee the insolvency of complex business have signed up.

Some of the most fundamental innovations of the Argentina Revision impact labor rights. The extensive modifications include the *suspension* of the accrual of interest on labor claims, which under prior prevailing law, were deemed exempt from the provisions of old Article 20 that suspended interest on claims upon initiation of a *concurso*.[142] The important changes include:

a) Under Ley 19.551 as interpreted in light of other laws, workers were free to seek validation of their claims in the labor courts despite the pendency of a *concurso*.[143] Under the Argentina Revision, most labor claims enjoy a right of "prompt payment"similar to the right enjoyed under Ley 19,551.[144] Now, if for any reason, the right of prompt payment is disputed, the labor claimant must proceed in the *concurso* proceeding and is not free to pursue the claim in the labor courts.[145]

b) Second, under Article 20 of the Argentina Revision, collective bargaining agreements are rendered "ineffective" for the shorter of three years or the duration of the preventive agreement.[146] During the pendency of the *concurso* proceeding, the debtor and the affected collective bargaining unit are to negotiate a collective bargaining

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the definition of an Article 288 "small business." See Rouillon, supra note 127, at 281.

[142]The modification results from the deletion in Article 11 of the filing requirements for a *concurso* that the petitioner certify payment of, loosely speaking, all remunerations and benefits due employees, coupled with the Argentina Revision's specification in Article 19 that only secured credits continue to accrue interest during the *concurso* proceeding. See Ley 19,551, Art. 11; Ley 22,917, Art. 11(8); Argentina Revision, Art. 11.

[143]Rivera, supra note 126, at 79.

[144]The right of prompt payment of specified labor claims is treated as an exception to the general prohibition against discriminatory treatment of pre-*concurso* claims. See Argentina Revision, Art. 16.

[145]See Argentina Revision, Art. 21.

[146]The phrase used by the Argentinean legislation is "acuerdo preventivo," which translated literally means "preventive agreement." To avoid injecting unintended nuances, a literal translation is used rather than English-language phrases under United States or other insolvency law, such as "plan of reorganization," that bear some similarity to, but are fundamentally different from, an "acuerdo preventivo."

agreement to be in effect during the debtor's period of crisis, but not beyond the shorter of three years or the pendency of the *concurso*.[147]

c) Third, Article 189 of Ley 19,551 specified that a purchaser of the debtor's business was the debtor's successor in interest with respect to all pre-existing labor contracts. Article 199 of the Argentina Revision expressly provides that the acquirer is not the successor in interest and generally that pre-acquisition labor claims are *concurso* liabilities for which the acquirer is not liable. This immunization is important, as under the operation of Ley 19,551, the potential investors could not reasonably determine the magnitude of the labor liability that encumbered the assets acquired, and interest in the debtor's business was chilled. [148]

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[147] Argentina Revision, Art. 20.

[148] See Rivera, supra note 126, at 104.

APPENDIX B
Brazil's Insolvency.

Brazil's insolvency law dates from 1945. Federal Decree Law no. 7.661 ("Brazilian Bankruptcy Law") brought what were regarded as innovations and advantages such as the ability of debtors to obtain preventive "concordata" relief without creditor approval, the elimination of the role of the liquidator, and the ability of criminal bankruptcy prosecutions to proceed simultaneously with the civil bankruptcy proceedings.

Two main objectives of the 1945 law were:

- to protect the honest debtor, so that under its management the enterprise could continue being a productive unit of the national economy;

- to punish the dishonest debtor, who by disrupting business and work relations was regarded as a source of harm to the economy.[149]

Notwithstanding the acknowledged progress made more than 50 years ago, the current Brazilian bankruptcy law is now generally regarded as outdated, unnecessarily rigid and not responsive to the needs of modern businesses. The concordata procedure, for example, does not provide an effective mechanism for the reorganization of a business in financial crisis. While it may have been adequate for small companies with a handful of employees, it is not suited for large companies having hundreds or thousands of employees, as more fully discussed below. And, while some consider the law to be a weapon which a debtor can use to postpone the inevitable, the law does not make meaningful provisions to help a debtor rehabilitate itself. Among the claims that a debtor cannot affect by means of filing for concordata are those of secured creditors and government entities. Of concern to foreign creditors is the provision that requires the conversion of foreign currency claims into Brazilian currency as of the date that bankruptcy or insolvency relief is ordered, thus shifting to foreign creditors the risk of a devaluation during the pendency of the proceedings.[150] Other concerns include the many time deadlines specified in the statute, which courts regard as overly rigid and therefore generally refuse to enforce.

Various proposals to reform the current law are being evaluated. For example, on March 27, 1992, a preliminary bill drafted under the auspices of the Ministry of Justice was published in the Official Gazette for consideration, and thereafter submitted for consideration by the legislature.[151] Most such proposals stress the need to create mechanisms to allow for the

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[149]Miranda Valverde, Comentários a Lei de *Falências* (1988).

[150]Brazilian Bankruptcy Law, Art. 213.

[151]Luiz Bernardo Gomide, 2 Sw. J. LAW & TRADE 123, 227 (Spring 1995).

rehabilitation of an enterprise. The main reforms being considered for the Brazilian Bankruptcy Law include:

- a proceeding to govern the rehabilitation of the enterprise, known as "recuperation";
- the inclusion of civil and commercial "concurso" proceedings in the same statute;
- the adoption of protective procedures such as moratória for reorganization proceedings;
- the appointment of a disinterested, independent administrator to manage the debtor's enterprise, in a "concurso" proceeding;
- the reformulation of the judiciary's role in "concurso" proceedings;
- the reclassification of priorities of claims and credits;
- the establishment of a summary proceeding for smaller organizations.[152]

Currently, only two forms of insolvency relief are available under the Brazilian law to a debtor in financial crisis: "*falência*," which is a court-supervised liquidation of the debtor's business carried out by a trustee, and a procedure for deferring and/or reducing repayment of unsecured debts, known as "concordata."

The court in the city where the debtor's main place of business is located is the proper venue to grant and administer the concordata and *falência* proceedings.[153] The bankruptcy court has jurisdiction to dictate all procedures regarding the assets and business of the bankruptcy estate. Some states such as Rio have separate courts that specifically deal with insolvency proceedings only.

A *falência* is an insolvency proceeding for the collection, disposition and liquidation of estate assets carried out by a court appointed trustee followed by a pro-rata distribution of the proceeds to creditors in a specific order of priority. The procedure is comparable to a Chapter 7 liquidation under United States law. *Falência* relief is available to most types of business organizations. Nevertheless, some debtors involved in trade and business are not eligible for

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[152]Nelson Abrão, O novo Direito Falimentar Brasileiro (Sao Paulo, ed. Revista dos Tribunais).

[153]Brazilian Bankruptcy Law, Art. 7.

falência relief[154] while others are not eligible for concordata.[155]

As more fully discussed below, concordata is essentially a payment plan, which, among other things, will protect a debtor from creditors seeking *falência* relief against the debtor. Under this procedure, the debtor must propose a plan for payment of its debts, in compliance with a statutory schedule.

***Falência* Relief.**

Brazilian bankruptcy doctrine contemplates that a debtor be declared "bankrupt" or in a state of "*falência*" as of a certain date. A petition for declaration of *falência* or bankruptcy liquidation may be filed by an unsecured creditor, the commercial debtor himself, the heirs of the debtor, the administrator of the debtor's estate, a partner, or even a shareholder.[156]

A commercial debtor is obligated to file voluntarily for a declaration of *falência*, within 30 days of the maturity date of a liquidated debt if its failure to pay is without a legal justification.[157]

For a creditor to petition for *falência* (i.e., for a debtor's involuntary bankruptcy liquidation), the creditor must either submit documentation establishing the "protest" of the debt[158] or prove that the debtor is in a state of insolvency within the meaning of Article 2 of the Brazilian Bankruptcy Law.[159]

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[154]Those not subject to *falência* relief under the Brazilian Bankruptcy Law include: private and public joint stock companies - Article 242 of the Brazilian companies law; insurance companies - Art. 26 of the Federal Decree Law No. 73/66; "sociedades de capitalização"- Art. 4, Federal Decree Law No. 261/67; "sociedades anônimas de previdência privada"- Law 6.435/77 (Art. 63). These institutions are subject to separate proceedings of liquidation.

[155]Those ineligible for concordata under the Brazilian Bankruptcy Law include financial institutions, Art. 53 of Law 6.024 of 1974; companies that render airline services - Article 187 of Law 7.565 of 1986; insurance companies - Federal Decree Law 73166; and cooperatives.

[156]Brazilian Bankruptcy Law, Arts. 8-9.

[157]Brazilian Bankruptcy Law, Art. 8.

[158]Brazilian Bankruptcy Law, Art. 11.

[159]Brazilian Bankruptcy Law, Art. 12. Article 2 of the Brazilian Bankruptcy Law defines the circumstances in which the state of insolvency is presumed to exist: I) where a judgment debtor does not pay the amount due and fails to nominate assets for attachment by the date determined by the court; II) where a debtor effects a liquidation or makes reckless or fraudulent

To "protest the debt" the creditor must present the documentation of the debt to an officer of the state judiciary who then presents the same to the debtor accompanied by a demand for payment. A record is prepared and published in the official gazette in case of nonpayment. The existence of a protested debt disqualifies a debtor from petitioning for preventive concordata.[160]

To petition for a debtor's liquidation, a secured creditor must either waive its right to the debtor's secured asset or, in order to preserve such right, must prove that the particular asset is not sufficient to pay its credit.[161]

After the petition for declaration is examined by the court, the commercial debtor is served and may either submit a defense within 24 hours[162] or stave off a declaration of bankruptcy by depositing the amount claimed by the petitioning creditor within 24 hours in order to contest the legitimacy and amount of the claim.[163]

If its defense is based on the circumstances mentioned in Article 4, such as false credit instrument, a commercial debtor may petition the court to grant a term of 5 days to present its defense.[164]

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payments; III) where a debtor convenes creditors and proposes to creditors an extension of due dates or forgiveness of debt; IV) where a debtor transfers or tries to transfer, part or the totality of its assets to a third party intending to delay payments or defraud creditors; V) where a debtor transfers its establishment to a third party without the creditors' consent, unless the debtor has sufficient remaining assets to cover any remaining liability; VI) where a debtor gives a creditor collateral without leaving enough unpledged assets to repay its debts; VII) where a debtor is absent from its business without leaving a qualified administrator in charge with sufficient resources to pay the creditors; VIII) where a debtor abandons its business establishment; and, IX) where a debtor conceals itself or tries to conceal itself by fleeing the domicile.

[160]Brazilian Bankruptcy Law, Art. 158.

[161]Brazilian Bankruptcy Law, Art. 9, III, b.

[162]Brazilian Bankruptcy Law, Art. 11, § 1.

[163]Brazilian Bankruptcy Law, Art. 11, § 2.

[164]Brazilian Bankruptcy Law, Art. 11, §3. The circumstances mentioned in Article 4 are: I) false instrument of credit; II) expiration of the statute of limitations; III) the obligation has been declared null; IV) payment of the debt, after protest but before the petition for declaration of bankruptcy; V) that a pleading for a "suspensive concordata" was filled before the petition of declaration of bankruptcy; VI) the amount due was deposited in due time; VII) proof by the production of the proper documentation issued by the proper register that the debtor has not engaged in commerce for the past two years.

If *falência* is declared, the proceedings have two phases.

The first is devoted to the verification of assets and liabilities of the estate. The order granting *falência* relief shall appoint a court trustee.[165] The trustee is to collect and maintain all assets of the estate until the same are sold or, until they are returned to the debtor if the *falência* proceeding is converted into a suspensive concordata.

Pursuant to Article 59, the liquidation is to be administered by the trustee under the direction and supervision of the court. The Brazilian Bankruptcy Law gives preference to the major creditors resident in the court's district, for the post of trustee. In practice, creditors decline the invitation to serve. After the top three creditors decline the appointment, the court is free to appoint a third party to serve as trustee.[166]

The Brazilian Bankruptcy Law provides for the continuation of the business in certain cases where continuation is more beneficial to the estate than liquidation. The court is empowered to authorize the continuation of the debtor's business by naming a qualified manager proposed by the trustee.[167] The statute specifies conditions for the continuation of the business, such as a requirement that purchases and sales be for cash, except that in special cases, the court can authorize purchases on 30-day credit terms.

During this phase, the court-appointed trustee, with the aid of a certified accountant, proceeds with: the collection of the assets; the examination of the books; the verification and classification of credits. The duties of the trustee, spelled out principally in Article 63, include preparation of a report on the classification and verification of claims, receipt and handling of the debtor's correspondence, publication of the *falência* decree (the court would provide for this publication), designation of an expert accountant to assist the trustee, and advising the court regarding any need to sell promptly any assets subject to deterioration.[168]

The ruling declaring the debtor in *falência* must indicate the time in which the declaration occurred. A commercial debtor loses the right to administer its assets from the moment that the bankruptcy is declared.[169] The declaration imposes upon the debtor a series of obligations under

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[165] Brazilian Bankruptcy Law, Art. 60.

[166] Brazilian Bankruptcy Law, Art. 60.

[167] Brazilian Bankruptcy Law, Art. 74.

[168] Brazilian Bankruptcy Law, Art. 63.

[169] Brazilian Bankruptcy Law, Art. 40, § 1.

Article 34, including to appear at proceedings, provide information requested by the trustee, judge, the public attorney, or creditors, and not to leave the jurisdiction without authorization.[170] For violation of such obligations, the debtor can be jailed by order of the judge.[171]

A review of the debtor's actions preceding insolvency is carried out in order to determine if any fraud was committed. If these investigations lead to the conclusion that the debtor's misconduct or fraud caused the state of bankruptcy, a judicial investigation is initiated. Some concern exists that many of the accountants conducting such review and investigations lack the training and sophistication necessary to understand the sophisticated transactions in which modern enterprises are engaging, such as foreign exchange, derivatives, tax-driven financings, and equities. Brazilian law provides for a prosecutor from the state attorney's office to represent the interests of the state in *falência* proceedings.

The date that the debtor's state of bankruptcy or *falência* is declared to have begun is considered critical, for the actions taken by the debtor thereafter, such as transfers without consideration, can be declared null.[172] The reachback period can begin no more than 60 days before: a) the date on which the first protest occurred; b) the date of the ruling of the initial petition for declaration of bankruptcy, either the debtor's voluntary petition[173] or by petition of creditor; c) the date of the filling of the petition for preventive concordata where concordata proceeding is converted into a *falência* proceeding by order of the court.[174]

Article 53 provides for the revocation of acts taken by the debtor with the intention of defrauding creditors. Under Article 52, however, some acts committed by the debtor are considered ineffective, regardless of the debtor's intention.[175] The only issue in these instances is whether the act in question was committed during the period specified. If the specific act was done within the applicable statutory period, the act will be ineffective and avoidable.[176] Under this provision, even acts done before the commencement of the period of *falência*, such as renunciation of an inheritance within 2 years of the date of *falência*, are voidable.

The instances governed by Article 53 of the Brazilian Bankruptcy Law are different, for

[170]Brazilian Bankruptcy Law, Art. 34.

[171]Brazilian Bankruptcy Law, Art. 35.

[172]Brazilian Bankruptcy Law, Art. 52.

[173]Brazilian Bankruptcy Law, Art. 8.

[174]Brazilian Bankruptcy Law, Art. 14.

[175]Brazilian Bankruptcy Law, Art. 52.

[176]Brazilian Bankruptcy Law, Art. 14.

the point in time in which they occurred is irrelevant. Here, the issue is whether the debtor has acted with the intention of committing a fraud with the assistance of a third party. Therefore, the "consilium fraudis" and the "eventus damni" have to be proved before the act is revoked.[177]

The Brazilian law excludes certain assets from the bankrupt estate, such as: the couple's wedding ring; the provisions for food and gas needed by the debtor to support his family for a month; the equipment of military personnel; the books, machines, and instruments used by a professional in his trade; pensions that are used by the debtor to support his family; the debtor's life insurance; the salaries for judges, teachers, and public workers; and in specified circumstances, the debtor's home.[178]

Bilateral contracts can be assumed by the trustee if beneficial to the estate. The other party to a bilateral contract is entitled to ask the trustee to declare within 5 days of the request whether the trustee intends to perform the contract, and in the absence of a timely affirmative response, the other party is entitled to a claim for damages.[179]

Once the court grants *falência* relief ("declares the bankruptcy"), the creditors are given a minimum of 10 and maximum of 20 days to file their claims.[180] The 10 to 20 day terms run from the date that the notice of bankruptcy is published in the Official Gazette and, depending on the size of the estate, in a widely circulated newspaper. The interests involved and size of the estate are taken in consideration in fixing the filing period.

A list of all the creditors is published in the Official Gazette. A creditor that does not file its claim by the initial filing date specified by the court may do so thereafter, but will not have the right to share in any distributions made by the estate to other creditors before such creditor filed its claim.[181]

The second phase is of liquidation of debtor's assets and distribution to creditors. The

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[177] (1) "Consilium Fraudis" - Latin expression for a plan to commit fraud; agreement to commit fraud. The debtor and a third party agree to cause a loss on the creditor.

(2) "Eventus damni" - The fraudulent event; fact or action in which the fraud is based, causing loss to the creditor.

[178] Brazilian Civil Procedure Code, Arts. 649, 650; Brazilian Civil Code, Art 1.676; Law 4.121 of 1962; Law 6.368 of 1976, Arts. 41, §§ 1 and 2.

[179] Brazilian Bankruptcy Law, Art. 43.

[180] Brazilian Bankruptcy Law, Art. 80.

[181] Brazilian Bankruptcy Law, Art. 98.

assets are sold either by sealed-bid sale or through a public auction.[182] The trustee is authorized to apply to the court at any time for permission to sell assets that are subject to deterioration or difficult to store or safeguard.[183] Article 123 authorizes the creditors holding two-thirds of the debtor's liabilities to consent to other means for liquidating the debtor's assets, such as the formation of an organization for the continuation of the debtor's business.[184]

The order of priorities for payment of creditors under the Brazilian bankruptcy law is the following, not counting expenses of the estate: I) labor claims for compensation for work accidents and disputes regarding dismissal and wages;[185] II) claims for taxes due; III) claims relating to social security; IV) claims for secured debts such as mortgages and pledges; V) credits with "special privilege" with respect to specific assets; VI) claims based on a credit with a "general privilege" or right as defined in the statute; and then VII) unsecured claims.[186] If any surplus exists after the liquidation of assets and the payment of principal and interest, the same must be refunded to the debtor.[187]

Concordata.

The concordata proceeding has several benefits such as staving off the debtor's liquidation. The debtor continues conducting business in the ordinary course under judicial supervision while it pays unsecured creditors.[188] In theory, the creditors also gain from the granting of a concordata for they should obtain higher percentages of their debts than through a liquidation proceeding.

The difficulty comes in the practice. First, as long as a claim has not been liquidated (i.e., is being contested), the courts will normally not interfere. Thus, by contesting the amount of a creditor's claim, the debtor is able to prolong the process, often for years. Moreover, a debtor that has proposed a concordata payment arrangement is not required to make a payment for a substantial period; more than once a debtor has reached the end of the deferral period and failed

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[182]Brazilian Bankruptcy Law, Art. 117-18.

[183]Brazilian Bankruptcy Law, Art. 73.

[184]Brazilian Bankruptcy Law, Art. 123.

[185]One principal concern expressed by creditors in Brazil is the high priority accorded to labor and government claims, over even secured claims.

[186]See Brazilian Bankruptcy Law, Arts. 102, 124.

[187]Brazilian Bankruptcy Law, Art. 129.

[188]See Brazilian Bankruptcy Law, Arts. 149, 167, and 183.

to make any payment. In the meantime the assets have been depleted, leaving even less for the creditors than if the debtor's business had been liquidated. In fact one lawyer called concordata "the room before *falência*," with another explaining that "concordata is easy to get into, but hard to get out of."

A secondary market in claims is developing in Brazil following the filing of concordata petitions. Among other things, a competitor can use a claim to try to obtain information regarding a debtor's suppliers and customers, and a debtor will arrange to buy creditors' claims at discounted prices by means of a third party.

A concordata petition does not bar secured creditors as such. That notwithstanding, a tactic known as a "white concordata" has developed aimed at secured creditors: essentially it is the threat of a debtor to file for *falência* relief, which does bar secured creditors. In response, banks and secured lenders will often voluntarily refrain from exercising their remedies pending other possible solutions. As explained by one writer:

> The devastating effects of bankruptcy [*falência*] on the recovery rights of creditors has an effect on the operation of the concordata laws. The mere threat of bankruptcy by the debtor will cause creditors to make concessions in a concordata proceeding, such as the forgiveness of debt (beyond that authorized by the concordata schedule) or the withdrawal of a protest for non-payment (as noted previously, an official protest of a matured debt obligation forecloses a debtor from being eligible for concordata).[189]

Two forms of concordata procedures exist, "preventive" and "suspensive" concordata[190], the distinction being whether the concordata petition is filed before or after the petition for *falência*.

Both suspensive and preventive concordatas can propose the following types of plans of payment:

1) Moratorium - in which the debtor proposes an extension of the due date of payments on its debts;

2) Reduction - in which the debtor proposes a partial release or extinguishment of its debt;

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[189]Antonio Mendes, A Brief Incursion Into Bankruptcy and the Enforcement of Creditor's Rights in Brazil, 16 J. INT'L. L. BUS. 107, 134 (Fall 1995).

[190]Brazilian Bankruptcy Law, Art. 139.

3) Mixed - in which the debtor proposes a combination of both forms, moratorium and reduction.

A creditor can oppose a concordata by establishing that the concordata will not yield as much as a liquidation, or clearly will not be performed.[191] If concordata relief is granted, it is binding on all unsecured creditors, domestic as well as foreign.[192]

Once granted, concordata relief can be rescinded on a variety of grounds, including prepayment to some creditors which prejudices other creditors and failure to perform a term of the concordata.[193] For example, if a debtor does not comply with the proposed schedule of payments[194] a creditor may petition to rescind the concordata. If concordata is rescinded, the proceeding in effect converts to a *falência* proceeding.[195]

Preventive Concordata.

To be eligible for preventive concordata relief, the debtor must have been in business for at least two years[196], have no outstanding protested[197] debts, not be a debtor ineligible for concordata relief under Article 140 (for example, one who has sought the same relief within the preceding 5 years), not be the subject of *falência* proceedings (or if the subject of *falência* proceedings, have had its debts extinguished),[198] and have assets worth more than 50% of its unsecured debts[199]. While these are the requirements of the letter of the law, practice indicates that the courts, for example, have allowed debtors with protested debts to qualify for concordata relief notwithstanding the statute's no-protested-debts requirement.

Upon granting the petition for concordata, the court is to order the *suspensíon* of all lawsuits and executions being pursued against the debtor for claims subject to concordata

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[191]Brazilian Bankruptcy Law, Art. 143.

[192]Brazilian Bankruptcy Law, Art. 147.

[193]Brazilian Bankruptcy Law, Art. 150.

[194]Brazilian Bankruptcy Law, Art. 150, I.

[195]Brazilian Bankruptcy Law, Art. 152.

[196]Brazilian Bankruptcy Law, Art. 158, I.

[197]Brazilian Bankruptcy Law, Art. 158, IV.

[198]Brazilian Bankruptcy Law, Art. 158, III.

[199]Brazilian Bankruptcy Law, Art. 158, II.

relief.[200] A petition for concordata does not terminate bilateral contracts.[201] During the concordata process, the debtor continues in control of its assets subject to the oversight by a "comissário" appointed by the court.[202] The comissário, among other duties, is to designate an accountant to verify the debtor's credits and assets.[203]

In a preventive concordata, a debtor must offer to pay its unsecured creditors in accordance with specified statutory minimums:

- A cash payment of at least 50% of the total owed is required when the preventive concordata proposes a reduction as the form of payment plan;

- A payout of 60%, 75%, 90% and 100% is required, where the term of payment proposed is 6, 12, 18, and 24 months respectively.[204]

As noted, then, no discount is permitted if the plan is a moratorium, in which the payment is made after the eighteenth month. The repayment must be made in full by the twenty-fourth month in any case and at least two-fifths must be paid within the first year whenever the distribution takes more than twelve months[205]

Suspensive Concordata.

Under a suspensive concordata, a bona fide commercial debtor can petition the Bankruptcy Court to convert a *falência* to "suspensive concordata," if the debtor satisfies the statutory requirements,[206] and the general requirements for the granting of a concordata already mentioned above (Article 140).[207]

A debtor granted a suspensive concordata will regain control over its assets and

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[200]Brazilian Bankruptcy Law, Art. 161.

[201]Brazilian Bankruptcy Law, Art. 165.

[202]Brazilian Bankruptcy Law, Art. 167.

[203]Brazilian Bankruptcy Law, Art. 169.

[204]Brazilian Bankruptcy Law, Art. 156.

[205]Brazilian Bankruptcy Law, Art. 156.

[206]For example, the debtor must have been in business for at least two years.

[207]Brazilian Bankruptcy Law, Art. 177.

business[208] subject to paying its unsecured creditors in accordance with statutorily-specified schedules.

In a suspensive concordata, a debtor must also offer to pay its unsecured creditors in accordance with the following statutory minimums, which are lower than the minimums required for preventive concordata:

- a cash payment of at least 35% of the total owed is required when the suspensive concordata proposes a reduction as the form of payment plan;

- A minimum payout of 50% is required, if paid over time, provided that the term may not exceed 2 years and that at least two fifths must be paid the first year.[209]

Claims relating to social security, taxes, debts of the bankruptcy estate and salaries must be paid within 30 days of the date the court grants the suspensive concordata.[210]

Conclusion

In sum, then, the concordata process provides little flexibility for effective restructuring of a complicated balance sheet or the financial affairs of debtor with multiple tranches of debt, secured as well as unsecured. It provides a debtor with no respite from efforts of secured creditors trying to enforce their rights, and as a result, is ineffective.

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[208]Brazilian Bankruptcy Law, Art. 183.

[209]Brazilian Bankruptcy Law, Art. 177.

[210]Brazilian Bankruptcy Law, Art. 149.

APPENDIX C
Mexico's Insolvency System.

In effect since 1943, Mexico's Ley de Quiebras y *Suspensíon* de Pagos ("LQSP") is not widely regarded as an effective tool for salvaging a business in crisis or the value of its assets. More than once observers independently called the law an "arma de ataque," an attack weapon used by unscrupulous debtors to extract concessions from creditors. Some have called it "the worst law that has been ever enacted in the history of Mexico."[211] Although no statistics were presented, observers asserted that few *suspensión de pago* (the closest thing in Mexico to a reorganization) proceedings ever really succeed. Many of the provisions in the LQSP were deemed simply theoretical or "letra muerta" (dead law) not followed in reality.

Apart from issues of corruption discussed in the main text, the complaints ranged from assertions that the statutory scheme was "too rigid" to claims that debtors are able to derail proceedings by making *suspensión* proposals without being required to show feasibility or grounding in reality.[212] Cited as well was the exaggerated deference paid under the Mexican system to matters of form, such that hyper-technical deficiencies at times wind up affecting substantive rights, examples being minor defects in the form of the power of attorney needed for a creditor to prosecute a claim and the perils of taking the wrong "form" of appeal.

The problems are deeper than simply an antiquated law. Among other examples cited were instances in which the executive branch at the state level had refused to lend the police power to execute judgments on account of political concerns over the impact that dispossessing a debtor or executing the judgment would have.

The creation of a rescue culture must happen at a national (as opposed to regional) level, as many factors affecting its existence are local in nature. For example, a bank's willingness to work with a borrower depends in part on its regulatory and political environment: when must the bank take a write-off, can it swap debt for equity under its regulatory constraints, and so on. According to some, the Mexican banking industry has not been too interested in entering into workout agreements with troubled borrowers, because they believe that ultimately the government will bail them out.[213]

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[211]Cervantes Ahumada, R., Derecho de Quiebras 261 (Editorial Herrero, S.A., Tercera Edicion 1981), as cited by Mike Lubrano, Practical Difficulties in Mexican Workouts and Bankruptcy, N. AMER. CORP. LAW., Vol. III, No. 3 (1996).

[212]In theory, the LQSP requires the court to consider the reasonableness of the proposal and the assurance of performance, but see the discussion below.

[213]In the aftermath of the December 1994 devaluation, the Government implemented a number of programs in response to the resulting dramatic decline in bank asset quality. These involved direct subsidies to troubled borrowers, provision of inflation-indexed funding to banks

Mexican law recognizes basically two avenues of insolvency relief: *quiebra* and *suspensión de pagos*, with the former being a liquidation and the latter intended as a temporary moratorium to enable the debtor time to solve a cash flow crunch. To qualify for *quiebra* relief, the debtor must be in a state of cessation of payments ("cesación de pagos"), for *suspensión* relief in a state of *suspensíon* of payments ("suspensión de pagos"), the difference being an implication in the latter term that the stoppage of payments is temporary. In Mexico as in Venezuela only a "comerciante" or business debtor is eligible for relief under the LQSP.[214]

***Quiebra* Relief.**

Creditors can petition for the debtor's involuntary *quiebra*, with the statute specifying the acts presumed to show a state of cessation of payments (the presumption being rebuttable). These include, for example, the debtor's general nonpayment or non-performance of its liquidated and matured debts. Some observers suggested that the statute as a whole and this section in particular, would benefit from clearer delineations; for example this section might specify what, exactly, is meant by "general nonpayment," the suggestion being that the statute should set a specific numerical threshold which, if met, would satisfy the test.

Upon the filing of the debtor's petition and the supporting documentation (which includes its accounting books and records, a listing by name, address and amount of its accounts receivable and accounts payable), the court is to rule within five days. If the petition is granted, the court shall specify measures to protect the estate and for the naming of a trustee. Under Mexican law, the trustee must be either a national bank or a chamber of commerce, which must in turn designate an individual to represent the trusteeship.

The order granting the petition is to contain important provisions, including:

a) The date of the beginning of the reachback period for avoidable transactions;

b) The date by which creditors must present proof of their credits, which shall be 45

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to encourage them to restructure assets, and most importantly, the purchase by the Government's savings support fund (Fondo Bancario de Protección al Ahorro -- FOBAPROA) of a large percentage of the non-performing loans of the Mexican banking system. In 1995 and 1996 FOBAPROA conducted three rounds of such loan purchases, which encouraged both debtors and bankers to believe that the Government would ultimately absorb much of the losses. The Government also established the Bank Enterprise Workout Unit (Unidad Coordinadora para el Acuerdo Bancario Empresarial -- UCABE), which assisted the largest companies in restructuring their obligations, many of which had already been sold to FOBAPROA.

[214]As does Venezuela, Mexico has a civil (non-commercial) bankruptcy process, not addressed here.

days after the last publication date of the notice;

c) The date and place for the meeting of creditors for verification and evaluation of credits to be held a certain number of days after the date for presenting the proofs.

In contrast to other jurisdictions, Mexico does not permit the debtor to rely only on published notice and requires that the debtor mail notice to each creditor whose address is known. Notice of the order is nevertheless to be published in the official gazette as well as in a newspaper of general circulation in the locality of the *quiebra* proceeding. The dates for proof and the meeting of creditors key off the last publication date. The statute admonishes that the trustee and the clerk responsible for publications shall see to it that publication is not delayed.[215]

The trustee is given a number of responsibilities, among them, the rendering of reports to the court and the creditors, the taking of possession of the estate assets and taking of an inventory.[216] The debtor loses the right to administer and dispose of its assets.[217] The trustee is empowered to dispose of assets without leave of court if they are at risk of deterioration or too costly to keep relative to their value.[218] The business can be operated if its closure would cause a material ("grave") loss of value for the creditors.[219]

To monitor the administration of the estate, the court is also provisionally to appoint creditors' representatives, called "interventores, " to be substituted or confirmed by vote of the creditors at the creditors' meeting. The interventores essentially are a voice of the creditor body with standing to be heard in opposition to the sindico, the debtor and others.

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[215]The statute even specifies that the clerk and the trustee shall be responsible for violations of the admonition. LQSP, Art. 18.

[216]As noted, complaints were raised about the inflexibility of the LQSP's procedures. In contrast to other statutes that have too few deadlines and time frames, the LQSP has detailed time frames but they are ignored in practice. Article 187, for example, specifies that the trustee shall commence an inventory within three days of taking office, and that not more than ten days shall be spent on the inventory, with a maximum extension of 20 days with leave of court pursuant to Article 192. By way of other example, Article 226 requires the court to send to the trustee and the intervenor a copy of each "proof of claim" (to use a U.S. term) filed, the very day it is received. In turn, the trustee and the intervenor are to acknowledge it the next day and are to respond within ten days. LQSP, Art. 227-28. In practice, these deadlines are not met.

[217]LQSP, Art. 83.

[218]LQSP, Art. 199.

[219]LQSP, Art. 201.

Mexico classifies its bankruptcies as "fortuitous," "culpable," and "fraudulent." Under the LQSP, a *quiebra* is fortuitous where the debtor has encountered misfortunes that despite good and sound management reduced the capital to the point that the debtor had to cease payments. Culpable *quiebra* results from acts contrary to good commercial management that cause or worsen the cessation of payments.

The noteworthy provision is for fraudulent bankruptcies. Actions deemed fraudulent include the failure to keep the required books and records, material falsification or destruction of records that makes it impossible to ascertain the true state of affairs, or the making of payments or granting of security to a creditor during the reachback period to which the creditor was not entitled.[220] Article 101 provides that the debtor's management (officers, directors, etc.,) responsible for the culpable or fraudulent acts in question shall be personally responsible.

The standard for a fraudulent bankruptcy, then, includes actions that might be taken in good faith (such as making of an avoidable payment, given that the reachback period is set by the court after the fact). Observers noted that the risk of incurring criminal liability from a bankruptcy deemed "fraudulent" is one reason not many liquidations are filed in Mexico. To complicate the matter even more, as a result of creditors' frustration with the ineffectiveness of the Mexican insolvency system, creditors are beginning to use the criminal system to pressure debtors, in effect criminalizing the bankruptcy remedy.

The declaration of *quiebra* (and in some instances publication of the notice) operates to: divest the debtor of its power over its assets[221]; prohibit the payment of debts due to the debtor; stop the accrual of interest on unsecured debts[222], and requires that all legal proceedings pending against the debtor, with a few exceptions, be consolidated or centralized in the bankruptcy case.[223]

The exception to the requirement that all suits be centralized in the *quiebra* court often overwhelms the rule. Two types of creditors under the Mexican system enjoy superior rights. First, labor claims are not required to be processed through the *quiebra* (nor through the *suspensíon* process, either). Rather, labor claims are to be adjudicated by the labor courts,[224] with

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[220]LQSP, Art. 96.

[221]The LQSP leaves the debtor with power over a limited number of assets, such as post-*quiebra* earnings from personal activities. LQSP, Art. 115(IV).

[222]LQSP, Art. 128(II). Secured claims accrue interest up the value of the collateral. Id.

[223]LQSP, Arts. 122, 126.

[224]Labor Law, Arts. 113-14, 892, and 979.

such adjudications binding on the bankruptcy court and the other creditors. That in and of itself is significant, but has an even deeper effect given that under Mexican labor laws, the worker claims entitled to priority go beyond simply wage claims. For example, Mexican workers are entitled to substantial (in proportion to wages) severance and pension benefits that are rarely funded. If a company is liquidated, the claims for these benefits can amount to a multiple of the annual wage bill and consume all estate proceeds.

Similarly, tax claims are not attracted into the *quiebra* process, and the government is not bound by the outcome of the *quiebra* process.[225] As stated in the American Law Institute's International Statement of Mexican Bankruptcy Law:

> In these cases, the tax authorities will notify the delinquent taxpayer, i.e., the Bankrupt or the Sindico, the amount and nature of the omitted tax obligation, and grant a term for payment. These notices can be opposed either through an administrative recourse, or through a nullification suit before the Federal Tax Court. If the tax, plus interest and penalties, has been finally adjudged payable and is not paid, then the government will attach and sequester assets of the taxpayer in an amount sufficient to cover the indebtedness and proceed to sell it at auction. In all of this process the Bankruptcy Court has no participation and cannot oppose it in any way whatsoever, except through the Sindico as above indicated.[226]

Observers identified both of these features as factors that seriously undermine the effectiveness of the Mexican *quiebra* and *suspensión* procedures. Some commented that more than once management has colluded with workers, cutting a deal so that through the use of labor's superpriority, management and labor would wind up with assets, shortchanging other creditors. As noted in the ALI's Statement:

> In any event and for practical purposes, the first priority is that of labor claims. This situation gives rise to an unhealthy practice. When a company goes into reorganization or into Bankruptcy, its workers become of strategic importance. If they oppose the debtor, then they can go outside the Bankruptcy proceedings and frustrate any attempts to reorganize the company or to reach the least onerous settlement with the creditors. They will go ahead with their claims through the Labor Court and [sic] *de fact* leave all other claimants - even secured creditors -

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[225]Tax Code, Art. 149.

[226]International Statement of Mexican Bankruptcy Law 41 (Preliminary Draft No. 2) (March 21, 1997). The Statement is in draft form; it has not been approved by the Council nor by the members of the American Law Institute, and does not represent the position of the ALI in connection with any of the issues addressed in the Statement.

with nothing. If, however, they support the debtor, the latter can use the threat of a strike and the Labor Court proceedings as a weapon in its negotiations with its creditors. Finally, when the workers are ready to execute on their claims through the Labor Court, it is not uncommon for them to buy the company's assets and resell them for a substantial amount.[227]

A secured creditor is free to litigate its secured claim outside the *quiebra* process, but once it is ready to execute a judgment, the claim must be pursued in the *quiebra* proceeding for purposes of ranking and payment.[228]

The LQSP provides for the avoidance of pre-*quiebra* transfers. Article 168 provides that acts of the debtor during the reachback period knowingly taken in fraud of creditors are ineffective if the third party involved knew of the fraud. On the other hand, the third party's knowledge is irrelevant if the act was done without consideration.

Under Article 169, certain acts during the period are conclusively presumed to be fraudulent, such as prepayments of debts and exchanges for evidently inferior value. Other acts, such as payments in kind for obligations payable in money and the granting of liens on collateral during the period for loans made before the reachback period, are deemed fraudulent unless the creditor establishes its good faith.[229]

Once the process of proving claims ("*reconocimiento de creditos*") has been concluded, the trustee is to present a proposal to the court for the disposition of the estate property. The Mexican statute directs that, if possible, the property should be disposed of first as a going concern, failing that through the disposition of discrete economic sub-units (the statutes speaks of separate establishments or branches), and so on, with the last and least desirable way of realizing value being the sale of individual assets.[230] As noted below, a *convenio* can be proposed in a *quiebra* proceeding for its amicable resolution. The disposition of estate assets can be stayed if the judge concludes that a proposed *convenio* has "serious possibilities" of being approved.[231]

To effect a sale, an appraisal by experts must be made and the court must fix a value for the assets. The statute sets floor price formulas, prohibiting the sale of goods below cost absent

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[227] Id. at 38, n. 116.

[228] LQSP, Art. 127.

[229] LQSP, Art. 170.

[230] LQSP, Art. 204.

[231] LQSP, Art. 208.

an expert opinion that such a price is unobtainable.[232] Sale of individual assets is to be by public auction at the court,[233] with the buyer being entitled to issuance of an order canceling liens on the purchased good.

As noted, the court is to set a date at the outset for a meeting for creditors to verify and establish their credits. In a procedure comparable to that of Venezuela, the trustee is to render a report to the court and the creditors, with each claim then being subject to challenge.[234] The judge is to rule on the proposed priority of credits[235] As noted already, labor and government claims rank at the top of the priority list as a practical matter.

A *quiebra* can be concluded in a number of ways under the LQSP, some more realistic than others (the ways include full payment of all creditors[236]). The key one, apart from lack of assets or distribution of all liquidation proceeds, is *convenio*. As noted earlier, the court can suspend the sales of assets upon presentation of a *convenio* proposal.[237]

Convenio proposals are to be presented and considered in a meeting of creditors. The statute expressly prohibits side agreements between the debtor and a creditor upon pain of forfeiture of the claim.[238] It requires the "most absolute of equal treatment" between unsecured creditors, and permits favoritism only with the consent of all creditors of the same rank.[239]

A *convenio* can include both a reduction in amount as well as a postponement of payment.[240] The statute establishes a sliding scale for the required percentage of creditors who must approve the proposal for it to be binding. A lump sum payment proposal must be for at least 35% of the debts owed; at least 75% of the claims (in amount) must vote in favor if the proposed payout is less than 45%, with the required approval vote ranging on down to only a

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[232]LQSP, Art. 212.

[233]LQSP, Art. 213. Sales of the going concern or sub-units are not by auction.

[234]LQSP, Arts. 232, 242-43.

[235]LQSP, Art. 260.

[236]LQSP, Art. 274.

[237]LQSP, Art. 307.

[238]LQSP, Art. 297.

[239]LQSP, Art. 304.

[240]LQSP, Arts. 317-18.

simple majority if the payout is at least 75%.[241] If the proposal includes a deferral as well as a discount, the postponement can be for no more than 2 years and the discount for not more than 55%, with again a sliding scale for the necessary majority depending on the specific terms.[242] A *convenio* that proposes to pay 100% can delay payment for 3 years, and requires the consent of only a majority. If a *convenio* is approved, it is binding on dissenting creditors.[243]

Observers criticized these schemes for proposals as impractical and exploitable by unscrupulous debtors. (Note that these *convenio*s are authorized not only in *quiebra* proceedings, where they are not common, but as well in *suspension* proceedings.) Although the LQSP specifies that the court shall examine the terms of the proposal, hear argument, consider whether the amount offered "is not inferior to the debtor's possibilities" and evaluate the adequacy of the assurances of performance that have been given, these provisions do not rise to the level of a "feasibility" requirement that is provided by other laws, such as the United States Bankruptcy Code.

Further reinforcing the theme found in all of the countries studied, practitioners opined that the judges are by and large incapable of carrying out the analysis that is necessary to evaluate the reasonableness and practicality of such proposals, and for the most part do not do so. In a context where creditor claims are at times inflated to manipulate voting, and creditors do not have an effective dispute resolution system nor the tools necessary to ferret out such collusion, the fact that at least a "majority" of the creditors consented is not an adequate safeguard.

The approval of a *convenio* restores the debtor's rights over its assets and their administration, subject to the terms of the *convenio*.[244]

Suspension of Payments.

The LQSP's provisions for suspension of payments relief are brief.[245] In great measure they incorporate the procedural provisions of the LQSP for *quiebra* relief.[246] In fact the *suspension* title expressly incorporates all non-conflicting provisions of the *quiebra* title of the LQSP.[247] Some of the key differences between the two proceedings are:

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[241]LQSP, Art. 317.

[242]LQSP, Art. 318.

[243]LQSP, Arts. 359-60.

[244]LQSP, Art. 348.

[245]LQSP, Arts. 394-429.

[246]See, e.g., LQSP, Art. 415 (the appointment of the *suspension* trustee shall be done in

- Although the trustee has many of the same powers and responsibilities of a *quiebra* trustee (see Article 416), the debtor in a *suspensíon* proceeding stays in possession and control, under the trustee's oversight;[248]

- The "stay" (to use a United States term) operates against unsecured as well as creditors secured by personality[249] in contrast to the stay in *quiebra* which does not bar creditors secured by personalty from at least litigating their claims;

- The percentage which the debtor may propose in a *suspensíon convenio* must be 5% more than the minimums set by the LQSP for a *quiebra convenio*.[250]

The reality seems to be that debtors have been able to use the *suspensíon* proceedings to effectively delay creditors, while sapping virtually all value out of the estate. Even secured creditors regularly accept discounts far below the value of their collateral in recognition of the delay and deterioration in value that are likely to ensue if the court process were to play itself out.

The dichotomy between the letter of the law and its application is striking in this context. By way of further example, the LQSP has provisions to permit an owner of property to request the withdrawal of its property from the *quiebra* estate,[251] thus a lessor should be entitled to recover the leased good upon non-payment of the lease. Notwithstanding the theoretical right, the creditor does not have a high probability of success, according to practitioners, if the debtor is a going concern with employees and the asset is being used in the business. The result might not seem too surprising at first blush, even to practitioners in pro-debtor jurisdictions, except that the LQSP makes no provision to "adequately protect" the lessor from the deterioration of its asset as a result of the debtor's use. As a practical matter, the owner/creditor is left without an immediate effective remedy.

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accordance with procedures for appointment of a *quiebra* trustee).

[247]LQSP, Art. 429. This incorporation by reference is apparently deemed not to include the avoiding powers in a *quiebra* under the LQSP.

[248]LQSP, Art. 411.

[249]LQSP, Art. 409. Creditors secured by realty, workers claiming work-related claims, and certain other creditors are not stayed.

[250]LQSP, Art. 403.

[251]LQSP, Art. 158. The LQSP also makes provisions for unperformed or "pending bilateral contracts" (or to use the analogous United States term, "executory contracts"). LQSP, Art. 139.

All this may account for a trend that seems to be developing: creditors are resorting to the criminal justice system to pressure debtors and their management to strike a deal. As explained by some, "one can always find something" in the administration of the business that is prosecutable. The use of the criminal justice system as simply another debt collection remedy will undermine the critical need to prosecute real bankruptcy crime and corruption.

APPENDIX D
Venezuela's Insolvency System.

Businesses[252] in financial crisis can be assisted in Venezuela through *atraso* proceedings (loosely speaking, arrearage proceedings) or liquidation ("*quiebra*") procedures, both of which are governed by the Venezuelan Commerce Code ("Código de Comercio").[253]

Atraso Relief.

*Atraso*s and liquidations are handled by the general jurisdiction commercial courts. Usually, this kind of matter is handled by Commercial Courts of the First Instance ("Tribunales de Primera Instancia en lo Mercantil").[254] Appeal procedures may normally include an appeal procedure conducted before Superior Commercial Courts and, possibly, even a further procedure before the Venezuelan Supreme Court. With the exception of the Supreme Court, the court handling the procedure must sit in the jurisdiction where the insolvent debtor is domiciled. Only one court may conduct corporate reorganization matters dealing with the same debtor and all ancillary matters must be centralized in such court.

Venezuelan *atraso* procedures derive from Italian principles. An *atraso* is not a reorganization or restructuring procedure as such. Its basic premise is to allow a business suffering a liquidity crisis to defer payment of all commercial debts until enough cash is obtained through the orderly liquidation of assets to meet its obligations.[255] In fact, the statute expressly speaks of a debtor in a state of *atraso* or arrearage being entitled to petition for authority to

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[252]Only "comerciantes" (sometimes translated as "merchants" but loosely speaking, meaning "business persons and entities") that have ceased to pay commercial debts are allowed to file for bankruptcy and *atrasos*. Article 10 of the Venezuelan Commerce Code defines "comerciantes" as those, who having the capacity to contract, engage in commerce as their regular occupation or profession, adding that commercial corporations are legally deemed *comerciantes*. Accordingly, non-merchant individuals and non-merchant legal entities are not allowed to file for bankruptcy or *atraso* relief in Venezuela under the Venezuelan Commerce Code.

[253]The Venezuelan Penal Code ("Código Penal") dictates penalties and certain procedures applicable for crimes relating to fraudulent bankruptcies.

[254]See Venezuelan Code, Arts. 1.069; 912.

[255]See Emilio Calvo Baca, Código de Comercio de Venezuela, Comentado y Concordado 540 (Ediciones Libra, Caracas) (1997). See also, María Auxiliadora Pisano Ricci, La *Quiebra*, Derecho Venezolano (Universidad Central de Venezuela 2d ed. 1996).

effectuate an "amicable liquidation."[256] The underlying principle (that *atraso* is intended to deal with liquidity problems, not negative net worth issues) is evidenced by the statute's requirement that a debtor have a positive net worth to qualify for *atraso* relief.[257]

The procedures for *atraso* relief do not accommodate themselves well to the complex financial affairs of any meaningful-size business. In the view of some observers, the *atraso* proceeding was adequate for the small business owner ("el comerciante") whose business was the norm when the *atraso* procedures were devised. The statute, for example, requires the debtor to present, among other things, all its business books regularly kept, its balance sheet, its inventory, dated not more than thirty days before, a listing of accounts receivable and other debtors, a listing by name and address of all its creditors indicating the amount and nature of each credit owed, and the consent of at least three creditors, all at the time of filing.[258] If the debtor fails to attach the records, the statute directs that its petition should be denied.[259]

Upon determining that the papers are in order, the court is to appoint a trustee and a commission of three major creditors, specify the considerations for the oversight of the proceedings, and direct publication of a date for a meeting of creditors.[260] At the meeting, the trustee first, and then the creditors' commission shall report their views on, on among other things, the petition and the conditions for proceeding, and propose members for a committee to oversee the liquidation process.[261] Within three working days of that meeting, the court shall hear the debtor, the trustee, the commission of creditors and other interested parties and rule on the petition, "considering especially the vote of the majority of the creditors."[262] On proper grounds, the court can deny requests for *atraso*s and instead decree the bankruptcy and consequent liquidation of the whole business.[263] If the petition is granted, the court shall among other things,

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[256]Venezuelan Code, Art. 898.

[257]Venezuelan Code, Art 898. The Code does authorize a debtor to enter into agreements with its creditors in which it is granted "quitas" or forgiveness of principal and interest. Id., Art. 906. However, the debtor is unable to effectuate such debt restructuring without creditor consent.

[258]Venezuelan Code, Art. 899.

[259]Id.

[260]Venezuelan Code, Art. 900.

[261]Venezuelan Code, Art. 902.

[262]Venezuelan Code, Art. 903.

[263]Venezuelan Code, Art. 911.

specify conditions for the protection of the debtor's estate, and appoint a committee of creditors to monitor the *atraso* process.[264]

In *atraso* proceedings, possession and administration of the business remain in the hands of the debtor and its management, but the court may impose conditions to protect the rights of creditors.[265] If granted *atraso* relief, a debtor is authorized to effectuate the asset-liquidation, with any disagreements between the debtor and the monitoring committee to be resolved by the court.[266] Practitioners in Venezuela observed that the monitoring commission is often not an effective protector of creditors' interest, because the members are often allied with the debtor.

The period for the liquidation of the assets is not to exceed twelve (12) months.[267] In theory, the court is permitted to extend the period for only one additional year.[268] Practitioners and judges both advise that further extensions are given regularly, notwithstanding the Code's directive. Under Article 905, the pendency of an *atraso* proceeding does not bar secured creditors from enforcing their rights, it does, however, stay other creditors from pursuing remedies against the debtor. In contrast to a liquidation proceeding, an *atraso* does not suspend the accrual of interest.[269]

Although *atraso* procedures do not contemplate a "plan of reorganization" in the U.S.-sense of the word, the statute does authorize a debtor to reach a "convenio" or agreement with its creditors in the context of the proceeding, subject to court approval.[270] The agreement can be binding without unanimous consent of the creditors, if creditors holding at least 75% of the claims consent and make adequate arrangements to protect the rights of the dissenting creditors, and the court approves it.[271] According to practitioners, this is simply another instance of theoretical provisions of law that are not currently deployed in real life. A *convenio* can propose even a forgiveness of interest and part of the principal.[272]

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[264]Id.

[265]Venezuelan Code, Art. 903.

[266]Venezuelan Code, Art. 904.

[267]Venezuelan Code, Art. 898.

[268]Venezuelan Code, Art. 908.

[269]Venezuelan Code, Art. 944.

[270]Venezuelan Code, Art. 906.

[271]Venezuelan Code, Art. 906.

[272]Venezuelan Code, Art. 906.

***Quiebra* Relief.**

Quiebra relief may be decreed when a business has ceased to pay commercial debts (i.e., is in a state of "cesación de pagos").[273] The statute itself speaks of the business debtor "not in a state of *atraso*" that ceases payment of its obligations.[274] Commentators assert that *quiebra* is for debtors having a negative net worth.[275] The conceptual underpinning for the difference between *quiebra* and *atraso* relief is the transitory nature of the *atraso* crisis (that is, the nature of the problem is liquidity, not insufficiency of assets) versus the irremediable nature of the debtor in need of "*quiebra*" relief.[276]

Quiebra proceedings may be voluntary or involuntary. A debtor is obligated to petition for *quiebra* relief within three days of ceasing payments.[277] In bankruptcy procedures voluntarily commenced by the debtor, the appropriate petition must be accompanied by: (i) the business' balance sheet or a statement explaining why the balance sheet is produced, and (ii) a statement explaining the causes of the bankruptcy. Involuntary *quiebra* relief can be decreed upon request of one or more of the business' commercial creditors; creditors whose credits have not matured are not entitled to petition for their debtor's involuntary *quiebra*.[278]

The court's order granting *quiebra* relief shall, among other things, name an interim trustee and set dates for a first general meeting of creditors by which creditors must present their claims.[279] As noted in the main text, the Venezuelan Code specifies the period in which domestic creditors must file their claims by adding, to fifteen days, one day for each 30 kilometers the creditor is located away from the court, and for foreign creditors, establishes a sliding scale ranging from three months to six months depending on where the creditor resides (e.g., Colombia, the Americas, Europe or elsewhere).[280] The Code specifies that the notice to

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[273]Venezuelan Code, Art. 914. Although "*quiebra*" is often translated as "bankruptcy," it is "bankruptcy" in the sense of a liquidation. Given that an *atraso* is also a form of liquidation, the untranslated phrase "*quiebra*" is used to avoid confusion.

[274]Venezuelan Code, Art. 914.

[275]See Pisano Ricci, supra note 252, at 24.

[276]Id.

[277]Venezuelan Code, Art. 925.

[278]Venezuelan Code, Art. 931.

[279]Venezuelan Code, Art. 937.

[280]Venezuelan Code, Art. 959.

creditors of the *quiebra* relief shall be made "only" by the posted edicts and publications cited in the statute.[281]

In an *atraso* proceeding, the debtor "remains in possession," to use a U.S. concept. In contrast in a *quiebra* proceeding, the authority to administer and liquidate the business' assets passes to the estate (which under Venezuelan notions is thought to be akin to a mandatory association or community of interests comprised of the creditors and other interested parties[282]) represented by the trustees ("síndicos").[283] In *quiebra* proceedings, only lawyers or "comerciantes," may serve as trustees.[284] Courts have in practice extended that requirement to trustees in *atraso* procedures. Also, courts have limited the trustee functions to individuals. In Venezuela, mostly lawyers are appointed as trustees of corporate *quiebras*. According to the letter of the law, neither minors nor women, among others, are qualified to serve as *quiebra* trustees [285], but the disqualification of women is regarded as unconstitutional.

Under the procedure contemplated by the statute, the assets are to be taken into the court's custody, figuratively at least, by means of court seals to be placed upon the assets the day *quiebra* relief is granted. Thereafter, the trustee, accompanied by two representatives, one chosen by the three largest local creditors and the other by the debtor, is to unseal the assets and take an inventory.[286]

Quiebra relief centralizes in the court handling the *quiebra* all proceedings that might be pending against the debtor.[287] Security interests of secured creditors cannot be enforced outside the *quiebra* proceeding, even if a separate procedure was commenced before the beginning of the *quiebra*.[288]

At the first general meeting, the creditors holding more than half the amount of the claims shall be free to propose that the liquidation be done by the creditors, in which case subject to

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[281]Venezuelan Code, Art. 959; see also, Art. 101.

[282]See J. R. Burgos Villasmil, Lecciones Sobre La *Quiebra* 20-21 Facultad de Derecho de la Universidad Central de Venezuela (1980).

[283]Venezuelan Code, Art. 940.

[284]Venezuelan Code, Arts. 937(1); 967; 970.

[285]Venezuelan Code, Art. 970.

[286]Venezuelan Code, Art. 957.

[287]Venezuelan Code, Art. 942.

[288]Venezuelan Code, Arts. 964; 1.041.

court approval, a liquidator shall be named together with a commission of three creditors to monitor the proceedings.[289] If at the first meeting, the majority of the creditors does not agree to proceed on a liquidation by the creditors, the court shall hear argument and appoint a permanent trustee, either someone new or continuing the appointment of the interim trustee named in the order granting *quiebra* relief.

Promptly after the first meeting, the court is to set and have published a date for a further meeting of creditors, this one to consider the qualification of claims.[290] At the meeting the trustee's report on what are the valid claims against the estate is presented in the presence of the judge. The important point here is that the credits are to be submitted "one by one" for the consideration of those gathered.[291] Although some undisputed credits are treated as a group, the requirement that each credit be submitted to the group, and the right, at least de jure, of each creditor to dispute the credit, makes for a tedious process. As these meetings tend to be less formal than court proceedings, the efficiency and effectiveness of such a procedure depend greatly on the skill of the judge and trustees at managing unpaid, often-vociferous small creditors. Thereafter the court is to attempt to conciliate between the parties disputing the claim, failing which a proceeding is to be opened to adjudicate the dispute.[292]

As occurs in other jurisdictions, Venezuelan insolvency law classifies debtors into three categories of fault: fortuitous bankruptcies, culpable bankruptcies and fraudulent bankruptcies.[293]

A fortuitous bankruptcy is one that results from *force majeure* or causes beyond the debtor's control.[294] A culpable bankruptcy results from the debtor's fault, imprudence or negligence.[295] By way of example, a debtor is deemed culpable if after ceasing payments to creditors generally it pays one creditor to the detriment of the rest, or if the debtor, in an attempt to obtain funds, uses means that it should know would only delay the filing of the bankruptcy.[296] The management may be held to have acted with fault or negligence ("culpa") in the

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[289]Venezuelan Code, Art. 960.

[290]Venezuelan Code, Art. 1001.

[291]Venezuelan Code, Art. 1002.

[292]Venezuelan Code, Art. 1.005.

[293]Venezuelan Code, Art. 915.

[294]Burgos Villasmil, supra note 279, at 17.

[295]Venezuealn Code, Art. 915.

[296]Venezuelan Code, Art. 916.

administration of a business if, for instance, their personal expenses are considered to be excessive by the court or if they have lost considerable amounts of money on behalf of the business in gambling activities. A bankruptcy is fraudulent if the debtor has hidden, falsified or altered its books, misappropriated or hidden assets, or if the debtor is shown to have fraudulently purported to owe sums not in fact owed.[297] The chief difference between fraudulent and culpable bankruptcies is the debtor's intent -- did the debtor intend to defraud creditors.[298]

In addition, if after the bankruptcy has been decreed by the competent commercial court there is enough evidence that the bankruptcy may have been fraudulent or that crimes may have been committed in the administration of the insolvent business, criminal courts may then indict and try the individuals responsible, including corporate directors and officers. While the commercial courts have the power to order the provisional arrest of the debtor's management if the bankruptcy appears either culpable or fraudulent,[299] only the criminal courts have the jurisdictional competence to declare a bankruptcy culpable or fraudulent.[300] That dichotomy of jurisdiction, some complain, only serves to delay the progress of the liquidation.

In general, observers expressed concern that the specter of the criminal sanctions that could flow from filing for insolvency relief served to deter even legitimate, albeit not perfect, business persons from resorting to the courts. While there was no sense expressed that the criminal justice system was in fact effective in prosecuting and punishing fraudulent or culpable bankruptcies, the chill was nevertheless felt to be real.

In the course of ruling upon the petition for *quiebra* relief, the court is to fix the date upon which the debtor entered the state of "cessation of payments," which cannot be more than two years before the petition date.[301] That date becomes the demarcation point for the period of payment-cessation in which specified transactions are either void or voidable, depending on the act.[302] This period is commonly referred to as the "suspicious period" ("período sospechoso").

Generally speaking, transactions during the period that are void (i.e., regardless of the recipient's knowledge of the cessation of payments) include: (i) transfers of property without

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[297]Venezuelan Code, Art. 918.

[298]Calvo Baca, supra note 252, at 554.

[299]Venezuelan Code, Art. 949.

[300]Venezuelan Code, Art. 924.

[301]Venezuelan Code, Art. 936.

[302]Venezuelan Code, Arts. 945-46. The avoidance period in fact begins 10 days before the first date of the cessation period. Id.

consideration; (ii) prepayments of debts (payments not yet due); or (iii) the collateralization of debts created before the tenth day before the commencement of the suspicious period.[303] Other transactions are voidable if the recipient "had knowledge" of the debtor's state at the time. Such transactions include the debtor's payment of matured debts.[304]

As occurred in Argentina, lenders expressed concern that the reach back provisions retracting payments on matured debts, collateralization of unsecured loans, and so on, particularly for a period as long as two years, hindered their flexibility in working out loan problems with borrowers.

Much as *atraso* proceedings contemplate an agreement between the debtor and the creditor body, *quiebra* procedures permit it as well, as long as the bankruptcy is not "fraudulent."[305] At any point in the proceedings, an agreement among the debtor and the creditors (a "*convenio*"), is authorized, if the creditors unanimously consent.[306] If the creditors are not all in agreement, the consideration of a proposed agreement can take place only after the claims have been resolved. If claims disputes are still outstanding, the judge has the discretion to convene a meeting to consider the proposal, having the power to validate claims provisionally in order to permit the claim holder to vote. [307]

At the meeting, the trustee is to report on the state of the bankruptcy.[308] The proposed agreement for the resolution of the *quiebra* will be binding upon all unsecured[309] creditors upon approval by the court and the specified percentage[310] of the creditor body.[311] The court can reject

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[303]Venezuelan Code, Art. 945.

[304]Venezuelan Code, Art. 946.

[305]Venezuelan Code, Arts. 1.009; 1.017.

[306]Venezuelan Code, Art. 1.009.

[307]Venezuelan Code, Arts. 1.008; 1.010.

[308]Venezuelan Code, Art. 1.013.

[309]Secured and privileged creditors are not barred by such an agreement from enforcing their rights. Venezuelan Code, Art. 1.022.

[310]The agreement must be approved by two thirds of the creditors entitled to vote who hold 75% in the total amount of such creditors' claims, or 75% of such creditors who hold two thirds of the amount of such claims. Venezuelan Code, Art. 1.014.

[311]Venezuelan Code, Art. 1.014.

such a creditor-approved agreement only for limited grounds, such as a finding that the bankruptcy is fraudulent or culpable.[312]

Approval of the agreement operates essentially to conclude the *quiebra,* revests in the debtor the rights to its property as is (no relation back), and entitles the debtor to the return of its books, records and other then existing estate property.[313] If no *convenio* is approved, the trustees will proceed to liquidate the estate assets and distribute the proceeds as appropriate.

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[312]Venezuelan Code, Art. 1.021.

[313]Pisano Ricci, supra note 252, at 217.

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