Insolvency Systems in Latin America:
A Tale of Two Countries

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INTRODUCTION

Latin America was a notable case of private sector underperformance for the better part of last century, mainly due to its overreliance, in general, to commodities and capital-intensive extractive and export practices, typically spearheaded through combinations between public sector oversight and foreign private enterprises (in the form of licensees or similar). The *sui generis* features of commodities-centered economies have shaped sociopolitical and macroeconomic dynamics in a region characterized (and overwhelmingly perceived) by instability and lackluster socioeconomic performance.

Indeed, the region tends to be particularly vulnerable to macroeconomic fluctuations, rooted largely in commodity prices boosts and busts cycles. It was only after the region-wide credits crisis of the 1980s-1990s that Latin American began to show steady signs of evolving economic activity, in which industry and services rose as a percentage of GDP. Such growth has been paired by sounder macro policies, which have further fostered the uptick in manufacturing and services industry during the 21st century.[1]

Naturally, the increase in business and industrial activity has pulled up credit activity and pumped breathing air into historically shallow financial markets across the region. Thus, real banking credit to the private sector picked up during the past couple of decades (alas, heterogeneously between countries, and even within countries itself through different periods). Such newly tapped access to credit has in turn incentivized supply-side economic growth.[2] Credit activity can be characterized as the lifeblood of economic growth and development. Private sector is largely dependent on it, as a source of capital, which then turns into enhanced fiscal income for public sector through taxes.

In tandem to the new economic realities, the Americas have seen several examples of overhauling insolvency laws and systems, updating decades-old legislation, to narrow the gap between the growing appetite for private sector-oriented credit markets and the business reorganization framework. However, in this particular instance as well, the initiatives have not been homogenous, leaving some jurisdictions trailing behind, while others have picked up the pace to leave behind XIX century European roots, and instead adapt (and adopt) current trends in insolvency regimes (mostly based upon alien common law notions, and in particular the U.S. Chapter 11 model adopted back in 1978).

The intent of this short paper is to look into this reality through the prism of two very different examples that can be found in neighboring countries in South America: The commodities' rich Venezuela and the continent's *big indiustrial brother*, Brazil. One, being a prime example of a petro-state economy traversing widespread economic shocks, and the other an aspiring industrial powerhouse in the hemisphere. We will address the main features of the diverting insolvency systems in both countries, focusing particularly in the ever-present tension between liquidation and restructuring goals, as well as creditor and debtor orientation. The idea is to analyze both systems not

[1] *Latin America: The Long Road*, Credit Suisse Research Institute (2014), p. 6.
[2] Harbo, NJ and Sulla, O., *Credit Growth in Latin America: Financial Development or Credit Boom?*, IMF Working Paper, WP/13/106 (2013), pp. 3-6.

in a vacuum of bankruptcy laws or judicial systems, but rather in a contextualized manner, taking into account the economic realities of the region, as well as of each the two specific countries.

BALANCING ACT BETWEEN SYSTEM-ORIENTATIONS

When approaching a restructuring framework, it is well recognized that the legislator / policy-maker will be juggling with incentives, carrots and sticks between the credit activity—in form of creditors and claimants—and debtors' ability to steer a flailing business out of illiquidity or outright insolvency. The historic approach towards bankruptcy gravitated around the notion of a shift in business control from the equityholders to the creditors. This translated into regulations generally perceived to be biased either towards liquidation of a debtor's assets or instead to the turnaround and reorganization of the debtor's estate.

Indeed, insolvency policymaking involves a tradeoff between investor-oriented incentives (liquid credit activity and monitoring firm performance) and incentives to efficient business management by the debtor. Insolvency law can promote efficient outcomes by providing these incentives either prior to an actual insolvency crisis arising (*ex ante* efficiency), or once a firm is in distress (*ex post* efficiency).[3] Insolvency systems have two primary objectives: (a) allocating risk among market participants in a predictable, equitable, and transparent manner, and (b) maximizing the value of the insolvent firm for the benefit of all interested parties, which goes beyond the economic interests of direct creditors, and steps into the toes of socioeconomic aspects and macro policies. The quest for value maximization requires reframing historical biases gravitating in direction of assets' liquidation, and instead acknowledging that business value may be maximized approaching the firm as a going concern.

Well-designed bankruptcy procedures can influence the establishment of a healthy business environment in a number of ways. From the *ex post* efficiency perspective, it maximizes the total value of a business and, consequently, the payoff that creditors receive. In turn, this reduces the cost of capital, as it enhances creditors chances and expectations of recovery as a plan B. From the *ex ante* perspective, emphasis is made rather than in the size of the pie, in how such pie is to be divided among stakeholders. This is accomplished by providing well-aligned managerial incentives throughout the different stages of life of a firm. A proper restructuring framework reduces bankruptcy risks, while at the same time saves value in bankruptcy for managers and shareholders, which motivates actions in favor of efficient investment and timely decisions.[4]

Properly allocating the balance between the rights of debtors and creditors—as well as the orientation towards either restructuring or liquidation—is in many ways a political decision, in the sense that it is falls within the tool-kit of macroeconomic policy-making. In the Americas that balance has often pivoted around protectionist socioeconomic notions such as the preservation of employment and jobs, trading-off creditors' rights and credit activity (which may be restricted to short-term financing), in order to procure business stability for the labor force. Yet, such short-term financing practices can

[3] McGowan, MA. and Andrews, D., *Design of Insolvency Regimes Across Countries*, Organisation for Economic Co-operation and Development (OECD), ECO/WKP/52 (2018), p. 9.
[4] Araújo, A. and Funchal, B., *Bankruptcy Law in Latin America: Past and Future*, in Economía, Volume 6, Number 1, Brookings Institution Press (2005), p. 151.

then become a self-fulfilling prophecy of sorts, as it tends to limit free cash flows and increases the risk of insolvency.[5]

AN APPROACH TO LATIN AMERICAN SYSTEMS

Latin American insolvency regimes show many aspects of their legacy European legal systems, yet have made strides in the past couple of decades to develop in correlation to their status as emerging economies. In many instances the path has been similar: specific insolvency legislation has been passed addressing aspects beyond merely procedural bankruptcy and enterprise liquidation, leaving behind the bankruptcy provisions included in outdated commercial and corporate codes.

In the case of Brazil, its restructuring regime—which dated back to the 1940s—was revamped in 2005 (after a crusade which spanned for over a decade, and which was carried out by different political administrations in the country), in an initial attempt to tackle issues such as the possibility of restructuring of a "viable" businesses, efficiently liquidating insolvent companies, or mitigating the statutory weight to certain privileged and guaranteed claims (such as tax or labor obligations).[6] Such reform was followed by a new amendment passed in 2020.

Venezuela, on the other hand, presents an old-fashioned insolvency regime regulated under the Code of Commerce, last amended in 1955—although it can be dated further back a century to 1862—and which has remained largely unaltered since 1904. Under such outdated view, insolvency is approached largely as a procedural—rather than substantive—concept; in which liquidation comes across as the governing idea.

The stark contrast in both Brazil and Venezuela's approach towards restructuring, makes for a great scientific observation on the subject of insolvency systems and credit markets development in emerging markets, as we can easily draw comparisons between an evolving regime—Brazil—and use a stalling one—Venezuela—as control group.

Country	Score Resolving Insolvency		Current Rank (as of 2020)
	2004	2020	
Venezuela	*17.4*	18.5	165
Brazil	*31.4*[7]	50.4	77
Argentina	*42.1*	40.0	111
Chile	*41.8*	60.1	53
Colombia	*59.5*	71.4	32

Fig 1

As seen in Fig. 1, World Bank data[8] reflects that Brazil has indeed improved largely in the past couple of decades when analyzing variables such as time, costs and outcome (including the recovery rate) of

[5] Rowat, M., *Reforming Insolvency Systems in Latin America*, Viewpoint, IMF, Public Policy for the Private Sector, Note No. 187 (1999).
[6] Felsberg, T. and Campana, P., *Corporate Bankruptcy and Reorganization in Brazil*, in: Leonard, B. (ed), Norton Annual Review of International Insolvency, Thomson Reuters / West (2009).
[7] This score is based upon data limited to the State of Sao Paulo.
[8] See https://www.worldbank.org/en/programs/business-enabling-environment/doing-business-legacy (accessed on December 28, 2021).

insolvency proceedings involving domestic legal entities. Venezuela, perhaps unsurprisingly, has pretty much stalled near the very bottom of the global ranking.

VENEZUELA—THE REGION'S LAGGARD

Venezuela's bankruptcy regime revolves around the notion of creditors' coordination (under the strict oversight of a commercial judge) for the orderly liquidation of the debtor's assets.

Pursuant to the Venezuelan Code of Commerce, insolvency proceedings consist of: (a) moratorium (*beneficio de atraso*), and (b) bankruptcy (*quiebra*).[9] The moratorium is a strictly voluntary judicial relief conceived to facilitate an orderly reorganization or liquidation of a business that is undergoing liquidity problems, but that is essentially solvent. For its part, a bankruptcy (i) may be either voluntary (filed by the debtor) or involuntary (brough forward by a creditor), (ii) provides for voidable preferences and (iii) automatically stays all collection actions against the debtor.

Notably, no general framework exists for out-of-court workouts in Venezuela, meaning that they are usually conducted through bespoke agreements tailored to the specifics of the situation, on a deal-by-deal basis, and on which creditor participation (and coordination) is voluntary. This typically translates, in practice, into unimpairment of certain types of claims, such as labor, tax or vendor-related credits, which are oblivious of the debtor's financial issues, while other creditors (mainly banks and strategic suppliers) are left with the burden to shoulder the costs of saving a still viable business. Due, among other things, to the typical length of bankruptcy proceedings (which tend to stretch for several years), the underdevelopment of insolvency practice and the liquidation-oriented spirit of the outdated legal regime, the common practice in Venezuela is to address insolvency situations, first and foremost, through out-of-court restructurings (*reestructuración de pasivos*).

The liquidation-oriented spirit of local law also entails a reputational stigma for the debtor who undergoes an insolvency proceeding. Business turnaround is not regarded as a likely outcome from formal bankruptcy. Additionally, from an operational and practical perspective, filing for either moratorium or bankruptcy inevitability triggers a cascade of defaults, debt accelerations and/or early contractual terminations, further limiting the prospects for a successful reorganization. Indeed, bankruptcy—even moratorium—are expressly designed in a way in which liquidation is almost the only plausible scenario, to the extent that references to liquidation are ubiquitous in the statutory provisions governing both mechanisms.

Other aspects, such as the absolute priority rule, means that, in practice, secured creditors will get paid first, following an assets' liquidation. This is yet another key aspect shaping the dynamic of any restructuring. For instance, in the context of a formal bankruptcy proceeding, holdout secured creditors who do not endorse a restructuring plan retain their security interest or privileged claim.

The role of the commercial judge overseeing an insolvency proceeding is prominent, with the unsecured creditor groups, trustees and other aides taking the backseat when it comes to shaping the outcome of the process. Third-party intervention is not featured in the applicable legislation and has

[9] Special reorganization rules—under specific, industry-oriented legislation—apply to financial institutions, insurance companies and stock brokerage houses.

not been incorporated as a standard practice. Although mediation as an alternative dispute resolution mechanism (including even court-mandated mediation) has been relatively on the rise in Venezuela during the past couple of decades, it has yet to be incorporated as a common practice in the context of insolvency proceedings.[10]

BRAZIL—A PACING JURISDICTION

Brazilian insolvency system consists of three types of proceedings: (a) in-court reorganization, analogous to a U.S. Chapter 11 proceeding (*recuperação judicial*); (b) out-of-court reorganization, a type of pre-packaged restructuring option (*recuperação extrajudicial*); and (c) liquidation (*falência*).

Recent reforms during the past couple of decades have been expressly aimed towards improving creditors' protections and standing in the context of insolvency proceedings, with the intent of boosting credit activity in the country. Greater balance between liquidation and reorganization has resulted from such reforms.

Brazil's 2005 law made significant headway in breaking with several paradigms under which insolvency was synonym to liquidation, allowing breathing room for flailing business to restructure, better serving debtors and creditors alike, in terms of value maximization of their respective claims. Under this new conception, insolvency aims to preserve and optimize the use of the company's assets.[11] Indeed, even when a liquidation proceeding is deemed necessary to traverse from dissolution to the definitive extinction of a bankrupt debtor, nothing more natural than this to be done by "optimizing" the realization of assets and maximizing the values to be distributed.[12]

The 2020 law further changed important aspects, such as: (i) the automatic stay period; (ii) the sale of assets, including an expansion of the protection to the buyers regarding the debtor's liabilities; (iii) credit assignments, including labor claims; and (iv) the requirements for approval of the plan by cramdown.[13]

Perhaps one of the key changes of the 2020 legislation is allowing for the creditors to come up with proposed alternative restructuring plans during the proceedings. This option to have a creditor-backed plan in play may somehow pave the road towards greater balance in the negotiation dynamics between debtors and creditors, addressing the perceived prior imbalances under the 2005 law, and the perception of Brazil as an overly debtor-friendly jurisdiction in general.[14]

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[10] Venezuela is a signatory of the United Nations Convention on International Settlement Agreements Resulting from Mediation (also known as the "Singapore Convention on Mediation"), which enhances the potential of mediation within the tool-kit of the restructuring practitioner, in the context of cross-border insolvencies.
[11] Art. 75 of the 2005 Law.
[12] Penteado, M., *Comentários à Lei de recuperação de empresas e falência, Lei 11.101/2005*, De Souza, F. and De Moraes, A. (eds), Editora Revista Dos Tribunais (2007), p. 77.
[13] Celidonio, L. and Humbert, PM., *Brazil: Amendment of Bankruptcy Code Approved by Federal Senate, Awaiting Presidential Approval*, Mayer Brown (2020), p. 1.
[14] Cooper, R., Cestero. F. and Soltman, D., *Insolvency Reform in Brazil: An Opportunity Too Important to Squander*, in Emerging Markets Restructuring Journal, Cleary Gottlieb, Issue No. 4—Fall (2007).

The inclusion of prepackaged restructurings, fostering third-party mediation, adopting debtor-in-possession (including DIP financing) as a standardized practice, allowing the presentation of a plan by the debtor (and now even an alternative plan by the creditors), have all been significant improvements in the insolvency ecosystem of Brazil during the 21st century, with undeniable impact in the recovery value of distressed claims and the general credit activity of the country. Brazil now has a system in place under which the liquidation of a company is actually an unlikely scenario in the face of a plethora of reorganization and turnaround alternatives, and in which the playing field between creditors and debtors alike has become more leveled.

OTHER INSOLVENCY REGIMES IN THE AMERICAS

In Argentina, the *Ley de Concursos y Quiebras* was first passed in 1995 to modernize the country's insolvency regime and was later amended less than a decade after. It sets forth three principal insolvency proceedings: (i) the preventive restructuring (*concurso preventive*), somehow similar to U.S. Chapter 11; (ii) the out-of-court pre-packaged proceeding (*acuerdo preventivo extrajudicial*); and (iii) bankruptcy (*quiebra*), which is a liquidation proceeding. As a result of Argentina being one of the first countries in Latin America to update its bankruptcy system, it may lack some of the features of more recent legilsation. In the case of Chile, the country has made recent efforts in the past decade to update its insolvency system and put it at par with its standing as the region's most developed economy. Its 2014 law expressly seeks the reorganization and turnaround of distressed business.[15]

Finally, Colombia may very well be branded as one of Latin America's frontrunner in the field of business restructuring. Its 2006 law decidedly encourages creditor participation and involvement in the following restructuring proceedings: (a) reorganization (*proceso de reorganización*); (b) prepackaged reorganization plans (*validación judicial de acuerdos extrajudiciales de reorganización*); and (c) judicial liquidation (*liquidación judicial*). Notably, insolvency proceedings are overseen by an administrative authority (Superintendency of Companies) instead of a bankruptcy or commercial court.

LOOKING FORWARD—THE EVOLUTION OF INSOLVENCY LAW IN LATAM

Latin America has a long road to climb in adapting to the trends of the time and implementing systems which take down the statutory legacy of inexorable liquidation of viable enterprises, as well as suboptimal value recovery for stakeholders. Several notions further providing leeway to a debtor, as well as general flexibility in debt renegotiations, have already been permeating into the region since the liberalism wave of the 1990s.

Overly rigid, formalities-heavy and judicialized insolvency proceedings are still very much the norm in the Americas. Court involvement still plays a prominent role in most jurisdictions, while the discretionary power and clout held by a presiding judge (who in most systems is not a bankruptcy specialist) tends to suppress involvement and creativity in coming up with alternatives that may, on side, maximize value for all stakeholders, while, on the other side, incentive the turnaround and

[15] *Latin America Insolvency Regime Scorecard*, Cleary Gottlieb (2020), pp 3, 27.

recovery of illiquid but still viable companies. Is not uncommon for insolvency practitioners, trustees, administrators, liquidators or other judicial auxiliaries to play a muted and subdued role in these proceedings; while way too much weight and leverage in the faith of the insolvency proceeding is still granted to certain players—such as certain privileged or secured creditors (*i.e.*, employees or tax authorities)—and/or certain socioeconomic policies (*e.g.*, preservation of employment).

Interestingly, while some countries in the region show strong correlation between the degree of development of their insolvency systems and the overall business environment—such as is the case the hot economy of Brazil and the underwhelming Venezuela—in other instances we see well developed economies with subpar restructuring systems (as is the case of Chile, at least from the period leading from the end of *pinochetismo* up until 2014).

When looking into the particular case of Venezuela, the good news is that a roadmap to catch up with its peers and neighbors, could relatively easy be drawn for the collective experience of both its neighbors Brazil and Colombia, as well as the rest of Latin America in general. On top of that, the country's policy-makers will probably have good incentives in providing its financial sector and industry with an updated, and well balanced, insolvency framework, which can further aid in a turnaround of the economy, in general. To that end, it may be worth keeping in mind the *ten commandments* for evolving insolvency regimes, namely: (i) deploy a judiciary training and education program; (ii) channel proceedings through specialized courts, with the involvement of ancillary bodies and aides; (iii) crackdown on corruption; (iv) decouple criminal liability from insolvency; (v) foster transparency and information disclosure; (vi) procure preservation of going concern value, while abandoning liquidation-oriented practices; (vii) adjust protection of collateral and security interests; (viii) shorten the time frame of proceedings; (ix) incentivize flexibility in addressing reorganization negotiations; and, finally, (x) promote efficient cross-border cooperation.[16]

[16] Rowat, M. and Astigarraga, J., *Latin America Insolvency Systems: A Comparative Assessment*, World Bank Technical Paper No. 433 (1999), pp. xi-xiv.

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