

# An Overview of Recent Bankruptcy Reforms in Latin America

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**Editor's Note:** *This is the inaugural article of a new column focusing on insolvency issues in Latin America.*

Globalization and integration of business operations, trade and finance as well as the 1994/97/98 financial crises of emerging markets has led several in the Latin American nations to review their archaic and inefficient insolvency statutes. The nations sought a balanced value-creation result based on economic rationality, social accountability and liquidation systems aligned with creditor rights. The Latin American countries perceived that the effectiveness and efficiency of creditor rights systems are vital to ensure a financial stability that stimulates private and financial sector growth, value preservation/creation and improved access to credit. Ultimately, these conditions promote sustained socio-economic development.



Josefina F. McEvoy

The international community (e.g., the Group of Eight, which represent about 65 percent of the world economy) were known to be concerned about (1) the domestic and international impact of weak legal institutions, (2) the lack of understanding by market participants of financial systems and (3) linkages between the speed of response and the speed of economic recovery. The international community responded by carrying out a comprehensive analysis of the components of the global financial system in key areas such as (1) transparency (data dissemination, fiscal clarity, and monetary and financial policy), (2) financial (banking supervision, payment and settlement, insurance supervision, security regulation and money laundering), (3) infrastructure

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(corporate governance, accounting, auditing, insolvency and creditor rights) and (4) accountability and predictability.

Whereas the historical emphasis had been on tangible property rights, rights of secured creditors and the realization of value to discharge debts through receiverships and liquidations, now we talk of cash flows and enterprise values that typically exceed tangible asset values. The "new order" encourages national systems that operate autonomously and respond to a growing

trend for reorganizations that allow a company to survive as a going-concern, enhancing enterprise and recovery values for stakeholders, and cash generation. There is a greater understanding that the social cell called "enterprise" is the only nucleus that generates development and social welfare, thereby responding to domestic needs.

A wave of bankruptcy and institutional reforms has taken hold worldwide in the last seven years. While significant progress has been made in approving new bankruptcy laws in Latin America, the consolidation process of reliable insolvency and creditor rights systems in the region represents an immense challenge mainly due to the long history of either (1) an inexperienced judiciary, (2) lack of exposure to modern insolvency concepts, (3) lack of a modern insolvency culture (insolvent company carries a social stigma from the preceding bankruptcy laws), (4) lack of specialized bankruptcy courts and judicial administrators, (5) fragile and slow legal systems and (6) white collar impunity.

The business and financial communities in the Latin American region are eager to see these new bankruptcy systems work efficiently and effectively. At this early stage, though, creditors and debtors are concerned with the learning curve process—courts' and markets' absorption of the new "culture." Their perception is that it is too soon to evaluate the effectiveness of the application of the new insolvency statutes under the paradigm of the new system.

Courts in Latin America have major hurdles to overcome. For instance, courts are just now beginning to understand that corporate reorganization and liquidation processes demand a totally different and dynamic mindset that adopts the important concept of the time-value of money. Thus, they need to remove from their systems the operational inefficiencies that cause delays. It is also imperative to understand the need to have

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well-prepared bankruptcy judges and judicial administrators capable of protecting the public interests, preserving the integrity of those institutions and creating an enabling environment for global competitiveness.

Global financial players specializing in the distressed market are eagerly observing the effective application of the new statutes in the region, to ascertain whether implementation will create conditions for them to participate more actively in areas such as debtor-in-possession financing, and equity and derivatives investment. Despite the recent wave of legislative reform, with the exception of Mexico, Latin American countries have not adopted UNCITRAL's Model Law on Cross-Border Insolvencies. Accordingly, Latin America is not a destination where reliable, predictable and effective multinational proceedings can be had. Adoption of the UNCITRAL Model Law would enable Latin America to keep pace with global trends and international best practices.

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## Principles Behind the Reforms: The Brazil Experience

Legislative reforms have either taken place or are underway in Brazil, Mexico, Argentina, Uruguay, Peru, Ecuador, Bolivia, Colombia, Dominican Republic and Costa Rica. A major development in the region is the enactment of Brazil's new bankruptcy and restructuring statute.

Brazil's New Bankruptcy and Restructuring Law (NBRL), which took effect on June 9, 2005, represents a great advance from the anachronistic retired statute of 1945. Aligned with the modernization wave of the insolvency statutes carried out by most developed countries, and modeled upon the fundamental premises of the U.S. Bankruptcy Code, it represents the first major overhaul of Brazil's corporate reorganization laws in over half a century.

Its underlying principle is that a viable company facing financial crisis possesses and generates greater socio-economic value as a going-concern than it would from the forced sale of its assets through a court-supervised liquidation. NBRL creates two legal proceedings, judicial (formal) and out-of-court (informal) reorganizations, which enable debtors to obtain court approval of reorganization plans negotiated directly with their creditors. These two new restructuring proceedings will permit Brazilian debtors to engage in an extensive array of rehabilitation strategies familiar to debtors pursuing chapter 11 reorganizations under the U.S. Bankruptcy Code. Moreover, these proceedings create a central role for creditors as they are contingent upon court-confirmed reorganization plans negotiated directly with creditors.

NBRL's key provisions include (1) its strong orientation toward preserving viable businesses and respective jobs and resulting socio-economic benefits, (2) provision of greater alternatives for the rescue of viable businesses, even in cases of bankruptcy liquidation, where priority is given to the maintenance of the going concern and the sale of the business rather than liquidating its assets at salvage values, (3) the dissociation between the fate of the social cell known as the "company" and of its founders or controlling shareholders, (4)

diligence and reduction in the legal bureaucracy of proceedings.

Another significant improvement of the NBRL is that it eliminates successor liability with respect to certain categories of claims. In particular, purchasers of certain types of the debtor's assets during a judicial reorganization (*e.g.*, separate production units or branches of the debtor's operations) will no longer inherit legal responsibility to pay the debtor's obligations for tax claims (and possibly labor or work-related injury claims and social security claims).

It is of supreme importance to understand that the NBRL constitutes legal bedrock whose objective is to provide the bankruptcy process with a legal regulatory framework, not a panacea for companies in difficulties. It represents a small part of what can be a large and complex puzzle, as the early cases demonstrate.

The basic nature of a business recovery is managerial—economic, not legal. If a business is not viable, it is not the NBRL will not save it. If management does not have the required credibility along its creditors and the market in general, and the ability to execute its reorganization strategy, it is not up to the law to save it. Even if a company has proven viability, with able management and a well-conceived recovery plan, if that plan is not executed in time, the company will succumb independent of the NBRL. Thus, it is not the new statute that is being tested with the first bankruptcy cases filed under the new law, but rather the actions, competencies and efficiency of companies' governance, management, the judiciary and stakeholders, on whose shoulders truly rely the success of the recovery process. They are responsible to deliberate with sound experience and judgment, and clear understanding which solution is more suitable to each different situation.

As in U.S. chapter 11, judges play a central role in the NBRL. Depending on their actions, viable businesses may become extinct while unfeasible ones may engage in a never-ending process, with great value destruction in both cases. Aspects for judicial discernment (1) whether the corporate distress is mainly caused by mismanagement, (2) a finding of business viability, (3) adherence to legal deadlines, (4) assessment of the quality of the reorganization plan and (5) the

effectiveness and execution of the plan.

It is important to highlight that court approval of the reorganization plan constitutes a mere formality, as the real challenge lies on its execution. It may seem obvious, but there are cases where respective approved plans face performance problems—a clear demonstration that the plan was poorly prepared and analyzed, or of the inability of those responsible for its execution to deliver it, or even both. Noncompliance with the approved plan poses serious risk to an already fragile relationship between debtor and its creditors, and above all to the going concern.

Success will depend on: (1) the skill of new management, reorganization plan, viability analysis, valuation work, and operational and business adjustments, (2) vendors' support, continuing to supply under normal conditions and possible credit conversion, (3) support from creditors, DIP finance and possible conversions, (4) support of employees and (5) new capital from new players. It is very unlikely that steps 2, 3 and 4 will occur without the fulfillment of the first, in the same manner that the fifth step will not materialize without the implementation of prior ones.

The logic is simple. If the parties who presently participate in the company's risk do not trust its governance/management and do not believe in the success of the reorganization plan, those who are outside the risk will not have the slightest motivation to participate, even if the company presents the most brilliantly conceived legal structure for raising capital. The first cases under NBRL show other critical aspects for the success of the restructuring process, such as the judge's awareness as to the correct choice of judicial administrators, who must possess the required qualifications and experience to perform his/her work effectively. The administrator's role is much broader under NBRL than under the prior statute, mainly considering that they will work inside the company and will need greater experience in management, finance, control and operations in distressed company environment in order to understand the intricacies involved in the restructuring process, as well as attention to fraud and financial crimes. ■