Latin American Principles for Out-of-Court Workouts[*]

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Motivation

Insolvency law may have a significant impact on a country's economy given that the treatment of creditors in insolvency may affect the availability and cost of credit and the treatment of debtors in insolvency may affect the optimal timing for the initiation of insolvency proceedings as well as the level of entrepreneurship, innovation and the use of debt finance in a country.[1] Thus, the design and efficiency of an insolvency system may affect the competitiveness and growth of an economy even if debtors ultimately remain solvent and therefore an insolvency proceeding is not even initiated. In fact, the low usage of insolvency proceedings observed in some countries can be explained, at least in part, by the existence of an unattractive insolvency law that encourages debtors and creditors to avoid the usage of the insolvency system or to take suboptimal levels of debt and risk as a way to minimize the risk of insolvency.[2]

In the last decades, many Latin American countries, including Argentina, Brazil, Chile, Colombia, Dominican Republic, Ecuador, Guatemala, Mexico, Panama, Peru, and Uruguay, have embarked on significant reforms of their insolvency systems. Despite their efforts, however, there is a low usage of insolvency proceedings in most Latin American countries.[3] For example, México –even though it is the second largest economy in Latin America– has reported an average of around 40 insolvency proceedings per year between 2000 and 2020.[4] In other countries, the number of insolvency proceedings has been even lower. For instance, Ecuador had a total of 27 reorganization procedures in the period between 1997 to 2021[5]. Other countries such as Argentina, Brazil, Chile and Colombia show a significantly higher number of insolvency proceedings.[6] Nonetheless, considering the number of firms existing in these countries, the

[1] Aurelio Gurrea Martínez, *Objetivos y fundamentos del Derecho concursal,* in Aurelio Gurrea Martínez and Adolfo Rouillon (eds.), DERECHO DE LA INSOLVENCIA: UN ENFOQUE COMPARADO Y FUNCIONAL (Bosch, 2022) p. 29.

[2] Stijn Claessens and Leora F. Klapper, 'Bankruptcy around the world: explanation of its relative use' (2005) 7 American Law and Economics Review 253; Marco Celentani, Miguel García Posada and Fernando Gómez Pomar, 'The Spanish Business Bankruptcy Puzzle and the Crisis' (2010) FEDEA Documento de trabajo 11; Aurelio Gurrea Martínez, 'La escasa utilización de los procedimientos concursales: Causas, implicaciones y la necesidad de un cambio de paradigma en el estudio y el diseño del Derecho concursal en Iberoamérica' (2017) 1 Estudios de Derecho Empresario 49.

[3] In many Latin American countries, natural persons (particularly non-entrepreneurs) do not even have access to an insolvency proceedings.

[4] IFECON, 'Estadísticas en materia concursal' <www.ifecom.cjf.gob.mx/resources/PDF/informesEst/2.pdf>.

[5] As shown in the statement of reasons of the 2023 Insolvency Bill <https://asobanca.org.ec/wp-content/uploads/2023/07/Decreto-Ley-Reestructuracion-Empresarial.pdf>.

[6] For instance, Brazil reported 1,405 filings for reorganization (*recuperação judicial*) and 983 petitions for insolvency liquidation (*falência*) in 2023 <https://www.serasaexperian.com.br/conteudos/indicadores-economicos/>. In Argentina, between 2016-2019, only three jurisdictions (City of Buenos Aires, Buenos Aires province and Cordoba) had 5,407 reorganizations and liquidations. See Centro de Economía Política Argentina, 'Concursos preventivos y quiebras de empresas entre 2016 y 2020' <https://centrocepa.com.ar/informes/272-concursos-preventivos-y-quiebras-de-empresas-entre-2016-y-2020.html>. Colombia reported 1,420 filings for reorganization in 2023 <https://www.larepublica.co/empresas/se-presentaron-mas-solicitudes-de-

number of insolvency proceedings is still low compared to what is observed in other economies with a similar size.[7]

The low usage of insolvency proceedings is probably due to a combination of economic, cultural, and institutional factors. Among others, the "stigma" of insolvency and the reluctance of debtors and creditors to use insolvency proceedings play a key role. Yet, while the stigma of insolvency can be associated with cultural or sociological factors, it often reflects an institutional problem: an unattractive insolvency system for debtors, creditors, or both.[8] In most Latin American countries, insolvency proceedings are lengthy, costly and complex. Moreover, they do not often provide enough tools to facilitate the effective reorganization of viable businesses while avoiding the opportunistic behavior of debtors and creditors. Consequently, these problems exacerbate the fear and reluctance of creditors and debtors towards the insolvency system.

The low usage of insolvency proceedings and the existence of an unattractive insolvency system can be detrimental not only to debtors and creditors involved in a situation of financial distress but more generally for the level of entrepreneurship, innovation, and access to finance in a country. Additionally, since an insolvency system will affect the recovery rate received by creditors, including financial institutions, an inefficient insolvency system can increase the levels of non-performing loans in the banking sector and ultimately jeopardize the stability of the financial system. Hence, the design of an efficient insolvency system is essential for the competitiveness and growth of an economy.

However, insolvency proceedings are not the only tools potentially used to handle a situation of financial distress. Other alternative mechanisms may consist of "hybrid procedures" – that is, restructuring tools that combine some of the advantages of both formal reorganization proceedings (such as the existence

insolvencia-empresarial-en-2023-que-en-pandemia-3866177#:~:text=En%20Colombia%2C%20con%20corte%20a,dura%20de%20la%20historia%20reciente>. In Chile, according to the statistics of the Superintendency of Insolvency and Entrepreneurship, only 49 business reorganisation proceedings were filed in 2023. However, 1,098 insolvent liquidations were reported for businesses. Therefore, the total number of insolvency proceedings in these countries is significantly higher than those observed in other jurisdictions in Latin America.

[7] For a groundbreaker analysis of the relative use of insolvency proceedings around the world, see Stijn Claessens and Leora F Klapper, 'Bankruptcy around the World: Explanations of Its Relative Use' (2005) 7(1) American Law and Economics Review 253. It must be kept in mind, however, that such study was conducted taking into account the insolvency legislation that existed prior to the wave of reforms that took place in Latin America between the end of the 1990s and the beginning of the 21st century. Given that these reforms improved the attractiveness of insolvency proceedings, the number of insolvency proceedings increased in various jurisdictions in Latin America, as evidenced in countries like Argentina, Brazil, Chile, and Colombia.

[8] Aurelio Gurrea-Martínez, REINVENTING INSOLVENCY LAW IN EMERGING ECONOMIES (Cambridge University Press, 2024) pp. 285-290.

of a moratorium or a majority rule) and out-of-court restructurings.[9] These hybrid procedures include the extrajudicial agreements subject to court approval adopted in Argentina, Brazil, Chile, Colombia, the Dominican Republic and Uruguay, which shares some similarities with the pre-packaged reorganization ("pre-pack") popularized in the United States. Additionally, another mechanism to resolve a situation of financial distress which is relatively underused in Latin America is an out-of-court agreement ("workout"). Through these mechanisms, debtors and creditors reach an agreement without any type of judicial involvement. In fact, with a few exceptions, out-of-court workouts are not even regulated in the insolvency legislation. These are generally promoted through principles or good practices published by central banks, professional associations, or international organizations.

The use of out-of-court workouts is becoming increasingly popular internationally. Moreover, it is a trend that complements – instead of replacing – formal insolvency proceedings and presents notable benefits, especially in jurisdictions that do not have an efficient insolvency system, as is the case in most Latin American countries. First of all, an out-of-court workout can avoid the economic and reputational costs associated with the initiation of a formal insolvency proceeding. Therefore, they can help minimize the loss of value experienced by the debtor, ultimately contributing to the maximization of the returns to creditors and the reorganization of viable but financially distressed firms. Furthermore, out-of-court agreements offer a level of flexibility and confidentiality usually lacking in formal insolvency proceedings. Finally, it should be kept in mind that insolvency proceedings are particularly needed when a debtor has multiple creditors and the existence of collective action problems may make negotiations and the possibility of reaching an agreement between debtors and creditors more difficult. In those circumstances, the initiation of insolvency proceedings will be more justified given that it will generally trigger a moratorium that will stop creditors' enforcement actions and it will also replace the unanimity rule governing out-of-court agreements with a majority rule that will facilitate the approval of an agreement. Therefore, those tools, among others, will increase the chances of reorganizing viable and financially distressed firms with many creditors. Similarly, the usage of the insolvency system may be needed for other purposes, such as the removal of dishonest or incompetent directors, the review of harmful transactions entered into by the debtor in the zone of insolvency, or obtaining new financing.

[9] For a comprehensive analysis of hybrid procedures and other alternative mechanisms for debt restructuring, see Adolfo Rouillon, *Mecanismos alternativos de reorganización de empresas: acuerdos extrajudiciales y procedimientos híbridos*, en Aurelio Gurrea Martínez and Adolfo Rouillon (eds.), DERECHO DE LA INSOLVENCIA: UN ENFOQUE COMPARADO Y FUNCIONAL (Bosch, 2022) pp. 225-269.

However, most Latin American companies are micro, small and medium-sized enterprises that, by definition, have a few creditors. In fact, even the largest Latin American companies often have concentrated debt structures comprising various major lenders. Therefore, the coordination problems that exist in companies with dispersed debt structures found in the context of listed companies in countries such as the United States do not exist in the case of most Latin American companies. Thus, the initiation of an insolvency proceeding might not often be needed. In those circumstances, negotiating and reaching an out-of-court agreement can be more easily achieved provided that there is a climate of cooperation and trust between debtors and creditors, and the company to be reorganized has an underlying viable business and therefore it is worth more alive than dead.[10] In such a case, an out-of-court restructuring will provide a more desirable outcome for both debtors and creditors.[11]

To facilitate a climate of trust that can favor workouts and ultimately save the costs associated with the initiation of an insolvency proceeding that might not often be needed, the Ibero-American Institute for Law and Finance decided to create a working group with the purpose of publishing this document.[12] In addition to explaining the reasons that often justify an out-of-court restructuring (especially in the context of Latin American companies), this document develops a series of principles that we have named "*Latin American Principles for Out-of-Court Workouts*".

These principles have been developed upon the analysis of the main practices and documents on out-of-court workouts existing internationally, including (i) the Principles for Out-of-Court Restructuring promoted by the Bank of England ("London Approach");[13] (ii) the INSOL Principles for a Global Approach to Multi-Creditor Workouts;[14] (iii) the Guide on Conducting an Out-of-Court Workout in Asia published by

[10] For the concept of viable firm, see Michelle, J. White, 'Corporate Bankruptcy as a Filtering Device: Chapter 11 Reorganization and Out-of-Court Debt Restructuring' 10(2) Journal of Law, Economics, and Organization 169 (1994); John Armour, 'The Law and Economics of Corporate Insolvency', ESRC Centre for Business Research University of Cambridge, Working Paper 197 (2001) p. 4.

[11] Certainly, the regulatory environment is another essential condition for the success of an out-of-court workout. For example, in some jurisdictions, directors of insolvent companies have a duty to file for bankruptcy or they may be held personally liable for new debts incurred by the company if it keeps trading while it is insolvent. Such rules may discourage out-of-court workouts. Likewise, there are certain tax, labor, corporate and administrative laws, among others, that may prevent or, at least, do not facilitate an out-of-court workout. Therefore, countries seeking to actively promote workouts should conduct a holistic review of their legal and institutional environment and remove any regulatory obstacles that may discourage workouts. For an analysis of the measures that could be adopted to create an enabling environment for workouts, see Adolfo Rouillon, *Mecanismos alternativos de reorganización de empresas: acuerdos extrajudiciales y procedimientos híbridos,* in Aurelio Gurrea Martínez y Adolfo Rouillon (eds.), DERECHO DE LA INSOLVENCIA: UN ENFOQUE COMPARADO Y FUNCIONAL (Bosch, 2022) pp. 260-269.

[12] Although some of the principles proposed in this document may apply to all types of debtors, the primary focus of the principles are businesses and particularly corporations.

[13] Bank of England, 'The London Approach' (1993) Quarterly Bulletin pp. 110-115 <https://www.bankofengland.co.uk/-/media/boe/files/quarterly-bulletin/1993/the-london-approach.pdf>.

[14] INSOL International, 'Statement of Principles for a Global Approach to Multi-Creditor Workouts II' (INSOL International, 2017).

the Asian Business Law Institute and the International Insolvency Institute; [15] (iv) the World Bank's Toolkit for Corporate Workouts;[16] (v) the Thematic Review on Out-of-Court Corporate Debt Workouts published by the Financial Stability Board;[17] and (vi) the Principles and Guidelines for Restructuring of Corporate Debt published by the Association of Banks in Singapore.[18] After an analysis of these principles, we have selected those practices that, in our view, can work best in the Latin American context, and we have included or expanded certain principles that we believe are essential for a successful out-of-court restructuring.

[15] International Insolvency Institute and Asian Business Law Institute, 'Guide on Conducting an Out-of-Court Workout in Asia' (2022) <https://abli.asia/abli-publications/guide-on-conducting-an-out-of-court-workout-in-asia/>.

[16] World Bank Group, A Toolkit for Corporate Workouts' (2022) <https://openknowledge.worldbank.org/bitstream/handle/10986/36838/A-Toolkit-for-Corporate-Workouts.pdf?sequence=1&isAllowed=y>.

[17] Financial Stability Board, 'Thematic Review on Out-of-Court Corporate Debt Workouts' (2022) <https://www.fsb.org/2022/05/thematic-review on-out-of-court-corporate-debt-workouts/#:~:text=FSB%20jurisdictions%20have%20adopted%20a,in%20response%20to%20COVID%2D19._>.

[18] The Association of Banks in Singapore, 'Principles & Guidelines for Restructuring of Corporate Debt' <https://abs.org.sg/docs/library/principles-amp-guidelines-for-restructuring-of-corporate-debtf1eea89f299c69658b7dff00006ed795.pdf>.

LATIN AMERICAN PRINCIPLES FOR OUT-OF-COURT WORKOUTS

A) Initiation and suitability of out-of-court workouts

Principle 1. Suitability of the out-of-court workout. When a company is facing or foreseeing financial difficulties, it is recommended to examine the suitability of conducting an out-of-court workout with all or some of its creditors before commencing a formal insolvency proceeding.

Principle 2. Debtor's economic and financial viability. An out-of-court workout should only be considered if the company facing financial difficulties is economically viable and generates, or expects to generate, sufficient cash flows to meet the financial obligations established in the agreement reached with its creditors.

B) Debtors' and creditors' duties during the negotiation

Principle 3. Good faith and confidentiality. Negotiations between the debtor and its creditors must be conducted in good faith to reach a viable and constructive solution. The parties must preserve the confidentiality of both the information provided during the negotiation and the agreements and proposals related to the out-of-court restructuring.

Principle 4. Debtor's duties. The debtor shall provide creditors and their advisors with all relevant information necessary for making an informed decision during the negotiation process eventually leading to an out-of-court restructuring. During the negotiation period, the debtor shall undertake, among other commitments: (i) not to initiate insolvency proceedings; (ii) not to engage in acts that fall beyond the debtor's ordinary course of business; and (iii) not to alter the economic or legal status that the creditors had at the beginning of the negotiation.

Principle 5. Creditors' duties. The creditors participating in the agreement shall cooperate with the debtor, as well as among themselves, to achieve a successful out-of-court workout. It is recommended that, from the beginning of the negotiation, the creditors enter into a standstill agreement that would prevent them from initiating legal actions, including insolvency petitions, against the debtor for a specified period sufficient for the negotiation and approval of an out-of-court workout. It is also recommended that the agreement includes clauses that could trigger the early termination of the standstill agreement, as well as the option to extend its duration with the consent of the parties.

C) Committee of creditors and involvement of experts

Principle 6. Creation of creditors' committees and appointment of 'lead' creditor. In an out-of-court workout involving multiple creditors, it is recommended to create a committee of creditors that may, if appropriate, be represented by a 'lead' creditor, with the purpose of facilitating negotiations and the exchange of information between the debtor and its creditors.

Principle 7. Involvement of legal and financial advisors. It is recommended that the debtor and the creditors be assisted by legal and financial advisors with a recognized reputation and track record as well as a high level of expertise in the fields of restructuring, corporate finance, accounting, corporate governance, and insolvency law.

Principle 8. Involvement of mediators and arbitrators. It is recommended to appoint independent mediators when a lack of trust or potential miscommunications between the parties may hinder reaching an agreement that could be beneficial for the debtor and its creditors. It is also recommended to include the possibility of submitting to arbitration any disputes arising between the parties during the negotiation of the out-of-court workout.

Principle 9. Remuneration of professionals. At the beginning of the negotiations, it is recommended to establish the terms of the remuneration for the professionals involved in the restructuring and budget any other expenses that may arise until the out-of-court workout is reached. It is also recommended to agree on the allocation of fees for other professionals, including mediators and other independent experts, as well as other costs resulting from professional services provided to debtors and creditors. Unless otherwise agreed by the parties, it is recommended that the expenses incurred from the involvement of mediators and independent experts acting in the collective interest of the debtor and its creditors, as well as the fees received by any potential advisors to the creditors' committee (if one exists), be borne by the debtor. Furthermore, it is recommended that the expenses associated with the legal and financial advice provided individually to the debtor or to each of the creditors be borne by the party that requests those professional services.

D) Debtor's management and financing

Principle 10. Administration and representation of the debtor. It is recommended that, during the negotiation of the out-of-court workout, the debtor company continue to be managed by its officers and directors. However, the appointment of an independent expert to monitor the debtor during the negotiation process is advised in cases where there is a lack of trust between the creditors and the debtor's management team or, if applicable, its controlling shareholders.

Principle 11. Financing the debtor and the treatment of new financing. It is recommended that any new financing obtained by the debtor during the negotiation process of the out-of-court workout receive preferential treatment in the ranking of claims. This outcome can be achieved by, for example, providing lenders with a security interest over the debtor's unencumbered assets (if any) or through an agreement among the creditors involved in the workout establishing that their claims would be junior to the new financing obtained by the debtor during the negotiation period.