Wednesday, October 21
11:00 am–12:30 pm

411 Honoring Financial Obligations in Latin America Under the Current Economic Crisis

Juan Carlos-Luna
General Counsel Latin America & Carribean
Hewlett-Packard Co.

Luis Gabriel Perez
Partner
Brigard & Urrutia Abogados

Guilherme Tepedino Hernandez
Partner
Castro, Barros, Sobral, Gomes Advogados

Francisco Velazquez
Former Chair, ANADE
Partner of Goodrich, Riquelme y Asociados

Copyright © 2009 Association of Corporate Counsel (ACC) and contributing authors.
Reproduction permission requests should be directed to legalresources@acc.com or +1 202.293.4103, ext. 342.

The information in this ACC Annual Meeting material should not be construed as legal advice or legal opinion on specific facts and should not be considered representative of the views of its authors, its sponsors, and/or the ACC. This ACC Annual Meeting material is not intended as a definitive statement on the subject addressed. Rather, it is intended to serve as a tool providing practical advice and references.

Faculty Biographies

Juan Carlos-Luna
General Counsel Latin America & Carribean
Hewlett-Packard Co.

Luis Gabriel Perez
Partner
Brigard & Urrutia Abogados

Guilherme Tepedino Hernandez

Guilherme Tepedino Hernandez is a partner of Castro, Barros, Sobral, Gomes Advogados (CBSG), one of the largest law firms in Brazil. He is specialized in corporate law, mergers and acquisitions, project finance and foreign investment. He also represents clients in negotiating and drafting commercial contracts. Mr. Hernandez has represented the CBSG office in Washington, D.C.

Mr. Hernandez is a member of the Brazilian Bar Association, Rio de Janeiro Section, of the International Bar Association (IBA), and also of the Corporate Subcommittee of the Center for Legal Studies (CESA).

Mr. Hernandez received his JD from Rio de Janeiro Catholic University Law School. In addition, he has completed a postgraduate course on corporate law and gained IAG Master certification from the Rio de Janeiro Catholic University Law School. Mr. Hernandez completed the program of instruction for lawyers at Harvard University, and he attended the frontiers in infrastructure finance program at the World Bank Institute.

Francisco Velazquez

Francisco Velazquez-Osuna is a senior partner of the Mexican full-service law firm Goodrich, Riquelme y Asociados. He has extensive experience in the international corporate and business transactions and international trade areas, advising clients including large and medium-sized multinational companies.

Mr. Velazquez-Osuna has been lecturer in the U.S., Canada, and Mexico on doing business in Mexico, strategic alliances, foreign investment, competition law, product liability, cross border legal issues, and NAFTA issues and has written several articles on such areas. He taught on legal aspects of NAFTA at the Universidad Iberoamericana in Mexico City and family and estates, obligations civil procedure, economic law, and consular law at the Universidad Nacional Autonoma de Mexico, Acatlan Campus.

He is a past national chairman of the National Association of Corporate Attorneys in Mexico in Spanish (ANADE) and a past coordinator of the NAFTA dispute-settlement committee of the Mexican Business Coordinating Council during NAFTA negotiations.

Copyright © 2009 Association of Corporate Counsel

He is currently chair of the ANADE's international law committee. Mr. Velazquez-Osuna is a board member of ANADE, and is a member of the Mexican Importers and Exporters Association, the Mexican Bar Association, the Mexican law committee of the American Chamber of Commerce of Mexico, and of the ABA.

He graduated from the Universidad Nacional Autonoma de Mexico and received a Master of Laws degree from the American University in Washington, DC.

Copyright © 2009 Association of Corporate Counsel

ACC ANNUAL MEETING

BOSTON OCTOBER 18-21, 2009

PROGRAM 411

HONORING FINANCIAL OBLIGATIONS IN LATINAMERICA UNDER THE CURRENT ECONOMIC CRISIS

PROGRAM MATERIALS SUBMITTED BY

FRANCISCO VELAZQUEZ

1. “LENDING TO MEXICANS” Eugenia Gonzalez and Francisco Velazquez, Goodrich Riquelme y Asociados
2. Will the Bubble Burst?
   Some Subprime Lessons for Mexico, Latin America´s Leader en Asset Securitization, Richard C. Jordan, The International Lawyer, Fall 2008, VOL. 42 No. 3
3. News reports on CEMEX from several websites
4. News reports on “Vitro Sada Family May fight for Control after default” and “Mexico Corporate Debt Default to Surge, JP Morgan says”, from several websites.
5. Excerpts from the Mexican Commercial Insolvency Law. Prepared by Francisco Velazquez, Goodrich Riquelme y Asociados

Copyright © 2009 Association of Corporate Counsel

GOODRICH RIQUELME Y ASOCIADOS

LENDING TO MEXICANS

FRANCISCO VELÁZQUEZ

1. THE MOST IMPORTANT CHALLENGE FACED BY US LENDERS IN MEXICO

Unless one is dealing with a publicly-held company, determining the creditworthiness of the borrower can be difficult. Information on privately-owned companies is not readily available, and the lender should begin a thorough fact-finding process well in advance of the desired closing date. The time required to complete a transaction in Mexico can also be longer than what foreign lenders normally expect; this is occasionally a source of
frustration.

The importance of a thorough legal and financial due diligence cannot be overstated, therefore, the first step should be to locate reliable local resources: Mexican counsel and a reputable accounting firm, as well as financial advisors, if required. These specialists will guide the lender through the due diligence and negotiation process. They can also point out any risks or difficulties posed by a specific borrower, as well as market conditions.

In some instances, governmental agencies may need to be involved. This is to be expected when the recipient of the loan benefits from guarantees provided by the Mexican government for certain sectors, such as the construction of homes or agriculture. In these cases, it will be necessary to obtain the consent of the corresponding agency prior to execution of all or some of the transaction documents. If the deal has been properly structured, the consent will usually be granted; the parties should, however, be prepared to wait the necessary time for the authority to complete the review process. The lender may be required to provide information in connection with the authorization that has been requested. My recommendation is to join the borrower in all meetings with the government officers who will be responsible for granting the authorization. Mexican counsel to the lender should attend any such meetings, along with the representatives of the borrower.

It is important to inquire about any regulations that may be applicable to the borrower, or to Mexican guarantors. Certain types of companies, particularly within the financial sector, are prohibited from guaranteeing obligations of third parties (including their parent companies). We have come across cases where these limitations made it necessary tochange the structure originally contemplated by the parties, with the corresponding inefficiencies in cost and time. In order to avoid this scenario, the regulatory analysis should be done as early as possible.

In the case of publicly-held companies, information will be available and can be obtained through customary channels, such as the company's website and the stock exchange. This type of borrower will be familiar with the due diligence process, and will have information readily available for review by the lender and its advisors. It is also possible that these companies may have obtained a public or private rating by a recognized rating agency, which will constitute an independent opinion regarding the creditworthiness of the borrower.

Copyright © 2009 Association of Corporate Counsel

2. PERFORMING A CREDIT CHECK REGARDING A MEXICAN BORROWER

There is no source for financial data of Mexican private companies, and the process of finding the relevant information is more complex than in other countries. Nevertheless, a thorough legal and financial due diligence will bring forth the relevant information.

The most important sources are the Public Registries of Property and Commerce. The Property Registry keeps files of all properties within a city or municipality, indicating current ownership, liens or attachments and the chain of title. The Registry of Commerce keeps records of all companies which have their domicile within a city or municipality, indicating the date of incorporation, changes to the company's bylaws, liens on corporate assets which are subject to registration, and the appointment of directors or legal representatives.

Mergers, spin-offs and dissolutions are also reflected in these files. Some important transactions, such as share transfers and certain types of liens, are not subject to registration. The review of registry information is therefore an essential part of the due diligence process, but it will not provide a complete picture: a lot of the information must be requested directly from the borrower.

One disadvantage is that these are local registries; without knowing the location of a property, or the domicile of a company, it is not possible to locate the corresponding file. It is necessary to physically visit the office of the registry in order to file a request, and to pick up the documents containing the information requested. Information is not provided free of cost, although the fees are not substantial. Currently, a system is being developed which will eventually make it possible to obtain registry data by electronic means, anywhere in Mexico.

Mexican banks rely on credit information companies to provide a credit history of potential clients. Unfortunately, these companies are only permitted to disclose information to the users authorized in the applicable law: Mexican financial institutions, companies which sell on credit, and individuals who request a copy of their own credit reports. In absence of other sources, lenders need to rely on the financial information provided by the borrower and, frequently, on the services of private agencies that carry out independent research.

The situation is different with publicly-held companies. Their relevant financial information can be reviewed via internet at the company's web site, and the site of the Mexican Stock Exchange. Bloomberg is another possible resource of data regarding large companies. Shares of the largest Mexican corporations are publicly traded in foreign stock exchanges, such as the NYSE, and therefore, these corporations are bound to comply with the applicable disclosure requirements.

3. ASSUMPTIONS OF AMERICAN BUSINESS LAWYERS THAT ARE INAPPLICABLE IN MEXICO

The belief that "the more familiar laws are always better," is widespread. Frequently, contracts are subject to the laws of the lender's domicile, under the assumption that this is the best way to protect the interests of the client. This is true when the borrower has an important connection to the US, or where no other option would be

Copyright © 2009 Association of Corporate Counsel

practical, given the number and nationality of the parties; however, it is not the best option in every case.

With this assumption, come two more: first, that submission to US courts or to arbitration is always best, and second, that it is most convenient to create security interests in accordance with US law. Neither of these statements are universally true: the choice of law and forum (or submission to arbitration), is a decision which must be made taking into account many factors, specific to each case.

I am partial to choosing the law of the place where we will seek to enforce our client's rights, whenever possible. Mexican courts have the authority to apply foreign law, but the process can be long and complex, particularly in light of the differences between our civil legal tradition and the common law system. Ultimately, the issue is how to obtain a fair judicial or arbitral decision that will be easier to enforce against the borrower, at the place where the majority of its assets are located. If the assets of the borrower are located in Mexico, it is appropriate to create a contract governed by Mexican law, and subject to the jurisdiction of Mexican courts or to arbitration. This will result in a less complex enforcement process. Choosing the courts of a country where neither one of the parties has its domicile is not advisable, as the resulting judicial decision will not be enforceable in Mexico.

Mexican courts do not enforce foreign judgments or arbitral awards regarding *in rem* rights, such as pledges or mortgages. A U.C.C. filing made in the US will have no impact on assets located south of the border. Because of this limitation, contracts creating a security interest on assets located permanently in Mexico must be governed by Mexican law, even if the loan agreement is subject to the laws of New York. This also true for security interests on vessels and aircraft.

Another common belief is that the creation of a valid and enforceable security interest in accordance with Mexican law will help to avoid the hassles of litigation. Mexican law does not acknowledge "self-help repossession", and therefore, unless the borrower willingly transfers possession and title of the collateral, it will be necessary to resort to the competent courts in order to enforce the rights of the lender.

Finally, it is important to note that shareholders and members of the board of Mexican companies do not necessarily have authority to individually execute loan agreements, promissory notes or contracts creating liens on corporate assets. Such authority must be granted in the form of powers of attorney, or in the company's bylaws. A thorough review of the corporate charter, as well as the deeds containing the relevant powers, is essential to ensure the validity of all transaction documents. No officer's certificate can eliminate the need for this review.

4. MAIN TAX CONSIDERATIONS FOR US LENDERS

When interest is paid by a Mexican tax resident or by a non-resident with a permanent establishment in Mexico, such interest is considered to be Mexican-source income for the lender. The tax rates applicable to this income are determined by the Income Tax Law and the treaties to which Mexico is a party. The following rates will usually apply:

Copyright © 2009 Association of Corporate Counsel

(a) A 4.9% rate will be applied on interest paid to foreign banks which are tax residents in a country that has a treaty with Mexico, including the US.

(b) A rate of 10% is applied to interest payments made to banks which are tax residents in countries which have not entered into a tax treaty with Mexico, upon compliance with specific requirements before the Mexican tax authorities.

(c) 21% withholding tax is applied to interest payments made by Mexican credit institutions to lenders different from those contemplated in (a) and (b) above, or when credit is granted by a foreign supplier for the purchase of equipment or machinery.

(d) The general rate of 28% withholding tax is applied in all other cases.

Specific rates will be applicable in the case of reinsurance companies, financial entities in whose capital the Mexican government has an interest, instruments traded in the stock exchange and transactions indexed to the Mexican Interbank Equilibrium Rate.

Interest paid in connection with the following loans is exempted from this tax: loans made to the Mexican government, loans granted for terms exceeding three years which are guaranteed by foreign financial institutions and dedicated to the promotion of exports (when the guarantor is an institution registered with the Ministry of Finance), and loans to entities authorized to receive deductible donations.

Usually, the rates contemplated in the tax treaties are lower than those set forth in the Law: the general rate as per the Income Tax Law is 28%, while the rate set forth in tax treaties is generally 15%. There are even cases where treaties provide that interest is not subject to withholding, given the specific characteristics of the lender. It should be borne in mind, however, that in the case of non-US banks which are residents in a country that has entered into a tax treaty with Mexico, the rate of 4.9% stated in the Law is the most favourable. Please note that this rate is contemplated in a transitory article of the Law, and is subject to yearly review. In the case of US lenders, this annual review is not relevant, given that the rate of 4.9% is set forth in the tax treaty with Mexico. This is the only treaty that provides for application of this withholding rate.

It is common for loan agreements to provide that the borrower shall bear all taxes imposed by the borrower’s home country, and pay to the lender the total principal and interest agreed, free of any withholding. Nevertheless, Mexican law provides that the lender will be jointly liable with the borrower for taxes that are not properly withheld and paid. The lender must ensure that the appropriate rate has been applied, and that the payment of the corresponding tax has been made. It is therefore advisable to request from the borrower copies of the documents which prove the proper withholding and payment of taxes on interest.

5. MITIGATION TOOLS THAT ARE ESPECIALLY USEFUL IN MEXICO

One option is credit insurance. It is also possible to obtain guarantees from US entities such as Eximbank and OPIC (to name only two examples). Independently

Copyright © 2009 Association of Corporate Counsel

from these forms of protection, it is customary to request from the borrower one or more of the following:

(a) *Pagaré*
A promissory note drafted in accordance with Mexican law, called a "*pagaré*" gives the holder access to a simplified collection proceeding. This judicial process is faster than an ordinary collection trial, and allows for the preventive attachment of assets of the borrower, which are immobilized until the court issues a decision regarding payment of the amount owed under the note. The legal costs for issuance of a promissory note are minimal. Our recommendation is that all loans be documented in a promissory note, even if additional securities are obtained.

(b) *Aval*: guaranty of payment of a promissory note
Payment of sums due under a promissory note may be guaranteed by including the signature of the guarantor on the note itself. The guarantor will then be responsible for payment of the note on the same terms as the maker.

(c) Guarantee
A guaranty may be included in the loan agreement or formalized in a separate contract. As a general rule, the guarantor will only have an obligation to pay the guaranteed amount after said amount has been claimed unsuccessfully from the borrower. It is advisable that the guarantor expressly waive the rights known as "*beneficios de orden y excusión*", which will eliminate the requirement of proceeding against the borrower.

It is possible to provide that a third party will be jointly liable for obligations of the borrower, rather than a mere guarantor. By signing a contract which expressly contemplates this type of liability, the joint obligor becomes bound in the same terms as the borrower.

(d) Pledge
Creation of a pledge requires different formalities, depending on whether the lien is created on tangible or intangible assets, and whether possession of the pledged goods is delivered to the lender. In the case of a pledge with transfer of possession to the lender, any of the following formalities should be observed for the perfection of the pledge:

(i) delivery to the lender of the goods or negotiable instruments being pledged;

(ii) endorsement of the negotiable instruments being pledged, in favour of the Lender

(iii) delivery to the lender of the non-negotiable instruments pledged and recording of the lien in any applicable registries;

(iv) deposit of the goods or bearer instruments at disposal of the lender in a place to which the lender has the keys;

(v) deposit of the goods or bearer instruments with a person appointed by the lender and the borrower. In light of the rather formalistic regulation of pledges

with transfer of possession, it is advisable to consult with local counsel in order to confirm compliance with all applicable requirements.

Pledges may also be created without transfer of possession to the lender. These “pledges without transfer of possession” are ideal in the case of liens on accounts receivable, or on assets which are used by the borrower in the ordinary course of its business. Under this form, it is also possible to create a lien on the total assets of the borrower.

(e) Mortgage
In Mexico, the term “mortgage” is used in cases where a lien is created on real estate, aircraft or vessels. In all other cases, the term “pledge” is employed. The mortgage extends to any new buildings constructed on the property after creation of the lien, and to any improvements to mortgaged buildings. Mortgages are formalized before a notary public, and must be registered at the Public Registry of Property of the place where the mortgaged property is located.

Prior to creation of a mortgage, it is important to check the deed of ownership, as well and the file of the property kept at the local Public Registry in order to ensure that there are no prior liens.

(f) Trusts
Assets may be transferred unto a Mexican trust for the duration of the secured obligation. In Mexico, only banks and other financial entities may act as trustees, and they charge fees both for the creation of the trust and for its management. Trust agreements require careful drafting, and the cost and time involved can be substantial.

Independently of the type of security created, it is always advisable to take the following precautions, in order to ensure the validity and enforceability of all documents:

- Companies may only act as guarantors, or encumber corporate assets to secure obligations of third parties, when their bylaws expressly permit them to do so. Review the bylaws of the borrower and all Mexican guarantors, in order to ensure that creation of the guarantee or security interest are permitted;

- Request copies of the file kept at the Public Registry of Commerce for the borrower and for any Mexican guarantors. The copies should not be more than 30 days old at the time of closing;

- Ensure that the person signing documents on behalf of a company has sufficient authority to do so, in accordance with Mexican law; and

- Keep in mind that only original documents are valid for purposes of enforcement in Mexico. All deeds or instruments formalizing the securities mentioned above should be safeguarded carefully.

6. PRIORITY OF CREDITORS

According to the Constitution and the Federal Labour Law, employees (including managerial employees) have priority over all secured and unsecured creditors of a

Copyright © 2009 Association of Corporate Counsel

company, for the collection of salaries and severance payments accrued within the last two years. This priority is a matter of public policy, and therefore, the parties to a loan agreement have no power to contract against it. Tax authorities have priority over other creditors, except for employees, and except for those creditors who have a prior mortgage or pledge created in accordance with Mexican law.

Among creditors whose rights have been secured by a mortgage, priority will depend on compliance with one specific formality: registration before the Public Registry of Property.

Priority will be given to the party whose mortgage was first filed for registration before the Public Registry, disregarding the date of creation of each mortgage. We recommend that, as soon as the parties agree on the terms of the mortgage, a notary public be instructed to notify the registry of their agreement; the registry will then reject any requests for registration of liens by other parties, for a term of 30 days.

These rules regarding priority show the importance of complying with all formalities for the creation of a valid security interest. Mortgages must be formalized before a notary public and registered; the same requirement applies to pledges when the borrower is allowed to keep possession of the pledged goods. Notarization and registration not only ensure the enforceability of the lien, but are also essential to establish priority with regard to other creditors, including tax authorities.

Banks and other lenders have the possibility of creating a lien on the total assets of a company, in the form of a “pledge without transfer of possession”. Before accepting one or more assets as collateral, it is essential to review the borrower’s file at the Public Registry of Commerce, in order to ensure that no such pledge exists.

As an effective way to protect the rights of the lender, it is possible to transfer assets of the borrower to a Mexican trust, or *fideicomiso*. Once this transfer is effected, the assets will be deemed to be owned by the trust, and not by the borrower. They will then be excluded from possible claims by all creditors of the borrower, including its employees. Another advantage of the trust is its flexibility: it allows for the creation of rather complex structures, including constant substitutions of the assets placed in trust, and the distribution of sums of cash to one of the parties, or to both of them, on a periodic basis. This is particularly useful in cases where the *corpus* of the trust are accounts receivable, and the borrower requires access to proceeds from these accounts in order to carry on with its business.

If a sale on credit is made to a Mexican company, neither the seller nor the party who financed the purchase will have any lien or priority with regard to the merchandise that has been sold. If the goods are easy to locate and identify, it is possible to effect a sale with reservation of title, which will protect the goods from any potential claims by other creditors of the purchaser. The reservation of title must be formalized in accordance with Mexican law, in order to be registered and thus enforceable against third parties.

Copyright © 2009 Association of Corporate Counsel

7. THE MOST IMPORTANT ADVICE FROM A MEXICAN LAWYER TO US LENDERS

The success of the transaction, and its timing, will depend to a large extent on local counsel. My most important advice is to choose your Mexican firm carefully. Your expectations of Mexican counsel, regarding the quality of the service provided, should be the same as those that would be applicable to US firms.

It is often assumed that Mexican counsel needs to be located in a specific area of the country. Most of the laws applicable to an international financing transaction are federal statutes, and the work can be done from one of the larger urban areas, where it is easier to find firms with experience on the subject.

Whenever possible, plan ahead of time and give local counsel notice of the transaction as early as possible process. This may make it possible to begin the work of requesting information from public registries (with minimal cost) and reviewing corporate documents of the borrower, saving time later in the process. One of our clients consistently closes transactions during the Easter holiday, when public registries and notaries are closed. By giving us a few weeks advance notice of the possible closings, this client allows us to get the information we need well before these critical days.

Provide local counsel with as much information as possible regarding the loan and any related operations, even if the Mexican firm will not be involved in every aspect of the deal. Understanding the transaction in its entirety avoids inefficiencies, and ensures that no important issues will be overlooked. Rest assured that Mexican lawyers are bound by strict confidentiality obligations.

Be prepared for things to take longer than they might in the US: exercise a high degree of patience. Mexican business lawyers will go to the same lengths as their American colleagues to get a deal closed on time, but the formalities involved in most transactions can cause delays, no matter how hard everyone tries to get things done on time.

It is the cultural and technical differences that make international work fun and rewarding: they also constitute the largest challenge in every transaction, by forcing us to leave aside our assumptions, and to understand systems that may differ radically from our own.

Copyright © 2009 Association of Corporate Counsel

1302CD

1 of 1 DOCUMENT

Copyright © 2008 American Bar Association
The International Lawyer

Fall, 2008

42 Int'l Law. 1181

LENGTH: 9333 words

SECTION: COMMENT.

TITLE: Will the Bubble Burst? Some Subprime Lessons for Mexico, Latin America's Leader in Asset Securitization

AUTHOR: RICHARD C. JORDAN *

* Rick Jordan received his J.D. from Southern Methodist University Dedman School of Law in May 2008. He is an associate in the corporate/securities section of Gardere Wynne Sewell, LLP.

TEXT:

I. Introduction

Structured finance innovation has changed the way ordinary people finance their homes. This shift is especially true in Latin America, where growing housing demands forced many countries to rethink their role in mortgage markets. In recent years, Mexico has emerged as Latin America's leader in asset securitization, and currently boasts the largest mortgage backed securities market in the region.

The importance of securitization is its ability to transform illiquid or risky mortgages into marketable securities. Rather than issue debt or equity to raise capital, lenders can bundle pools of individual mortgages into securities and sell them to investors who enjoy fixed-rate returns. All market participants benefit from this process because it makes markets more efficient and allows lenders to increase credit to borrowers. Complex financial structures like securitization are especially important for emerging economies because studies show that countries with underdeveloped and ineffective financial markets have higher rates of poverty. n1 The chief benefit of mortgage securitization to Latin America is that it provides a means through which lenders can grant greater access to credit for lower-income borrowers.

n1 Edward C. Skelton, *Laying the Foundation for a Mortgage Industry in Mexico,* 1 ECON. LETTER-INSIGHTS FROM THE FEDERAL RESERVE BANK OF DALLAS 10 (2006), *available at* http://www.dallasfed.org/research/eclett/2006/el0610.html [hereinafter Dallas Federal Reserve Mexico Article Two].

As the United States faces economic recession due to the fallout from the subprime mortgage market, Mexico seems resilient, due in small part to U.S. investors seeking refuge in the country's emerging mortgage market. Mexico remains the focus of this comment because its growing mortgage-backed securities market is beginning to attract U.S. capital and because its efforts are at the forefront of securitization developments in Latin America. The question this comment explores is whether the U.S. subprime mess can help Mexico avoid a housing market bubble burst.

Accordingly, Part II of this comment provides an overview of securitization, its advantages and legal framework, as well as its development in the United States. Part III discusses the origin of the U.S. subprime crisis and its effect on the market. Part IV provides a brief overview of Mexico's 1994 Peso Crisis, its subsequent regulatory and legal reforms in light of increased housing demands, and ends with a look at Mexico's current secondary mortgage market. Part V provides some thoughts on what Mexico may learn from the U.S. subprime debacle.

II. Overview of Securitization

A. DEFINITION OF SECURITIZATION

Securitization, or structured financing, occurs when an entity (the Originator) converts certain non-marketable assets or cash flows into a larger marketable security for resale. n2 In the typical situation, individual assets with similar characteristics, like mortgages or auto loans, are aggregated and pooled such that investors can purchase the securities that back those assets. n3 By packaging the illiquid individual assets, the Originator creates a liquid asset that the Originator can sell and a buyer can resell on a secondary market. n4 The process generally improves the Originator's balance sheet by replacing risky assets with cash. Purchasers of these pooled securities are mostly institutions, such as hedge funds, insurance companies, pension funds, and mutual funds. n5

n2 BLACK'S LAW DICTIONARY 1384 (8th ed. 2004); Michela Scatigna, *Securitisation in Latin America,* BIS. Q. REV., September 2007, at 2, *available at* http://www.bis.org/publ/qtrpdf/r_qt0709h.pdf?noframes=1.

n3 SECURITIZATION, ASSET BACKED AND MORTGAGE BACKED SECURITIES 1-7 (Ronald S. Borod ed., Butterworth Legal Publishers 3d ed. 1991) [hereinafter BOROD].

n4 *Id.*

n5 Claire A. Hill, *Securitization: A Low-Cost Sweetener for Lemons, 74 WASH U. L.Q. 1061, 1067-68 (1996).*

B. THE SECURITIZATION OF CERTAIN ASSETS

Originators can securitize almost any asset as long as it has a predictable cash flow. n6 An example of a predictable cash flow is a borrower's monthly mortgage payments. Residential mortgages, equipment leases, auto loans, trade receivables, credit card receivables, and student loans, are all assets capable of being securitized and subsequently traded on a secondary market. n7

Even a rock star can securitize his or her royalty payments. n8 Securitized mortgages are commonly referred to as mortgage-backed securities (MBS), although different forms of structured financing are prevalent.

n6 Erica W. Stump, *Securitizations in Latin America, 8 U. MIAMI BUS. L. REV. 195, 198 (2000).*

n7 *Id.*

n8 SECURITIES INDUSTRY AND FINANCIAL MARKETS ASSOCIATION, TYPES OF ASSETS THAT BACK SECURITIES (2008), http://www.investinginbonds.com/learnmore.asp?catid=11&subcatid=57&id=12.

C. THE ADVANTAGES OF SECURITIZATION

The underlying theory behind securitization is that companies can use certain assets to raise funds in capital markets at a lower cost than if the company, with the risks associated with the assets, had raised the funds through traditional methods, like equity or debt issuance. n9 The company benefits from lower capital formation costs while investors in the securitized assets benefit by holding investments with lower risk and higher yield. n10 Securitization also helps "complete" financial markets by creating liquid assets from illiquid assets, like turning individual mortgages into securities, and by improving the credit quality of the structured asset. n11 This latter point is important because a securitized asset essentially bridges the credit quality gap between borrowers and lenders--i.e., lenders are less interested in individual assets and more interested in pools of assets that they can bundle and sell. n12 Lenders therefore are encouraged to market similar products so that they can package them for securitization, and will lower interest rates to entice people to borrow.

n9 Steven L. Schwarcz, STRUCTURED FINANCE: A GUIDE TO THE PRINCIPLES OF ASSET SECURITIZATION 1-8 (Adam Ford ed., 3d ed. 2002).

n10 *Id.;* BOROD, *supra* note 3.

n11 Scatigna, *supra* note 2, at 12.

n12 *Id.*

D. EVOLUTION OF THE MORTGAGE BACKED SECURITIES MARKET

Congress created three entities to address deficiencies in the U.S. housing market: Gin-nie Mae, Freddie Mac, and Fannie Mac. Freddie Mac and Fannie Mae are government-sponsored enterprises (GSEs). All three entities, discussed in turn, "facilitate a secondary market for residential mortgage loans and . . . enhance liquidity in such loans." n13 They do this by enabling Originators to package and sell their mortgages and use the proceeds from those sales to make more loans. n14

n13 SEC, Task Force on Mortgage-Backed Securities Disclosure, Staff Report: Enhancing Disclosure in the Mortgage-Backed Securities Markets 6 (2003), *available at http://www.sec.gov/news/studies/mortgagebacked.htm* [hereinafter SEC Staff Report].

n14 *Id.*

Copyright © 2009 Association of Corporate Counsel

The first structured financing occurred in the early 1970s when the Government National Mortgage Association (Ginnie Mae) first guaranteed a pool of pass-through mortgage securities--the most common form of MBS today. n15 Originators create pass-through securities when they pool together assets in a trust and then sell those securities to investors through a government agency, a private conduit, or a private placement. n16 In the MBS pass-through transaction, the investor "purchases a fractional undivided interest in a pool of mortgage loans, and is entitled to share in the interest income and principal payments generated by the underlying mortgages." n17 The Originator typically continues to service the mortgages, and a servicer will collect payments and pass-through the principal and interest to the security holder, less any fees. n18

n15 *Id.* at 7; Schwarcz, *supra* note 9, at 1-8.

n16 BOROD, *supra* note 3 at 7-8; Schwartz, *supra* note 9, at 1-8.

n17 Schwartz, *supra* note 9, at § 1:2.

n18 BOROD, *supra* note 3 at 7-8; Schwartz, *supra* note 9, at 1-8.

Up until the late 1980s, Ginnie Mae and other governmental-backed mortgage securities dominated the secondary MBS market. n19 The largest player was Ginnie Mae, a wholly-owned federal government corporation within the Department of Housing and Urban Development (HUD). n20 HUD guarantees securities created by pools of mortgages that are less than one year old and issued by the Federal Housing Administration, the Farm Housing Administration, and the Veterans Administration. n21 Ginnie Mae MBS are fully modified pass-through securities, meaning that the security holder receives full and timely payment of principal and interest regardless of whether the borrower pays his or her mortgage payment. n22 Thus, it is said that Ginnie Mae MBS are "backed by the full faith and credit of the federal government." n23

n19 Edward Pittman, *Economic and Regulatory Developments Affected Mortgage Related Securities, 64 Notre Dame L. Rev. 497, 500 (1989).*

n20 BOROD, *supra* note 3, at 1-17.

n21 Pittman, *supra* note 19, at 500.

n22 BOROD, *supra* note 3, at 1-17.

n23 SEC, *Mortgage-Backed Securities,* June 25, 2007, http://www.sec.gov/answers/mortgagesecurities.htm [hereinafter Mortgage-Backed Secuirites].

Freddie Mac is the second largest source of pass-throughs. Unlike Ginnie Mae pass-throughs, Freddie Mac pass-throughs are not a direct obligation of the federal government, but rather the obligation of a corporate instrumentality of the U.S.-owned Federal Home Loan Banks and member savings and loan associations. n24 The goal of Freddie Mac MBS was originally to create a secondary market for mortgages by purchasing mortgages from savings and loan associations. n25 Whereas Ginnie Mae guarantees a fully modified pass-through, Freddie Mac only guarantees the timely payment of interest and the eventual payment of principal. n26 This pass-through is called a modified, rather than fully modified, pass-through. n27 Although Freddie Mac MBS are not backed by the full faith and credit of the federal government, they have special authority to borrow from the U.S. Treasury and are considered just as safe as Ginnie Mae MBS. n28 Rating agencies do not rate

Copyright © 2009 Association of Corporate Counsel

Freddie Mac securities. n29

n24 BOROD, *supra* note 3, at 1-17.

n25 Freddie Mac, Our Mission, http://www.freddiemac.com/corporate/company_profile/our_mission/index.html (last visited Aug. 16, 2008).

n26 James E. MURRAY, *The Developing National Mortgage Market: Some Reflections and Projections, 7 Real Prop. Prob. & Tr. J. 441, 445-46 (1972); see also* Freddie Mac, Our Role Within the Secondary Market, http://www.freddiemac.com/corporate/company_profile/our_role_secmkt/index.html (last visited Aug. 16, 2008).

n27 BOROD, *supra* note 3, at § 1.04.

n28 Mortgage-Backed Securities, *supra* note 23.

n29 BOROD, *supra* note 3, at § 1.04; *see also* Freddie Mac, Freddie Mac's Mortgage Securities Frequently Asked Questions, http://www.freddiemac.com/mbs/html/cs_faq.html#6_6 (last visited September 24, 2008).

Freddie Mac also issued the first collateralized mortgage obligation (CMO) in 1983. n30 A CMO is a type of mortgage-backed security that creates multiple classes of bonds that represent claims to specific cash flows from large pools of home mortgages. n31 Each class, called a tranche, is paid sequentially as principal payments are received from the underlying mortgages. n32 The first tranche may have a life of two to three years, the second tranche five to seven years, the third tranche ten to twelve years, and so on. n33 In addition to different maturity dates, tranches may have different principal balances, coupon rates, and prepayment risks. n34 CMOs were welcomed by investors who wanted greater flexibility in their investments, as a typical MBS only matured after ten to twelve years. n35

n30 LELAND C. BREDSEL, SECURITIZATION'S ROLE IN HOUSING FINANCE, IN A PRIMER ON SECURITIZATION 17, 22 (Leon T. Kendall & Michael J. Fishman eds., 1996).

n31 U.S. Securities and Exchange Commission, Collateralized Mortgage Obligations, June 25, 2007, http://www.sec.gov/answers/tcmos.htm [hereinafter Collateralized Mortgage Obligations].

n32 *Id.; see* Julia P. Forrester, *Fannie Mae/Freddie Mac Uniform Mortgage Instruments: The Forgotten Benefit to Homeowners, 72 MO. L. REV. 1077, 1081 (2007).*

n33 The Securities Industry and Financial Markets Association, Types of Bonds, http://www.investinginbonds.com/learnmore.asp?catid=5&subcatid=17&id=35 [hereinafter Types of Bonds].

n34 Collateralized Mortgage Obligations, *supra* note 31.

n35 Types of Bonds, *supra* note 33.

Another significant player in the pass-through market is Fannie Mae, also a GSE, which began

securitizing mortgages and purchasing MBS from commercial and mortgage banks in the early 1980s. n36 Fannie Mae, like Ginnie Mae, uses a fully modified pass-through security, meaning that it guarantees the timely payment of both principal and interest for all securities it issues. n37 Like Freddie Mac, Fannie Mae is not supported by the full faith and credit of the federal government, but is still considered resolute against an economic downturn. Rating agencies do not rate Fannie Mae securities. n38

n36 Andrew R. Berman, *"Once a Mortgage, Always a Mortgage"--The Use (and Misuse of) Mezzanine Loans and Preferred Equity Investments, 11 STAN. J.L. BUS. & FIN. 76, 92 (2005); see also,* Murray, *supra* note 26, at 437.

n37 BOROD, *supra* note 3 at §1.04.

n38 *Id.*

Since the 1990s, private entities have slowly taken over a majority of the MBS market in the United States, due in part to the passage of the Secondary Mortgage Market Enhancement Act of 1984 (SMMEA). n39 SMMEA relaxed the regulatory burdens that prevented private sector MBS from participating in the secondary market. n40 At the end of 2006, private entities shared 54 percent of the MBS market. n41 Whereas GSEs and Ginnie Mae traditionally cater to borrowers with good credit, private entities like banks, savings associations, and investment banking firms, generally issue and securitize riskier mortgages. n42 Also unlike GSEs, private sector MBS are not insured or guaranteed by the federal government or any quasi-governmental entity; rather, they rely on pool insurance and other private guarantees. n43 Throughout the 1990s and early 2000s, private issuers of MBS filled a gap by creating a secondary market for conventional mortgages and other loans that did not qualify for Fannie Mae or Freddie Mac programs. The most common type of privately issued security is the Real Estate Mortgage Investment Conduit (REMIC), which the Tax Reform Act of 1986 officially sanctioned. n44 Like a CMO, the REMIC is a multiple-class security vehicle that avoids the burden of double taxation. n45 The underlying assets of a REMIC security are either MBS or whole mortgage loans. n46 The main benefit of REMIC securities is that they allow issuers to create securities with short, intermediate, and long-term maturities, which attracts a broader group of investors. n47 Ginnie Mae and the GSEs have REMIC programs, each of which guarantees (to a different degree) the timely payment of both principle and interest of each class. n48

n39 Faten Sabry & Thomas Schopflocher, *The Subprime Meltdown: A Primer,* 1633 PRACTICING. L. INST. 89, 91 (2007).

n40 SEC Staff Report, *supra* note 13, at 8.

n41 Sabry, *supra* note 39, at 95.

n42 BOROD, *supra* note 3, at § 1.04; Sabry, *supra* note 39, at 95. Both Fannie Mae and Freddie Mac place caps on the amount of a loan that an individual may receive.

n43 *Id.*

n44 SEC Staff Report, *supra* note 13, at 13.

n45 *Id.*

Copyright © 2009 Association of Corporate Counsel

n46 *Id.*

n47 *Id.*

n48 *Id.*

E. LEGAL STRUCTURE OF A SECURITIZATION DEAL

In the most basic structuring of MBS, lenders package mortgage loans and sell them to a special purpose vehicle (SPV) who owns the mortgage loans. n49 The SPV is a bankruptcy-remote trust that is exempt from taxes and insulates investors from the liabilities of the Originator. n50 Acting as an underwriter, the SPV issues securities that are either backed by, or represent interests in, the mortgages. n51 Investors receive payments as the borrowers make payments on their loans. n52 When lenders pool residential home mortgages, a sufficiently large number are included so that "information on no one loan is important in analyzing the pool." n53 The Originator typically services the loan, but sometimes Originators hire a servicing firm to collect the mortgagor's payments and to pass these payments, less fees, to the SPV who in turn pays the investors. n54 As discussed above, the GSEs and Ginnie Mae guarantee the MBS, which in turn helps facilitate the secondary MBS market. n55 If mortgagors fail to make timely payments, the GSEs and Ginne Mae make the payments due on the MBS (either in whole or in part depending on whether it is modified or fully modified). n56

n49 Scatigna, *supra* note 2, at 2.

n50 Sabry, *supra* note 39, at 6.

n51 SEC Staff Report, *supra* note 13, at 7.

n52 *Id.*

n53 *Id.*

n54 *Id.*

n55 *Id.*

n56 *Id.*

This securitization process generally triggers the application of 1) the Investment Company Act of 1940; 2) The Securities Act of 1933; and 3) the Securities Exchange Act of 1934.

The 1940 Act requires that all investment companies register with the Securities and Exchange Commission (SEC) unless an exemption applies. Section 3(a)(1) defines an investment company as any issuer who "engage[s] primarily . . . in the business of investing, reinvesting, or trading in securities;" or one who "owns or proposes to acquire investment securities having a value exceeding 40 per centum of the value of such issuer's total assets (exclusive of Government securities and cash items) on an unconsolidated basis." n57 The 1940 Act broadly defines "investment security" to include any security "except (A) Government securities, (B) securities issued by employees' securities companies, and (C) securities issued by majority -owned subsidiaries of the owner which (i) are not investment companies, and (ii) are not relying on the exception" from the definition of investment company. n58

Copyright © 2009 Association of Corporate Counsel

n57 Investment Company Act of 1940, *15 U.S.C. § 80a-1* at § 3 (a)(1), (3) (2006), *available at* http://wwwl.law.uc.edu/CCL/InvCoAct/sec3.html [hereinafter Investment Company Act].

n58 *15 U.S.C. § 3*(a)(2) (2007).

The 1940 Act lists fourteen explicit exemptions from registration for entities, including one that explicitly exempts entities who deal in mortgages. n59 Section 3(c)(5)(C) exempts entities that are primarily engaged in "purchasing or otherwise acquiring mortgages and other liens on and interests in real estate." n60 In addition, Rule 3a-7 specifically excludes from the definition of investment company SPVs that meet the following four conditions: 1) the SPV must issue securities whose payment depends primarily on the cash flow from receivables; 2) the securities being issued must be non-redeemable debt securities or equity securities with debt-like characteristics that are rated at the time of their initial sale as investment grade or better by a nationally recognized rating agency; 3) the SPV must acquire or dispose of receivables only in accordance with the terms of the issuance agreements; and 4) if the SPV issues securities that are not exempt under section 3(a)(3) of the 1933 Act, the SPV must appoint an independent trustee for those securities. n61

n59 *15 U.S.C. § 3*(c) (2007).

n60 *15 U.S.C. § 3*(c)(5)(C) (2007).

n61 Issuers of Asset-Backed Securities, 17 C.F.R. § 270 (1992), Rule 3a-7. An exception to this condition is that non-rated securities may be sold to qualified institutional buyers and that non-rated fixed income securities may be sold to accredited investors

Since the receivables and payment streams present in a securitization deal fall within the definition of "investment security" under the 1940 Act, the SPV must rely on an exemption to avoid registration with the SEC. n62 The same is not true for GSE and Ginne Mae MBS, however, which are completely exempt from the 1940 Act. n63 Thus, it is only private-label MBSs that are potentially subject to the registration requirements of the 1940 Act and other federal securities laws. But Rule 3a-7 has effectively exempted most private-issue structured financings from the registration requirement. n64 Given the compliance costs and burden of registering with the SEC, lenders structure most SPVs to fall within Rule 3a-7. n65

n62 BOROD, *supra* note 3, at § 6.1.

n63 SEC Staff Report, *supra* note 13, at 19.

n64 BOROD, *supra* note 3, at § 6.1.

n65 Hill, *supra* note 5, at 1067-68.

The next hurdle in the MBS transaction is to determine whether to register the securities or find a registration exemption under the Securities Act. As with all registration statements, extensive disclosure of the deal is required. As mentioned above, the chartering legislation of Fannie Mae, Freddie Mac, and Ginnie Mae generally exempt these securities from registration under the Securities Act and other securities laws. n66 Thus, only non-GSE MBS, i.e., private-label MBSs, are required to find an exemption or face registration. While most private-label MBS file a registration statement, those that do not use the transactional exemptions, which includes the section 4(2) and Rule 506 of Regulation D. n67 Section 4(2) exempts "transactions by an issuer not

involving any public offering," and Rule 506 creates a safe harbor to this provision. n68 Since any security issued pursuant to the section 4(2) or Rule 506 exemption is a restricted security, resales are generally not permitted unless a registration statement is in effect. Most private-label issuers use the 144A limited safe harbor for certain resales to Qualified Institutional Buyers (QIBs). A QIB is an institutional investor that has at least $ 100 million in securities invested. In 2001, over 98 percent of private-label MBS were sold with a registration statement in effect while the remainder were sold in Rule 144A transactions. n69

n66 Danielle T. Berofsky, *Nuts & Bolts of Financial Products 2007: Understanding the Evolving World of Capital Market & Investment Management Products,* 1589 PRACTICING L. INST. 101, 193 (2007).

n67 SEC Staff Report, *supra* note 13.

n68 The Securities Act Rules 17 C.F.R. § 230 (2006).

n69 SEC Staff Report, *supra* note 13.

GSEs, Ginne Mae, and private-label issuers are all subject to the antifraud provisions of federal securities laws, which include section 17(a) of the Securities Act and section 10(b) (and Rule 10b-5 promulgated thereunder) of the Exchange Act. n70 Only the SEC uses section 17(a) while both the SEC and private litigants may use 10(b) and Rule 10b-5 to bring antifraud suits. n71 The provisions of 17(a) and 10(b) are similar and generally prohibit any person from making a false or misleading statement of material fact in the offer or sale of MBS. n72 A statement (or omission) is material if it would cause a reasonable investor to view it as altering the "total mix" of information made available to him or her. n73

n70 The Securities Act of 1933, *15 U.S.C. § 77*-a (2007); 17 C.F.R. § 240.10b5-1 (1951).

n71 *15 U.S.C. § 77*-a (2007); 17 C.F.R. §240.10b5-1 (1951).

n72 *15 U.S.C. § 77*-a (2007); 17 C.F.R. § 240.10b5-1 (1951).

n73 *Basic Inc. v. Levinson , 485 U.S. 224, 231-32 (1988).*

III. An Explanation of the U.S. Subprime Debacle

Subprime mortgage defaults and the resulting collapse of the secondary MBS market lie at the heart of the subprime mortgage meltdown. A subprime mortgage is a residential loan that does not conform to the criteria for "prime" mortgages, and therefore has a higher probability of default. n74 Whether someone is a subprime borrower depends on their credit score, their debt service-to-income ratio, and the mortgage loan-to-value (LTV) ratio. n75 Contrary to popular thought, the term "subprime" does not correspond to interest rates but instead goes to the nature of the borrower. Subprime borrowers generally seek loans that do not require down payments and loans that have low monthly payments. n76

n74 John Kiff, & Paul Mills, *Lessons from Subprime Turbulence,* IMF SURVEY MAGAZINE, Aug. 23, 2007, *available at* http://www.imf.org/external/pubs/ft/survey/so/2007/RES0823A.HTM [hereinafter Kiff article].

n75 *Id.*

n76 Christine Daleiden, *Understanding Subprime Mortgages,* 12 HAW. BAR J. 6, 6 (2008).

Subprime mortgage lending greatly expanded in the mid-1990s, mainly due to innovations that "reduced the costs for lenders of assessing and pricing risks." n77 Those innovations included technological advances that facilitated credit scoring which made it "easier for lenders to collect and disseminate information on the creditworthiness of prospective borrowers." n78 In 1995, only 5 percent of mortgages were subprime; and by 2005, the figure jumped to 20 percent. n79

n77 Ben Bernanke, Chairman, Fed. Reserve, Remarks at the Federal Reserve Bank of Chicago's 43rd Annual Conference on Bank Structure and Competition (May 17, 2007), *available at* http://www.federalreserve.gov/newsevents/speech/bernanke20070517a.htm [hereinafter Bernanke's May 2007 Chicago Remarks].

n78 *Id.*

n79 Sabry, *supra* note 39, at 2.

The increased rate of securitization during the 1980s and 1990s played a large role in the growth of the subprime market. Lenders traditionally held mortgages on their books until mortgagors repaid the loans; but regulatory changes in the 1980s allowed lenders to sell mortgages to financial intermediaries with greater ease. The financial intermediaries in turn pooled mortgages and sold the cash flows as structured securities. n80 Since securitization generally increases liquidity and reduces the cost of lending, the secondary MBS market grew over time. n81 The result was that lenders had more money to loan and became more comfortable loaning to subprime borrowers. n82

n80 Bernanke's May 2007 Chicago Remarks, *supra* note 77.

n81 *Id.*

n82 Sabry, *supra* note 39, at 2.

Products also emerged during the past decade that made credit affordable to subprime borrowers, including interest only loans and adjustable rate mortgages (ARMs). n83 By 2005, this access to credit resulted in incredible home ownership rates, with almost 70 percent of American families owning their homes, including minority families who were homeowners for the first time. n84 Subprime loans accounted for as much as 14 percent of outstanding mortgage debt by 2006, and lenders packaged most of it into MBS, CDO, or REMIC that they sold on the secondary market. n85 Unwary entities, such as pension funds, hedge funds, insurers, and municipalities, heavily invested in these subprime structured securities and, until 2007, enjoyed their expected fixed returns. n86

n83 David Anderson, *The Subprime Lending Crisis, 71 TEX. B. J. 20, 20 (2008).*

n84 *Id.;* Bernanke's May 2007 Chicago Remarks, *supra* note 76.

n85 Anderson, *supra* note 83, at 1.

n86 *Id.*

Copyright © 2009 Association of Corporate Counsel

A major problem loomed, however, because subprime borrowers faced higher costs of borrowing and were more likely to default in tough times than prime borrowers. n87 So when housing prices fell precipitously across the country in 2006-2007 at the same time that rates on many subprime loans adjusted upward, many borrowers simply could not afford their mortgage payments and defaulted. n88 Not surprisingly, most defaults resulted from ARMs rather than fixed-rate subprime mortgages, with some mortgages almost doubling overnight. n89 By June 2007, 12 percent of all ARMs borrowers defaulted, a 50 percent increase from the previous low in 2005. n90

n87 Bernanke's May 2007 Chicago Remarks, *supra* note 77.

n88 Ben Bernanke, Chairman, Fed. Reserve, Remarks to the 2007 International Monetary Conference (June 5, 2007), *available at* http://www.federalreserve.gov/newsevents/speech/bernanke20070605a.htm [hereinafter Bernanke's June 2007 Cape Town Remarks].

n89 *Id.*

n90 *Id.*

In response to the subprime debacle, the U.S. Congress, inter alia, passed the Mortgage Forgiveness Debt Relief Act of 2007, which sought to prevent foreclosures by giving tax relief to subprime borrowers. n91 Whereas the tax code used to treat as income any amounts forgiven by lenders, the 2007 Debt Relief Act allows borrowers--in 2007, 2008, and 2009--to refinance their mortgages and exclude from income certain debt forgiveness offered by lenders. n92

n91 Mortgage Forgiveness Debt Relief Act of 2007, Pub. L. No. 110-142 (2007).

n92 *Id.*

The U.S. House of Representatives passed more comprehensive legislation on November 15, 2007. n93 The Mortgage Reform and Anti-Predatory Lending Act of 2007 (2007 Act) amends the Truth in Lending Act and generally attempts to broadly reform consumer mortgage practices. n94 The bill is not yet law, however, because the U.S. Senate has yet to push through a companion bill. As of this comment's submission date, the U.S. Senate has not seriously considered a similar bill, mainly because of pressure from the mortgage industry to keep out certain provisions.

n93 Mortgage Reform and Anti-Predatory Lending Act, H.R. 3915, 110th Congress (1st Sess. 2007) [hereinafter 2007 Act].

n94 *Id.*

The House was mainly concerned with aggressive lending tactics that caused many low-income borrowers to take out loans they could not afford. n95 To curb such tactics, the 2007 Act imposes a duty of care on lenders and prohibits "steering," which is the practice of steering borrowers to high cost mortgage products, like ARMs. n96 The duty of care generally requires that lenders present customers with appropriate mortgage loans, i.e., they must look at whether the potential borrower has a reasonable ability to repay and whether the customer will receive a "net tangible benefit" if he or she refinances the loan. n97 Lenders face fines of up to three times their broker fee plus any costs if they violate their duty of care. n98 They also face potential civil actions, as the 2007 Act grants borrowers a cause of action against both Originators and participants in the secondary market for

rescission of the loan and any costs. n99 The bill additionally requires the licensure of mortgage Originators, including brokers and bank loan offers. n100

n95 *Mortgage Reform Bill Advances in the House,* AM. BKRP. INST. J. Dec. 2007/Jan. 2008, *available at* http://findarticles.com/p/articles/mi_qa5370/is_200712/ai_n21300140?tag=content;col1.

n96 2007 Act, *supra* note 91, at § 103.

n97 *Id.* at § 202.

n98 *Id.*

n99 *Id.* at § 204. The current version of the bill creates a safe harbor for assignees and securitizers who are able to cure the defect by making the loan conform to the required standard within ninety days. *See id.* at § 205.

n100 *Id.* at § 104.

There is a great deal of uncertainty as to whether the 2007 Act will become law, particularly since the mortgage industry has pushed back on the bill and demanded drafting changes. The Bush Administration has neither endorsed the bill nor indicated whether the president will sign it into law. Lenders are especially weary of the standard of liability for "predatory lending" because the bill seems to impose liability on lenders for "any loan a borrower fails to pay off." n101 Perhaps the greatest concern about the bill is that bad lending practices already punish lenders by having them writing down their losses when investments go south. From a lender's perspective, an additional layer of liability will only raise interest rates for borrowers in order to hedge against potential lawsuits. n102

n101 Yaron Brook, *Predatory Lending,* FORBES, Dec. 4, 2007, *available at* http://www.forbes.com/2007/12/03/predatory-business-act-oped-cx_yb_1204predatory.html.

n102 *Id.*

IV. Rise of the Secondary MBS Market in Mexico

A. INTRODUCTION

Latin America has traditionally been unable to finance homes because a combination of "inflation, social instability, and currency weakness" n103 has resulted in high interest rates for borrowers. n104 In the mid to late 1990s, only one in five homes carried a mortgage, n105 and the typical interest rate usually fluctuated between 15 and 20 percent, forcing most people to finance homes with cash or build them by hand. n106 While U.S. borrowers have enjoyed incredible access to credit, Latin American borrowers--and Mexicans until recently--generally could not afford the long-term debt needed to finance a home. Securitization offers great benefits to Latin America because it tends to "mitigate sovereign risk, improve the resilience of markets in periods of stress, and provide a source of funding for housing system[s]." n107

n103 Many banks refused to give mortgage loans in local currencies because of the risk of having to reimburse a loan in dollars if the local currency deflated. *See* Georgette C.

Poindexter, *Ed Ruta Hacia El Desarrollo: The Emerging Secondary Mortgage Market in Latin America, 34 GEO. WASH. INT'L L. REV. 257, at 259 (2002).*

n104 *Id.*

n105 *Id.*

n106 *Id. at 262.*

n107 Scatigna, *supra* note 2, at 5.

The importance of this comment lies in the fact that during the last decade, Latin America--and Mexico in particular--has experienced increased housing demands that have caused the region to encourage securitization and the development of secondary markets. n108 Efficient MBS markets will not only change the financing landscape of Latin America, but will also attract more foreign capital as the United States sinks into recession. Because Mexico arguably leads these efforts, and boasts the largest residential MBS market in Latin America, it is the focus of this comment. n109 The remainder of this comment provides an overview of Mexico's housing demands, the regulatory environment necessitated by the 1994 Peso Crisis that halted lending in the 1990s, the emerging MBS market, and some concluding thoughts on whether Mexico's MBS market will stay strong in light of the U.S. subprime debacle.

n108 *See* FEDERAL RESERVE BANK OF ATLANTA, Financial Update (First Quarter 2004): *Creating a Secondary Mortgage Market in Mexico, available at* http://www.frbatlanta.org/invoke.cfm?objectid=e832daf8-0e12537c-c41e9c3d915b2b19&method=display [hereinafter Atlanta Federal Reserve Mexico Article]; Poindexter, *supra* note 103, at 259; Otaviano Canuto, *Securitization of Latin America: Advantages of Latecomers,* LATIN AMERICA ECOMONITOR, Oct. 1, 2007, http://www.rgemonitor.com/latam-monitor/331/securitization_in_latin_america_advantages_of_latecomers [hereinafter Canuto]; FEDERAL RESERVE BANK OF DALLAS, *Beyond the Border: Mexico Emerges from 10-Year Credit Clump,* 3 Southwest Economy (2005), http://www.dallasfed.org/research/swe/2005/swe0503d.html (stating "Despite a slight rise in interest rates over the second half of the year, Mexico's securitization market almost quadrupled in 2004, making it the top such market in Latin America.") [hereinafter Dallas Federal Reserve Mexico Article] .

n109 Dallas Federal Reserve Mexico Article, *supra* note 108. That Mexico is emerging as a market leader is evidenced in part by the over $ 300 million that the US's largest public pension fund, the California Public Employees Retirement System, has invested in Mexican structured finance deals since the recent US market: slide. *See* Theresa Bradley, *Mexico Enjoys a Housing Boom,* AUSTIN AMERICAN STATESMAN, Feb. 17, 2008, *available at* http://banderasnews.com/0802/nz-mexboom.htm. As of 2007, Mexico was number one in asset securitization in Latin America, with over six and a half billion in US dollars securitized. *See* Caunto, *supra* note 108.

B. MEXICO'S HOUSING DEMAND

Although Mexico has seen a real estate boom in the past six years, it cannot seem to build houses fast enough. n110 The strength of Mexico's housing demand is evidenced by the fact that in

2006, housing construction represented almost 3 percent of the country's gross domestic product, which is roughly the same as Mexico's manufacturing leader--the auto industry. n111 In addition, the construction sector was the most profitable sector in 2005, with construction firms listed on the Mexican stock exchange enjoying a 44 percent increase over previous annual returns. n112

n110 Bradley, *supra* note 109.

n111 THE WHARTON SCHOOL OF THE UNIVERSITY OF PENNSYLVANIA, *The War between Banks and 'Sofoles' Propels Mexican Real Estate,* Feb. 8, 2006, http://www.wharton.universia.net/index.cfm?fa=viewfeature&language=english&id=1104 [hereinafter Wharton].

n112 *Id.*

Yet, despite the growth of construction companies, demand for housing remains high, with over six million households without adequate dwellings. n113 "President Felipe Calderon has set a national goal of a million new mortgages a year by 2010." n114 When Mexico privatized its banks in the early 1990s, there was rapid growth in ability of individuals to finance homes--but when the Peso Crisis of 1994 came about, interest rates skyrocketed, and a record number of individuals defaulted on their mortgage loans. n115 With such a negative experience during this period, it took years for Mexicans to put faith in private banks. Instead of relying on mortgages, Mexicans went back to their old ways, and either bought houses with cash or built them by hand. n116 The looming economic recession in the United States might cause Mexican immigrants to lose their jobs and return to Mexico, creating an even larger housing demand. n117 Harsh U.S. immigration laws are another factor that might swell the growing demand for housing in Mexico. n118

n113 Bradley, *supra* note 109.

n114 *Id.*

n115 INT'L MONETARY FUND, *Mexico: Selected Issues* 41 (Dec. 2007), *available at* http://www.imf.org/external/pubs/ft/scr/2007/cr07378.pdf [hereinafter IMF Mexico Article].

n116 Bradley, *supra* note 109.

n117 *Id.*

n118 *Id.*

C. MEXICO'S REGULATORY FRAMEWORK

Like in the United States where droves of people bought homes during the last decade, Mexico has rebounded from its 1990s economic woes and now boasts one of the strongest housing sectors in Latin America. As the United States sinks into recession because of the subprime debacle, Mexico's mortgage market not only seems resilient but has the potential to shape regulatory reforms throughout Latin America. An adequate discussion of Mexico's current mortgage situation must begin with a primer on the Mexican economic woes of the 1990s.

The well-documented 1994 Peso Crisis devastated Mexico's economy for close to a decade. Before 1994, the Mexican economy showed healthy growth with the emergence of market-oriented institutions and other reforms, such as the abolition of protectionist trade barriers and the

Copyright © 2009 Association of Corporate Counsel

restructuring of foreign debt. n119 Just before the crash, Mexico's inflation was down to single digits for the first time in over twenty years, and foreign investments were pouring into the economy. n120 The once-nationalized banking sector became privatized, and credit became widely available, resulting in the rapid growth of mortgage loans in the early 1990s. n121 The good times quickly ended with the 1994 Peso Crisis as borrowers defaulted in record numbers causing the near collapse of the banking sector. n122 Although commentators disagree on the precise cause of the 1994 Peso Crisis (e.g., some blame the North American Free Trade Agreement), one of the greatest economic crashes of modern times hit Mexico in 1994, leading to the severe devaluation of Mexico's currency, the peso, which lost half of its value in less than three months. n123

n119 Francisco Gil-Diaz, *The Origins of Mexico's 1994 Financial Crisis,* 17 CATO J., Winter 1998, *available at* http://www.cato.org/pubs/journal/cj17n3-14.html; *see also* Joseph A. Whitt, *The Mexican Peso Crises,* Federal Reserve Bank of Atlanta, ECONOMIC REVIEW, Winter 1996, *available at* http://www.frbatlanta.org/filelegacydocs/J_whi811.pdf.

n120 Diaz, *supra* note 119.

n121 *Id.*

n122 IMF Mexico Article, *supra* note 115, at 41.

n123 Dallas Federal Reserve Mexico Article, *supra* note 108.

On the housing sector side, the recession that emerged after the devaluation caused the real estate market to collapse as private capital quickly left the housing market. n124 Because lenders had indexed most mortgages to both inflation and minimum wage, the peso depreciated interest rates soared. n125 The economy's collapse caused unemployment to skyrocket, meaning that people could not afford their mortgage payments. n126 About 80 percent of borrowers defaulted on their mortgages while banks' portfolios lost nearly 50 percent of their value. n127 Banks abruptly halted their lending and effectively withdrew from the mortgage market. n128 Because of the need for housing (and perhaps because of the negative experience Mexicans had with private banks), n129 the Mexican government had to step up the role of governmental institutions. n130

n124 Wharton, *supra* note 111; JOINT CENTER FOR HOUSING STUDIES OF HARVARD UNIVERSITY, *The State of Mexico's Housing* (2004), *available at* http://www.jchs.harvard.edu/publications/international/som2004.pdf [hereinafter June 2004 Harvard Study].

n125 *Id.*

n126 *Id.; see also* Bradley, *supra* note 109.

n127 June 2004 Harvard Study, *supra* note 124.

n128 Wharton, *supra* note 111; *see also* Natalie Pickering, *The Mexico Mortgage Boom, Bust and Bail Out: Determinants of Borrower Default and Loan Restructure After the 1995 Currency Crisis,* JOINT CENTER FOR HOUSING STUDIES OF HARVARD UNIVERSITY, April 2000, *available at* http://www.jchs.harvard.edu/publications/international/pickering_w00-3.pdf [hereinafter April 2000 Harvard Study].

Copyright © 2009 Association of Corporate Counsel

n129 *See* Wharton, *supra* note 111.

n130 *Id.; see also* Natalie Pickering, *The SOFOLES: Niche Lending or New Leaders in the Mexican Mortgage Market,* JOINT CENTER FOR HOUSING STUDIES OF HARVARD UNIVERSITY, May 2000, *available at* http://www.jchs.harvard.edu/publications/international/pickering_w00-2.pdf [hereinafter May 2000 Harvard Study].

The rest of this section discusses how the Mexican Government used three different entities--SHF, INFONAVIT, and SOFOLES--to deal with the growing housing demand and the departure of private banks from lending to the lower-income sector. Also included is a discussion of Mexico's important legal developments, an explanation of how private banks returned to lending, and an overview of Mexico's emerging MBS market.

D. SHF

As discussed above, a MBS market cannot develop without government guarantees. n131 In the United States, Ginnie Mae and the GSEs guarantee timely payment (either through a fully modified or modified guarantee) of mortgages to investors in case the borrower is unable to make a payment. The most important MBS development in Mexico was the creation of Sociedad Hipotecaria Federal, S.N.C., (SHF), a national development bank, in 2001. n132 Although the Mexican government did not explicitly model SHF after the U.S.'s GSEs or Ginne Mae, its purpose is similar as it hopes to "promote the construction and purchase of housing" by aiding the development of an efficient secondary MBS market. n133 SHF is the only Mexican governmental entity whose explicit purpose is to promote a secondary MSE market. n134

n131 Scatigna, *supra* note 2, at 75.

n132 SOCIEDAD HIPOTECARIA FEDERAL, S.N.C. , *About SHF, available in English at,* http://translate.google.com/translate?hl=en&sl=es&u=http://www.shf.gob.mx/sobre_shf.html&sa=&oi=translate&resnum=1&ct=result&prev=/search%3Fq%3DSobre%2BSHF%26hl%3Den. Translated, SHF means the "Federal Mortgage Society."

n133 *Id.*

n134 Carlos Aiza Haddad, *The Securitization of Assets in Mexico, 7 U.S.-MEX. L.J. 141, 143 (1999);* Brigitte Posch & Philip Kibel, *Sociedad Hipotecaria Federal: Does the Mortgage Partial Guarantee Work?--The Proof is in the Pudding,* STRUCTURED FINANCE SPECIAL REPORT, MOODY'S INV. SERV. (July 26, 2002), *available at* http://www.natlaw.com/seminar/doc37.pdf [hereinafter Special Report].

Like the U.S. GSEs, SHF puts the "'full faith and credit' of [the] federal government" behind mortgages, but unlike the U.S. GSEs, SHF has an expiration date--2013. n135 SHF does not lend directly to the public, n136 rather, it simply guarantees the timely payment of mortgages as follows: if a mortgage is six months late, SHF pays to the lender between 25 and 75 percent of the outstanding balance of the mortgage loan, plus interest, and any unpaid servicer and insurance fees. n137 It is important to note, however, that SHF will only guarantee mortgages that conform to specific criteria, which include certain debt-to-income and loan-to-value requirements, as well as reporting obligations. n138

Copyright © 2009 Association of Corporate Counsel

n135 WORLD BANK, *Housing Finance in Mexico: Evolution, Strategy and Challenges Ahead,* Powerpoint Presentation, March 2006 (on file with author) [World Bank Powerpoint].

n136 *Id.*

n137 Special Report, *supra* note 134.

n138 *Id.* By creating the said criteria, SHF effectively has standardized the mortgage market.

SHF accomplishes its goal by hedging the risk of dramatic interest rate increases and promoting the securitization of mortgage portfolios and mortgage origination by enhancing credit. n139 Like the U.S.'s GSEs, SHF has several different programs in which financial intermediaries may participate, and the result is that banks can offer mortgage loans with lower interest rates. n140 With time, SHF's guarantee will create a larger demand for MBS. As banks package and sell their mortgages, the extra cash in hand will allow them to issue more mortgages.

n139 *Id.*

n140 Vicente Grau and Sergio Chagoya, *Securitization of Mortgage Loans in Mexico,* 1 U.S.-MEX. L. REV. 3, 4 (2007).

E. INFONAVIT

Along with SHF, the other major mortgage lender in Mexico is Instituto del Fondo Nacional de la Vivienda para los Trabajadores, or the National Workers' Housing Fund Institute (INFONAVIT), n141 a government agency created in 1972. INFONAVIT played a large role in the housing sector following the 1994 Peso Crisis by funding the construction of affordable housing for workers. n142 INFONAVIT has a double mandate of "providing individual pension funds for private sector employees in Mexico" and granting mortgages to those who qualify. n143 To support its pension fund, INFONAVIT instituted a mandatory 5 percent payroll deduction for all workers. n144 INFONAVIT makes payments on its MBSs from " automatic deductions from worker's wages," which helps keep the delinquency rate down. n145 As of 2006, INFONAVIT held loans totaling over forty billion, "the largest mortgage portfolio in Latin America." n146

n141 Melissa Hall, *Foreigners Funding the Future: Investment Opportunities in Mexico's Privatized Pension System, 34 TEX. INT'L L.J. 151, 172(1999).*

n142 *Id.;* Dallas Federal Reserve Mexico Article Two, *supra* note 1.

n143 AMBAC, *Mexico's Largest Mortgage Lender Completes First Guaranteed RMBS Transaction,* Oct. 3,2007, http://www.ambac.com/pdfs/Deals/Infonavit.pdf.

n144 Dallas Federal Reserve Mexico Article Two, *supra* note 1.

n145 *Id.*

n146 *Id.*

F. SOFOLES

Copyright © 2009 Association of Corporate Counsel

In 1993 as part of NAFTA, n147 the Mexican Government authorized Sociedades Financieras de Objeto Limitado (SOFOLES), which are limited purpose financial companies equivalent to U.S. mortgage houses. n148 Also called non-bank banks, the SOFOLES obtain licenses from the Secretariat of Finance and Public Credit that allow them to lend to particular sectors, including the housing, consumer, small business, and auto finance markets. n149 On the housing side, the SOFOLES function mostly as mortgage companies that both originate and service mortgages to the low-income segment of the mortgage market. n150 As non-deposit entities, the SOFOLES fund their loans through commercial or development bank loans (including SHF), n151 private investors, or the Mexican stock markets. n152 In 2007, SHF funded almost 45 percent of SOFOLES' loans. n153

n147 ASOCIACION MEXICANA DE SOCIEDADES FINANCIERAS DE OBJETO LIMITADO, A.C., *available in English at* http://translate.google.com/translate?hl=en&sl=es&u=http://www.esmas.com/emprendedores/pymesint/proveedores/400855.html&sa=X&oi=translate&resnum=4&ct=result&prev=/search%3Fq%3DSociedades%2BFinancieras%2Bde%2BObjeto%2BLimitado%2B%26hl%3Den [hereinafter AMSFOL].

n148 *See* Special Report, *supra* note 134; May 2000 Harvard Study, *supra* note 130. As of 2005, the Mexican Government had authorized forty-eight SOFOLES entities. AMSFOL, *supra* note 147.

n149 INT'L MONETARY FUND, *Mexico: Financial System Stability Assessment Update* October, 13 2006, *available at* http://www.imf.org/external/pubs/ft/scr/2006/cr06350.pdf; Wharton, *supra* note 111.

n150 May 2000 Harvard Study, *supra* note 130.

n151 Including SHF discussed *infra.*

n152 Ana Maria Rosas Pena, *New Aliadas of SMEs, available in English at* http://translate.google.com/translate?hl=en&sl=es&u=http://www.jornada.unam.mx/2005/02/14/004n1sec.html&sa=&oi=translate&resnum=9&ct=result&prev=/search%3Fq%3DSociedades%2BFinancieras%2Bde%2BObjeto%2BLimitado%2B%26hl%3Den.

n153 FITCH RATINGS MEXICAN MORTGAGE COMPANIES 4, Mar. 6, 2008, *available at* http://www.fitchratings.com/corporate/login/setSessionVars.cfm?userIdParam=rikk03&SCRIPT_NAME=/corporate/reports/report_frame.cfm&QUERY_STRING=rpt_id=377542§or_flag=21&marketsector=1&detail=.

Getting SOFOLES involved in mortgage lending was important to the Mexican Government, particularly after it became virtually impossible for the low-income sector to borrow during the mid-1990s. n154 By 1996, only 15 percent of households were eligible for private bank mortgages. n155 The reason that banks only lent to high incomes individuals has its roots in Mexico's nationalization of the banking system in 1982. When the Government took over the banks, they maintained a certain amount of "social interest loans," typically ranging from 3 to 6 percent of the bank's mortgage portfolio. n156 These so-called "social interest loans," funded in part by Fondo de Operacion y Financiamiento Bancario a la Vivienda (FOVI), a government trust within the central bank designed to promote lower-income housing, were not required after the liberalization of the

banks in late 1980s. n157 Since private banks no longer had to participate in the FOVI "social interest loans" program, they did not, leaving nearly 100 percent of their mortgage portfolios (if they had such portfolios) to the upper-income brackets. n158 When the SOFOLES emerged in the mid-1990s, using FOVI funds, they filled gap that private banks created when they halted participation in FOVI's "social interest loan" program.

n154 May 2000 Harvard Study, *supra* note 130, at 3.

n155 *Id.* at 6.

n156 *Id.* at 7.

n157 *Id.*

n158 *Id.*

G. LEGAL DEVELOPMENTS

As discussed above, the creation of a trust or SPV is a necessary component of a U.S. securitization deal, as the SPV acts as both an underwriter and insulator from bankruptcy. Mexicans also use bankruptcy-remote SPVs n159 that issue so-called *certificados bursatiles fiduciaries* and hold the pooled mortgage loans after securitization. n160

n159 Under Mexican law, a financial intermediary must act as the trustee. *See* Alfonso Castro Diaz, *Facts are Meaningless,* INT'L FIN. L. REVIEW, 2007, *available at* http://www.iflr.com/?Page=17&ISS=23918&SID=696635 [hereinafter Int'l Law Review Article].

n160 *Id.*

Before 2005, the biggest impediment to securitization deals in Mexico was trust law. The old system prevented trusts from issuing debt, which meant that the dealmaker issued the assets through securities, with a governmental agency certifying that the pooled assets were equal to the MBS. n161 In December 2005, the Mexicans instituted a new Securities Market Law that authorized the *certificados bursatiles fiduciarios* (exchange-traded trust certificates) and permitted *the trust* to issue these securities for the first time. n162 The Securities Market Law made the requirements for the issue of *certificados bursatiles fiduciaries* more flexible n163 by eliminating the previous impediments to issuing debt securities. n164 Today, the use of such trusts "has become the means par excellence" for the securitization of mortgage loans. n165

n161 Stump, *supra* note 6, at 204; Scatigna, *supra* note 2, at 75.

n162 Int'l Law Review Article, *supra* note 159.

n163 Grau, *supra* note 140, at 4.

n164 Int'l Law Review Article, *supra* note 159.

n165 Grau, *supra* note 140, at 4.

Another impediment to securitization was that Mexican law required the notarization and subsequent recording of mortgages with the Public Registry of Property. n166 This effectively

prevented any assignment of mortgages (i.e, securitization) that did not utilize a notary and inform the borrower. To help develop its MBS market, Mexico passed a new law that allows the assignment of mortgages without notice to the debtors and without use of a notary public. n167

n166 Poindexter, *supra* note 103, at 270.

n167 *Id.*

Mexican states also modified their foreclosure laws to allow banks to initiate a foreclosure proceeding within two months of a borrower's default or discovery of a fraud. n168 The ability of lenders to foreclose mortgages in default is crucial to the success of a secondary market because it gives investors some certainty that certain loans will not completely default. But a foreclosure must be quick, and the new law accomplishes this by putting a foreclosure proceeding atop a court's docket. n169

n168 *Id.* at 271.

n169 *Id.*

H. REEMERGENCE OF THE PRIVATE BANKS IN 2004

Private banks reemerged slowly after the 1994 Peso Crisis, and it was not until 2004 that these banks actively lent to the masses. The process of reintroducing private banks to borrowers was slow, but a new regulatory framework governing credit bureau operations helped--the new regulations improved the timeliness and accurateness of a potential borrower's creditworthiness. This improvement gave banks greater comfort in lending to lower-income individuals. n170

n170 Dallas Federal Reserve Mexico Article Two, *supra* note 1.

Recent trends show that private banks and the SOFOLES are slowly catching up with the securitization rates of the government issued securities, and may surpass them soon.

1302CD

Copyright © 2009 Association of Corporate Counsel

CEMEX

http://www.cnbc.com/id/32461459

Mexico's Cemex shares rise on restructuring

By: AFX | 18 Aug 2009 | 11:23 AM ET

MEXICO CITY, Aug 18 (Reuters) - Shares of Mexican cement maker Cemex rose more than 4.5 percent on Tuesday as investors warmed to the company's recently announced deal to restructure its debt. Shares traded at 14.86 pesos each. Its stock in New York added 4.74 percent to $11.48. The company said on Monday it must raise $1 billion in equity by June or pay a penalty as part of a $15 billion debt restructuring that has allayed fears of default.

http://www.reuters.com/article/innovationNewsIndustryMaterialsAndUtilities/idUSTRE57D48220090814?pageNumber=2&virtualBrandChannel=11611&sp=true

Cemex still faces hard time after debt restructure

Fri Aug 14, 2009 3:02pm EDT

By Gabriela Lopez - Analysis

MONTERREY, Mexico (Reuters) - Mexico's Cemex has created breathing room with a deal to avoid defaulting on $15 billion in debt, but the world's No. 3 cement maker still faces asset sales, a beat-up credit rating and a likely share offer.

Cemex (CMXCPO.MX) (CX.N) allayed investors' biggest concerns on Friday when it announced it had reached agreement after months of talks to extend payments on the debt it had taken on to acquire Australia's Rinker in 2007.

Winning the extension until 2014 on the debt, which would have matured over the next two years, has been Cemex's main hurdle this year but the Monterrey-based company now still has to deal with slumping sales in its key U.S. market.

Cemex must sell some of its businesses as part of the debt restructure and will probably also offer investors shares to raise more cash to pay creditors.

This year, Cemex expects earnings before interest, taxes, depreciation and amortization to fall 29 percent to $3.1 billion and free cash flow to drop 38 percent to $1.6 billion.
"The company's leverage continues to be too high for the EBITDA it is generating," Santander said in a recent report.

Cemex, which has seen its long-battered stock surge around 20 percent since the end of July on expectations that it would close the debt deal, traded down 3.87 percent at 13.92 pesos on Friday after announcing it had clinched the refinancing.

Copyright © 2009 Association of Corporate Counsel

SHARE OFFER EXPECTED

Cemex said as part of the deal it will use capital market transactions to help pay down its debt.

Analysts say the company is likely to offer between $1 billion and $2 billion in new shares, although it may wait for market conditions to improve.

"Knowing Cemex, they probably negotiated some sort of window to do it, which could be quite a long time," said Carlos Legaspy, president of San Diego-based Precise Investment Management, which holds Cemex bonds.

Cemex's market capitalization is about $9.5 billion, according to Reuters data.

Experts say it could take up to five years for Cemex to regain its investment grade credit rating, key to cheap financing, after being hit with downgrades in recent months.

Since last year, Standard & Poor's has cut its investment grade rating on Cemex by several notches to "B-." Fitch has also removed its investment grade rating from the company.

Rinker's U.S. assets have made Cemex the top cement maker in the United States, but the deal closed as the U.S. housing collapse struck.

Cemex, which acknowledges the Rinker purchase was ill-timed, operates in 50 countries and competes globally with Switzerland's Holcim (HOLN.VX) and France's Lafarge (LAFP.PA).

Cemex has also pledged to cut costs to improve its cash flow and to sell more of its assets. Scrambling to raise cash, Cemex agreed in June to sell its Australian operations to Holcim at a fire-sale price of $1.6 billion, about half what it paid in 2007.

But Cemex's efforts to sell its Austrian assets faltered after Vienna-listed Strabag (STRV.VI) pulled out of a $435 million asset deal to buy Cemex units.

(Writing and additional reporting by Noel Randewich, editing by Gerald E. McCormick)

http://www.marketmemorandum.blogspot.com/2009/03/cemex-announced-plans-to-restructure.html

Tuesday, 10 March 2009

Cemex Announced Plans to Restructure $14.5 Billion of Debt. Bond Sale Scrapped

Cementos Mexicanos SA, the famous **Cemex** and No. 3 cement producer in the world, **kicked off a $14.5 billion debt restructuring effort with banks. It also scrapped a**

plan to sell a dollar-denominated benchmark size issue as conditions in capital markets deteriorated. We heard from a source that the issue had lost considerable appeal by Thursday, when the size has been chopped and yield talk was reaching 16 percent to 18 percent.

Cemex said yesterday in a statement that it will seek to meet all its obligations while it carries out the renegotiation talks. Completion of the renegotiation may require consent from all lenders. The company's main lenders include **Banco Santander** *(reputation tarnished by the Madoff scandal and profit generation is at jeopardy following the pronounced recession in Spain,)* **HSBC Holdings** *(which stock plunged 24 percent yesterday in Hong Kong,)* **Royal Bank of Scotland** *(recently nationalised by the U.K. government),* **BBVA** *(well, another Spanish giant suffering in its home market)* and **Citigroup** *(well, the jewel of the crown as you imagine. Nearing nationalisation, the Citi empire is falling apart.) Negotiations, therefore, will be marked by intense pressure on both sides: on one hand the company feeling the pinch of a possible downgrade or default; on the other, banks trying to cut their exposure to highly-leveraged companies like Cemex.*

Cemex is also considering selling assets in an effort to ***''quickly achieve maximum financial flexibility.´´*** This may hamper the ratings situation as you know -- the risk of selling assets in such an environment is catching low prices for them. A ratings downgrade is almost certain in such event -- asset sales.

The loan restructuring announcement followed recent warnings by rating agencies that the company faces a downgrade if it fails to refinance more than $4 billion to $6 billion in obligations due this year. The company has struggled to obtain refinancing for short term loans used to buy rival Rinker Group last year. The cost of such acquisition was between $14 billion and $15 billion -- and the timing of the purchase couldn't have been worse, as the markets were beginning to experience the hangover of five years of economic boom and feast.

VITRO

http://www.bloomberg.com/apps/news?pid=20601013&sid=aPN3jNhunSig

Vitro Sada Family May Fight for Control After Default (Update2)

By Thomas Black

Feb. 4 (Bloomberg) -- Monterrey's Sada family risks losing control of Mexican glassmaker **Vitro SAB** after 100 years of ownership as the company prepares to restructure $1.2 billion of debt.

Bondholders may demand equity after Vitro missed $44.8 million in interest payments on Feb. 2 to preserve cash for its operations, said **Wilbur Matthews**, chief executive officer of Vaquero Global Investment LLC, a San Antonio-based hedge fund that owns Vitro bonds due in 2017.

Wresting Vitro from the Sadas would mark a shift in the tradition of Mexico's richest families retaining control of their companies even after defaulting on debt. The Sadas directly own 24.9 percent of Vitro and vote an additional 18.1 percent through shares in a pension fund and stock-option plan, according to **Bloomberg** data and regulatory filings. Owners include **Federico Sada**, 59, who took over as chief executive officer in 1995 from his father and resigned in November, and his older brother Adrian, Vitro's chairman.

"They're going to fight like a cat in a corner," said **Carlos Legaspy**, president of San Diego-based Precise Investment Management, a fund that owns bonds sold by Mexican companies, including **Cemex SAB** and Gruma SAB. "They are very proud."

The Sada family declined to comment, **Albert Chico**, Vitro's spokesman, said in an e-mail.

Wrong Bets

Wrong bets on natural gas left the company saddled with $358 million of derivative losses last year. Monterrey-based Vitro closed positions on its derivatives, financial instruments whose value is based on, and determined by, another security or benchmark, and locked in the losses. Those will be added to **debt** that's now 12 times larger than the company's market value.

Copyright © 2009 Association of Corporate Counsel

Failure to cover the derivatives losses triggered cross- defaults on all of Vitro's debt, according to a company filing with the U.S. Securities and Exchange Commission on Jan. 29. Vitro has a 30-day grace period to make the interest payments before officially defaulting on the bonds. Chico, Vitro's spokesman, said this week the company won't pay the interest.

Vitro's American depositary receipts rose 2 cents to 82 cents at 4:15 p.m. in New York trading, up 2.5 percent from yesterday's record low of 80 cents. The ADRs are down 53 percent this year, compared with a 7.9 percent drop in the Standard & Poor's 500 Index and a 12 percent decline in Mexico's Bolsa.

Vitro's Mexican shares rose 10 centavos, or 2.4 percent, to 4.25 pesos at 4:12 p.m. New York time in Mexico City **trading**. The shares have dropped 78 percent in the past 12 months.

Shrinking Equity

Vitro's debt restructuring may leave creditors with securities worth just 30 cents on the dollar, Matthews said. **Eric Ollom**, a corporate debt analyst with ING Groep NV in New York, said he expects bondholders may recover 40 cents to 56 cents per dollar of bonds they own, depending on profit estimates for Vitro's businesses.

"When you take that kind of haircut on the debt, there really shouldn't be any residual value to equity holders," Matthews said.

Vitro, like most Mexican companies, has sold debt for its financing needs instead of equity, keeping the family in control, **Dan Kastholm**, managing director for Latin America at ratings service Fitch Inc. in Chicago, said in a telephone interview.

The families of Mexican companies, including papermaker **Corp. Durango SAB**, Cydsa SAB, Sanluis Corp. and **Alfa SAB**'s former steel unit Hylsamex, have retained control after defaulting on debt and working out new terms with creditors. Vitro's bylaws, which force the trustee representing owners of ADRs to vote with the majority of Mexican-owned shares, give the Sada family even more control over the company. Vitro had 59.9 million shares in the form of ADRs as of April 2008.

'Almost Worthless'

"The question is really are existing shareholders willing to dilute and will anybody be willing to pay what existing owners think it's worth when some people on the street are saying the

equity is almost worthless," Kastholm said. The company's market capitalization has dropped about 85 percent to $96.9 million in the past 12 months.

Vitro has struggled for years to bring its debt down to manageable levels, selling off businesses, cutting costs and focusing the company on glass. In 2007, it convinced investors to buy $1 billion of bonds maturing in 2012 and 2017, touting the consolidation of its debt into the two bonds as alleviating its long-time debt problems and allowing the company to grow again.

Plastic Containers

Once one of Mexico's largest companies, Vitro was weakened during the 1990s after acquiring Tampa Bay, Florida-based glass- bottle maker Anchor Glass Corp., just as consumers began turning to plastic containers, and buying a stake in a Mexican bank.

Vitro declared Anchor Glass bankrupt in 1996 after purchasing the company for $820 million in cash and assumed debt in October 1989. The Mexican government confiscated Banca Serfin, the Sada family's Mexico City-based bank, after Vitro stopped shoring up the bank's balance sheet following Mexico's economic crisis in 1995.

The company returned to its glassmaking roots after selling a home-appliance unit to **Whirlpool Corp.** in 2002, a fiber-glass company to Toledo, Ohio-based Owens Corning Inc. in 2004 and a tableware unit to **Libbey Inc.**, also of Toledo, in 2006, among other divestitures.

Vitro is now a low-cost producer able to fill small orders that are unprofitable for other glassmakers, said **Aaron Holsberg**, a corporate debt analyst with ABN Amro Inc. in New York. The company's management should be able to negotiate a traditional debt workout in which creditors get a minority equity stake in exchange for reducing the amount of debt to a sustainable level.

"I'm hoping this will be a reasonable, amicable restructuring done within a reasonable amount of time because Vitro hasn't had any bad intentions here," Holsberg said. "They've really tried."

Takeover Attempt

Vitro pledged to keep serving its customers as it renegotiates its debt payments, according to the Jan. 29 statement.

Copyright © 2009 Association of Corporate Counsel

Some investors want new management and a cash infusion to reverse Vitro's decline. The Sada family fought off an attempt last year by a group of investors to take a controlling stake. The group was led by Roberto Hernandez, the chairman of **Citigroup Inc.**'s Mexican unit Banamex, and Mexican businessman **Alfredo Harp Helu**, according to an **annual report** Vitro filed with the SEC in June.

Those shareholders may be at odds with the Sada family in debt talks, Matthews said. Hernandez didn't respond to a message left yesterday with his secretary.
Now, the Sada family needs to convince bondholders there's value in the company and they should be left in control, said ABN Amro's Holsberg.

"It's a total wipeout for equity holders," Legaspy said. "The only reason there's a potential recovery there is because you need someone to run the business."

To contact the reporter on this story: **Thomas Black** in Monterrey at **tblack@bloomberg.net**.

Last Updated: February 4, 2009 16:56 EST

http://www.bloomberg.co.jp/apps/news?pid=conewsstory&tkr=VITROA%3AMM&sid=aWTT2wy.5gcs

Mexico Corporate Debt Default to Surge, JPMorgan Says (Update2)

By Fabio Alves

April 23 (Bloomberg) -- Mexican corporate defaults on junk- rated foreign bonds may jump to 31 percent this year as the global recession crimps revenue and chokes off companies' access to credit markets, JPMorgan Chase & Co. said.

The default rate on overseas debt sold by Mexican companies will rise from 22 percent in 2008, already the highest in Latin America, JPMorgan analysts including Luis Oganes and Fabio Akira wrote in a report dated yesterday. High-yield bonds, or junk, are rated below Baa3 by Moody's Investors Service and BBB- by Standard & Poor's.

Declining revenue amid slumping demand and losses stemming from currency derivatives forced Mexican papermaker Corporacion Durango SAB to file for bankruptcy in October and glassmaker Vitro SAB to default on more than $1.2 billion of debt last month. Cemex SAB, the world's third-largest cement maker, is in talks to renegotiate $14.5 billion of loans with its bankers after it was unable to sell $500 million of bonds last month.

"Pressure on corporate issuers in Mexico continues to build in 2009 on the back of significant derivative losses since late 2008 and large exposure to dollar debt," the JPMorgan analysts wrote.

‘Financial Challenges’

Mexico’s non-financial companies will likely restructure or repay $5.2 billion of debt outstanding international debt maturing in 2009 and refinance $37.6 billion, the analysts wrote. That leaves about $7 billion of overseas debt obligations for which Mexican companies will need to find “alternative sources” of financing, according to JPMorgan.

“The ability of Mexican corporates to bridge this financing gap will depend on access to local financing sources and may result in more debt restructurings,” the analysts wrote. “The financial challenges of Mexican corporates have become an important source of potential balance of payments stress.”

Mexico’s central bank tapped for the first time this week a $30 billion swap line with the U.S. Federal Reserve to help companies meet their financing needs in dollars. The central bank auctioned off $3.2 billion of loans. Central Bank Governor Guillermo Ortiz on April 21 said the bank will “probably” hold another auction of funds from the swap line.

Mexico’s decision to tap the swap agreement with the Fed helped reverse a rout in the peso that triggered losses in currency derivatives. The companies bought the derivatives contracts to hedge against fluctuations in energy costs and foreign-exchange rates.

Brazil Default Rate

In Brazil, the central bank’s decision to provide credit lines to help the private sector pay back dollar debt eased concerns over short-term rollover risks, the JPMorgan analysts wrote. The government will use its foreign-exchange reserves to help banks pay back dollar loans, expanding a program already in place for companies, Mario Toros, the director of monetary policy at the central bank, said on March 4.

Still, Brazilian corporate defaults on high-yield foreign debt will climb to as high as 9 percent from 4 percent, according to JPMorgan.

The overall default rate on Brazilian companies’ foreign debt rose to 2.3 percent in February, from 1.8 percent in December, the JPMorgan analysts wrote. They forecast default rates for all Latin American corporate high-yield bonds may rise to 10 percent this year.

To contact the reporter on this story: Fabio Alves in New York at falves3@bloomberg.net

Last Updated: April 23, 2009 13:41 EDT

Copyright © 2009 Association of Corporate Counsel

MEXICAN COMMERCIAL INSOLVENCY LAW

Excerps Prepared by

Francisco Velazquez,

Goodrich Riquelme y Asociados

1. WHEN THERE IS INSOLVENCY

Article 9. The businessman who generally does not pay his obligations shall be declared in insolvency.

A businessman shall be considered as generally not paying his obligations if:

I. The businessman requests a declaration of insolvency and falls within any of the instances referred to in sections I or II of the following article [Article 10]; or

II. Any creditor or the Public Ministry have demanded the businessman's declaration of insolvency, and the businessman falls within the two instances referred to in sections I and II of the following article [Article 10].

Article 10. For purposes of this Law, a businessman's general failure to pay his obligations, referred to in the preceding article, consists of the failure to meet his obligations to pay two or more distinct creditors, and the following conditions are present:

I. Those past due obligations referred to in the preceding paragraph have been past due for at least thirty days and represent thirty-five percent or more of all of the businessman's obligations as of the date in which the demand or application for insolvency is filed; and

II. The businessman does not have any of the assets specified in the following paragraph to satisfy at least eighty-five percent of the debts outstanding as of the date of the demand.

The assets that shall be considered for purposes of the section II of this article shall be:

a) Cash on hand and demand deposits;

b) Term deposits and term investments the expiration date of which shall not exceed ninety calendar days after the date the demand is allowed to proceed;

c) Clients and accounts receivable, the due date of which shall not exceed ninety calendar days after the date the demand is allowed to proceed; and

d) The credit instruments for which purchase-sale transactions are regularly registered in the relevant markets that may become due and payable within

Copyright © 2009 Association of Corporate Counsel

a period not to exceed thirty banking days and the value of which is known on the date the demand is filed.

The report of the inspector and the expert opinions that may be offered by the parties shall refer specifically to the types of instances/examples set forth in the preceding sections.

2. CONCILIATION (REORGANIZATION US CH.11) AND BANKRUPTCY (US CH.7)

Article 2. Bankruptcy consists of two successive stages, known as conciliation reorganization and insolvency. (bankruptcy)

Article 3. The purpose of conciliation is to conserve the company of the businessman through an agreement signed with its acknowledged creditors. The purpose of insolvency is the sale of the businessman's company, its productive units or the company's assets in order to pay the acknowledged creditors.

3. INSOLVENCY PRESUMPTION

Article 11. A businessman shall be presumed to fail generally to meet his payment obligations in any of the following instances:

I. Lack of, or insufficient, assets to seize when enforcing an attachment order resulting from the failure to pay a debt, or when enforcing a final judgment entered against the businessman;

II. Failure to pay two or more creditors;

III. Hiding or absence without appointing someone who may satisfy his obligations to manage or operate the business;

IV. In similar circumstances as those described in the preceding section, closing the stores of the company;

V. Engage in ruinous, fraudulent or false practices to satisfy or to avoid debts;

VI. Failure to meet pecuniary obligations contained in agreements entered into in accordance with Title Five of this Law; and

VII. In any other similar instance.

Copyright © 2009 Association of Corporate Counsel

4. INSOLVENCY JUDGEMENT

Article 43. The judgment declaring commercial insolvency shall contain:

I. The name, corporate/partnership name and the domicile of the businessman and, if applicable, the complete name and domicile of the partners with unlimited responsibility.

II. The date of the judgment.

III. The bases for the judgment in accordance with the provisions of Article 10 of this Law, as well as, if applicable, a list of creditors the inspector identified from the accounting records of the businessman, which list shall indicate the amount of each debt. The list shall not exhaust the procedure of acknowledging, grading and prioritizing the credits referred to in Title Four of this Law;

IV. The order requiring the Institute to appoint a conciliator using the random selection method previously established, together with the decision that, among other things, the businessman, its administrators, managers and employees shall have the obligations that the law imposes on trustees;

V. The declaration initiating the conciliation phase, unless the businessman requests insolvency;

VI. The order requiring the businessman to make available to the conciliator the books, registers and other documents of the company, as well as the necessary resources to pay for the publications required by this Law;

VII. The order requiring the businessman to allow the conciliators and receivers to conduct the activities required of their posts;

VIII. The order requiring the businessman to suspend payments on debts contracted prior to the date on which the judgment of commercial insolvency becomes effective, except for those that are essential to the ordinary operation of the company; the businessman shall notify the judge within twenty-four hours of making such payments;

IX. The order staying all attachment orders or enforcement orders against the property and rights of the businessman during the conciliation stage, except those orders specified in Article 65;

X. The retroactive date;

XI. The order requiring the conciliator to publish a summary of the judgment in accordance with Article 45 of this Law;

XII. The order requiring the conciliator to register the judgment in the public commercial registry in the domicile of the businessman and in all other places

Copyright © 2009 Association of Corporate Counsel

in which the businessman has an agency, branch or property subject to registration in any public register;

XIII. The order requiring the conciliator to initiate the procedure to acknowledge credits;

XIV. The notice to the creditors so that they may request the acknowledgement of their credits; and

XV. The order requiring that a certified copy of the judgment be issued at the expense of those who request it.

Article 65. As of the issuance of the judgment declaring commercial insolvency and until the end of the conciliation phase, the enforcement of any attachment or enforcement order against the property and rights of the businessman shall be stayed.

When the attachment or enforcement order is related to a labor claim, the stay shall not be valid with respect to the provisions of Article 123(A)(XXIII) of the Constitution and the related regulations, for which purposes the salaries of the two years prior to commercial insolvency shall be considered. If the order is related to a tax claim, the provisions of Article 69 of this Law shall govern.

5. SEPARATION OF PROPERTY HELD BY INSOLVENT BUSINESS

Article 70. Property in the possession of the businessman that may be identified and that has not been transferred to the businessman by definitive and irrevocable legal title may be claimed by the legitimate owner thereof. The insolvency judge shall have jurisdiction to hear the action to reclaim such property.

Once the complaint to reclaim the property is filed and the requirements set forth in Article 267 are satisfied, the judge shall order the return of the property to the plaintiff, provided the businessman, the conciliator or the receivers do not oppose the complaint. In the event of opposition, the suit shall continue as a incidental proceeding.

Article 71. Property that falls into the following categories, or in any other analogous category, may be separated from the Estate:

I. Property subject to replevin in accordance with the laws;

II. Real property sold to, the businessman, but not paid for, if the sale-purchase was not properly recorded in the corresponding public register.

III. Property purchased with cash, if the businessman has not paid the entire price at the time of the declaration of commercial insolvency.

IV. Real or personal property acquired on account, if the resolution clause for default in payment is recorded in the corresponding public register.

Copyright © 2009 Association of Corporate Counsel

V. Credit instruments of any kind issued or endorsed in favor of the businessman as payment for third party sales, provided it is proven that the obligations satisfied in this manner arose from such sales and that the entry was recorded in the current account between the businessman and his principal;

VI. Taxes retained, collected or transferred by the businessman for the account of the tax authorities; and

VII. The property in his possession that falls within any of the following categories:

a) Deposit, usufruct or trust or that have been received in management or consignment, if commercial insolvency is declared prior to the purchaser stating [his intention] to make the property his own, or if the time period for making such statement has not run;

b) A purchase, sale, transit, delivery or collection commission;

c) To deliver to a specific person on behalf of a third party or to satisfy obligations to be satisfied in the businessman's domicile;
If the credit resulting from the remission is allocated to the payment of a bill of exchange, the legitimate owner of such bill may reclaim it; or

d) The amounts in the name of the businessman for sales made by third parties. The reclaiming party may also obtain the assignment of the corresponding accounts receivable.

6. BUSINESS MANAGEMENT DURING REORGANIZATION

Article 74. During the conciliation phase, the businessman shall manage the company, except in the case set forth in Article 81 hereof.

Article 75. If the businessman continues to manage his company, the conciliator shall oversee the accounting and all operations undertaken by the businessman.

The conciliator shall make decisions concerning pending contract and shall approve, after considering the opinion of the receivers, new obligations, the creation or substitution of guarantees and the sale of assets if they are not related to the ordinary operation of the businessman's company. The conciliator shall provide the judge with a report of such decisions. Any objections thereto shall be litigated collaterally.

In the case of the substitution of guarantees, the conciliator shall obtain the prior, written consent of the creditor in question.

7. OBLIGATIONS PENDING PAYMENT

Article 88. The following rules shall apply for purposes of calculating the total credits owed by the businessman as of the issuance of the order imposing commercial insolvency:

I. The businessman's current obligations shall be considered due and payable;

II. With respect to the credits subject to condition precedent, the condition precedent shall de deemed to have occurred.

III. [With respect to] credits subject to conditions subsequent, the condition shall be deemed to have occurred without requiring the parties to return the payments/consideration received during the term of the obligation;

IV. The amount of the credits for periodic or successive services shall be determined at its present value, considering the interest rate agreed upon, or in the absence thereof, the rate applied in the market to similar transactions taking into account the currency or unit in question, and if such alternative is not possible, the legal interest rate.
V. The creditor of a **annuity** shall be entitled to a credit acknowledged in the amount of its replacement value in the market, or in the alternative, in the amount of its present value calculated in accordance with commonly accepted practices.

VI. Obligations with indeterminate or uncertain amounts shall be valued in cash; and

VII. Non-pecuniary obligations shall be valued in cash; if such valuation is not possible, the credit shall not be acknowledged.

Article 89. On the date the judgment imposing commercial insolvency is issued:

I. The capital and unpaid, related financial charges of unsecured credits denominated in domestic currency shall cease earning interest and shall be converted into UDIs using the conversion rates for such units issued by the Bank of Mexico. The credits originally denominated in UDIs shall stop earning interest;

II. The capital and unpaid, related financial charges of unsecured credits denominated in foreign currency, regardless of the place of payment agreed to by the parties, shall stop earning interest and shall be converted into domestic currency at the exchange rate determined by the Bank of Mexico to pay obligations denominated in foreign currency that are payable in Mexico. In turn, such amount shall converted into UDIs in accordance with the provisions of the foregoing section; and

III. Secured credits, regardless of whether the parties agreed initially that payment should be made in Mexico or abroad, shall remain denominated in the currency originally agreed upon and shall only earn the ordinary interest specified in the contract, up to the amount of the property guaranteeing such credits.

For purposes of calculated the participation of the secured creditors in the decisions they are permitted to make pursuant to this Law, the amount of their credits as of the

Copyright © 2009 Association of Corporate Counsel

date of the judgment imposing commercial insolvency shall be converted into UDIs in accordance with the provisions for converting unsecured credits set forth in sections I and II of this article. Secured creditors shall participate as such in such amount, notwithstanding the value of the guarantees, unless such secured creditors exercise the option set forth in the following paragraph.

If a secured creditor considers that the value of his guarantee is less than the amount due for capital and related charges on the day of the declaration of commercial insolvency, such creditor may motion the judge to recognize him as a secured creditor for the amount that the creditor himself attributes to his guarantee and as an unsecured creditor for the remainder. The value the creditor attributes to his guarantee shall be converted into UDIs at the value on the date the declaration of commercial insolvency is issued. In this case, the creditor shall expressly waive, in favor of the Estate, any excess between the price obtained upon enforcing the guarantee and the value he attributed such guarantee, taking into account the value of the UDIs on the date of such enforcement.

Article 90. As of the date on which the judgment imposing commercial insolvency is issued, only the following may be compensated:
I. The rights of, and the obligations payable by, the businessman that are derived from the same transaction, which transaction is not interrupted by virtue of the judgment imposing commercial insolvency;

II. The rights of, and the obligations payable by, the businessman that became due and payable prior to the judgment imposing commercial insolvency, the compensation for which rights and obligations is provided for in the laws;

III. The rights and obligations derived from the transactions specified in Articles 102 to 105 of this Law; and

IV. The tax credits of and against the businessman.

8. CONTRACTS PENDING COMPLIANCE

Article 91. Commercial insolvency shall not affect the validity of contracts related to property that is strictly personal in nature, which property does not form part of the assets or the property or rights over which the businessman retains control and dominion in accordance with Article 179 hereof.

Article 92. Preliminary and final contracts pending execution shall be performed by the businessman, unless the conciliator opposes performance thereof in the interests of the Estate.

Any party who has entered into a contract with the businessman shall have the right to have the conciliator declare whether the conciliator opposes completion of the contract. If the conciliator states that he shall not oppose the completion thereof, the businessman shall perform the contract or guarantee performance thereof. If the conciliator states that he shall oppose, or if the conciliator does not respond within a

Copyright © 2009 Association of Corporate Counsel

period of twenty days, the party who has contracted with the businessman may, at any moment, consider the contract terminated and shall notify the conciliator of such fact.
If the conciliator is in charge of the administration [of the business] or authorizes the businessman to perform the pending contracts, [the conciliator] may avoid the reclaiming of the property or, if applicable, may demand the delivery of the property, paying the price therefor.

Article 93. A seller cannot be forced to deliver the real or personal property the businessman has acquired unless the sale price is paid or guaranteed.

The seller shall have a right of replevin over the property if he delivered such property in relation to a final contract that was not executed in the form required by law. Replevin shall not proceed if the contract absolutely requires that the contract be executed in the form required by law, and if the businessman, with the conciliator's authorization, requires such form; similarly replevin shall not proceed if the complaint to declare the contract void on the basis of the form of the contract is terminated in any other manner.

Article 94. The seller of personal property that has not been paid for and that are in route for delivery to the businessmen at the time commercial insolvency is imposed upon such businessman may oppose the delivery:

I. By varying the consignment as permitted by law; or

II. Stopping the physical delivery of the property despite not having the documents required to vary the consignment.

The opposition to the delivery shall be litigated collaterally between the seller and the businessman, with the intervention of the conciliator.

Article 95. If the seller of real property is declared in commercial insolvency, the buyer shall have the right to demand delivery of the property prior to paying the price therefor, provided the sale was perfected in accordance with applicable legal provisions.

Article 96. The businessman who has been declared commercially insolvent who has purchased property that has not yet been delivered to him may not demand that the seller effectuate the delivery as long as he does not pay the price or guarantee such payment.

If delivery was made on the basis of a promise to purchase, the seller may repossess the property if the sale contract was not formalized through a public deed, provided such requirement was legally requested.

Article 97. If the decision is made to perform the contract and the if payment is subject to a period that has not expired, the seller may demand a guarantee of performance.

Article 98. In the case of installment sales, if some installments have been made but not paid for, the price of such installments shall be paid, which payment shall be required for the effects of performance foreseen in the preceding article and in the third paragraph of Article 92 of this Law.

Copyright © 2009 Association of Corporate Counsel

Article 99. Notwithstanding the declaration of commercial insolvency of the seller of personal property, if the property was calculated prior to such declaration, the purchaser may demand performance of the contract, subject to payment of the price therefor.

Article 100. Bailment contracts, contracts to establish a credit, commission contracts and agency contracts shall not be terminated by the declaration of commercial insolvency of one of the parties, unless the conciliator considers that such contracts should be considered terminated.

Article 101. As a result of the commercial insolvency, the current accounts shall be anticipatorily terminated and shall be liquidated to demand or to cover the amounts thereof, unless the businessman, with the conciliator's consent, expressly states that such account will continue.

Article 102. The declaration of commercial insolvency shall terminate repurchase agreements entered into by the businessman, in accordance with the following rules:

> I. If the businessman is the repurchasee, he shall provided to the repurchaser, within a period not to exceed fifteen calendar days as of the date of the declaration of commercial insolvency, the share certificates for the corresponding shares upon reimbursement of the [purchase] price, plus the premium agreed upon.
>
> II. If the businessman is the repurchaser, the contract shall be considered void as of the date on which commercial insolvency was declared, and the repurchasee may demand payment for the differences, if any that exist exactly on the date of the declaration of commercial insolvency, by means of the acknowledgement of credits. The businessman shall maintain the transaction price and the repurchasee shall maintain the property and free access to the shares subject to the repurchase; and
>
> III. Reciprocal repurchase agreements entered into between the businessman and the other party to such agreements, whether or not documented in a master agreement or a contract that establishes rules for future dealings between the parties, shall be deemed terminated anticipatorily on the date of the declaration of commercial insolvency, even if the termination date thereof is subsequent to the date of such declaration, compensation [for which termination] shall be paid in accordance with this Law.

In the event the corresponding agreements do not contain a provision for the compensation and liquidation of the underlying obligation [termination/damages clause], for purposes of making payment, the value of the shares shall be calculated in accordance with their market value on the day of the declaration of commercial insolvency. If there is no available and demonstrable market value, the conciliator may retain a third party with experience in such matters to appraise the shares.

The amount that may be payable by the businessman as a result of the anticipatory termination may be demanded by the acknowledgement of credits process. In the event

credits are generated in favor of the businessman, the other contracting party shall deliver such amount to the Estate within a period not to exceed thirty calendar days as of the declaration of commercial insolvency.

Article 103. Transactions involving the lending of securities entered into by the businessman, which transactions are guaranteed with domestic currency, shall be subject to the same rules that govern repurchase agreements.
Transactions involving the lending of securities by the businessman that are guaranteed with securities denominated in foreign currency, shall be subject to the provisions of section III of the preceding article.

Article 104. Differential or futures contracts and financial derivative operations that become due and payable after commercial insolvency is declared shall be deemed terminated anticipatorily on the date of such declaration. These contracts and transactions shall be liquidated in accordance with this Law.

In the event the corresponding agreements do not contain a provision for the compensation and liquidation of the underlying obligation [termination/damages clause], for purposes of making payment, the value of the underlying property or obligations shall be calculated in accordance with their market value on the day of the declaration of commercial insolvency. If there is no available and demonstrable market value, the conciliator may retain a third party with experience in such matters to appraise the property or obligations.

The credit that may be generated against the businessman may be demanded through the acknowledgement of credits process. In the event the anticipatory termination referred to in this Article results in an amount payable by the party who has contracted with the businessman, such party shall deliver the amount to the Estate within a period not to exceed thirty calendar days as of [the date] commercial insolvency is declared.

For purposes of this Law, derivative financial transactions shall mean those transactions in which the parties are obligated to pay monies or to satisfy other obligation to provide, which transactions have as the underlying object a property or market security, as well as any agreement defined as a financial derivative transaction by the Bank of Mexico.

Article 105. The debts and credits resulting from master agreements, agreements that establish rules for future dealings between the parties, specific agreements, any of which agreements relate to derivative financial transactions, repurchase transactions, futures transactions and other equivalent transactions, shall be paid for and may be demanded, on the date commercial insolvency is declared, in accordance with the provisions of such agreements or in accordance with the provisions of this Law. The foregoing shall also apply to any other juridical acts in which one party is both debtor and creditor of the other party, when such acts may be reduced to case, even if the debts and credits are not liquid and are not subject to demand on the date commercial insolvency is declared, but which may become liquid and payable pursuant to the terms of the foregoing agreements or this Law.

Copyright © 2009 Association of Corporate Counsel

The provisions of this article shall apply notwithstanding the provisions of Article 92 of this Law, even if the compensation is paid within the period referred to in Article 112 hereof, unless it is proven that the agreement(s) that resulted in the compensation were signed or amended to give preference to one or more creditors.

The amount due, if any, resulting from the payment permitted by this article, which amount is payable by the businessman, may be demanded by the other party in question through the acknowledgement of credits process. If an amount is payable to the businessman, the other party shall deliver such payment to the conciliator for the benefit of the Estate within a period not to exceed thirty calendar days as of the date commercial insolvency is declared.

Article 106. If a landlord is declared in commercial insolvency, the lease agreement is not deemed terminated.
If a lessee is declared in commercial insolvency, the lease agreement is not deemed terminated. Notwithstanding the foregoing, the conciliator may choose to terminate the contract, in which case, the conciliator shall be the lessee the indemnification stipulated in the contract, or if no such indemnification is stipulated, an indemnification equal to three months rent for anticipatory termination.

Article 107. Personal service agreements, in favor of, or to be rendered by, a businessman who is declared commercially insolvent shall not be deemed terminated, and shall be governed by the agreement between the parties.

Article 108. Lump sum labor contracts shall be deemed terminated if one of the parties is declared commercially insolvent, unless the businessman, with the conciliator's authorization, agrees with the other contracting party to perform the contract.

Article 109. If an insured is declared commercially insolvent, the insurance contract is not deemed rescinded it covers real property. If the contract covers personal property, the insurer may rescind it.

If the conciliator does not inform the insurer of the declaration of commercial insolvency with a period of thirty calendar days as of the date it is issued, the insurance contract shall be deemed rescinded as of the expiration of such thirty day term.

Article 110. With regard to life insurance contracts or mixed insurance contracts, the businessman, with the conciliator's authorization, may decide to surrender the policy and receive a reduction of the capital insured in proportion to the premiums paid to date, in accordance with the calculations the insurance company made when entering into the contract and considering the risks taken by the insurance company. Similarly, the businessman may enter into another transaction that shall result in an economic benefit to the Estate.

Copyright © 2009 Association of Corporate Counsel

9. REORGANIZATION (CONCILIATION STAGE)

Article 145. The conciliation stage shall last one hundred eighty-five days, as of the day the final publication of judgment imposing commercial insolvency is made in the Diario Oficial de la Federación.

If they believe that an agreement is imminent, the conciliator or the Acknowledged Creditors that represent at least two-thirds of the total amount of the credits acknowledged may request that the judge extend the period up to ninety calendar days as of the date on which the period referred to in the preceding paragraph expires.

The businessman and ninety percent of the Acknowledged Creditors may request that the judge grant an extension of up to ninety days more than the extension referred to in the preceding paragraph.

In no event may the period of the conciliation stage and the extension there exceed three hundred sixty-five days as of the date of the last publication of the judgment imposing commercial insolvency in the Diario Oficial de la Federación.

Article 154. Agreements between the businessman and any of his creditors entered into as of the declaration of commercial insolvency shall be void. The creditor that enters into such an agreement shall lose his rights in the commercial insolvency process.

Article 160. Those secured Acknowledged Creditors that do not participate in the agreement may initiate or continue the enforcement of their guarantees, unless the agreement contemplates the payment of their credits in accordance with the terms of Article 158 hereof, or the payment of the value of their guarantees. In the latter case, the difference between the amount of the debt and the amount of the guarantee shall be deemed an unsecured credit and shall be subject to the provisions of the preceding article.

Article 163. The agreement may be vetoed by a simple majority of the unsecured Acknowledged Creditors, or by any number of unsecured Acknowledged Creditors whose acknowledged credits jointly represent at least fifty percent of the total credits acknowledged to such class of creditors.
Unsecured Acknowledged Creditors that do not sign the agreement may not exercise their veto power if such agreement provides for the payment of their corresponding credits in accordance with Article 158 hereof.

Article 165. The agreement approved by the judge shall bind:

I. The businessman;

II. All the unsecured Acknowledged Creditors;

III. The secured Acknowledged Creditors or those creditors with special privilege that sign the agreement; and

Copyright © 2009 Association of Corporate Counsel

IV. The secured Acknowledged Creditors or those creditors with special privilege whose credits shall be made under the terms of the agreement in accordance with Article 158 hereof.

The signing of the agreement by the secured Acknowledged Creditors or those creditors with special privilege does not imply that such creditors waive their guarantees or privileges, which guarantees and privileges shall continue to exist to assure the payment of such credits in accordance the terms of the agreement.

Article 166. Once the order approving the agreement is issued, the commercial insolvency process shall be deemed terminated and all entities related thereto shall cease their duties. For such purposes, the judge shall order the conciliator to cancel the registrations recorded in the public registries as a result of the commercial insolvency process.

10. BANKRUPTCY DECLARATION (US CH.7)

Article 167. The businessman subject to commercial insolvency shall be declared in insolvency if:

I. The businessman so requests;
II. The period for the conciliation and any continuances thereof have expired and an agreement has not been submitted for the judge's approval in accordance with the provisions of this Law; or

III. The conciliator requests the declaration of insolvency, and the judge grants such request within the terms of Article 150 of this Law.

Article 169. The judgment imposing insolvency shall contain:

I. An order to suspend the businessman's capacity to control the property and rights that comprise the Estate, provided such control was not previously withdrawn;

II. An order instructing the businessman, his directors, managers and officers to deliver to the trustee possession and control of the property and rights that comprise the Estate, except such property and rights that are inalienable, not subject to attachment, or not subject to a statute of limitations;

III. An order instructing persons who have in their possession property belonging to the businessman to deliver such property to the trustee, unless such property was subject to a final order for the satisfaction of obligations issued prior to the commercial insolvency process;

IV. An order prohibiting the debtors of the businessman from paying him or delivering to him property without the authorization of the trustee, under penalty of double payment; and

Copyright © 2009 Association of Corporate Counsel

V. An order instructing the Institute to appoint the conciliator as trustee within a period of five days, or in the alternative, to appoint a trustee; in the interim, the person in charge of managing the businessman's company shall have the obligations of the trustee with respect to the property and rights that comprise the Estate.

In addition, the judgment imposing insolvency shall also contain elements sets forth in sections I, II and XV of Article 43 hereof.

Article 178. The judgment declaring bankruptcy implies the immediate removal, without the need of any additional judicial order, of the businessman from the management of his company; the businessman shall be replaced by the trustee.
To perform his duties, and subject to the provisions of this Law, the trustee shall have the broadest powers of control and dominion granted by law.

11. CREDITORS´ PRIORITIES

Article 217. Creditors shall be classified in the following classifications:

I. Singularly privileged creditors;
II. Secured creditors;
III. Creditors with special privilege; and
IV. Unsecured creditors.

Article 218. The following are singularly privileged creditors, whose priority shall be determined in numerical order:

I. The funeral costs/expenses of the Businessman, provided the order imposing commercial insolvency is issued after the Businessman's death; and

II. The creditors of the costs of the illness that resulted in the Businessman's death, provided the order imposing commercial insolvency is issued after the Businessman's death.

Article 219. For purposes of this Law, the following are secured creditors, provided their guarantees are duly created in accordance with the applicable provisions:

I. Mortgage holders; and

II. Holders of chattel mortgages or security interests.
Secured creditors shall receive payment of their credits from the proceeds of the sale of the property pledged, to the absolute exclusion of the creditors referred to in sections III and IV of Article 217 hereof and subject to the order established in accordance with the applicable provisions related to the recordation date.

Article 220. Creditors with special privilege are those creditors who have a special privilege or some lien right pursuant to the Commercial Code or to applicable law.

Copyright © 2009 Association of Corporate Counsel

Creditors with special privilege shall charge in the same terms as secured creditors or in accordance with the date of their credit, if such credit is not subject to recordation, unless various creditors with special privilege have credits related to the same property, in which case, a pro rata share shall be distributed regardless of the date of the credits, provided the law does not provide otherwise.

Article 221. Labor credits other than those specified in Article 224(I) and tax credits shall be paid after payment of the singularly privileged credits and the secured credits, but prior to the payment of credits with special privilege.

If the tax credits are secured, they shall be paid in accordance with Article 219 of the Law up to the amount of the underlying guarantee and any remaining amount shall be paid in accordance with the first paragraph of this article.

Article 222. Unsecured creditors are all those creditors who do not fall within the purview of Articles 218 - 221 and 224 hereof; they shall receive a pro rata share regardless of the date of their credits.

Article 223. No payments shall be made to creditors of one classification until all the creditors of the preceding classification have been paid, pursuant to the priority given such creditors.

Article 224. Credits against the Estate shall be paid in the order indicated [below] before any of the credits referred to in Article 217 of this Law.

> I. The credits referred to in Article 123 (XXIII)(A) of the Constitution and regulatory provisions, increasing the salaries to those corresponding to the two year prior to the Businessman's declaration of commercial insolvency;
>
> II. Credits contracted by the Businessman for the management of the Estate, which credits were approved by the conciliator or the trustee, or if applicable, which credits were contracted by the conciliator himself;
>
> III. Credits contracted to cover normal costs for the security of the property comprising the Estate, or the repair, preservation or administration thereof.
>
> IV. Credits arising from judicial or extrajudicial proceedings; and
>
> V. The fees of the inspector, conciliator and trustee and the costs incurred by them, provided such costs were strictly necessary to perform their duties and were duly verified in accordance with the provisions issued by the Institute.

Article 225. The privilege referred to in the preceding article shall not be valid vis-à-vis secured creditors or creditors with a special privilege; instead only the following shall have privilege:

> I. Creditors based on Article 123(XXIII)(A) of the Constitution and its regulatory provisions with regard to the salaries of the two years prior to the Businessman's declaration of commercial insolvency;

Copyright © 2009 Association of Corporate Counsel

II. Costs of litigation to defend or recuperate property that served as a guarantee or over subject to the privilege; and

III. The costs required for the repair, preservation and sale of such property.

12. CROSSBORDER INSOLVENCY PROCEEDINGS

Article 278. The provisions of this Title shall be applicable to cases in which:

I. A Foreign Court or a Foreign Representative requests the assistance of the Mexican Republic in relation to a Foreign Proceeding;

II. The assistance of a foreign State is requested in relation to a proceeding brought in accordance with this Law;

III. Proceedings are being processed simultaneously against the same Businessman in a Foreign Proceeding and a proceeding in the Mexican Republic brought in accordance with this Law; or
IV. The creditors or other interested persons, which creditors or persons are located in a foreign State, have an interest in initiating a proceeding or in participating in a proceeding brougt in accordance with this Law.

Article 279. For purposes of this Title:

I. A Foreign Proceeding is a collective proceeding, whether judicial or administrative, including provisional proceedings, brought in a foreign State pursuant to a law governing the commercial insolvency, bankruptcy or insolvency of the Businessman, as a result of which proceeding the property and business of the Businessman are subject to the control or supervision of a Foreign Court for purposes of reorganization or liquidation;

II. Principal Foreign Proceeding is the Foreign Proceeding in the State in which the Businessman has the center of his prinicipal interests;

III. Non-principal Foreign Proceeding is a Foreign Proceeding brought in a State in which the Businessman has an establishment described in section VI of this article;

IV. Foreign Representative is the person or entity, including one appointed provisionally, that was named in a foreign proceeding to manage the reorganization or liquidation of the property or business of the Businessman or to act as representative in the Foreign Proceeding;

V. Foreign Court is the judicial authority or other authority with jurisdiction over the control or the supervision of a Foreign Proceeding; and

Copyright © 2009 Association of Corporate Counsel

VI. Establishment is every place of operations in which the Businessman conducts, in a manner that is not transitory, an economic activity with human resources, property or services.

Article 280. The provisions of this Title shall apply when the provisions of the international treaties to which Mexico is a party do not provide otherwise, unless international reciprocity does not exist.

Article 282. The inspector, the conciliator or the trustee shall be empowered to act in a foreign State, to the extent permitted by the applicable foreign law, in representation of the commercial insolvency proceeding brought in the Mexican Republic pursuant to this Law.

13. FOREIGN INSOLVENCY PROCEEDINGS

Article 292. The Foreign Representative may request that the judge recognize the Foreign Proceeding in which he was appointed.
All motions for recognition shall attach:

I. A copy certified by the Foreign Court of the order initiating the Foreign Proceeding and appointing the Foreign Representative;

II. A certification issued by the Foreign Court verifying the existence of the Foreign Proceedings and the appointment of the Foreign Representative; or

III. In the absence of the evidence referred to in sections I and II, the motion shall attach any other evidence that may be accepted by the judge of the existence of the Foreign Proceeding and the appointment of the Foreign Representative.

All motions for recognition shall attach a statement setting forth all the information for all the Foreign Proceedings initiated against the Businessman of which the Foreign Representative is aware.

The judge shall require that all documents filed in a foreign language in support of a motion for recognition attach a translation into Spanish.
Similarly, the Domicile of the Businessman shall be provided for purposes of serving the motion. The proceedings shall be heard as a collateral issue between the Foreign Representative and the Businessman, in which the inspector, the conciliator or the trustee may intervene, as applicable.

Article 293. If the recognition of a foreign proceeding against a Businessman with an Establishment in Mexico is requested, the provisions of Chapter I of Title One of this Law shall be followed, including those related to the issuance of precautionary measures.

The judgment referred to in Article 43 hereof shall also specify a statement recognizing the Foreign Proceeding(s) in question.

Copyright © 2009 Association of Corporate Counsel

The commercial insolvency proceedings shall be governed by the provisions of this Law.

Article 296. Except for the provisions of Article 281 of this Law, a Foreign Proceeding shall be recognized if:

I. The Foreign Proceeding is a proceeding that falls within the purview of Article 279(I);

II. The Foreign Representative requesting the recognition is a person or entity within the meaning of Article 279(IV);

III. The motion satisfies the requirments of Articles 292, 293 and 294 of this Law, as applicable; and

IV. The motion was filed before the court with jurisdcition.

The Foreign Proceeding shall be recognized:

I. As the Prinicpal Foreign Proceeding, if such proceeding is being conducted in the State in which the Businessman has his center of prinicpal interests; or

II. As a Non-principal Foreign Proceeding if the Businessman has within the territory of the State of the foreign forum an Establishment within the meaning of Article 279(VI) hereof.

Article 299. As of the recognition of a Principal Foreign Proceeding:

I. All enforcement measures against the property of the Businessman shall be stayed; and

II. All rights to transfer, to encumber or to otherwise dispose of the Businessman's property shall be stayed.

The extent, the amendment and the termination of the effects of the paralyzing and staying referred to in the first paragraph of this article are subject to the provisions of Title Three, Chapter I of this Law regarding the staying of enforcement proceedings during the conciliation stage.

14. INTERNATIONAL COOPERATION

Article 304. With regard to the issues referred to in Article 278 of this Law, the judge, the inspector, the conciliator or the trustee shall cooperate, in the exercise of their duties and in any manner possible, with foreign courts and representatives.

The judge, the inspector, the conciliator and the trustee shall have the power, in the performance of their duties, to communicate directly with foreign courts and representatives, without requiring letters rogatory or other formalities.

Copyright © 2009 Association of Corporate Counsel

Article 305. The cooperation referred to in Artilce 304 may be rendered in any appropriate manner, and particularly as follows:

I. The appointment of a person or entity to act under the direction of the judge, the conciliator, the inspector or the trustee;

II. The communication of information by any means the judge, the conciliator, the inspector or the trustee deem appropriate;

III. The coordination of the management and the supervision of the property and transactions of the Businessman;

IV. The approval or the application by the courts of the agreements related to the coordination of proceedings; and

V. The coordination of proceedings that are brought simultaneously against the Businessman.

15. THE MEXICAN INSTITUTE OF EXPERTS ON COMMERCIAL INSOLVENCY

Article 311. The Federal Institute of Commercial Insolvency Specialists is created as an auxiliary boby of the Federal Judiciary Council, with technical and operating autonomy, and with the following powers:

I. To authorize the enrollment in the corresponding register of the persons who certify that they satisfy the necessary requirements to perform the duties of inspector, conciliator or trustee in commercial insolvency proceedings;

II. To create and maintain the registers of inspectors, conciliators and trustees;

III. To rovoke the authorization to act as an inspector, conciliator and trustee in commercial insolvency proceedings, pursuant to the provisions of this Law;

IV. To appoint persons to act as an inspector, conciliator or trustee in each commercial insolvency proceeding, from those persons enrolled in the corresponding registers;

V. To establish general provisions for the random selection process for the appointment of the inspectors, conciliators or trustees.

VI. To draft and apply public procedures for the selection of, and the updating of authorizations issued to, inpsectors, conciliators or trustees, the corresponding critieria for which procedures shall be previously published in the Diario Oficial de la Federación;

Copyright © 2009 Association of Corporate Counsel

VII. To establish the fees payable to the inspectors, conciliators and trustees for the services they render in commercial insolvency proceedings;

VIII. To supervise the rendering of services by the inspectors, conciliators and trustees in commercial insolvency proceedings;

IX. To promote the training and the up-dating of the current level of knowledge of the inspectors, conciliators and trustees enrolled in the corresponding registers;

X. To undertake and support analyses, studies and investigations related to its duties;

XI. To publish its duties, goals and procedures, as well as the provisions it may issue in accordance with this Law;

XII. To draft and make available statistics related to commercial insolvency;

XIII. To issue general rules required for the exercise of the powers set forth in sections IV, V, VII and XI of this article;

XIV. To submit a report to the Congress of the Union, every semester, concerning the duties it undertakes; and

XV. All remaining powers conferred by this Law;

16. PRE-PACKAGED RESTRUCTURING

Article 339. Petition for commercial insolvency with a pre-packed plan shall be admitted when:

I. Petition meets requirements set for in Article 20 of this Law.
II. Petition is signed by insolvent merchant along with 40% of the holders of his total liabilities.

…

III. Insolvent merchant declares under oath to say the truth that:

a) His case is within the assumptions set forth in Art. 10 and 11 of this Law, stating the reasons therefor, or

b) It is imminent that he is within the assumptions set forth in Art. 10 and 11 of this Law, stating the reasons therefor.

By imminence it shall be understood an unavoidable 30 day-term, and

IV. Petition comes with the proposal for pre-packed restructuring of liabilities, signed by the creditors referred to in Section II of this Article.

Copyright © 2009 Association of Corporate Counsel

FUNDAÇÃO GETULIO VARGAS

EPGE

Escola de Pós-Graduação em Economia

Ensaios Econômicos

Escola de

Pós Graduação

em Economia

da Fundação

Getulio Vargas

Nº 599 ISSN 0104-8910

Past and Future of the Bankruptcy Law in Brazil and Latin America

Aloisio Araujo, Bruno Funchal

Agosto de 2005

Os artigos publicados são de inteira responsabilidade de seus autores. As opiniões neles emitidas não exprimem, necessariamente, o ponto de vista da Fundação Getulio Vargas.

Past and Future of the Bankruptcy Law in Brazil and Latin America[*]

Aloisio Araujo[++] Bruno Funchal[+]

Abstract

This paper studies the Bankruptcy Law in Latin America, focusing on the Brazilian reform. We start with a review of the international literature and its evolution on this subject. Next, we examine the economic incentives associated with several aspects of bankruptcy laws and insolvency procedures in general, as well as the trade-offs involved. After this theoretical discussion, we evaluate empirically the current stage of the quality of insolvency procedures in Latin America using data from Doing Business and World Development Indicators, both from World Bank and International Financial Statistics from IMF. We find that the region is governed by an inefficient law, even when compared with regions of lower per capita income. As theoretical and econometric models predict, this inefficiency has severe consequences for credit markets and the cost of capital. Next, we focus on the recent Brazilian bankruptcy reform, analyzing its main changes and possible effects over the economic environment. The appendix describes difficulties of this process of reform in Brazil, and what other Latin American countries can possibly learn from it.

JEL classification: G33; K40; K00

Keywords: Bankruptcy; Financial Distress; Legal System; Law and Economics

I – Introduction

The modern economic theory recognizes more and more the relevancy of the legal and institutional structures for the good functioning and development of the economy. The present paper works specifically on the law that governs the bankruptcy procedure of corporations, its characteristics and effects over the economic environment, besides the recent reforms that occurred in Latin America focusing specially on the Brazilian case.

---

[*] The authors would like to thank Ronald Fischer, Sara Castellanos and especially Eduardo Engel for their comments at the 11th Economia Panel Meeting at David Rockefeller Center for Latin American Studies at Harvard University.
[++] EPGE/FGV and IMPA, email: aloisioa@fgv.br.
[+] EPGE/FGV, email: bfunchal@fgvmail.br. I am grateful to FAPERJ for their financial support.

Copyright © 2009 Association of Corporate Counsel

Firms take debts for several different reasons. One important characteristic of this act is that such firms wish to repay their debts with their future gains. But, there is always the possibility, for some reason, of no fulfillment of such repayment promise. The bankruptcy law is concerned with what happens in such circumstances.

In the absence of a bankruptcy law, a creditor has two legal procedures at his disposal. First, in the case of secured loan, creditors can seize the firm's assets that serve as collateral for their loans. Second, in case of unsecured loans, creditors can go to court asking to sell some of the firm's assets. However, this method of debt collection runs into difficulties when there are many creditors and the debtor's assets do not cover his liabilities (i.e. when the firm is insolvent). Under these conditions each creditor will try to be the first to recover his debts. This uncoordinated race of creditors may lead to the dismantlement of the firm's assets, and to a loss of value for all creditors.

Given this situation, it is in the collective interest that the disposition of the debtor's assets be carried out in an orderly way, via a centralized bankruptcy procedure.

In a perfect world, there would be no need of a bankruptcy law because individuals could solve this problem via contracts, i.e. the debtor could specify as part of the debt's contract what would happen in case of default (like the division and the procedure). Writing such contracts is in fact very difficult, since debtors may acquire new creditors and assets as time passes and it may be very hard to specify how the division process should change as function of such adjustments. Besides, in practice, contracts like this are not written. Therefore, the bankruptcy law provides a default option for this problem of contract incompleteness.

To summarize the role of the bankruptcy law, we can say that it works to avoid problems of uncoordinated debt collection and contract incompleteness in a situation of no repayment of debts. But how should the bankruptcy law look like? Most countries have two bankruptcy procedures, one for liquidating assets of failing firms and another for reorganizing failing firms.

When a firm files for bankruptcy liquidation, the bankruptcy court appoints a trustee who shuts the firm down and sells its assets. This could be done in different ways: sale of the business or its productive

Copyright © 2009 Association of Corporate Counsel

units or piecemeal sale of its assets, depending on the demand and which option maximizes the value of the company's assets. The Absolute-Priority Rule determines how the proceeds of sale are divided among the claimants. It specifies what claims are paid in full according to an order defined by the bankruptcy law of each country.

However, when capital markets are imperfect, what is very common in developing countries, the best managers may not be able to raise the cash necessary to buy the firm. The firm may be inefficiently dismantled and its assets sold cheaply. Therefore, reorganization provides a good alternative for countries that have problems in their capital markets. An additional explanation[1] for the loss of value in liquidation is that when a firm in financial distress needs to sell assets, its industry peers are likely to be experiencing problem themselves, leading the asset sales to prices below value in best use. Hence, in cases where asset specificity and the correlation of returns across the firm are high, reorganization is likely to maximize the insolvency return instead of liquidation.

An alternative solution for the liquidation procedure, especially for firms financially distressed[2] but not economically inefficient[3] is the reorganization procedure, where there is no actual sale of the company's assets. There are different approaches to choose between both proceedings. Some countries (like Germany, France and England) prefer to give the exclusive control of the proceeding to an outside official who makes the initial decision whether the firm will be liquidated or remain in operation while a reorganization plan is formulated. Other countries choose to supervise the manager with an impartial and independent administrator who assumes complete power if management proves incompetent or negligent or has engaged in fraud or misbehavior. And finally, there are countries (like the U.S.) that give managers the right to choose between filing for bankruptcy liquidation or reorganization together with exclusive power to propose a reorganization plan.

---

[1]See Shleifer and Vishny (1992)
[2] A firm is in financial distress or insolvent when it can no longer meet its debt obligations with another firm or institution.
[3]A firm is economically efficient if the best use of its capital is the current use and it is economically inefficient if the value of its assets is greater in some other use.

Copyright © 2009 Association of Corporate Counsel

Once the reorganized procedure is chosen over liquidation, there is a conflict between the secured creditors' right to claim their collateral versus the goal of reorganizing the firm. In order to reorganize successfully, it must retain assets, which are crucial to its operations, but secured creditors often wish to claim these assets. In some countries this conflict is resolved in the firm's favor by applying an automatic stay to secured creditors (like U.S.), making the reorganization process more appealing. This protection varies from one country to another, with some not applying it, like the United Kingdom and Germany, thereby weakening or even eliminating the possibility of reorganization.

The next step is to provide the reorganization plan that specifies how much each creditor will receive in cash or claims from the new firm. An appropriate majority of creditors should be required to approve a plan. Assuming that reorganizing the firm causes it to be worth more than its assets would bring in liquidation, usually the reorganization procedure provides a framework within which creditors and managers (with equity holders) bargain over the distribution of the extra value and eventually adopt a reorganization plan, otherwise, if there is no agreement, the firm is liquidated.

The law leaves the division of the reorganized company's value to a process of bargaining among the classes of participants. Each class of equity holders and debt holders whose interests are not aligned must vote to approve a reorganization plan, which should include a division of value. The outcome of this bargaining process often diverges from the legal rights of the classes since managers and shareholders have some bargain power. It should be noted that violations of absolute priority rule usually happen in the reorganization procedure.

Ideally, the bankruptcy law should provide a good balance between liquidation and reorganization procedures, in such a way that minimizes the so-called *Filtering Failure* problem. There are two different cases of filtering failure problem: the first is when economically efficient firms in financial distress are liquidated but should be reorganized (its value would be bigger in reorganization), which is called *Type I Error*; the second is when economically inefficient and financially distressed firms are saved in reorganization but should be liquidated, which is called *Type II Error*. Avoiding filtering failure problem

Copyright © 2009 Association of Corporate Counsel

makes the efficiency of the economy higher since the good firms will stay alive and the bad ones will be closed, passing its assets to firms with higher efficiency.

A good design of bankruptcy law's procedures may influence in different ways the establishment of a healthy business environment. From an ex-post efficiency perspective, a bankruptcy law should maximize the total value of the company and consequently, the pay-off that creditors receive from insolvent firms. The positive effect comes over the cost of capital that is reduced since the expectation of recovery by creditors is higher in case of bankruptcy. As important as the ex-post efficiency is the ex-ante efficiency. At this perspective what matters is not the total value of the failed firm, but the division of its value among the participants. An ex-ante efficient bankruptcy law is capable to produce rights incentives over managers' decisions, in both the initial period of firm's life and after the firm goes to financial distress. Bankruptcy procedures should penalize managers adequately in bankruptcy states. Without any adverse consequence at all there is very little incentive to work hard in the early stage of a firm's life to pay its debts. This incentive has implications in the portion of insolvent firms and it is reduced when well provided. In the post-insolvency period, the management will tend to give rise to two inefficient bankruptcy decisions: first, undertaking excessively risky investments as a means of avoiding bankruptcy; second, delaying filing for bankruptcy aiming at extracting pecuniary gains as much as possible. A good insolvency system reserves some portion of value in bankruptcy for managers and shareholders to motivate actions in favor of efficient investment and timely decisions.

Notice that all mechanisms cited above contribute to a larger expected return of creditors, or by raising the return in bankruptcy states or by diminishing the probability of bankruptcy, reducing the cost of capital in the economy. Since an ex-ante objective of the bankruptcy law should be to maximize the project option set that creditors want to finance, lower capital costs are fundamental to reach this goal.

La Porta et al (1998) study empirically the impact of different bankruptcy laws in financial markets. The authors found that countries with a bankruptcy system that gives a higher protection to creditors have better and broader functioning financial markets than countries where the legal system provides weaker

Copyright © 2009 Association of Corporate Counsel

support to creditors. They argue that better legal protections provide a high expected return in bankruptcy states, enabling the financiers to offer entrepreneurs money at better terms. Levine et al (2000), studying empirically the second-order consequence of changes in bankruptcy law, found a strong link between financial development (that could be boosted by changes in bankruptcy law) and growth. Their econometric results suggest that, for example, if Brazilian financial market increases in 10%, Brazil could grow 0.6% faster per year. The reason for this effect on growth comes from the reduction in the cost of capital, promoting entrepreneurship by the creation of new firms and investments and therefore, fostering the economic growth.

The severe economic crises experienced by Latin American countries in the early 80's served as a natural experiment to alert that most of them needed to reform their bankruptcy system. Bergoeing et al (2002) compare the recoveries of the Mexican and Chilean economic crises in the early 80's. Chile carried out an administrative reform of the bankruptcy management service in 1978; the 1982 bankruptcy reform law clearly defined the rights of each creditor and replaced public officials for private officials. The old law does not provide for an efficient and timely bankruptcy management because it relied on poorly paid public officials and highly bureaucratic procedures. In contrast Mexico had an obsolete and unwieldy bankruptcy law from 1943 effective until 2000. The authors concluded that despite many similarities in initial conditions, such as appreciation of real exchange rates, large current-account deficits, inflation, and weakness in the banking sector, the reform of bankruptcy procedures in Chile had effects on both incentives to accumulate capital and efficiency with which that capital was accumulated[4]. Both effects are crucial to explain that Chilean faster recovery was due to its earlier bankruptcy law reforms.

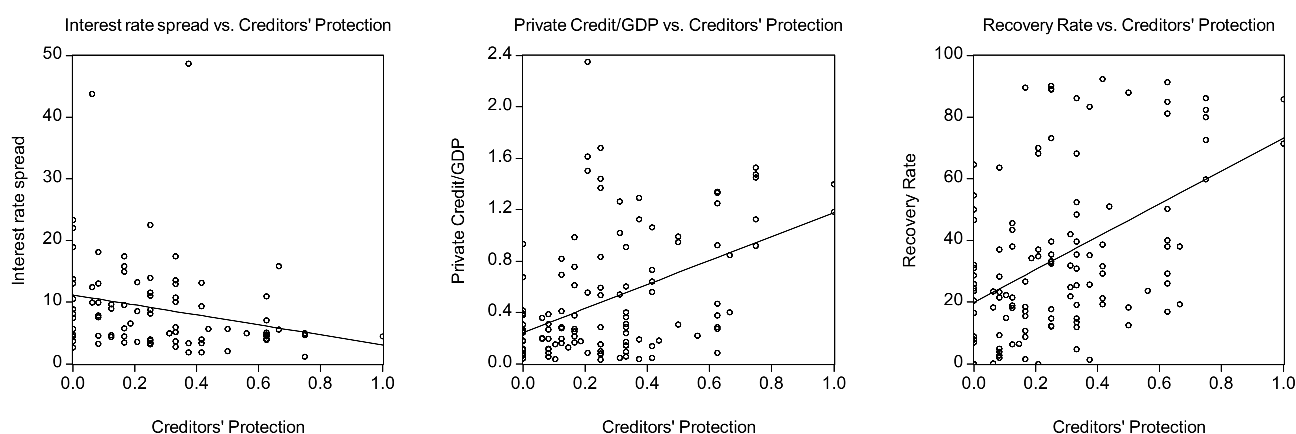
An extra relevant function of the bankruptcy law design is to avoid, as much as possible, fraud. Fraudulent actions have an important role in bankruptcy process mainly in Latin America. Mechanisms that contribute to raise the role of creditors (like an active participation in reorganization) and the expected return in bankruptcy, work to increase their incentive in monitoring the bankruptcy procedure, making fraudulent

Copyright © 2009 Association of Corporate Counsel

actions more difficult. Taking the former Brazilian Bankruptcy Law as an example, due to the top priority of labor and tax claims, creditors receive almost nothing in bankruptcy states, eliminating their incentive in participating in the bankruptcy procedure. Another important source of fraud in Brazil was also provided by the top priority of labor credit. This structure of priority opened the possibility of managers to cheat the law by creating jobs to "friends" in such a way to receive as regular workers (for the manager) of the failing firm. Therefore, the structure of priorities acts to avoid fraud, besides reducing the cost of capital.

Nowadays, despite all research in bankruptcy there is no conclusion about the design of the optimal bankruptcy law. However, there exist two consensual points in this debate. The first concerns the protection that bankruptcy law must provide for creditors and the second is about the goals-of-insolvency procedure.

Figure 1: Effects of Creditors' Protection over interest rate spread, private credit and creditors' recovery rate



Note: Creditors' protection index is calculated by the interaction between the measure of creditors' rights of La Porta et al (1997) and the variable of legal enforcement "rule of law".

Source: Doing Business database, International Country Risk Guide, World Development Indicators and International Financial Statistics

Evidences in the empirical field show that countries with strong legal creditors' protection would provide for firms an easier access to external finance in the form of both high value and broader capital markets. This happens because creditors expect to recover a bigger portion of their loans in case of insolvency. In this case they will be more prone to supply credit, making it cheaper and easy to get. Figure 1 illustrates exactly this situation.

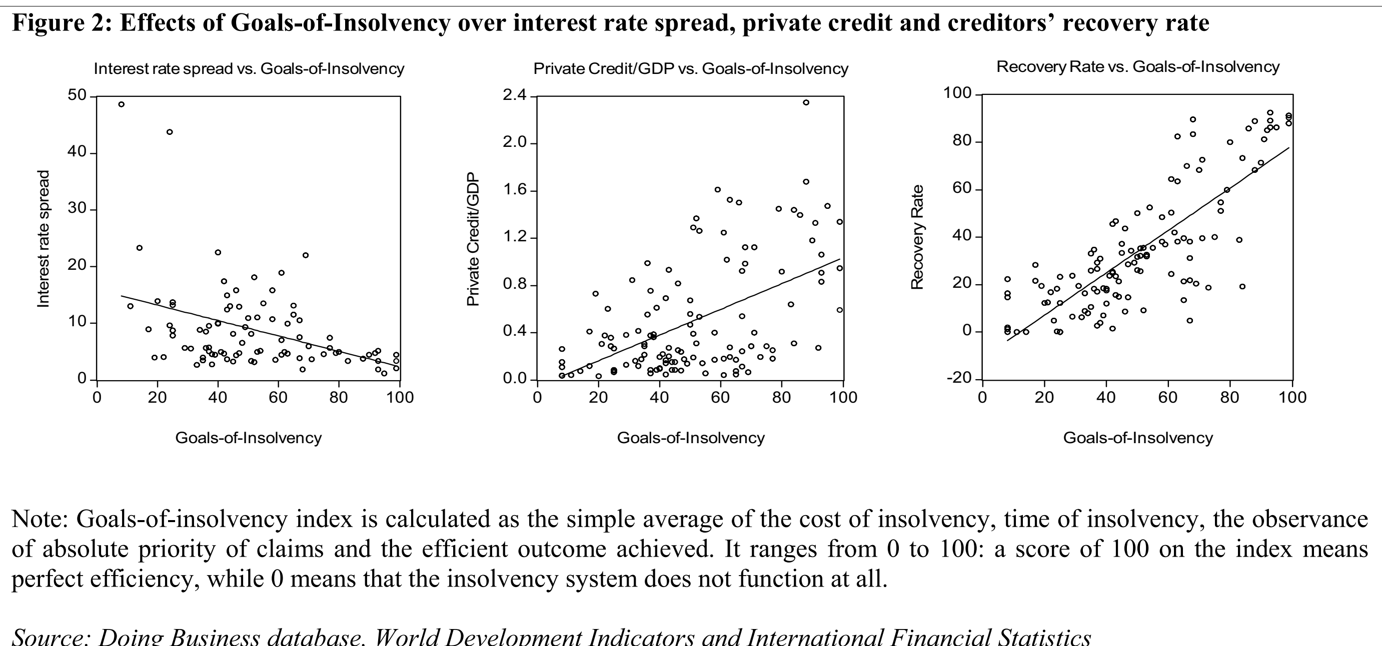
[4] However, since Chile also made changes in the banking law and the paper did not disentangle the dynamics effects of both

Copyright © 2009 Association of Corporate Counsel

The other consensual point concerns goals-of-insolvency stated by Oliver Hart (1999). The author specifies characteristics of a good bankruptcy procedure, which are three-fold: first, it should deliver an ex-post efficient outcome, which maximizes the firm's total value available to be divided among the interested parties; second, it should penalize debtors adequately in bankruptcy states, otherwise it could exacerbate the moral-hazard problem; and finally, but not least important, it should preserve the order of the claims defined when the contract was created, which helps to ensure that creditors receive a reasonable return in bankruptcy state and therefore encourages lending. Figure 2 illustrates the positive effects of goals-of-insolvency stated by Hart over the credit market.

Using both measures, we can feel that Brazil and Latin America have a quite inefficient bankruptcy procedure and that the bankruptcy law provides a low level of creditor protection, both results with negative effect on their credit market, cost of capital and creditors' recovery rate. Notice by Table 1 how poorly the Brazilian bankruptcy law was doing in both crucial variables, much worse than the average of Latin American Countries.

Figure 2: Effects of Goals-of-Insolvency over interest rate spread, private credit and creditors' recovery rate



Note: Goals-of-insolvency index is calculated as the simple average of the cost of insolvency, time of insolvency, the observance of absolute priority of claims and the efficient outcome achieved. It ranges from 0 to 100: a score of 100 on the index means perfect efficiency, while 0 means that the insolvency system does not function at all.

Source: Doing Business database, World Development Indicators and International Financial Statistics

---

reforms, it is possible that part of the differences between Chile and Mexico comes from the banking reform.

Copyright © 2009 Association of Corporate Counsel

Table 1: Bankruptcy Law Indicators

	Creditors' Protection [0,1]	Goals-of-Insolvency [0,100]
Brazil	0.06	24.0
Mean of Latin American Countries	0.19	46.3
Mean of OECD	0.46	79.6

Source: Doing Business 2003

Despite both consensual issues, the design of this law is still a real challenge, which makes the reform process very difficult. In the economic literature there is no convergence of opinions about how an optimal bankruptcy law should be, especially concerning violations of the absolute priority rule (i.e. the violation in the receiving order in case of bankruptcy). This occurs due to trade-offs that exist in case of violation or not of the absolute priority rule (from here on APR).

The role of the APR is to determine how the division of the failing firms' value is done. It specifies that claims are paid in full in the following order: first, administrative expenses of the bankruptcy process; second, claims taking statutory priority, such as tax claims, rent claims, and unpaid wages and benefits; and third, unsecured creditors' claims, including those of trade creditors. Equity holders receive the remainder, if any. Usually[5] secured creditors are outside the priority ordering because they have bargained with the firm for the right to claim a particular asset or its value if the firm files for bankruptcy. Thus, they may receive a payoff in bankruptcy even when all other creditors receive nothing. This rule is easily followed in liquidation procedure because the cash received is simply distributed among claimants according to the priority of their claims defined by the bankruptcy law. However, in reorganization procedure the sale of the company's assets is fictional. Consequently, no verifiable objective figure is available for the total value to be distributed (like the cash in liquidation). In this situation, a conflict of interest among participants emerges. Senior creditors have an incentive to advance a low valuation of the firm's value, because a low valuation would entitle them to a larger fraction of the reorganized company. For a similar reason, managers and equity holders have an incentive to advance a high valuation. Reorganization procedures – like Chapter 11 of U. S. Bankruptcy Code – that chose firms' restructuring plan using a bargaining process between interested parties allow deviations from the order specified by the bankruptcy law. The violation of APR means that equity holders,

Copyright © 2009 Association of Corporate Counsel

who always have bottom priority, get some amount of the firm's value even when secured creditors' claims are not paid in full.

Bankruptcy laws that do not offer a reorganization procedure like Chapter 11 to insolvent firms, rule out the possibility of APR deviations. This is valuable because the priority of creditors is maintained, guaranteeing bigger returns once the firm filed for bankruptcy. Moreover, the nonviolation of APR offers the correct incentive to managers' effort, minimizing problems of moral-hazard and therefore raises the possibility of firms' success. On the other hand, bankruptcy laws that provide the possibility of reorganization like Chapter 11, APR violations are possible. Despite its negative effect in the level of effort chosen by managers, such violation inhibits investments in inefficient risky projects when the firm is in financial distress; encourages desirable investments in firm's specific capital; and makes easier the transference of information to creditors, improving the timing of filing to bankruptcy. Such benefits tend to increase the firms' return in both bankruptcy states and non-bankruptcy states. Sometimes this higher return in bankruptcy states may offset creditors' direct losses of such violation (i.e. the part of the value that is given to managers and shareholders in bankruptcy), reducing the cost of capital.

Proposals of rigid legal structures that admit just the liquidation as a solution to insolvent firms were defended since the mid 80's until the beginning of the 90's by auctions' method, as a way to avoid deviations from APR. Under the auctions approach, the assets of the insolvent company will be always put on the block and auctioned off. Nevertheless, this method does not provide the possibility of reorganization for economically efficient firms (leading to a high frequency of type I error and to an inefficient allocation of assets); and it might result in systematic under-pricing[6]. With the evolution in the literature of bankruptcy, theorists began to defend reorganization as an alternative method to liquidation for economically viable firms. Bebchuck became a reference by his method called "options approach" that gives to the firm the opportunity of restructuring without deviations of APR. Under this approach, all participants in

[5] However, the bankruptcy law of some countries does not maintain this top priority, putting labor and/or tax and/or another claim above claims of secured creditors (see Table A in Appendix A).
[6] See the arguments at page 4.

Copyright © 2009 Association of Corporate Counsel

reorganization would receive certain options with respect to the new equities of the reorganized company. The division of value would result from the participants' own decisions concerning the exercise of the options given to them. The options would be designed so that, whatever the reorganized value of the firm, no participants would ever be able to complain that they would end up with less than the value to which they are entitled. This approach would be capable to reduce the frequency of type I error and to improve the efficiency of asset allocation. However, this view seems like to be changing again. Recently, several theorists of bankruptcy law have alerted to benefits brought by reorganization procedures that allow deviations from APR (like Chapter 11) through the bargain procedure between debtors and creditors.

It has been observed since the 80's that many Latin American countries, particularly in South America, have found themselves in the process of bankruptcy reforms to improve their system, aiming at providing a more attractive environment for business. In their majority, the main change concerns the creation or the improvement of the reorganization procedure, allowing specially the survival of viable business in financial distress. Besides, changes that reduce costs of the bankruptcy procedure were also an important target as in Brazil and Ecuador that simplify their legislations attempting to raise the agility of the procedure; and the creation of out-of-court reorganization procedure done in Brazil, Colombia, and Bolivia. Reaching this goal, the amount to be divided among creditors tends to increase, reducing the cost of capital.

Chile was the first to reform its system at the beginning of the 80's. The new law clearly defined the rights of each creditor and replaced public officials for private officials. The first change operates to improve the forecast of creditors' return in insolvency states; the second change reduces the bureaucracy, cost and time of the process. The reform diminished the cost of capital, raised investments and the efficiency, fostered a large ratio private credit/GDP and growth, all factors very important to the economy. Moreover, a good guarantee system, like mortgage for housing, and an efficient enforcement procedure support the well functioning of Chilean bankruptcy law. However, Chile still has many negative aspects in its insolvency system. The current law does not have the objective to keep viable business alive (high possibility of type I error); does not provide incentives to creditors in monitoring debtors (more possibility of fraud); the average

Copyright © 2009 Association of Corporate Counsel

time of the procedure is (still) too long; it misses specialized courts in bankruptcy etc. All these problems motivate new recommendations[7] to reform the Chilean bankruptcy system.

In 1994 the Mexican bankruptcy law from 1943 proved to be insufficient to respond effectively to the problems provided by the economic crisis and a new commercial bankruptcy law began to be considered. The new law that passed in May 2000 was designed to provide restructuring for commercial debtors as an alternative for viable distressed firms and an orderly liquidation of the estate, if necessary. Both measures work to increase the return of the insolvent firm. The first one gives the opportunity to efficient firms to keep themselves alive, improving the balance between liquidation and reorganization and therefore reducing filtering failure problems – which enhance the efficiency of the production factors–; and the second one avoids the inefficient dismantlement of the firms' asset caused by the uncoordinated debt collection. Even if it may seem that the new law favors restructuring, a careful reading reveals that the reform may be pro-liquidation, looking to strengthen creditors' rights and enhance resource allocation (both liquidation and restructuring were secondary)[8]. Some of the most important features of the reform were that: the federal district court is given original and exclusive jurisdiction over bankruptcy cases; the Federal Institute of Bankruptcy Specialists ("IFECOM") was created to supervise insolvency administrators and establish rules of procedures for insolvency cases (good at first sight); guidelines were established for the administration and disposition of the bankruptcy estate; and international cooperation is facilitated by the adoption, with the reciprocity clause, of UNCITRAL Model Law on Cross Border Insolvencies. The negative aspect is that the whole process is too bureaucratic and very dependent on the IFECOM.

The Argentinean bankruptcy law, differently from Brazil and Mexico, suffered several changes in few years. In a period of seven years three reforms occurred. The current legal framework for corporate insolvency is concentrated on the *Ley de Concursos y Quiebras* (LCQ hereinafter) of 1995, which replaced the previous bankruptcy system that ruled from 1972 to 1995. The most recent law provides for both

[7] See "Análisis y Recomendaciones para una Reforma de la Ley de Quiebras", by Claudio Bonilla, Ronald Fischer, Rolf Lüders, Rafael Mery, José Tagle.
[8] The authors appreciate Sara Castellanos' comments that were very useful to clarify this issue.

Copyright © 2009 Association of Corporate Counsel

liquidation and reorganization proceedings, allowing the possibility of rescue of viable business and closing the inefficient ones. This change impacts positively on the aggregated economic efficiency and on filtering failure problem. Modified on several occasions, the new law establishes a liquidation proceeding with generally modern features and a reorganization proceeding that is reasonably modern and largely consistent with the best practices. These modifications tend to reduce the time of the procedure and its cost, increasing the expected return of creditors and credit market. In February 2002, on the occasion of external crises, an emergency law was enacted in Argentina to help stabilize the corporate sector, where many firms which were indebted in dollar went into bankruptcy and then were passing the control to creditors (usually Banks). The main change is that such law imposed moratoria on different enforcement actions and precautionary measures of almost all kinds of creditors. Despite the attitude to preserve interests of corporation in a period of serious crises, this reform may bring serious damage to the reputation related to the bankruptcy law, and since creditors see this attitude as a reduction of the chance of being repaid in bankruptcy states, it may increase the cost of capital. In May 2002, a new reform was introduced which abrogated most of the emergency measures.

The Brazilian reform was the most recent in the region, in force since June 2005. The former law that was enacted in 1945 was very fragmented. In practice the insolvency process always proved to be ineffective at maximizing asset values and protecting creditor rights in liquidation (see table 1). Both forces make capital costs very high. This could explain the bad situation of Brazilian credit market (see figures 1 and 2). The new law improves on existing legislation by providing an option to reorganize in (inspired in Chapter 11 of the U.S Bankruptcy Code) or out of court, and striking a reasonable balance between liquidation and reorganization that reduces the type I error. Also, changes that look to raise creditors' protection and improve the role of creditors in bankruptcy procedure were pursued, making credit cheaper and easier to get, with positive consequences in the development of the economy. Additionally, these measures pro-creditors work against fraud of managers. This paper will focus specially on the Brazilian bankruptcy reform, analyzing the main changes and difficulties of the reform, such as its potential effects over the economy.

Copyright © 2009 Association of Corporate Counsel

The remainder of this work is organized as follows: Section 2 presents how the literature of bankruptcy theory evolves and what the current discussion is. Also, macro direct and indirect consequences of a successful reform that improves the bankruptcy procedure are discussed. Section 3 begins with a description of a simple model that captures economic effects and trade-offs involved in the bankruptcy law, showing how changes in the system could impact on a firm's investment, effort and other choices. Then, using data from World Bank[9] and IMF (IFS), in section 4 we take a picture of the Latin American situation to evaluate bankruptcy procedures by comparison with other groups of countries, in addition to testing empirically the effects that come from the quality of the bankruptcy law. In section 5 we discuss the Brazilian bankruptcy reform, emphasizing on its main changes and effects over the economic environment. In addition, the appendix presents the experience of one of the authors with this process, describing what he wanted to do but did not succeed, policy lessons that the Brazilian case provides and what other Latin American countries have to keep in mind when they reform their bankruptcy law. Section 6 concludes.

II – Review of the Literature

Modern bankruptcy theory began with the recognition of the collective action problem among creditors of an insolvent firm. Jackson (1986) stresses this "common pool" problem. He argues that despite the objective of maximizing the value of the failing firms' assets, creditors tend to act in their own self-interest, making an uncoordinated debt collection possible, which proves very costly to the value of the firm. This happens because if unsecured creditors perceive that a firm is insolvent, they anticipate that it will not be able to repay all its creditors in full, giving them an incentive to race against each other to be first to collect from the firm. When creditors act uncoordinatedly in liquidation, the assets are sold piecemeal, disrupting the firm's operations and probably forcing it to shut down even when the best use of its assets is continued operation[10], bringing social-welfare losses and not maximizing the firm's value. Moreover, such conflict delays the liquidation resolution, which leads to additional losses in the firm's value. A bankruptcy system can avoid

[9] Doing Business database 2003 and 2004 and World Development Indicators 2004.
[10] Webb (1991) shows that this is a classical case of prisoner's dilemma.

Copyright © 2009 Association of Corporate Counsel

this inefficient equilibrium by staying the creditors' collection effort to give a state official time to decide whether the firm is worth saving.

The ensuing debate attempted to specify how a bankruptcy law should do its job. The early economic view tried to avoid deviations from the absolute-priority rule as well as to cut costs associated with the bargaining present in the reorganization procedure called Chapter 11. Some of the economic theorists, such as Baird (1986) and Jensen (1991), were favorable to a market-auctions approach to cut costs implicit at reorganization. More concretely, a state official would auction insolvent firms to the market, free of current claims, distributing the proceeds to creditors according to absolute-priority rules. If economic value would be maximized by a piecemeal liquidation, the highest bids would be for individual assets; if continuing the firm as an economic entity, it would maximize value, then the highest bids would be for the firm as a unit.

Bebchuck (1988) argues that reorganization can capture a greater value than the liquidation process, especially when the assets of a company are worth much more as a going concern than if sold piecemeal, and if there are few or no buyers with both accurate information about the company and sufficient resources to acquire it. He, therefore, proposed an optional approach that homogenizes the interest of the holders and follows the Absolute Priority Rule, keeping alive the reorganization procedure without the burden of APR violations and the cost of bargain.

Bebchuck's idea received some significant support in subsequent literature; for example, it was adapted as the basis for bankruptcy reform in proposals by Aghion, Hart and Moore (1992), who combined it with auction, and by Hart, La Porta, Silanes and Moore (1997), who suggested a new procedure using multiple auctions. These procedures have also received their share of critical or skeptical reactions. The criticism is about the lack of liquidity (since the firms are in financial distress) what makes impossible for shareholders to exercise their options; and the skeptical reaction is due to the complexity that makes it difficult for the implementation of Aghion et al (1992) and Hart et al (1997) proposals.

Copyright © 2009 Association of Corporate Counsel

Therefore, early theorists held that bankruptcy systems should follow absolute priority strictly. This requires creditors to be repaid so that the firm's contracts were created. An implication of the rule is that equity holders should receive nothing because the residual claim on an insolvent firm is worth nothing.

Modern theory relates the results of a bankruptcy procedure to earlier stages in the life of the borrowing firm. An ex-post efficient bankruptcy system maximizes the pay-off that creditors receive from insolvent firms. Turning to the borrowing stage, a competitive credit market would reduce the amounts that lenders can require solvent firms to repay when the lenders' expected insolvency pay-offs increase. Thus, interest rates fall as the efficiency of the applicable bankruptcy system increases. On the other hand, the ex-ante efficiency of the bankruptcy system is related to the optimal division of the firm's total value. This point of research is the main target of the current discussion.

We saw that much of the research on bankruptcy procedures and reform had assumed that the absolute-priority rule was the optimal division and had focused on procedures that could secure this rule. However, some substantial research has already been done on violations of the absolute-priority rule (APR), highlighting that the ex-ante effect of deviations from APR are actually beneficial. In particular, this line of research has shown that deviations from APR encourage desirable ex-ante investments in firm-specific human capital as in Berkovitch, Israel and Zender (1997); that they facilitate the transfer of information to creditors and improve the timing of decisions to file for bankruptcy, to liquidate, or to recapitalize as in Povel (1999) and Berkovitch and Israel (1999); and that they discourage excessive risk-taking by financially distressed firms as in Eberhart and Senbet (1993). Recently Bebchuck (2002) showed that ex-post deviations from APR also have negative effects on ex-ante decisions made by shareholders. He argues that such deviations have an adverse effect on ex-ante management decisions made prior to the onset of financial distress. The presence of APR deviations aggravates the moral-hazard problem but the final effect of such deviations is still inconclusive.

Also, direct and indirect consequences of a bankruptcy-law improvement are being investigated in the macroeconomic field. The first direct macro implication holds that reducing the cost of debt capital will

Copyright © 2009 Association of Corporate Counsel

reduce the cost of capital generally. The equity holds a call option on a levered firm because shareholders can buy the firm by repaying the debt. The strike price for exercising the equity option is therefore the firm's cost of credit. Reducing this cost – i.e., reducing the strike price – makes stock more valuable to own. Hence, it becomes easier for firms to raise equity capital as their country's bankruptcy system becomes more efficient.

The second direct implication of reducing the cost of capital by an improvement in the bankruptcy system is the expansion of the credit market (reduction on credit constraint). La Porta, Lopez-de-Silanes, Shleifer and Vishny (1997) present an important empirical study about legal systems and their influence in finance. They show that a bankruptcy law and an enforcement mechanism that protect the rights of creditors tend to generate more financial development. Araujo and Funchal (2004) examining the same relation argue that when the protection of creditors implies penalization of debtors, an extremely high level of protection reduces debtors' interest in demanding credit, fearing possible consequences[11]. Notice that the supply of credit is increasing in creditors' protection because of the moral-hazard problem, while on the other hand the demand for credit is decreasing in creditors' protection due to the fear of punishment. So there exists an intermediary level of creditor protection (neither too strong nor too weak) that provides the maximal level of credit in the economy.

However, this relationship is just a first-order consequence of the bankruptcy law. The most important impacts of an improvement of the law are second-order, that is, the consequences generated by financial development. They are two-fold: one is the impact of financial development on growth and the other is the impact on income distribution and poverty.

King and Levine (1993) study the impact on growth empirically with a sample of 77 countries over the period 1960-1989, using different measures of financial development and growth indicators. The result indicates a strong, positive relationship between each financial-development and growth indicators. The authors confirm these findings using alternative methods of robustness checks.

[11] This is valid only if markets are incomplete. Otherwise, when markets are complete, there always exists the asset of promising to repay only in cases of success.

Copyright © 2009 Association of Corporate Counsel

However, they do not deal formally with the issue of causality. It may be the case that financial markets develop in anticipation of future economic activity. To solve the possible problem of simultaneity bias, Levine, Loayza and Beck (2000) use La Porta et al (1998) measures of legal origin as instrumental variables. They analyze 71 countries, using two different econometric techniques: GMM dynamic-panel estimators and a cross-sectional instrumental-variable estimator. The results indicate a very strong connection between the exogenous component of financial development and economic growth. They use various measures of financial-development and conditioning-information sets. Furthermore the data do not reject legal origin as a good instrument for financial development. These results indicate that the strong link between financial development and growth is not due to simultaneity bias.

With regard to the relationship between financial development and both income distribution and poverty alleviation, the theory provides conflicting predictions. Some theorists claim that a financial-intermediary development makes financial services available to a lager portion of the population, rather than restricting capital to selective groups. Thus, by ameliorating credit constraint, financial development may foster entrepreneurship, formation of new firms and economic growth. On the other hand, some argue that it is primarily the rich and politically connected who benefit from improvements to the financial system. Especially at early stages of economic development, access to financial services, especially credit, is limited to wealthy and connected persons. Thus, it is an open question whether financial development will narrow or widen income disparities even if it boosts economic growth.

Other theorists analyze the relationship between financial development and income distribution as a non-linear form. Greenwood and Jovanovic (1990) show that the interaction of financial-intermediaries development and income inequalities can give rise to an inverted U-shape curve. At early stages of financial development, only a few relatively wealthy individuals have access to the financial market and hence higher return projects. With the aggregate economic growth generated, more people can afford to join the financial system with more positive consequences on economic growth. The distributed effect of financial deepening is thus adverse to the poor at early stages, but positive after the turning point.

Copyright © 2009 Association of Corporate Counsel

Using cross-country regressions, a very recent research by Beck, Demirguc-Kunt, and Levine (2004) examines whether the level of financial-intermediaries development influences the growth rate of Gini coefficients of income inequality, the growth rate of the income of the poorest quintile of society, and the fraction of the population living in poverty. The results indicate that finance exerts a disproportionately large and positive impact on the poor and hence reduces income inequality.

III – Bankruptcy Law: Economic Issues and Trade-offs

III. 1 – The ex-ante financial distress effects

The relevance of a good bankruptcy law is not present only when a firm goes bankrupt. It also has strong ex-ante effects on cost of capital and incentive to pursue projects that are as important as the ex-post bankruptcy effects. The relationship between the performance of the bankruptcy system, a firm's cost of capital and its incentive and ability to pursue projects can be exhibited with a simple model that we describe as follows. There are five important assumptions:

1 – The borrowing firm is run by an owner/manager.

2 – Creditors are imperfect monitors of actions related to pay-offs that the firm takes after it borrows.

3 – Capital markets are competitive.

4 – Creditors can predict the mean of their pay-offs in the default state.

5 – Creditors and the firm are risk-neutral.

Assumption 1 is made because this essay is not concerned with the corporative-governance problem. Assumption 2 captures the asymmetric information between the firm and its creditors. Assumption 3 is realistic. Assumption 4 rests on the view that professional creditors have considerable experience with default and 5 is more accurate when applied to firms than to individual persons.

The borrowing firm has a project that requires capital of I, which the firm must raise externally. The firm promises to repay creditors the sum F. The project can return a value v, where the firm is solvent if $v \geq F$ and insolvent if $v < F$. There are two states of nature in the future, one if the firm is solvent and the other if it is not.

Copyright © 2009 Association of Corporate Counsel

The solvency and the insolvency state of nature returns to the firm v_{solv} and v_{ins} respectively, where $v_{solv} \geq F > v_{ins}$. The probability of solvency is p_{solv} and the insolvency probability is $(1 - p_{solv})$. This implies that the expected value of the project is $E(v) = p_{solv}v_{solv} + (1 - p_{solv})v_{ins}$, the expected return conditional to solvency state is $E_{solv}(v) = v_{solv}$, and the expected return conditional to insolvency state is $E_{ins}(v) = v_{ins}$. The bankruptcy system costs c to run. A bankruptcy system can thus distribute to the creditors of an insolvent firm at most the sum $v_{ins} - c$. Therefore the repayment to creditors is F if solvent and $v_{ins} - c$ if it goes bankrupt.

Because the credit market is competitive, F is the largest sum that creditors can demand to fund the project. The risk-free interest rate is assumed to be zero, so that a borrowing firm's interest rate is a function only of the riskiness of its project and the properties of the bankruptcy system that is in place.

Investment Problem

Creditors who lend I should expect to receive I in return. This expectation can be written as:

$$I = p_{solv} \cdot F + (1 - p_{solv})[v_{ins} - c]$$

$$F = \frac{I - (1 - p_{solv})[v_{ins} - c]}{p_{solv}} \tag{1}$$

If the expected value that creditors receive conditional to insolvency increases (higher $[v_{ins} - c]$), F declines, diminishing the interest rate charged by creditors. Intuitively, the more that creditors expect to receive in the insolvency state, the less creditors will require the firm to repay in the solvency state. The firm's interest rate is $r = \frac{F}{I} - 1$, that is increasing in F, which is the value that the firm is required to repay in solvency state. Denoting by $v^u{}_{ins}$ and c^u the per-unit-of-investment ($I = 1$) counterparts of v_{ins} and c we also have:

$$r = \frac{1 - p_{solv}}{p_{solv}}\left[1 - (v^u_{ins} - c^u)\right]$$

that is decreasing in the probability of success and/or in the return of insolvency states.

Copyright © 2009 Association of Corporate Counsel

Proposition 1: A higher (lower) expectation of return in the insolvency state reduces (raises) the interest rates charged by the creditors.

The bankruptcy system affects both elements that compose the return in case of insolvency (v and c). Agility in the bankruptcy procedure decreases the cost of the procedure (c) and brings ex-ante gains. Moreover, the return is affected by the procedure choice. If the return in reorganization (liquidation) is greater than in liquidation (reorganization) $(v_R > (<) v_L)$, the firm should be reorganized (liquidated). Thus, the firm's insolvency-state value is higher in a system that liquidates economically inefficient firms and saves economically efficient (but financially distressed) firms than it would be in a system that attempted to save or liquidate all firms.

Obviously, F, and thus r, also will increase if creditors receive only a fraction of the insolvency return ($v_{ins} - c$). Two characteristics of bankruptcy law may affect the insolvency return in this way. First, if reorganization is allowed, violations of the Absolute-Priority Rule may occur, with some portion of value in bankruptcy going to shareholders even when creditors are not paid in full. The second characteristic happens when the bankruptcy law decrees the priority of tax and/or labor claims over secured creditors' claims, very common in developing countries.

Suppose that l is the value of claims that came before creditors' claims or the expected amount that shareholders extract in insolvency states, thus:

$$I = p_{solv} \cdot F^{l} + (1 - p_{solv}) \max[v_{ins} - c - l, 0]$$

Defining $[v_{ins} - c - l]^{+} = \max\,[v_{ins} - c - l, 0\,]$ we have:

$$F^{l} = \frac{I - (1 - p_{solv})[v_{ins} - c - l]^{+}}{p_{solv}}$$

Notice that creditors' return may fall in this situation to zero, strongly increasing the cost of capital.

Proposition 2: Violations in APR and priority of labor and/or tax claims over creditors' claims increase the cost of capital.

Copyright © 2009 Association of Corporate Counsel

An ex-ante objective of bankruptcy law should be to maximize the project option set that creditors want to finance. Lower cost of capital is fundamental to this objective.

Society prefers firms that pursue projects with positive expected returns. Denoting W as social welfare, a firm should therefore undertake a project that creates value, i.e.

$$W = p_{solv} v_{solv} + (1 - p_{solv})[v_{ins} - c] - I \geq 0$$

$$W = p_{solv} E_{solv}(v) + (1 - p_{solv}) E_{ins}(v - c) - I \geq 0$$

As there always exists a minimum conditional expectation value of return $(E_{solv}(\underline{v}))$ needed for social efficiency, let $W = 0$. Then

$$E_{solv}(\underline{v}) = \frac{I - (1 - p_{solv}) E_{ins}(v - c)}{p_{solv}}, \quad (2)$$

always remembering that $F = \frac{I - (1 - p_{solv}) E_{ins}(v - c)}{p_{solv}}$ is identical to the right side of $E_{solv}(\underline{v})$.

Since (1) solves for the minimum-repayment promise the firm must make to obtain financing and (2) solves for the minimum conditional expected return socially accepted, we have that it is socially efficient for firms to take all projects that creditors will finance. More precisely, since $E_{solv}(\underline{v})$ is the minimum return conditional to solvency states accepted by the society, they will take every project that makes $E_{solv}(v) \geq E_{solv}(\underline{v})$, and consequently debtors will be able to fulfill their promises in solvency states since (1) = (2). Notice that if there are deviations from APR and/or claims with priority above creditors' claims, F would be higher and this equality no longer holds, with certain socially efficient projects not being financed. If the project returns $E_{solv}(v) \geq E_{solv}(\underline{v})$, and if $E_{solv}(v) < F$, despite the project creates value (W > 0) – being accepted to the society – creditors would not be fully repaid for sure (i.e. there are no solvency states), eliminating their appeal in financing such projects. Therefore, projects with return between $[E_{solv}(\underline{v}), E_{solv}(v^F))$, where $E_{solv}(v^F) = F$, despite being socially efficient they would be no longer financed by creditors.

Copyright © 2009 Association of Corporate Counsel

Proposition 3: If creditors' claims have top priority and if there are no APR violations, then all socially efficient projects are financed.

Proposition 4: If APR violations are allowed and/or other claims come above creditors' claims, then there is a set of socially efficient projects that would not be financed.

Until now we have studied the set of projects that are socially efficient, but it is important to see the borrowers' incentives to invest. The interest rate imposes on firms the expected costs of failure so that a firm's expected return, when it borrows, becomes under APR:

$$E(R^B) = p_{solv}[v_{solv} - F] + (1 - p_{solv})(0) \geq 0$$

$$E(R^B) = p_{solv}(E_{solv}(v) - F) \geq 0 \qquad (3)$$

Substituting for F from expression (1) we have:

$$E(R^B) = p_{solv}E_{solv}(v) + (1 - p_{solv})E_{ins}(v - c) - I \geq 0,$$

which is the expression that tells us that the project is socially efficient. For the minimum conditional expected return $E_{solv}(\underline{v})$, this equation holds with equality. Therefore, the borrower invests in all projects that creditors will finance and which are socially efficient.

Proposition 5: If creditors' claims have top priority and if there are no APR violations, a profit-maximizing firm will pursue projects that creditors will finance and which are socially efficient.

Moral-Hazard Problem

Now let us introduce an asymmetric-information problem that refers to the effort level that firms financing with debt choose when pursuing projects. As the variable effort is not observed by creditors, it is difficult for them to know whether a borrowing firm chose the optimal effort level. Until now we have implicitly assumed that the probability that the firm's project would succeed, p_{solv}, was exogenous, therefore p_{solv} did not depend on what the firm did. More realistically, when we consider effort in the problem we assume that the probability of success increases with the firm's effort level. In precise terms, it is assumed that $p_{solv}(e)$ is differentiable, strictly increasing and strictly concave in effort variable e, that

Copyright © 2009 Association of Corporate Counsel

$\lim_{e \to 0} p'_{solv}(e) = \infty$, meaning that it is efficient for the firm to choose a positive effort level and that $p_{solv}(\infty) < 1$ for the insolvency state is always possible.

The effort level, despite increasing the probability of the firm's success, is costly to the manager (borrower). The first problem emerges because the socially optimal effort is different from the optimal private effort. From the social perspectives we have:

$$\max_e W = p_{solv}(e) \cdot v_{solv} + (1 - p_{solv}(e)) \cdot (v_{ins} - c) - e - I$$

$$p'_{solv}(e_{soc}) = \frac{1}{v_{solv} - (v_{ins} - c)}$$

The effort socially optimal is the level of effort that makes equal the marginal gains from the higher probability of success and the marginal cost to exert such an effort.

From the manager's perspective we have:

$$\max_e W = p_{solv}(e) \cdot (v_{solv} - F) + (1 - p_{solv}(e)) \cdot (0) - e$$

$$p'_{solv}(e_{priv}) = \frac{1}{v_{solv} - F}$$

The manager exerts effort until its marginal private gain from the higher probability of success is equal to its marginal cost to exert such an effort. The difference between the social and private problem appears because the firm divides its gain with creditors in the success state while the marginal cost is the same to both. Therefore, since $F > v_{ins} - c$ (otherwise the firm is solvent) $p'_{solv}(e_{priv}) > p'_{solv}(e_{soc})$, which implies that $e_{priv} < e_{soc}$.

Proposition 6: Any bankruptcy system produces an effort lower than the socially optimal.

Notice that some characteristics of bankruptcy law could reduce the private level of effort exerted by managers. First, let us consider the case where the law puts tax and/or labor claims before creditors' claims. As we saw above, this diminishes creditors' gains in insolvency states, making the payment in solvency states

24

higher $(F^l > F)$. This implies that $p'_{solv}(e^*_{priv}) = \frac{1}{v_{solv}-F^l} > \frac{1}{v_{solv}-F} = p'_{solv}(e_{priv})$, and $e^*_{priv} < e_{priv}$, reducing the private level of effort. Intuitively, closer pay-offs reduce the incentive to avoid insolvency states. In the second situation, let us consider a bankruptcy system that allows violations of APR. Suppose that managers extract l in insolvency states, thus:

$$\max_e W = p_{solv}(e)\cdot(v_{solv} - F^l) + (1 - p_{solv}(e))\cdot(l) - e$$

$$p'_{solv}(e^{**}_{priv}) = \frac{1}{v_{solv} - F^l - l}$$

This implies that $p'_{solv}(e^{**}_{priv}) = \frac{1}{v_{solv}-F^l-l} > \frac{1}{v_{solv}-F} = p'_{solv}(e_{priv})$, and $e^{**}_{priv} < e_{priv}$, also reducing the private level of effort. Intuitively when managers get a payoff in insolvency states, they have less incentive to avoid it creating a moral-hazard problem.

Proposition 7: The private level of effort is reduced when the bankruptcy system gives priority to tax and/or labor claims over creditors' claims and when managers are paid in insolvency states.

Sub-investment in effort exacerbates the financing problem shown before. The probability of success declines as the firm exerts less effort, making the minimum conditional expectation value of return increase and shrinks the set of fundable projects.

III. 2 – The ex-post financial distress and ex-ante bankruptcy effects

Now suppose that some firms have become financially distressed, but have not filed for bankruptcy. Managers of failing firms may incur two types of effect: the gambling effect that occurs when managers attempt to avoid bankruptcy and the delay effect when managers attempt to delay filing for bankruptcy.

The Gambling Effect

This refers to the fact that managers of firms in financial distress have an incentive to undertake excessively risky investments as a means of avoiding bankruptcy. If risky investment succeeds, its high returns enable the firm to avoid bankruptcy, at least temporarily; if it fails, the firm goes bankruptcy but managers are no worse off since it would have done so anyway without the investment, since managers

Copyright © 2009 Association of Corporate Counsel

cannot get less than zero, which is what they take in case of bankruptcy. Equity holders are also in favor of risky investments in this situation of financial distress, since equity is likely to be worth zero if bankruptcy occurs. Losses on risky investment go to creditors in the form of lower pay-off in bankruptcy, with the same pay-off holding in solvent state.

Let us consider now a multi-period model following the model used in an earlier section[12]. At time $t = 0$ the firm borrows $I > 0$, and agrees to pay F $(F = I(1+r))$ in solvency states. At time $t = 1$ the firm enters financial distress, but it still owns an amount $Z > 0$ $(Z < F)$ in cash that the manager will use to make a choice between two projects, one risky and another risk-free. Finally at $t = 2$, the firm's final output v is realized, and this is divided between equity holders and creditors. All the hypotheses of section *III.1* still hold.

If managers choose the risk-free project, then the final output v will be Z, where $Z < F = I(1+r)$. If they choose the risky project instead, then the final output v will be γR, where R is the expected return, which is positive, and γ a random variable with expected value equal to 1. Let γ be distributed discretely in the interval $[0, \bar{\gamma}]$, where $\bar{\gamma} > 1$. At $t = 1$ the equity holders observe R and the range, but the value of γ is realized in $t = 2$.

It is assumed that given the information available in $t = 0$, the parties know Z but only the distribution of R in [0, R]. The risky project may offer a higher or lower expected return than the risk-free project. The moral-hazard problem is that equity holders may choose the risky project even if $R <$ Z. At $t = 2$ the final output is realized and divided between equity holders and creditors. Assuming APR[13], and that the cost to run bankruptcy is zero ($c = 0$), if the firm is solvent equity holders receive $v - F$ and creditors F. Otherwise, if the firm is insolvent, equity holders receive nothing (because $v < F$) and creditors receive v. Therefore, the return for equity holders is $\max[v - F, 0]$ and for creditors is $\min[F, v]$.

[12] The model follows Bebchuck (2002).
[13]Later we will see the effect of APR violations.

Copyright © 2009 Association of Corporate Counsel

Let us see how managers decide between projects at $t = 1$. Once managers observe the value of R and its distribution, they will choose the risky project if and only if:

$$E_\gamma \max[\gamma R - I(1+r), 0] \geq \max[Z - I(1+r), 0] \qquad (4)$$

Let $R_{AP}(r)$ be the smallest non-negative value of R that makes the left- and right-hand sides of (4) equal. Equity holders will choose the risky project if and only if $R \geq R_{AP}$.

If there exists any risky project with expected value equal to $R \leq Z$ that does not always lead to insolvency ($\gamma R > I(1+r)$ in some state of nature), it makes the left-hand side strictly greater than the right-hand side and it is preferred by the managers over the risk-free project. This happens because since we are working with choices after the firm enters a financial distress, we have $Z < I(1+r)$ and $\max[Z - I(1+r), 0] = 0$ as the return to equity holders for the risk-free project, then by construction $R_{AP}(r) = 0$. It follows that for any given r, $R_{AP}(r) < Z$ (since $R_{AP} = 0$ and $Z > 0$). This inequality implies that managers may choose the risky project even if $R < Z$, it suffices to satisfy $R > 0$ and $\gamma R > I(1+r)$ in some state of nature.

Then, equity holders may choose the risky project inefficiently because they have more gain from a favorable outcome of this project than they have to lose from an unfavorable outcome.

Proposition 8: If a firm is in financial distress and the Bankruptcy System follows APR, managers will undertake risky projects even if this produces economic costs ($Z - R > 0$).

Now suppose that the reorganization procedure is available, allowing deviations from APR. In this case equity holders will be able to obtain some value regardless of how small v turns out to be. If the firm is in financial distress ($Z < I(1+r)$), equity holders will be able to obtain αv (where $\alpha > 0$). Moreover, by using or threatening to use the reorganization procedure[14], equity holders will be able to get more than their contractual right if the firm is sufficiently close to insolvency, that is if v exceeds $I(1+r)$ by a sufficiently

[14] The reorganization procedure provides the possibility of APR violations.

Copyright © 2009 Association of Corporate Counsel

small amount[15]. For simplicity, it will be assumed that the equity holders will always be able to get at least αv even if their contractual right $v - I(1+r)$ is less than that. On the other hand, debt holders will not get full payment but only $(1-\alpha)v < I(1-r)$. Thus, if violations of APR are allowed, equity holders will receive $\max[v - I(1+r), \alpha v]$ and creditors will receive $\min[I(1+r), (1-\alpha)v]$.

Let us see how managers decide between projects at $t = 1$. They will choose the risky project if and only if:

$$E_\gamma \max[\gamma R - I(1+r), \alpha\gamma R] \geq \max[Z - I(1+r), \alpha Z] \qquad (5)$$

Let $R_{VAP}(r)$ denote the value of R that makes left- and right-hand sides of (5) equal. Equity holders will choose the risky project if and only if $R \geq R_{VAP}(r)$. Let us compare the project choices at $t = 1$ at two regimes.

Once the firm is in financial distress, we have $Z < I(1+r)$, thus $E_\gamma \max[\gamma R - I(1+r), \alpha\gamma R] \geq \alpha Z$. The left-hand side of (5) is strictly greater than the left-hand side of (4), since $\alpha Z > 0$. Furthermore, with $R_{AP} = 0$ the left- and right-hand sides of (4) are equal and therefore $E_\gamma \max[\gamma R_{VAP} - I(1+r), \alpha\gamma R_{VAP}] = \alpha Z > E_\gamma \max[\gamma R_{VA} - I(1+r), 0] = 0$, where the first equality holds with $R_{VAP} > 0$ because $\alpha Z > 0$, and the second holds with $R_{AP}(r) = 0$. Thus, since $R_{VAP} > R_{AP}$, the set of risky projects available to the equity holders decreases, diminishing the investment in risky projects relative to the bankruptcy system that does not provide reorganization, and always follows APR. Notice that under both regimes the equity holders capture benefits of favorable outcome of the risky project, however when APR violations are allowed, safe investments also provide gains for equity holders, and this reduces the set of risky projects that they could invest with higher expected gains, decreasing the amount of risky investment when compared with the regime that follows APR.

[15]If the gains of bankruptcy reorganization are greater than solvency, equity holders will go or threaten to go bankrupt to raise their gains.

Copyright © 2009 Association of Corporate Counsel

Proposition 9: W*hen firms are financially distressed, the amount of investment in risky projects is higher in regimes that always follow APR than in regimes that allow APR deviations.*

Thus, the availability of a reorganization procedure like Chapter 11 diminishes managers' incentive to invest in inefficient and risky projects.

Now, to see the aggregated gambling effect in the economy, let us denote $G = Z - R$ the economic cost per failing firm. Suppose that $(1 - p_{solv})$ is the probability that a firm is financially distressed and *N* the total number of firms. Therefore the aggregated gambling effect is $(1 - p_{solv})NG$. But notice that $(1 - p_{solv}(e))$ is negatively related to the effort *e* by managers, since higher effort is less likely to be in financial distress. Therefore there is a trade-off in bankruptcy between the punishment effect and the gambling effect. As we saw in the earlier section, managers have an incentive to work hard when there are no pay-offs in bankruptcy states (APR). This makes fewer firms in financial distress because once $p_{solv}(e)$ increases, the proportion of firms in financial distress $(\downarrow (1 - p_{solv})N)$ reduces. However, once firms are in financial distress, this system gives the manager the incentive to gamble to avoid bankruptcy, making G high. On the other hand, a lenient bankruptcy system that violates APR makes the effort smaller than the former, thus increasing the proportion of firms in financial distress. However, this system gives the manager the incentive to gamble less than the hard system. The final effect is ambiguous with a trade-off between effort and the incentive to gamble. If we consider the system that gives priority to other claims instead of creditors' claims, the final result is no longer ambiguous because it provides the negative effect in effort (*proposition 7*) and does not diminish the gamble of equity holders since they still gain nothing in insolvency state, therefore the proportion of financially distressed firms increases and the gamble remains constant, thereby increasing the aggregate gamble effect.

The Delay Effect

This refers to the fact that managers of financially distressed firms have an incentive to delay filing for bankruptcy, in particular if they are automatically replaced in bankruptcy.

Copyright © 2009 Association of Corporate Counsel

To analyze effects of APR violations it is necessary to introduce one more source of asymmetric information, where the two types of asymmetric information are the manager's effort choice and at an intermediate stage the manager alone receiving a signal about the prospects of his project. The idea is to analyze the trade-offs between these two conflicting goals. On the one hand, creditors want a bankruptcy procedure to be harsh on the borrower, following APR, as a severe punishment may increase the borrower's incentive to generate sufficient earnings to repay. On the other hand, creditors want to prevent the waste of resources that takes place if a rescue is necessary but not undertaken in time. The method to obtain this information is to reward for poor outcomes. This reward should be bigger (or at least equal) to the pecuniary gains that managers would receive during the delay period in such a way to incentive them to declare the financial problems at the right time. However, this works against effort incentives aggravating the moral-hazard problem because it diminishes the punishment in bad states of nature. It is not clear a priori whether one of the incentive problems is more relevant.

Let us consider a multi-period model variant of the earlier model[16]. In period 1 the manager must invest an amount I, which is lent by creditors. The manager must invest effort e, which creditors cannot observe. In period 2 the project type is realized and there are three possible states of nature: the project is a success with probability $p_{solv}(e)$ and return $v(s_{solv})$; the project is bad with probability $q(1-p_{solv}(e))$ with return $v(s_{bad}) < v(s_{solv})$; and with probability $(1-q)(1-p_{solv}(e))$ the project is a failure and returns $v(s_f)$. The firm agrees to repay lenders F where $v(s_{solv}) > F > v(s_{bad}) > v(s_f)$, thus the firm is solvent only if the project succeeds with or without rescue.

In period 3, the project can be rescued by buying information from managers at a cost y. This attitude could be necessary to implement changes[17] in the firm to help it to improve the possibility of success. If the project type is bad, the project becomes a good project, otherwise it does not change. The failed project must

[16] The analysis follows Povel (1999).
[17] These changes could be in organizational structure, in market strategy or by an infusion of money.

Copyright © 2009 Association of Corporate Counsel

be liquidated. In period 4 the information becomes public. The failed project that was not rescued in period 3 must be liquidated but the delay depreciates liquidation value by δ, and the non-rescued bad project becomes good with probability g (the wait-and-pray strategy), and fails with probability $1 - g$, while a bad project that is rescued becomes good with probability G and fails with probability $1 - G$, where $G > g$. Finally, in period 5 the verifiables are earned and if the manager stays all the periods he earns private benefit b, otherwise if he is excluded because the liquidation or reorganization (in this case the manager is replaced) the manager stops receiving the pecuniary gains in the third period.

The manager always accepts the reward if $y + q\frac{3}{5}b + (1-q)\frac{3}{5}b > qb + (1-q)b \Rightarrow y > \frac{2}{5}b$ (i.e. if the reward is bigger than his gains from delay)

Now let us compare the pay-offs of equity holders and creditors if the firm is rescued and not rescued.

Not rescued (t = 5)

states	*Payoff*	*Manager*	*Creditor*
good	$v(s_{solv})$	$v(s_{solv}) - F + b$	F
bad	$gv(s_{solv}) + (1-g)v(s_f)$	$g(v(s_{solv}) - F) + (1-g)(0) + b$	$g(F) + (1-g)v(s_f)$
failure	$(1-\delta)v(s_f)$	b	$(1-\delta)v(s_f)$

Rescued (t = 5)

states	*Payoff*	*Manager*	*Creditor*
good	$v(s_{solv})$	$v(s_{solv}) - F + b$	F
bad	$Gv(s_{solv}) + (1-G)v(s_f)$	$G(v(s_{solv}) - F) + (1-G)(0) + \frac{3}{5}b + y$	$G(F) + (1-G)v(s_f) - y$
failure	$v(s_f)$	$\frac{3}{5}b + y$	$v(s_f) - y$

The optimality of the APR violation depends on economic parameters indicating rescue to be good for both lenders and borrowers. Otherwise, if the rescue is not good for lenders they will not rescue the firm in insolvency state and no deviations from APR are optimal.

Copyright © 2009 Association of Corporate Counsel

Lets begin with the effect on manager effort comparing the level that they exerted in both cases.

If rescue occurs:

$$\max_e p(e)\ (v(s_{solv}) - F + b) + q(1 - p(e))[G(v(s_{solv}) - F) + \tfrac{3}{5}b + y] + (1 - q)(1 - p(e))[\tfrac{3}{5}b + y] - e$$

$$p'^{R}_{e} = \frac{1}{(1-qG)(v(s_{solv})-F)+\frac{2}{5}b-y}$$

If rescue does not occur:

$$\max_e p(e)(\ v(s_{solv}) - F + b) + q(1 - p(e))[g(v(s_{solv}) - F) + b] + (1 - q)(1 - p(e))[b] - e$$

$$p'^{NR}_{e} = \frac{1}{(1-qG)(v(s_{solv})-F)}$$

Thus we have $p'^{R}_{e} = \frac{1}{(1-qG)(v(s_{solv})-F)+\frac{2}{5}b-y} > p'^{NR}_{e} = \frac{1}{(1-qG)(v(s_{solv})-F)} \Rightarrow e^{R} < e^{NR}$, because $y > \frac{2}{5}b$ and $G > g$.

Therefore, the level of effort chosen by the managers is bigger when there is no rescue.

Now let us analyze when lenders have incentive to rescue the insolvent firm. Their expected returns in case of rescue and non-rescue are:

$$E(R_l^R) = p(e_R)F + (1 - p(e_R))\{q[GF + (1 - G)v(s_f)] + (1 - q)v(s_f) - y\}$$

$$E(R_l^{NR}) = p(e_{NR})F + (1 - p(e_{NR}))\{q[gF + (1 - g)v(s_f)] + (1 - q)(1 - \delta)v(s_f)\}$$

$$E(R_l^R) - E(R_l^{NR}) = \Delta E = -\Delta pF + \{q[(G - g)(F - v(s_f))] + (1 - q)(1 - p(e_{NR}))\delta v(s_f) - (1 - p(e_R))y\} +$$
$$+ \Delta p v(s_f) + q[F - v(s_f)][p(e_{NR})g - p(e_R)G],$$

where $[p(e_{NR}) - p(e_R)] = \Delta p > 0$.

Comparative static says more about some elements in trade-off and in which type of economy APR violations are optimal. Notice that:

- $\frac{\partial \Delta E}{\partial G} > 0,$ means that rescue is more (less) valuable when the chance of success in rescue is higher (lower).
- $\frac{\partial \Delta E}{\partial \delta} > 0,$ means that rescue is more (less) valuable when the depreciation rate is higher (lower).
- $\frac{\partial \Delta E}{\partial y} < 0,$ means that rescue is more (less) valuable when the information rent is lower (higher).
- $\frac{\partial \Delta E}{\partial (F - v(s_f))} > 0,$ means that rescue is more (less) valuable when the net gain to be solvent is higher (lower).

32

If parameters are such that $E(R_l^R) > E(R_l^{NR})$ there is a positive gain of APR violations, otherwise if $E(R_l^R) < E(R_l^{NR})$, no gains exist in such violations being optimal following APR.

In summary, the optimal procedure depends on the parameters of the economy. A bankruptcy system that allows APR violations rewards the entrepreneur if he cooperates in a rescue by starting early. This reward violates APR because it must be paid even if some of the firm's debt is not paid in full. This procedure allows an efficient rescue or an efficient early liquidation, mitigating the delay effect. On the other hand it does not induce the firm to exert the right effort because the firm receives a non-zero pay-off in bad states. Therefore the optimal procedure depends on which incentive it is more important to the parties to encourage: optimal effort, at the cost of foregoing the opportunity of an efficient early intervention, or optimal disclosure at a cost of reducing the incentive to effort.

To see the aggregate effect consider *A = losses of delay per insolvent firm.* As the number of firms in financial distress is $(1 - p_{solv}(e))N$, the total cost of delay is $(1 - p_{solv}(e))NA$. As in gambling, a bankruptcy law with strong punishment to debtors raises their incentive to work hard ($\downarrow (1 - p_{solv}(e))N$) but with negative effect in delay declaring bankruptcy ($\uparrow A$). On the other hand a lenient bankruptcy system leads to the opposite result. The final effect is ambiguous with a trade-off between effort and the incentive to delay. If we consider the system that gives top priority to other claims instead of creditors' claims, the final result is no longer ambiguous because it provides a negative effect in effort (*proposition 7*) and does not reward debtors to incentive optimal disclosure, increasing the proportion of financial distressed firms and remaining constant the delay, increasing the aggregate delay losses.

III. 3 – The ex-post Bankruptcy Effects

From an ex-post efficiency perspective, a bankruptcy law should maximize the total value of the company. There are three main elements behind this objective: first, as little value as possible should be dissipated during the process (minimizing the cost *c*), therefore it is desirable to minimize the time that the process will take – essentially the part of time that is spent on delay tactics of equity holders, and not the time spent

Copyright © 2009 Association of Corporate Counsel

on complexity of claims – and the direct and indirect costs incurred during this process. Second, when the reorganizing process ends, the company's assets should be located at their highest value of use. Finally, when a firm enters bankruptcy the procedure should be chosen correctly, otherwise the company's assets will not produce their highest value.

From an ex-ante efficiency perspective, the ex-post bankruptcy division of firms' value among the participants has important ex-ante consequences as we saw in earlier sections. However, it is quite indeterminate whether the beneficial effects of deviations from APR exceed the negative effects.

Here we will analyze how the characteristics of bankruptcy will affect both the maximization and the division of companies' value.

Filtering Failure

There are two types of firms in financial distress: firms that are economically efficient, i.e. the best use of its capital is the current use, and firms that are economically inefficient, i.e. the value of their assets is greater in some other use. When an economically inefficient firm enters bankruptcy, the best outcome is for its assets to be liquidated, thereby releasing its capital to move to higher-value uses. On the other hand, when an economically efficient firm enters bankruptcy, the best outcome is for it to continue operating, since its capital has no higher-value use. Therefore, there is an economic justification for having two separate bankruptcy procedures.

Nevertheless, while financial distress is observable, economic efficiency depends on some unobservable variables such as the earnings of the firm's assets in the best alternative use, so it is difficult to surely assert which type they are. This situation produces the so-called Filtering Failure in bankruptcy. There are two cases of failure: the first is when economically efficient firms in financial distress are liquidated but should be reorganized, which is called *Type I Error*; the second is when economically inefficient and financially distressed firms are saved in reorganization but should be liquidated, which is called *Type II Error*.

Copyright © 2009 Association of Corporate Counsel

Each country has its own means of assigning financially distressed firms to a liquidation or reorganization procedure, so the levels of type I and type II errors vary from country to country. Countries where reorganization is rare, like England, have high levels of type I error probably occurring. Conversely, in countries where liquidation is rare, high levels of type II error probably occur.

One important factor in filtering failure is who decides whether or nor to save failing firms. In countries where the court appoints officials to take this responsibility, if their decisions are unbiased, they do not influence the frequency of both types of error. But in countries like the United States, where managers have the right to choose between liquidation and reorganization, it is implied that high levels of type II error are likely to occur[18].

As a general rule, ex-post efficiency requires the availability of both bankruptcy procedures, as like a careful balance between them. Let us suppose that a financially distressed and economically efficient firm goes bankrupt. The optimal solution in this case is reorganization that returns v_R. But if type I error occurs, it returns $v_L < v_R$. This eliminates ex-post efficiency and by *proposition 1* increases the cost of capital. The same logic is valid for type II error.

Notice that besides the positive effect on credit market, the minimization of *filtering failure* also improves the efficiency of production factors of the economy. This happens because it allows that the most efficient firms continue to operate, or by the rehabilitation of firms economically efficient or by the liquidation that transfers the assets of firms economically inefficient to a more efficient use.

Bargaining in Reorganization

First of all let us consider how the features of reorganization process – like Chapter 11 – affect the division of value. The model of Bebchuck and Chang (1992) identifies three reasons why equity holders might be able to extract value even when creditors are not paid in full. First, if equity holders delay agreement over a plan, there may be a favorable resolution of uncertainty that would cause the value of the firm to exceed the value of its debt. These equity holders have an option value, and to forgo it they must be

Copyright © 2009 Association of Corporate Counsel

compensated. Second, if equity holders delay agreement, the company can be expected to incur during the process of bargaining financial distress costs that will dissipate some of the value that debt holders can expect to receive at the end of the process. Therefore, expecting these costs, creditors agree with a plan to save these costs, obtaining a share of these savings in return for their consent. Third, which is valid only for countries that give management the power to propose reorganization plans (like the U.S.), the bargaining power of equity holders is enhanced, strengthens the bargaining position and obtains a bigger share of the extra value[19].

As a consequence, this bankruptcy design provides for violations of APR and the trade-off exposed in earlier sections, with benefits in gambling and delay effects, but with negative result in effort incentive and maybe at the cost of capital.

The reorganization process under the existing bargaining-based rules takes substantial time[20]. The delaying tactics of equity holders and the complexity of the firm's claims dictate the length of the process. During this time, substantial value might be dissipated. Potential buyers may be reluctant to deal with the company, or may demand especially favorable terms while insolvency hovers over the company. Moreover, the reorganization process involves substantial administrative costs, and more importantly, the company under reorganization might incur substantial "indirect" costs from functioning throughout the reorganization process. All these costs grow bigger as time passes.

All these factors increase the cost in insolvency states. If the return in reorganization is v, creditors get $v - c$ where c is the cost of procedure. A bankruptcy law that minimizes such costs ($c^m < c$) by reducing either the delay tactics of equity holders or the administrative and/or the indirect cost of the procedure, diminishes the bargain power of managers ($l^m < l$), which increases creditors' return in insolvency state ($v - c^m - l^m > v - c - l$) and makes (by *proposition 1*) capital less costly. Notice that a reorganization procedure

[18]See White (1994), who uses an asymmetric information game to model whether U.S. Bankruptcy procedure led to filtering failure.
[19]See Franks and Torous (1989), LoPucki and Withford (1990), and Eberhart et al (1990) for empirical studies.
[20]See Lopucki and Withford (1990)

Copyright © 2009 Association of Corporate Counsel

that minimizes managers' bargain power produces the same benefits of APR violations at lower costs, where lower costs mean lower payment to managers (l) and alleviation of the moral-hazard problem related to the manager's effort.

IV – Evaluating Bankruptcy Law in Latin America

Our challenge here is to evaluate the current stage of bankruptcy law in Latin American countries. Nowadays there is little to say about the design of optimal bankruptcy law. However, there exist two consensual points in this debate. One refers to the protection that bankruptcy law must provide to creditors, and the other is about the goals-of-insolvency procedure. The measure of bankruptcy procedure goodness comes from these two sources. The creditors' protection variable tells us if the bankruptcy law is good enough to make loans attractive to creditors, providing the firms with easier access to external finance. The goals-of-insolvency procedure represents the consensus about the characteristics of an efficient bankruptcy procedure. For a comparative analysis, we use seven groups of countries: the OECD, Latin America & the Caribbean[21] (LAC), the Middle East & North Africa (MENA), Europe & Central Asia (ECA), East Asia & the Pacific (EAP), South Asia (Sas) and Sub-Saharan Africa (SSA). The data used is from Doing Business 2003 and 2004, World Development Indicators 2004 and International Finance Statistics 2004.

IV. 1 – Creditors' Protection

The literature of Law and Finance points to the fact that a good bankruptcy law has to provide legal protection to creditors. In section *III.1* we saw that better legal protections enable financiers to offer entrepreneurs money at better terms, which induces to a broader credit market.

Several forms of bankruptcy laws are being used around the world. Some of them are too favorable to creditors, giving them a strong protection, like the English Law, where liquidation is nearly always used. Its cost is the elimination of good and still healthy firms. On the other hand there are countries like Brazil, where

[21] Latin American and Caribbean block is composed by: Argentina, Bolivia, Brazil, Chile, Colombia, Costa Rica, Dominican Republic, Ecuador, El Salvador, Guatemala, Haiti, Honduras, Jamaica, Mexico, Nicaragua, Panama, Paraguay, Peru, Uruguay, and Venezuela.

Copyright © 2009 Association of Corporate Counsel

the law provides a weak protection to creditors, giving priorities to labor and tax claims before claims of secured creditors.

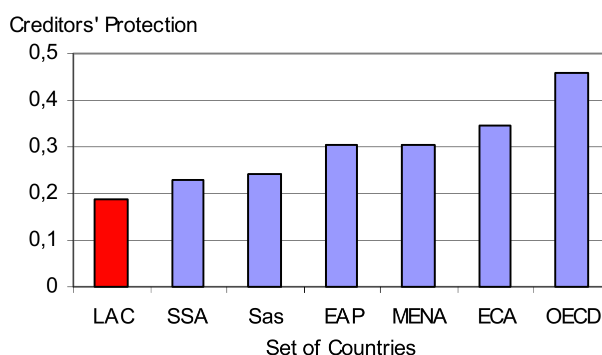
It is possible to compare the creditor protection provided by bankruptcy law in different groups of countries and rank the current situation of Latin America. As a measure for creditors' protection we use the index constructed by La Porta, Lopez-de-Silanes, Shleifer and Vishny (1997)[22] that summarizes creditors' rights[23] in bankruptcy law interacted with a measure of enforcement. This interaction between law and enforcement is important because if rules and regulations are not enforced, creditor rights will be inadequate regardless of what is written in the bankruptcy-law procedure codes.

Creditors' rights is an index that is formed by adding 1 when: secured creditors are paid first; the manager does not stay in reorganization; there is no "automatic stay" imposed by the court; and creditors need to consent to file the reorganization petition. As a measure of legal enforcement was used the variable "rule of law"[24] that is an assessment of the law and order tradition in the country. Therefore the creditor-protection measure is defined as:

Creditors' Protection = creditors' rights x measure of enforcement.

Since we normalize this measure, it will vary between [0, 1], where the score 1 means that the country provides the strongest level of protection to creditors; while zero means that the country does not protect creditors at all.

Figure 3: Creditors' Protection in each set of countries



Source: Doing Business database and International Country Risk Guide

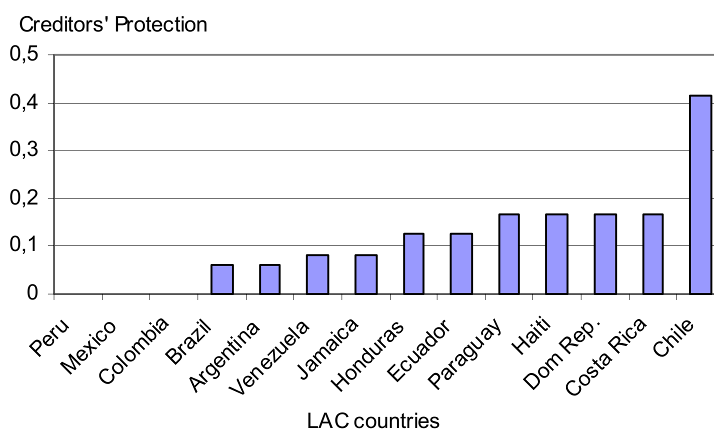
[22] Their creditors' rights measure was calculated from a sample of 49 countries and is referent to 1996.
[23] Creditors' rights is computed by Doing Business 2003 from World Bank.
[24] Rule of Law index is computed by International Country Risk Guide.

Copyright © 2009 Association of Corporate Counsel

Looking at Figure 3 that shows creditor protection in different sets of countries, we notice that the OECD has the highest level of creditor protection, while Latin America and the Caribbean have the lowest. Latin America and the Caribbean protect their creditors very poorly (even less than Sub-Saharan Africa), reducing the interest of creditors in the credit market, increasing the cost of capital and the difficulty for firms to finance their investments with debt.

Looking more specifically at LAC countries (Figure 4), Chile has the highest creditor protection provided by the legal system, with a degree similar to the average of OECD countries. However, most countries vary between 0.05 and 0.17, which is a very low level in a measure ranging between 0 and 1.

Figure 4: Creditors' Protection in LAC countries



Source: Doing Business database and International Country Risk Guide

A common notion in the literature of Law and Finance is that a good bankruptcy law has to provide strong protection to creditors. La Porta, Silanes, Shleifer and Vishny (1997, 1998) were pioneers in studying empirically the relevance of this relationship. Using a sample of 49 observations, they show that countries with a high level of creditor protection have higher levels of financial development.

Controlling for log (GDP), log (population), information-sharing and quality of enforcement, we explore the relation between the credit market development (measured by log (Private Credit/GDP)) and Creditors' Protection, in a sample of 120 countries. We control for the total GDP (log (GDP)) on the theory that larger economies may have bigger credit markets because of economies of scale in organizing the supporting institutions. We control for population on the theory that countries with large population tend to be poorer in per capita terms (log (GDP) – log (population) = GDP per capita) with negative effects on credit

Copyright © 2009 Association of Corporate Counsel

market. We use the number of days that the court takes to enforce a simple debt contract as a proxy for the efficiency (or quality) of legal system. Finally, we control for information-sharing[25] – that refers to data on the existence of public- and/or private-credit registries – to capture the adverse-selection problem in the credit market. In Table 2 we see that the coefficient of the creditor protection is statistically significant at the 5% level and reveals that the bigger the protection provided by law to creditors is the larger is the credit market. According to the result if, for example, the Brazilian bankruptcy reform shifts its protection of creditors of 0.06 to the mean of Latin America (0.19) or to the mean of OECD (0.46), it would increase credit market in approximately 9% and 30% respectively.

Also, the GDP, GDP per capita, information-sharing, population and quality-of-enforcement controls are all significant, the first three being positive and the last two negative, as we expected. The effect of information-sharing on credit market is considerably large but it is not important to Latin America once that except for Jamaica, the rest of the countries have the mechanism of information on credit registry. If Jamaica implements such mechanism it would increase its credit market in more than 70%. An increase in the quality of enforcement also produces a relevant effect on credit market. The average time that Latin America takes to enforce contracts is the highest between regions, 462 days. A fall of the average to OECD level (230 days) means an increase of 11% in Latin American credit market. Looking exclusively to Guatemala that has the lowest quality of enforcement (1459 days), an improvement in its mechanism that brings to Latin America average means an expansion of 60% of its credit market.

Table 2: OLS regression of Private Credit/GDP on Creditors' Protection
Dependent Variable: log (Private Credit/GDP) – 120 observations (average 2000 – 2003)

Independent Variable	Coefficients	t-statistic
Constant	-1.06	1.19
Creditors' Protection	0.66[b]	2.28
log GDP	0.40[a]	9.30
log Population	-0.25[a]	4.40
Quality of Enforcement	-0.0005[c]	-1.93
Information-Sharing	0.55[a]	3.35
Obs	120	
R-squared	0.66	
Adjusted R-square	0.64	

Note: a=significant at the 1% level; b=significant at the 5% level; c=significant at the 10% level.
Standard errors and covariance robust to heteroskedasticity.

[25]It is equal 1 if either public registry or a private credit bureau operates in the country, zero otherwise.

Copyright © 2009 Association of Corporate Counsel

To examine which components of creditors' rights index are responsible for its effect on credit market, we regress the measure of credit market development on each sub-index of creditors' rights. We find that creditors' consent to reorganize and priority have positive effect on credit market, with automatic stay, and the exclusion of managers in the process of reorganization having no significance at all.

Table 3: OLS regression of Private Credit/GDP on each sub-index of Creditors' Rights
Dependent Variable: log (Private Credit/GDP) – 120 observations (average 2000-2003)

Independent Variable	Coefficients	t-statistic
Constant	1.32	1.51
Consent of creditors	0.23[c]	1.74
Priority	0.24[c]	1.83
No Autostay	-0.05	-0.37
Manager out	0.17	1.27
Quality of Enforcement	-0.0006[b]	-2.40
Information-Sharing	0.60[a]	3.58
log Population	-0.27[a]	-5.11
log GDP	0.42[a]	11.23
Obs	120	
R-square	0.67	
Adjusted R-square	0.64	

Note: a=significant at the 1% level; b=significant at the 5% level; c=significant at the 10% level.
Standard errors and covariance robust to heteroskedasticity.

These results are aligned with theoretical claims in earlier sections that highlight: the negative effect when other claims such as labor and/or tax claims have priority over creditors' claims, and the relevance of the role of creditors in reorganization, mainly due to the provision of protection and incentive against fraud. According to results in table 3 any country that reforms its bankruptcy law giving top priority to secured creditors tends to increase its credit market in 27% in absolute terms. Also, creditors' consent in reorganization may expand credit market in 26% in absolute terms. The null effect of automatic stay and exclusion of managers in case of reorganization illustrates the ambiguity of both variables. The existence of automatic stay makes the reorganization procedure easier and reduces type I error – which increases the firm's value in bankruptcy –, while its absence guarantees the fast recovery of secured creditors. The exclusion of managers in case of reorganization weakens their bargain power in reorganization, which increases creditors' return in bankruptcy and their appeal in supply credit, but such a punishment may incentive managers to delay filing for bankruptcy as well as to gamble with firm's investments as a means of

Copyright © 2009 Association of Corporate Counsel

avoiding bankruptcy, both attitudes reduce creditors' return. Using the same controls as the last regression their results are practically the same.

IV. 2 – Goals of Insolvency

Despite all the research on bankruptcy, today there does not exist a consensus on the best procedure to adopt. It is hard to design an optimal bankruptcy procedure from first principles, given that economists do not at this point have a satisfactory theory of why parties cannot design their own bankruptcy procedures (i.e., why contracts are incomplete). Frequently, suggestions for new bankruptcy procedures emanate from different visions[26]. However, it is possible to identify a consensus on certain issues, such as some characteristics of an efficient bankruptcy procedure.

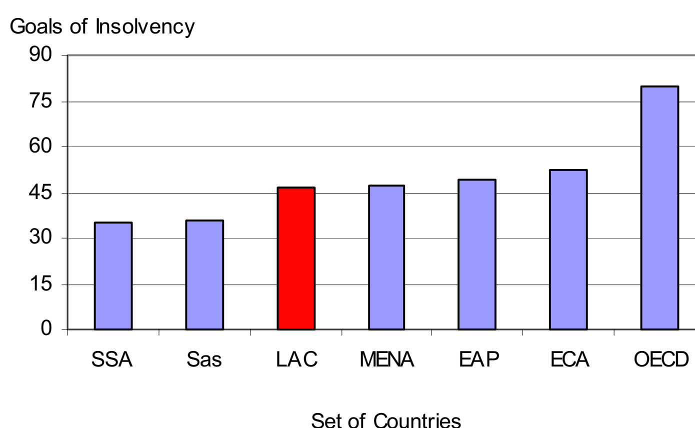
Oliver Hart (1999) states the characteristics of a good procedure. First, there is a strong argument that a good bankruptcy procedure should deliver an ex-post efficient outcome, that is, it should maximize the total value available to be divided between the debtor, creditors and possibly other interested parties. The second goal concerns ex-ante efficiency, and says that a good bankruptcy procedure should preserve the bonding role of debt by penalizing managers and shareholders adequately in bankruptcy states. Without any adverse consequence at all, there is very little incentive to pay their debts. The third goal, concerned with the stability of priority claims, says that a good bankruptcy procedure should preserve the order of the claims defined when the contract was created, except that some portion of value should possibly be reserved for shareholders. This goal has two advantages: first, it helps to ensure that creditors receive a reasonable return in bankruptcy state, what encourages them to lend; second, it means that bankruptcy and non-bankruptcy states are not threatened differently. However, it should be remembered that criticism can be made against APR: the management, acting on behalf of shareholders, will have an incentive to avoid bankruptcy even if this gives rise to inefficient bankruptcy decisions like the gamble and delay effects. For this reason, there may be a case for reserving some portion of value in bankruptcy for shareholders.

[26] See section II.

Copyright © 2009 Association of Corporate Counsel

Doing Business from World Bank computed a measure that documents the success in reaching the three goals-of-insolvency, as stated in Hart (1999). It is calculated as the simple average of the cost of insolvency (from 0 to 100, where higher scores indicate less cost), time of insolvency (from 0 to 100, where higher scores indicate less time), the observance of absolute priority of claims, and the efficient outcome[27] achieved. The total Goals-of-Insolvency Index ranges from 0 to 100: a score of 100 on the index means perfect efficiency, while 0 means that the insolvency system does not function at all.

Figure 5: Goals-of-Insolvency Index in each set of countries



Source: Doing Business database

Looking at figure 5, we notice that LAC countries do not have an efficient bankruptcy procedure, performing better than Sub-Saharan Africa and South Asia alone, while the OECD has the best insolvency system.

Figure 2, in the introduction, shows that an efficient bankruptcy system has a positive effect on the credit market, making access to credit cheaper and easier; both results being aligned with propositions 1 and 3 respectively. This happens because creditors are more confident in having their loans repaid when a firm fails. Notice that figure 2 (third graphic) also shows they are right to have this expectation.

Table 4 reports results of regressions between goals-of-insolvency versus credit market development (log (Private Credit/GDP)), interest rate spread and creditors' recovery rate. The regression between the

[27] The efficient outcome is defined as any bankruptcy procedure that results in a going-concern sale without an interruption in operations, or a successful rehabilitation.

Copyright © 2009 Association of Corporate Counsel

interest-rate spread and the goals-of-insolvency index is statistically significant at the 1% level[28], controlling for log (GDP per capita)[29]. This means that for each point increased in the insolvency efficiency, the interest-rate spread decreases by 0.13%.

Credit market development and recovery rate are positively related with goals-of-insolvency and both statistically significant at the 1% level, also controlling by log (GDP per capita). In this case, for each point increased in the insolvency efficiency, log (Private Credit/GDP) and recovery rate increase by 0.02 and 0.83 cents on the dollar respectively.

Table 4: Effects of goals-of-Insolvency
Independent Variable: Goals-of-Insolvency

Dependent Variable	OLS regression
Interest rate spread	-0.13%[a] (2.58)
log(Private Credit/GDP)	0.02[a] (5.70)
Creditors' recovery rate	0.83[a] (12.95)

Note: a=significant at 1%.
t-Statistic are in parentheses.
Standard errors and covariance robust to heteroskedasticity.
R-square varies between 0.16 and 0.67, considering all cases.

To exemplify the impact of an improvement in bankruptcy efficiency, let us consider a case where Brazil (24) increases its insolvency efficiency up to the Latin American average (46). Its interest-rate spread will fall approximately 3% (7% in relative terms), and its private credit and creditors' recovery rate rises by 19.79% (credit market expands in 55%) and 17.6 cents on the dollar respectively. If the Latin America average increases to OECD level (80), its interest-rate spread falls 4% (33% in relative terms), its private credit and recovery rate increases by 32.77% and 24.8 cents on the dollar respectively (approximately 97% and 93% respectively in relative terms).

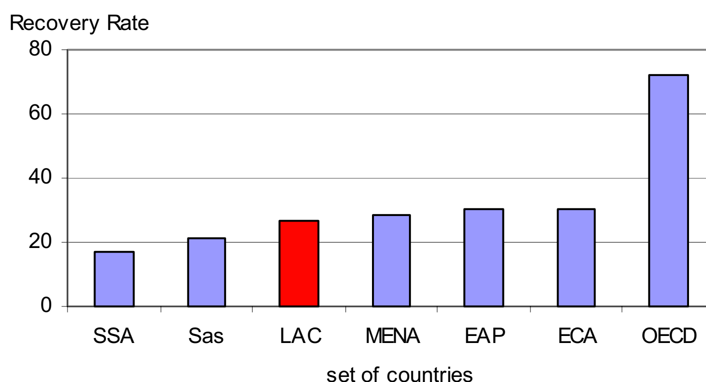
Recovery rate varies widely among countries, the most desirable being to have as big a recovery rate as possible, because this increases creditors' return in bankruptcy states, reducing the cost of capital. Figure 6 shows that the OECD has the highest recovery rate, with creditors recovering more than 70 cents on the dollar when a firm fails. The average in Latin America is 26 cents on the dollar of recovery, higher than

[28] To verify if outliers (two observations in the upper left-hand side in the first graphic of figure 2) were driven the result we use a

Copyright © 2009 Association of Corporate Counsel

South Asia and Sub-Saharan Africa alone. The worst result among Latin American countries (Figure 7) comes from Brazil, with a recovery rate of 0.2 cents on the dollar, and the best result is from Mexico, where creditors recover 64.5 cents on the dollar. The highest recovery rate in the world is Japan, with 92.4 cents on the dollar.

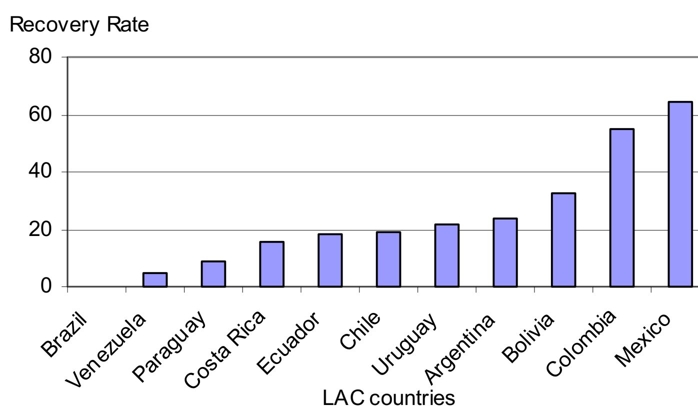
Figure 6: Recovery rates in each set of countries



Source: Doing Business database

Therefore, it would be interesting for Latin American countries to concentrate efforts on reforming their bankruptcy systems in the direction of the characteristics listed by Hart (1999) to improve the efficiency of bankruptcy procedure and ensuing credit market conditions.

Figure 7: Recovery rates of LAC countries



Source: Doing Business database

quantile regression in the median. We find that the coefficient is still negative and significant.
[29] We also regress against GDP per capita to control effects of richness or poorness over the credit market.

Copyright © 2009 Association of Corporate Counsel

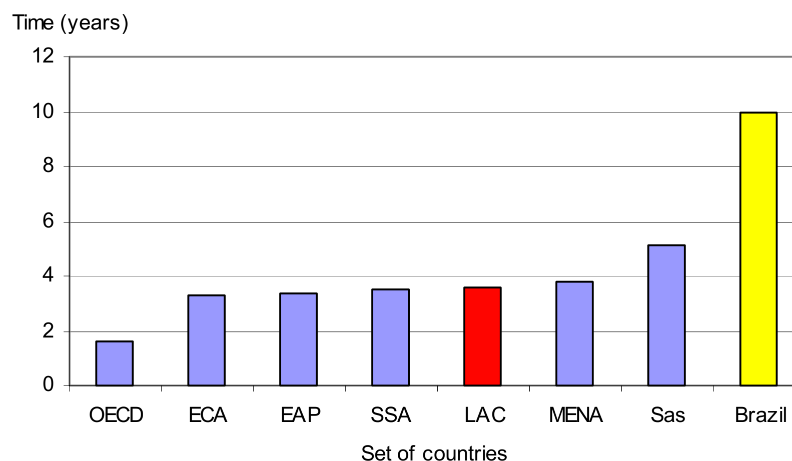
V – Brazilian Bankruptcy Reform[30]

In the last decades, a legislative reform has taken place in several Latin American countries. Particularly, Argentina, Bolivia, Brazil, Chile, Colombia, Costa Rica, Ecuador, México and Peru focused on their insolvency system, reforming their legal framework for bankruptcy. The most recent reform occurred in Brazil in a process that began in 1993, concluded in June 2005. This section will focus on such reform, explaining the characteristics of the former law, its main changes and effects over the Brazilian economy.

V. 1 – The Former Brazilian Bankruptcy Law

The former legal framework for corporate insolvency in Brazil was very fragmented, with the core of legislation for bankruptcy proceedings enacted in 1945. The *Lei de Falências* regulates both liquidation (*falência*) and reorganization *(concordata*) proceedings for merchants (i.e., a legal entity that engages in commerce in its usual course of conduct). State-owned corporations and private-public joint-stock companies were excluded from bankruptcy proceedings until 10.31.2001, when a modification allowed the bankruptcy of private-public joint-stock companies.

Figure 8: Average time involved in the insolvency proceeding per region of countries



Source: Doing Business database

Despite providing both proceedings and intending to prevent or avoid liquidation of enterprises, in practice the insolvency process has proven to be ineffective at maximizing asset values and protecting creditor rights in liquidation – bad to the cost of capital (*proposition 1 and 2*) – or at salvaging viable

[30]In Appendix A, the co-author Aloisio Araujo, explains the process of the reform in Brazil.

Copyright © 2009 Association of Corporate Counsel

distressed businesses incurring type I error. The insolvency proceeding is very slow, taking ten years on average to complete the whole process. The average time of insolvency proceeding in Brazil is the slowest in the world and much higher than the mean of Latin America countries (figure 8). Liquidation is marked by severe inefficiencies, and the reorganization process is obsolete and excessively rigid to provide meaningful rehabilitation options for modern business.

The process of disposing of assets is slow and highly ineffective, due to court and procedural inefficiency, lack of transparency and the so-called *problema da sucessão*, i.e. the transfer of liabilities, notably tax and labor liabilities to the buyer of property sold in liquidation, thus deteriorating the assets market value of an insolvent company. In addition, the priority given by bankruptcy law to labor and tax claims has the practical effect of eliminating any protection to other creditors. The process has led to an informal use of the system to promote consensual workouts[31]. An insufficient legislative framework otherwise hampers workouts.

As a consequence of shortcomings in the present Brazilian legal and institutional system concerning insolvency, it is possible to conclude that:

- creditors' rights are only weakly protected and financial markets are characterized by a relatively low credit volume and high interest rates (the ratio Private Credit/GDP is only 35% and the spread of interest rate is 49% in average for the period of 1997 to 2002),
- distorted incentives and the lack of effective mechanisms to support corporate restructuring result in disproportionately high default rates of potentially viable companies,
- exit costs for non-viable companies are increased,
- productivity and employment are reduced.

In 1993 Brazil initiated efforts to update its corporate insolvency legislation. Since then, the original project has undergone several amendments until the House of Representatives approved its latest version in October 2003. The project was sent to the Senate that introduced some further improvements to the new law,

[31] Workout (out-of-court): Informal renegotiation of loans.

Copyright © 2009 Association of Corporate Counsel

being approved in July 2004. In December 2004 the modified project that had returned to the House of Representatives was approved again, put in effect in June 2005.

V. 2 – Credit Market and Changes in Brazilian Bankruptcy Law

As we saw in earlier sections, the bankruptcy law has a strong effect on the credit market, and this is not different in Brazil, whose credit market is not well developed, with scarce and expensive credit. To make the analysis more attractive, we will compare several indicators of the Brazilian credit market and bankruptcy law against the mean of Latin American countries and rich countries.

Table 5: Credit Indicators

	Private Credit/GDP (1997-2002)	Interest-Rate Spread (1997 – 2002)
Brazil	35.00%	49.00%
Latin American Countries	44.23%	11.00%
OECD	102.748%	3.87%

Source: World Development Indicators 2004.

Table 5 reports credit characteristics in Brazil, Latin America and the OECD. We present the 1997-2002 mean because it is the period in which all countries had observations for private credit and interest-rate spread. At first sight we tend to think that Brazilian private credit as a proportion of GDP is very low when compared with the OECD, but it is not so inferior to the mean of Latin America countries. However, this situation is even worse than it seems, since a significant part of credit came from a development bank (BNDES) that is controlled by the government. The Development Bank finances a large share of non-housing investments at a subsidized interest rate. Looking at the interest-rate spread confirms this chaotic situation. This rate is more than four times bigger than the average rate in Latin American countries and more than twelve times bigger than the average rate in OECD countries.

One important reason[32] for this situation in the credit market is the design of the Brazilian bankruptcy law. Using the same measures as section IV, we see in Table 1 (in the introduction) that creditors have a very low protection in Brazil even when compared with the mean of Latin American countries. This characteristic reduces the expected return of creditors in insolvency states, what raises the interest rate spread and inhibits the supply of credit. Also from the Goals-of-Insolvency Index we see that the bankruptcy procedure is very

Copyright © 2009 Association of Corporate Counsel

inefficient, being long, costly and rarely achieving efficient outcome, reducing the return in bankruptcy states and raising the cost of capital (see *proposition 1*). We can see this return in bankruptcy states as the creditors' recovery rate in the case of bankruptcy, which is 0.2 cents per dollar in Brazil, while the average of Latin American and OECD countries is 26 and 72 cents respectively.

So the recent reform in the Brazilian bankruptcy law is on the way to improve the efficiency in insolvency procedure, with potential positive effects on the credit market and on the economic efficiency of the productive factors. The new law improves on existing legislation by integrating the insolvency system with the country's broader legal and commercial systems, providing an option to reorganize in or out of court, and striking a reasonable balance between liquidation and reorganization. It also would significantly improve the flexibility of the insolvency legal system, by allowing the conversion of recuperation proceeding in liquidation, permitting the debtor's application for rehabilitation during the procedural term awarded to respond in the liquidation proceeding filed against him, and introducing a new out-of-court reorganization system for pre-package restructuring plans.

The new liquidation procedure suffered a series of changes itself. Its main changes are:

C1 – Limitation of labor credit (until 150 minimum wages).

C2 – Credit with collateral above tax credit.

C3 – Unsecured credit above some of the tax credit.

C4 – Firms will be sold first, preferably as a whole, and the constitution of the creditors' list will come later, thus speeding up the process and increasing the value of the bankruptcy state.

C5 – No more transference of liabilities, notably tax and labor liabilities, to the buyer of property sold in liquidation.

C6 – New credit given in the reorganization step will be given first priority in liquidation.

Notice that C1, C2 and C3 provide several expected effects on the life of firms. In the period ex-ante financial distress is expected a reduction of the cost of capital (*proposition 2*), an expansion of the credit

---

[32] Other factors not treated in this paper contribute to this bad credit-market situation, such as poor competition in the banking

Copyright © 2009 Association of Corporate Counsel

market and the set of socially efficient projects that would be financed (*proposition 4*), and a reduction of the sub-investment in effort that is exacerbated when the bankruptcy system gives priority to tax and/or labor claims over creditors' claims (*proposition 7*). In the period ex-post financial distress the portion of financially distressed firms probably will be reduced because the investment in effort increases, and despite the gamble and delay effects remaining constant, the aggregate gamble and delay effect are diminished. The expected effect of C4 and C5 is that the value of firms in bankruptcy states will increase and the more those creditors intuitively expect to receive in the insolvency state the less they will require the firm to repay in the solvency state, reducing the cost of capital (*proposition 1*). Also, C5 will speed up the process of putting the capital of liquidated firms to more efficient use. C6 is important for reducing the indirect costs in reorganization procedure, where potential buyers could be more reluctant to deal with the company or may demand more especially favorable terms than if C6 did not exist. This factor tends to increase: creditors' return in the insolvency state, and the chance of success in reorganization.

Notice that all these changes work to raise both measures of bankruptcy efficiency. C1 and C2 improve secured creditors' protection, while C4, C5 and C6 diminish costs and improve goals of insolvency.

Reorganization was inspired in Chapter 11 of the U.S Bankruptcy Code. Unlike the old process called "concordata" that does not permit any renegotiation between the interested parts and with only few of them being entitled to recovery, now managers make a sweeping proposal of recuperation that should be accepted by each one of the three classes: workers, secured creditors and unsecured creditors (including trade creditors). Creditors, now with a more significant role at the procedure, will have to negotiate and vote for the reorganization plan. Looking to increase the chance of reorganization success, two changes were introduced by the new law. First is the application of the automatic stay by 180 days, when creditors cannot take any of the firm's goods, even those given as collateral, having in view not to disturb the firms' activities. The second one is related to the new credit obtained by reorganizing firms. Credit that is given in post-bankruptcy period will have priority over older credits if liquidation occurs (see C6), motivating creditors to

---

sector, high yield of treasury bills, high banking costs, etc.

Copyright © 2009 Association of Corporate Counsel

make new loans at better terms, and reducing indirect cost brought by the insolvency. These changes may permit more economically efficient firms to recover, improving the balance between liquidation and reorganization and reducing filtering failure problems (type I error). Such balance between bankruptcy procedures allows for a more efficient allocation of the productive factors by both saving economically efficient firms that are suffering from financial distress and transferring assets of economically inefficient firms to more efficient use.

An additional effect of the new reorganization procedure is the possibility of APR violations. As we saw in former sections, such violation incentives managers to make more efficient decisions when the firm is in financial distress, diminishing the perverse gambling and delay effects. On the other hand, this violation reduces managers' incentive on effort at the earlier stages of firms' life, what makes the aggregated result ambiguous if it were the only change in the law. However, several modifications made in liquidation and in reorganization should produce a reduction of the cost of capital for firms in the economy, which makes the gap between the return in solvency and insolvency states bigger than before the reform[33], generating a positive final effect on managers' effort. Therefore, the aggregated cost of gambling effect and delay effect will be reduced and no longer ambiguous.

An extrajudicial procedure was also created, which is very important in Brazil since it saves the high court costs. The off-the-court reorganization is a "pre-packaged" mechanism, where the majority imposes the decision on the minority. The private renegotiation between groups of creditors and debtors avoids several losses during the firm's rehabilitation that is observed in case of open renegotiation procedure.

Due to the relevancy of fraud in bankruptcy, important changes were made in the new law to avoid it. Changes in liquidation like C1 (limitation of labor credit), C2 and C3 (Credit with collateral above tax credit and unsecured credit above some of the tax credit) as like the important role of creditors in reorganization provide incentives against fraud in bankruptcy procedure. The limitation of labor credit (until 150 minimum

[33] Let v_{solv} e F be the pre-reform values of firm's return and creditors' payment in solvency states, v_{solv} and F^R be the post-reform values and l the amount that managers get with APR violations. If changes in the bankruptcy law are such that $v_{solv} - F^R - l > v_{solv} - F$ (where $F^R + l < F$) , then $p'(e) = 1/(v - F) > 1/(v - F^R - l) = p'(e^R)$, and therefore $e^R > e$, i.e., given these changes the manager's effort is bigger than in the pre-reform stage.

Copyright © 2009 Association of Corporate Counsel

wages) diminishes the possibility of the manager to cheat the law by creating jobs to "friends" in such a way to receive as regular workers (for the manager) of the failing firm. Secured credit above tax and labor claims that makes higher the recovery of creditors in case of bankruptcy and the important role of creditors in reorganization raise creditors' incentive in monitoring the bankruptcy process, mitigating fraudulent actions. There were several reasons for indictment for fraud in the old law, but these were not cumulative and each one stipulated a maximum of two years of penalization. Since the judicial process was very slow, most penalties were prescribed and as a result there was always the possibility of no punishment at all. Under the new law, those two years of penalty are cumulative and the judicial process is accelerated, hence the cost of fraud is expected to increase considerably. Another important change in the new law is that all frauds are remitted directly to the procedures of general criminal law, which is much more punitive than the special bankruptcy-crime law and the old special bankruptcy-crime law. Moreover, since private creditors expect to receive more under the new law, they will be watching the judicial procedures of bankruptcy more closely and most likely they will be important allies in enforcing fraud penalty.

Besides the reform in bankruptcy law, many other changes in laws have been important to credit-market development. Changes in mortgage law allow for the house to remain in the possession of the creditor, thereby circumventing the difficulty of the judiciary not to transfer property from the debtor to the creditor in case of default due to an ideological bias. This has caused the collapse of mortgage in Brazil. However, it is not clear that the situation will improve. Also, changes were made in contractual laws that allow for fast collection in case of unpaid debt.

V. 3 – The Relevancy of the Judiciary

The role of the judiciary is fundamental to the fulfillment of the law. If rules and regulations are not properly enforced, even if the law is well designed it will not attain its objectives in full.

There are two measures of enforcement that can qualify the quality of courts. The first one is the "quality of enforcement", that is, the number of days that the court takes to solve a payment dispute. The second is called "rule of law", which is the measure of the "law and order" tradition of a country. Table 6

Copyright © 2009 Association of Corporate Counsel

indicates that under both measures, the quality of the Brazilian Judiciary is inferior to the mean in Latin America. Contracts take more time to be enforced and the tradition of fulfilling the law is weak.

Table 6: Judiciary's Quality Indicators

	Quality of Enforcement (days)	Rule of Law [0, 6]
Brazil	566	1.50
Latin American Countries	440	2.35
OECD	230	5.33

Source: Doing Business 2004 and International Country Risky Guide 2004.

Castelar (2001, 2003) made a careful study of the Brazilian Judiciary. Following his research, it is possible to find explanations for the low quality of the judiciary in Brazil. Castelar reports an interview held with entrepreneurs and magistrates. Entrepreneurs evaluate agility as bad or worse in 91% of the cases, while even magistrates themselves evaluate it as regular or worse in 86.4% of the cases. Like agility, the low capacity to forecast judiciary decisions was pointed out as an important feature of the Brazilian Judiciary. Asked when the decision of the magistrate reflects his political views, only 22% answered *rarely* or *never*. Therefore the decisions of the majority of magistrates are affected by political views. Finally, magistrates were asked how they would behave in the case of a conflict between (a) compliance with contracts and (b) the interests of less privileged social segments: only 19.7% answered option (a), that is, that they would follow contracts.

Therefore, all these answers indicate an environment unfavorable to credit, indicating why expectations of recovery are low when a firm goes bankrupt and courts enter the process.

However, recent changes have occurred in the Brazilian Judiciary. Congress approved a law that establishes the higher court's decision as binding, which means that if a superior magistrate's court makes certain decisions, a lower court cannot make a different decision in similar cases. This change reduces the burden of the judiciary and decreases the court's time. There is also a law in Congress that changes the procedural code in order to eliminate several procedures that contribute to court delays. Both changes contribute to raise the efficiency of the judiciary and help to develop the credit market.

Copyright © 2009 Association of Corporate Counsel

VI – Conclusion

As a theoretical basis, we understand that a bankruptcy system should seek ex-post and ex-ante efficiency. Ex-post efficiency means that the procedure maximizes the total value of the firm's assets, providing higher return to creditor in insolvency states and consequently lower cost of capital and larger set of financed projects in the economy. Ex-ante efficiency treats the optimal division of value in case of bankruptcy. Violations of APR have positive effects in situations of financial distress by providing incentives to reduce delay and investments in inefficient risky projects, but also have negative effects ex-ante financial distress by reducing the incentive of managers' efforts. The effect over the cost of capital is ambiguous. Therefore its optimality depends particularly on the country's characteristics that will determine which effect is more relevant. Priority of creditors' claims over tax and/or labor claims proves to be more efficient than otherwise because of the significant positive impact on both cost of capital and managers' effort, without negative impact. Additionally, it offers incentive to creditors to monitor actions of managers in bankruptcy, which helps to avoid fraud.

In practice, our empirical analysis says that Latin American countries have a poor system of bankruptcy with problems in both measures of bankruptcy procedure goodness. Their inefficient procedure does not allow maximizing the firms' value, reducing significantly the creditors' recovery rate and increasing the cost of capital. In addition, the protection for creditors is the lowest in the whole world, reducing their interest in supply credit, and increasing the negative impact on the credit market.

Due to the severe inefficiency of the bankruptcy law in Latin America, many governments have initiated efforts to change this picture, and a series of reforms in the bankruptcy system have occurred. The Brazilian case has been emphasized since it is the most recent reform in the region. Improvement in liquidation and reorganization procedures, as well as the creation of an extra-judicial procedure should have a strong and positive impact on the Brazilian credit market. The new law works to reduce the inefficiency of bankruptcy procedure, making it less costly and faster and providing a good balance between liquidation and reorganization. Moreover, the new law tries to increase both protection and the role of creditors in the

Copyright © 2009 Association of Corporate Counsel

insolvency procedure. Also, despite the performance of courts in Brazil indicating an environment unfavorable to credit, efforts are being made to change this image.

These changes tend to provide a more attractive business environment to entrepreneurs. Using our findings in theoretical and empirical field it is possible to describe expected consequences that emerge from this reform. The theoretical model suggests that gains in efficiency of the procedure – that produce an increase in firm's value in insolvency states – as well as the higher priority to creditors will be reflected into a lower cost of capital to firms and in a bigger set of financed projects, promoting entrepreneurship by the creation of new firms and investments, and therefore fostering the economic growth as a consequence. Besides, moral-hazard effects related to managers' effort are reduced, diminishing the possibility of financial problems in companies. As to the efficiency of production factors, the new reorganization procedure may offer a good balance with liquidation, allowing that economically efficient firms continue their operations, and closing economically inefficient firms, moving their assets to more efficient business, what promotes economic gains. Therefore reforms like the Brazilian bankruptcy law reform will possibly bring significant and positive consequences to both the credit market and general economic efficiency.

References

[1] Aghion, P., Hart, O. and Moore, J. 1992: "The Economics of Bankruptcy Reform", *Journal of Law, Economics and Organization*, 8:523-546.

[2] Andrade, G., Kaplan, Steven N., 1998: "How Costly is Financial (Not Economic) Distress? Evidence from Highly Leveraged Transactions That Became Distressed", *The Journal of Finance*, 53: 1443-93

[3] Araujo, A. and Funchal, B., 2004: "How much creditor protection?", mimeo.

[4] Araujo, A., Lundberg, E., 2003: "A Nova Lei de Falências: Uma Avaliação", *Workshop of Banking and Credit, Central Bank of Brazil.*

[5] Baird, Douglas G., 1986: "The Uneasy Case for Corporate Reorganizations", *Journal of Legal Studies*, 15: 127-47.

[6] Baird, Douglas G., 1998: "Bankruptcy's Uncontested Axioms", *The Yale Journal of Law*, 108: 573-599.

Copyright © 2009 Association of Corporate Counsel

[7] Bebchuck, Lucian A., 1988: "A New Approach to Corporate Reorganizations*", Harvard Law Review*, 101: 775-804.

[8] Bebchuck, Lucian A. and Chang, H. F., 1992: "Bargaining and the Division of Value in Corporate Reorganization", *Journal of Law, Economics and Organization*, 8:253-279.

[9] Bebchuck, Lucian A., 2002: "Ex ante Costs of Violating Absolute Priority in Bankruptcy", *Journal of Finance,* 57: 445-460.

[10] Bebchuck, Lucian A., 2000: "Using Options to Divide Value in Corporate Bankruptcy", *European Economic Review*, 44: 829-43.

[11] Beck, T., Demirgüç-Kunt, A. and Levine, R., 2004: "Finance, Inequality and Poverty: Cross-Country Evidence", University of Minnesota (Carlson School of Management), mimeo.

[12] Bergoeing, R., Kehoe, P. J., Kehoe, T. J., Soto, R., 2002: "A Decade Lost and Found: Mexico and Chile in the 1980s", *Review of Economic Dynamics*, 5: 166-205.

[13] Berkovitch, E., Israel, R., 1999: " Optimal Bankruptcy Laws across Different Economic Systems", *The Review of Financial Studies*, vol 12, nº 2: 347-77.

[14] Berkovitch, E., Israel, R., Zender, Jaime F., 1997: " Optimal bankruptcy law and firm-specific investments", *European Economic Review*, 41: 487-97.

[16] Bonilla, C., Fischer, R., Lüders, R., Mery, R., Tagle, J., 2003: "Análisis y Recomendaciones para una Reforma de la Ley de Quiebras", mimeo.

[17] Brown, David T., 1989: "Claimholder Incentive Conflicts in Reorganization: The Role of Bankruptcy Law", *The Review of Financial Studies,* vol2, nº1: 109-23.

[18] Castelar, A., Cabral, C., 2001: "Credit Markets in Brazil: The Role of Judicial Enforcement and other Institutions", Defusing Default: Incentives and Institutions pp: 157-188, The Johns Hopkins University Press.

[19] Castelar, A., 2003: "Judiciário, reforma e economia: A visão dos magistrados", *Working paper nº. 966*, IPEA.

Copyright © 2009 Association of Corporate Counsel

[20] Cornelli, F., Felli, L., 1997: “Ex-ante efficiency of bankruptcy procedures”, *European Economic Review*, 41: 475-85.

[21] Eberhart, A. C., Moore, W. and Roenfeld, R., 1990: “Security Pricing and Deviations from the Absolute Priority Rule in Bankruptcy Proceedings”, *The Journal of Finance*, vol 45, nº 5: 747-769.

[22] Franks, J. and Torous, W., 1989: “An Empirical Investigation of U.S. Firms in Reorganization”, *Journal of Finance*, 44: 747-769.

[23] Greenwood, J. and Jovanovic, B., 1990: “Financial Development, Growth and Income Distribution”, *Journal of Political Economy*, 98: 1076-1107.

[24] Hart, O., 1999: “Different Approaches to Bankruptcy”, working paper nº 1903.

[25] Hart, O., La Porta, R., Lopez-de-Silanes, F. and Moore, J., 1997: “A new bankruptcy procedure that uses multiple auctions”, *European Economic Review*, 41: 461-473.

[26] Jackson, T. H., 1986: The Logic and Limits of Bankruptcy Law. Cambridge, MA: Harvard University Press.

[27] Jensen, M. C., 1991: “Corporate Control and Politics of Finance”, *Journal of Applied Corporate Finance*, vol. 4, nº 2: 13-33.

[28] Johnson, G. W. and Alonso, D., 2004: “Revitalizing Business Environments: Reexamining the Foundations of Trust” World Bank Document of Forum on Insolvency in Latin America 2004.

[29] King, R. G. and Levine, R., 1993: “Finance, Entrepreneurship and Growth: Theory and Evidence”, *Journal of Monetary Economics*, 32: 513-542.

[30] La Porta, R., Lopez-de-Silanes, F., Shleifer, A. and Vishny, R., 1998: “Law and Finance”, *Journal of Political Economy*, 106: 1113-1155.

[31] Levine, R., Norman, L. and Beck, T., 2000: “Financial Intermediation and Growth: Causality and Causes”, *Journal of Monetary Economics*, 46: 31-77.

[32] Levine, R., 2004: “Finance and Growth: Theory and Evidence”, NBER working paper 10766.

Copyright © 2009 Association of Corporate Counsel

[33] Levine, R., Beck, T., 2003: "Legal Institutions and Financial Development", NBER working paper 10126.

[34] LoPucki, L., 1983: "The Debtor in Full Control: Systems Failure under Chapter 11 of the Bankruptcy Code?", *American Bankruptcy Law Journal*, 57: 99-126 (part I) and 247-273 (part II).

[35] LoPucki, L. and Whitford, W., 1990: "Bargaining over Equity's Share in the Bankruptcy Reorganization of Large, Publicly Held Companies*", University of Pennsylvania Law Review*, 139: 125-196.

[36] Povel, Paul, 1999: "Optimal "Soft" or "Tough" Bankruptcy Procedures", *Journal of Law, Economics and Organization*, 15: 659-84.

[37] Shleifer, A., Vishny, Robert W., 1992: "Liquidation Values and Debt Capacity: A Market Equilibrium Approach", *The Journal of Finance,* vol 47, nº 4: 1343-66.

[38] Schwartz, A., 1998: "A Contract Theory Approach to Business Bankruptcy", *The Yale Journal of Law,* vol. 107, nº 6: 1807-51.

[39] Schwartz, A., 1999: "Bankruptcy Contracting Reviewed", *The Yale Journal of Law,* vol. 109, nº 2: 343-64.

[40] Schwartz, A., 2002: "The Law and Economics Approach to Corporate Bankruptcy", Global Corporate Governance Forum, Research Network Meeting.

[41] Webb, D., 1991: "An economic evaluation of insolvency procedures in the United Kingdom: Does the 1986 Insolvency Act satisfy the creditors' bargain*?", Oxford Economic Papers*, 43: 139-157.

[42] White, M., 1994: "Corporate Bankruptcy as a Filtering Device: Chapter 11 Reorganization and Out-of-Court Debt Restructuring*", Journal of Law, Economics and Organization*, 10: 268-295.

Copyright © 2009 Association of Corporate Counsel

Appendix A

Personal participation and comments of Aloisio Araujo[34] in Brazilian Bankruptcy Reform.

A. 1 – Brazilian bankruptcy reform

A. 1.1 – History

The current Brazilian bankruptcy law is very old, dating from the forties. In 1993 the Executive sent the draft of a new law, which was viewed with skepticism by specialists since it tried to save firms at all costs. In 2001 the president of the Central Bank, Arminio Fraga Neto, and the director of economic studies, Sergio Werlang, invited me to participate as a consultant in a group to study the new law from both the economic and juridical points of view.

The first decision of the group was to choose between going ahead for a new law, which would take an enormous amount of work both in terms of convincing and the intellectual effort of adapting the draft, taking into consideration economic incentives, or simply amending the current one by eliminating its main distortion. With arguments such as that the old law contained jargon and concepts that were already in the domain of courts all over Brazil, which were even more convincing since business bankruptcy is under state rather than federal domain, and also that the draft of the new law was so bad in terms of its economic impact. This position also had the support of important lawyers like the eminent Luis Bulhões Pedreira, who has a high reputation for having written in the sixties a corporate law which at the time was quite advanced in terms of economic reasoning. However, it was clear that Congress was going to pass a law which preserved firms, or no law at all. So, the decision was made (correctly, in my view) that a new law should be pursued, a difficult task taking in consideration that there was a strong anti-creditor political and juridical bias, in part due to the high real interest in the last few years, to the much higher returns on capital and to bad income distribution (which, although due to differences in education, is not perceived this way).

[34] I would like to thank Eduardo Engel the invitation to write this article and in special this appendix, relating my personal experience with the Brazilian bankruptcy reform. His patience and interest were particularly important in giving me the energy to write this paper, together with my co-author, which I hope will be useful to the much-needed microeconomic reforms in Latin America.

Copyright © 2009 Association of Corporate Counsel

With this decision in mind, the group in charge of the project, which involved many lawyers and economists as well as international consultants, kept working and bargaining with Congress and in particular with the staff of Congressman Biolchi, the author of the original draft and an important figure in the process until the end. However, the former administration did not put the project to a vote, due to other priorities such as the independence of the Central Bank.

In the new government, Ilan Goldfajn and Henrique Meireles, the new director of economic studies and president of the Central Bank, respectively, invited me to remain as a consultant. Also, due to the positive influence of Marcos Lisboa[35], the project became high priority. The Lower House approved it at the end of 2003. It contained some very sound principles, such as strengthening the creditors' opinion on reorganization and eliminating some of the fiscal priorities in the selling of assets, as mentioned below. However, some very important elements were missing.

At that point many economists, executives and lawyers thought that it was better not to have a new law since this would create even more uncertainty to creditors than the old one. Fortunately, the Senate presented a much more positive prospective for the new law. I happen to be a teen-age friend of the influential Senator of the political opposition, Tasso Jereissati, who gave me full access to all the important Senators in the matter, including Lucia Vania, Ramis Tebet (the head of the economic commission of the Senate) and Aloisio Mercadante (the leader of the government in the Senate). I found a very positive environment for the discussion of an important law. The Senate withdrew the fiscal priority and limited the labor priority in liquidation. Also, at considerably high cost the Senate allowed for an extra-judicial procedure of the pre-packed type that exists in the United States. Many other improvements were made.

The challenge now is how the Judiciary is going to interpret the new law.

A. 1.2 – The previous situation and the main changes

- Introduction: The bad mechanics of credit.

[35] Secretary of Treasury Ministry.

Copyright © 2009 Association of Corporate Counsel

Total credit was scarce: just 26% of GDP[36]. But even worse, banks had low priority in case of liquidation. Therefore, in the case of any bad signs as to the economic health of a firm, banks would reduce credit even further since the recovery rate was so low[37]. So firms would finance themselves with a delay in paying taxes. Since tax authorities had the priority in case of liquidation that would scare banks even further, and so on. Credit would just collapse to many types of firms.

Banks do not have incentives to liquidate firms, even if they have no perspectives of recuperation. On the other hand, few firms are successful in recovering. This is so due to the high priority of tax in liquidation, combined with the Brazilian tax structure, which relies too much on indirect taxes. The situation could have been better if corporate taxes were more important in the tax structure, since in this case firms would not accumulate such a big tax debt: firms in financial distress do not have profits. Hence, banks would not fear liquidation so much, increasing the banks' incentive and recovery in case of bankruptcy.

- The reasons for optimism

As described above, the credit market in Brazil was in total disorder. Certain changes seemed impossible at the beginning of the process five years ago. The modifications obtained will introduce incentive mechanisms that will enable the development of credit markets in Brazil. The main changes obtained were:

In liquidation:

- Limitation of labor credit
- Credit with collateral above tax credit
- Unsecured credit above some of the tax credit
- Firms will be sold first, preferably as a whole, and the constitution of the creditors' list will come later, what will speed the process and increase the value of the bankruptcy state.
- New credit given in the reorganization step will be given first priority in liquidation.

In reorganization:

[36] Data from Brazilian Central Bank 2004.

Copyright © 2009 Association of Corporate Counsel

Inspired by Chapter 11 of the U.S Bankruptcy Code, here some of the well-known problems might be found, but it is certainly much better than the alternatives that try to save firms at all costs that were proposed initially in Brazil. Creditors will have to vote for the reorganization plan. The alternative of a new manager appointed by the judges was also rejected. A simplified version of it was adopted in Brazil, having some advantages in terms of the simplification of court procedure but missing some of the credit strength by making heterogeneous creditors vote together.

The adoption of extra-judicial procedure:

This is very important in Brazil since it saves the high court costs.

The elimination of the provision on tax-inheritance debt:

This almost eliminates any possibility of asset-selling for firms in distress, since the new owner would inherit all the labor and tax liabilities, even the hidden ones. This change will speed up the process of putting the capital of firms to new use, giving new incentives to mergers and acquisitions.

A. 1.3 – What ideas failed in the Brazilian experience?

When I first started working on the new law, I thought it would be a good idea to have a very simple procedure which would strengthen creditors' rights, save on court costs and at the same time avoid a possible bias on the part of the judges. This last point is very well documented in Castelar and Cabral (2003). One possibility was to follow the suggestions of Bebchuck (1988) and Hart (1997). Their idea is simply to give the firm in financial distress to the senior creditor and allow the more junior creditor to buy from the senior for the price of his credit, and so on. Although ingenious, this idea received much opposition from lawyers and politicians in Brazil. Lawyers alleged that rights of the parties involved would not be fully preserved in the sense that the court does not have a prominent role. In general, the justice culture is against any summary resolution. At the political front the Congress had a bias in favor of the firms' owners. So I had to give it up. Another idea was to try to follow a law of the type in England, where the creditor has more power and there is no effort to save firms as a whole. This could be important in countries that are reluctant to close firms,

[37] See the data in the previous section.

Copyright © 2009 Association of Corporate Counsel

even those without sound economic prospects. However, the Brazilian Congress was in the mood to pass a law where the emphasis was on saving firms, and Chapter 11 fulfills this role, at least it gives creditors a strong role in the process, although perhaps this is too complex for a poor country.

One problem with the Brazilian law is that it is the Judge who appoints the clerk in charge of liquidation, rather than the creditors.

Another problem is the solution found for tax liabilities under reorganization. As mentioned before, firms under distress in Brazil tend to have many tax liabilities. The solution that I proposed was for the government to organize an auction of the tax liabilities of firms that asked for reorganization. This way the auction would attract many new specialists interested in reorganizing the firm. The owner would avoid having too many tax liabilities for the fear of losing the control of the firm. This solution was scrapped for fear that it might be unconstitutional. The solution adopted was to give an automatic reorganization of the tax debt in 8 years. This could give firms the incentive to keep accumulating tax debts and to ask for re-organization within five years. This could also be very bad for credit.

A. 2 – Policy Lessons

A. 2.1 – The Brazilian Case

What I learned from the Brazilian experience is that first of all the main distortions that I found are probably very specific to Brazil, at least I have never seen them mentioned in the international literature. The first distortion is the priority given to taxes over security credit. In a paper by Araujo & Lundberg (2003), it was shown that only four countries out of thirty-five share this unfortunate property (see Table A). Actually this was an important argument in convincing the Senators to change the law in a moment when everything looked hopeless. The fact that the tax authorities were able to collect the insignificant amount of less than four million dollars in a recent year makes one wonder why there was so much fighting over this, although corruption could be an explanation. An equally distortional aspect of the old law was the labor and tax-inheritance provision. Again, when carefully explained by a neutral party, Congressmen understood the economic argument and voted to create the right incentive, but this took time. Compared with this type of

Copyright © 2009 Association of Corporate Counsel

distortion, the usual debate about bankruptcy seems far less important. Countries, mainly the poor ones, create very distortional institutions, sometimes in the attempt to solve other distortions. In this example I think the distortions were created just to avoid tax evasion rather than to benefit any special group in particular.

Another lesson that I learned is that it is sensible to separate the law itself from the judiciary, although the two problems are to some extent related. For example, it is good to have a simpler – even if more imperfect – law in a less developed country. It is a big mistake to think the entire credit problem is due to the pro-debtor bias of the judiciary. I believe that the very low recovery rates and the very long time of liquidation, as shown in the World Bank data for Brazil[38], are in great part due to the lack of interest of creditors in a liquidation procedure from which they are not going to benefit anyhow. With the change in the priority in liquidation, the whole governance of liquidation is bound to change. However, the judiciary plays a very important role. For example, I have been giving talks to many audiences and many judges are considering not calling for liquidation even if creditors vote not to accept the plan to reorganize the firm, although the new Brazilian legislation does not have the figure of the cram down[39] in chapter 11 of the American Code.

A. 2.2 – Relations with reforms in other Latin America countries

Although countries do obviously learn from each other, I think each country has its own distortions. Brazil, for example, is in the top 40% less corrupt but in the bottom 5% with respect to credit according to the World Bank. So, the reforms have to take into consideration what the country has already achieved. I think the reforms should be conducted, as in Brazil, by a multidisciplinary group of lawyers, judges and economists, mainly micro-economists who have an intuition of the incentives[40] of the several parties involved. The main goal should be a better system, since there is no agreement among economists about what constitutes an optimal bankruptcy.

[38] Figures 7 and 8 respectively.
[39] This is a procedure whereby reorganization can be adopted by the bankruptcy judge despite being voted down by one or more classes of creditors.
[40] Some of these are described in section III.

Copyright © 2009 Association of Corporate Counsel

Table A- Priority order in bankruptcy (35 countries)

Countries	Priorities			
	1	2	3	4
Australia	Secured Credit	Post-Bankruptcy Credit	Wages	
Austria	Secured Credit	Post-Bankruptcy Credit		
Belgium	Secured Credit	Post-Bankruptcy Credit	Tax and and Social Welfare claims	
Bermudes	Secured Credit	Wages and Assignments	Post-Bankruptcy Credit	Tax claims
Brazil	Labor claims	Tax Claims	Post-Bankruptcy Credit	Secured Credit
Bulgaria	Secured Credit	Post-Bankruptcy Credit		
Canada	Secured Credit	Post-Bankruptcy Credit	Wages (bounded)	Tax claims
China	Secured Credit	Post-Bankruptcy Credit	Labor claims	Tax claims
Czech Republic	Secured Credit	Post-Bankruptcy Credit	Labor claims	
Estonian	Post-Bankruptcy Credit	Secured Credit	Labor claims	Tax claims
Finland	Secured Credit	Post-Bankruptcy Credit		
France	Wages	Post-Bankruptcy Credit	Secured Credit	
Germany	Secured Credit	Post-Bankruptcy Credit		
Hong Kong	Post-Bankruptcy Credit	Secured Credit	Labor claims	Tax claims
Hungary	Post-Bankruptcy Credit	Secured Credit	Wages	Tax claims
Irland	Secured Credit	Tax Claims (bounded)	Labor claims	
Israel	Secured Credit	Post-Bankruptcy Credit	Labor claims (bounded)	Tax claims
Italy	Post-Bankruptcy Credit	Tax and Labor claims	Secured Credit	
Japan	Secured Credit	Post-Bankruptcy Credit	Labor claims	
Korea	Secured Credit	Post-Bankruptcy Credit		
Malasya	Secured Credit	Post-Bankruptcy Credit	Labor claims	Tax claims
Netherlands	Secured Credit	Post-Bankruptcy Credit	Tax claims	Labor claims
Poland	Tax claims	Post-Bankruptcy Credit	Secured Credit	
Portugal	Secured Credit	Labor Claims	Post-Bankruptcy Credit	Tax claims
Russia	Post-Bankruptcy Credit	Labor Claims	Secured Credit	Tax claims
Scotland	Secured Credit	Post-Bankruptcy Credit	Tax claims	Labor claims
Singapure	Secured Credit	Post-Bankruptcy Credit	Labor claims (bounded)	
Slovak Republic	Secured Credit	Post-Bankruptcy Credit		
Spain	Wages (last 30 days and maximum of 2 mimimum wages)	Tax Claims	Secured Credit	
Sweden	Post-Bankruptcy Credit	Secured Credit	Tax claims	labor claims
Switzerland	Secured Credit	Post-Bankruptcy Credit	Labor claims (bounded)	
Thailand	Post-Bankruptcy Credit	Secured Credit	Labor claims	
UK	Secured Credit	Post-Bankruptcy Credit	Tax and and Social Welfare claims	Labor claims
United States	Secured Credit	Post-Bankruptcy Credit	Labor claims (bounded)	Tax claims
Vietnam	Post-Bankruptcy Credit	Secured Credit	Labor claims	Tax claims

Source: Araujo, A., Lundberg, E., 2003: "A Nova Lei de Falências: Uma Avaliação", *Workshop of Banking and Credit, Central Bank of Brazil.*

Copyright © 2009 Association of Corporate Counsel

Appendix B

Table B- Data from countries

Country	creditor rights between [0,1]	rule of law between [0,1]	Days to enforce contracts	credit info. registry	Goals of Insolv. between [0,100]	Private Credit/GDP 2000-03	% Interest Rate 2000-02	Recovery Rate
Algeria	0,25	0,33	407	0	45	0,08	3,25	37,1
Angola	0,75	0,50	1011	1	8	0,04	48,65	1,2
Argentina	0,25	0,25	520	1	43	0,20	12,43	23,5
Armenia	0,5	0,50	195	0	65	0,08	11,54	39,6
Australia	0,75	1,00	157	1	80	0,92	4,98	80
Austria	0,75	1,00	374	1	71	1,12		72,5
Bangladesh	0,5	0,17	365	1	25	0,26	7,83	23,2
B&H	0,75	0,00	330	1	51	0,39	8,17	32,1
Belgium	0,5	0,67	112	1	93	0,91	5,11	86,2
Belarus	0,5	0,67	250	1	40	0,09	10,03	11,9
Benin	0,25	0,00	570	1	33	0,12		8,8
Bolivia	0,5	0,50	591	1	53	0,53	11,05	32,5
Botswana	0,75	0,58	154	1	77	0,18	5,66	50,9
Brazil	0,25	0,25	566	1	24	0,36	43,73	0,2
Bulgaria	0,75	0,25	440	1	48	0,18	6,58	34,2
Burkina Faso	0,25	0,58	458	1	29	0,13		6,4
Burundi	0,25	0,00	512	1	8	0,26		16,4
Cameroon	0,25	0,33	585	1	44	0,09	13,00	21,4
Cambodia	0,5	0,00	401	0	25	0,07	13,74	0
Canada	0,25	1,00	346	1	93	0,83	3,38	89,1
Chad	0,25	0,00	526	1	11	0,04	13,00	0
Chile	0,5	0,83	305	1	19	0,73	3,96	19,3
China	0,5	0,75	241	1	51	1,29	3,33	35,2
Colombia	0	0,17	363	1	77	0,25	7,39	54,6
Congo	0,5	0,17	909	0	8			1,9
Ivory Coast	0,25	0,42	525	1	44	0,15		14,8
Costa Rica	0,25	0,67	550	1	43	0,27	14,96	15,5
Croatia	0,75	0,83	415	0	50	0,47	10,95	26,1
Czech Republic	0,75	0,83	300	1	22	0,37	4,05	16,8
Denmark	0,75	1,00	83	1	79	1,45	4,70	59,8
Dom Rep.	0,5	0,33	580	1	37	0,38	9,52	17,1
Ecuador	0,25	0,50	388	1	24	0,29	9,61	18,1
Egypt	0,25	0,67	410	1	39	0,61	4,46	18,4
El Salvador	0,75	0,42	275	1	42	0,05		24,9
United Arab Emir.	0,5	0,67	614	1	23	0,60		4,7
Ethiopia	0,75	0,83	420	0	75	0,29	4,55	40
Finland	0,25	1,00	240	1	99	0,59	3,33	90,2
France	0	0,75	75	1	43	0,93	3,60	46,6
Georgia	0,5	0,00	375	0	69	0,07	22,02	20,4
Germany	0,75	0,83	184	1	61	1,25	7,04	50,3
Ghana	0,25	0,33	200	1	17	0,12		28,2
Greece	0,25	0,50	151	1	42	0,69	4,66	45,6
Guatemala	0,25	0,25	1459	1	40	0,20	9,95	18,3
Guinea	0,25	0,42	306	1	8	0,04		22,2
Haiti	0,5	0,33	368	1	42	0,17	17,43	1,5
Hong Kong	1	0,75	211	1	63	1,53	4,66	82,3
Honduras	0,5	0,25	545	1	17	0,41	8,95	21,5
Hungary	0,5	0,67	365	1	38	0,36	2,76	30,8
India	0,75	0,67	425	0	21	0,31		12,5
Indonesia	0,5	0,33	570	1	35	0,21	3,44	10,6
Iran	0,5	0,67	545	1	84	0,31		19,1
Ireland	0,25	1,00	217	1	88	1,68	3,73	88,9
Israel	0,75	0,83	585	1	67	0,92	3,86	38
Italy	0,25	0,50	1390	1	46	0,82	4,34	43,5
Jamaica	0,5	0,17	202	0	63	0,19	9,93	63,5
Japan	0,5	0,83	60	1	93	1,06	1,83	92,4
Jordan	0,25	0,67	342	1	37	0,76	5,76	26,7
Kazakhstan	0,5	0,67	400	0	65	0,17		13,4
Kenya	1	0,33	360	1	47	0,24	12,97	14,7
Korea	0,75	0,83	75	1	91	1,33		81,1
Kuwait	0,5	0,83	390	1	83	0,64	3,33	38,7
Kyrgyz Republic	0,75	0,00	492	0	61	0,04	18,90	24,4

Copyright © 2009 Association of Corporate Counsel

Cont.

Lao PDR	0	0,00	443	1	14	0,08	23,33	0
Latvia	0,75	0,83	189	1	92	0,27	4,73	85
Lebanon	1	0,67	721	1	31	0,84	5,55	19,3
Lithuania	0,5	0,67	154	1	54	0,14	5,15	52,4
Macedonia, FYR	0,75	0,00	509	1	34	0,18	8,80	7,9
Madagascar	0,5	0,42	280	1	25	0,09	13,25	0
Malawi	0,5	0,50	277	0	40	0,10	22,46	17,6
Malaysia	0,5	0,50	300	1	52	1,37	3,19	35,4
Mali	0,25	0,50	340	1	32	0,16		6,3
Morrocco	0,25	0,83	240	1	36	0,55	8,58	34,8
Mexico	0	0,33	421	1	61	0,18	4,44	64,5
Moldova	0,5	0,83	280	0	49	0,14	9,32	29,3
Mozambique	0,5	0,50	580	1	25	0,08	8,72	12,3
Nepal	0,5	0,00	350	1	35	0,30		25,8
Netherlands	0,75	1,00	48	1	95	1,48	1,19	86,2
Nicaragua	1	0,67	155	1	58	0,40	15,84	38,1
Nigeria	1	0,25	730	1	45	0,15	8,10	33,2
Niger	0,25	0,33	330	1	37	0,05		2,6
Norway	0,5	1,00	87	1	99	0,95	2,08	87,9
New Zealand	1	1,00	50	1	90	1,18	4,48	71,4
Oman	0	0,83	455	0	29	0,38	5,66	23,6
Pakistan	0,25	0,50	395	1	63	0,28		38,1
Panama	1	0,50	355	1	36	0,99	5,62	18,2
Paraguay	0,5	0,33	285	1	46	0,25	15,80	8,7
Peru	0	0,50	441	1	67	0,24	10,54	31,1
Philippines	0,25	0,33	380	1	38	0,39	4,53	3,9
Poland	0,5	0,67	1000	1	70	0,28	5,93	68,2
Portugal	0,25	0,83	320	1	66	1,50		69,9
Romania	0	0,67	335	1	39	0,08		6,9
Russia	0,5	0,67	330	0	58	0,17	10,75	48,4
Rwanda	0,25	0,00	395	1	8	0,11		0
South Africa	0,75	0,42	277	1	53	1,26	4,98	31,8
Saudi Arabia	0,5	0,83	360	1	50	0,56		31,7
Senegal	0,25	0,50	485	1	73	0,19		18,8
Singapore	0,75	0,83	69	1	99	1,34	4,46	91,3
Sierra Leone	0,5	0,50	305	0	20	0,03	13,93	12,1
Slovak Republic	0,5	0,67	565	1	71	0,40	3,60	39,6
Slovenia	0,75	0,75	1003	1	41	0,22	4,93	23,6
Spain	0,5	0,75	169	1	68	1,12	1,81	83,4
Sri Lanka	0,5	0,50	440	1	35	0,29	3,95	33,1
Sweden	0,25	1,00	208	1	84	1,44		73,2
Switzerland	0,25	0,83	170	1	59	1,61	3,50	37
Syrian Arab Rep.	0,75	0,83	672	0	37	0,09	5,00	29,2
Tanzania	0,5	0,83	242	0	65	0,05	13,15	21,3
Taiwan	0,25	0,67	210	1	68	0,98		89,6
Thailand	0,75	0,42	390	1	62	1,02	4,90	42
Togo	0,5	0,50	535	1	8	0,15		14,6
Tunisia	0	0,83	27	1	50	0,67		50,1
Turkey	0,5	0,75	330	1	51	0,19		25,7
Uganda	0,5	0,67	209	0	55	0,05	13,53	35,5
UK	1	1,00	288	1	86	1,40		85,8
Ukraine	0,5	0,67	269	0	42	0,14	17,42	25,5
Uruguay	0,75	0,42	620	1	67	0,54		21,9
USA	0,25	0,83	250	1	88	2,35		68,2
Venezuela	0,5	0,17	445	1	67	0,11	7,58	4,9
Vietnam	0	0,67	404	1	33	0,42	2,61	16,4
Yemen	0	0,33	360	1	47	0,08	4,71	28,6
Zimbabwe	1	0,08	350	0	52	0,31	18,10	9,2

Copyright © 2009 Association of Corporate Counsel

Últimos Ensaios Econômicos da EPGE

[574] Gustavo M. de Athayde e Renato Galvão Flôres Junior. *Do Higher Moments Really Matter in Portfolio Choice?*. Ensaios Econômicos da EPGE 574, EPGE–FGV, Dez 2004.

[575] Germán Calfat e Renato Galvão Flôres Junior. *The EU–Mercosul free trade agreement: Quantifying mutual gains*. Ensaios Econômicos da EPGE 575, EPGE–FGV, Dez 2004.

[576] Andrew W. Horowitz e Renato Galvão Flôres Junior. *Beyond indifferent players: On the existence of Prisoners Dilemmas in games with amicable and adversarial preferences*. Ensaios Econômicos da EPGE 576, EPGE–FGV, Dez 2004.

[577] Rubens Penha Cysne. *Is There a Price Puzzle in Brazil? An Application of Bias–Corrected Bootstrap*. Ensaios Econômicos da EPGE 577, EPGE–FGV, Dez 2004.

[578] Fernando de Holanda Barbosa, Alexandre Barros da Cunha, e Elvia Mureb Sallum. *Competitive Equilibrium Hyperinflation under Rational Expectations*. Ensaios Econômicos da EPGE 578, EPGE–FGV, Jan 2005.

[579] Rubens Penha Cysne. *Public Debt Indexation and Denomination, The Case of Brazil: A Comment*. Ensaios Econômicos da EPGE 579, EPGE–FGV, Mar 2005.

[580] Gina E. Acosta Rojas, Germán Calfat, e Renato Galvão Flôres Junior. *Trade and Infrastructure: evidences from the Andean Community*. Ensaios Econômicos da EPGE 580, EPGE–FGV, Mar 2005.

[581] Edmundo Maia de Oliveira Ribeiro e Fernando de Holanda Barbosa. *A Demanda de Reservas Bancárias no Brasil*. Ensaios Econômicos da EPGE 581, EPGE–FGV, Mar 2005.

[582] Fernando de Holanda Barbosa. *A Paridade do Poder de Compra: Existe um Quebra–Cabeça?*. Ensaios Econômicos da EPGE 582, EPGE–FGV, Mar 2005.

[583] Fabio Araujo, João Victor Issler, e Marcelo Fernandes. *Estimating the Stochastic Discount Factor without a Utility Function*. Ensaios Econômicos da EPGE 583, EPGE–FGV, Mar 2005.

[584] Rubens Penha Cysne. *What Happens After the Central Bank of Brazil Increases the Target Interbank Rate by 1%?*. Ensaios Econômicos da EPGE 584, EPGE–FGV, Mar 2005.

Copyright © 2009 Association of Corporate Counsel

[585] GUSTAVO GONZAGA, Naércio Menezes Filho, e Maria Cristina Trindade Terra. *Trade Liberalization and the Evolution of Skill Earnings Differentials in Brazil*. Ensaios Econômicos da EPGE 585, EPGE–FGV, Abr 2005.

[586] Rubens Penha Cysne. *Equity–Premium Puzzle: Evidence From Brazilian Data*. Ensaios Econômicos da EPGE 586, EPGE–FGV, Abr 2005.

[587] Luiz Renato Regis de Oliveira Lima e Andrei Simonassi. *Dinâmica Não–Linear e Sustentabilidade da Dívida Pública Brasileira*. Ensaios Econômicos da EPGE 587, EPGE–FGV, Abr 2005.

[588] Maria Cristina Trindade Terra e Ana Lucia Vahia de Abreu. *Purchasing Power Parity: The Choice of Price Index*. Ensaios Econômicos da EPGE 588, EPGE–FGV, Abr 2005.

[589] Osmani Teixeira de Carvalho Guillén, João Victor Issler, e George Athanasopoulos. *Forecasting Accuracy and Estimation Uncertainty using VAR Models with Short– and Long–Term Economic Restrictions: A Monte–Carlo Study*. Ensaios Econômicos da EPGE 589, EPGE–FGV, Abr 2005.

[590] Pedro Cavalcanti Gomes Ferreira e Samuel de Abreu Pessôa. *The Effects of Longevity and Distortions on Education and Retirement*. Ensaios Econômicos da EPGE 590, EPGE–FGV, Jun 2005.

[591] Fernando de Holanda Barbosa. *The Contagion Effect of Public Debt on Monetary Policy: The Brazilian Experience*. Ensaios Econômicos da EPGE 591, EPGE–FGV, Jun 2005.

[592] Rubens Penha Cysne. *An Overview of Some Historical Brazilian Macroeconomic Series and Some Open Questions*. Ensaios Econômicos da EPGE 592, EPGE–FGV, Jun 2005.

[593] Luiz Renato Regis de Oliveira Lima e Raquel Menezes Bezerra Sampaio. *The Asymmetric Behavior of the U.S. Public Debt.*. Ensaios Econômicos da EPGE 593, EPGE–FGV, Jul 2005.

[594] Pedro Cavalcanti Gomes Ferreira, Roberto de Góes Ellery Junior, e Victor Gomes. *Produtividade Agregada Brasileira (1970–2000): declínio robusto e fraca recuperação*. Ensaios Econômicos da EPGE 594, EPGE–FGV, Jul 2005.

[595] Carlos Eugênio Ellery Lustosa da Costa e Lucas Jóver Maestri. *The Interaction Between Unemployment Insurance and Human Capital Policies*. Ensaios Econômicos da EPGE 595, EPGE–FGV, Jul 2005.

[596] Carlos Eugênio Ellery Lustosa da Costa. *Yet Another Reason to Tax Goods*. Ensaios Econômicos da EPGE 596, EPGE–FGV, Jul 2005.

[597] Marco Antonio Cesar Bonomo e Maria Cristina Trindade Terra. *Special Interests and Political Business Cycles*. Ensaios Econômicos da EPGE 597, EPGE–FGV, Ago 2005.

Copyright © 2009 Association of Corporate Counsel

[598] Renato Galvão Flôres Junior. *Investimento Direto Estrangeiro no Mercosul: Uma Visão Geral*. Ensaios Econômicos da EPGE 598, EPGE–FGV, Ago 2005.

Copyright © 2009 Association of Corporate Counsel

RESTRUCTURING INSOLVENT DEBTORS IN BRAZIL

THE NEW BRAZILIAN BANKRUPTCY LAW

- A new Brazilian Bankruptcy Law (Law nº 11.101/2005) was enacted on February 9th, 2005.
- The new Law introduced significant changes to the Brazilian insolvency system, providing for recovery mechanisms much more effective than the one provided under the previous legislation.
- On contrary to the previous legislation, the new Law gives the insolvent companies the means to overcome their financial difficulties by negotiating with its creditors with much more flexibility.

MAIN FEATURES OF THE NEW LAW

- Protection of honest debtors through a recovery procedure that focuses on negotiations between creditors and debtor in order to rehabilitate the insolvent company.
- The enterprise is considered as productive component of the nation's economy.
- Adoption of protective procedures (similar to the automatic stay) such as temporary moratorium for recovery proceedings.
- Control of the debtor's management during the recovery proceeding by an impartial, independent administrator appointed by the courts.
- Reclassification of the priorities of claims and credits.
- Establishment of summary recovery proceedings for smaller organizations.

Copyright © 2009 Association of Corporate Counsel

TYPES OF PROCEDURE FOR INSOLVENT DEBTORS

- The New Brazilian Law provides three types of formal procedures for companies in financial difficulties:

a) Extrajudicial Restructuring –an out-of-court recovery;

b) Judicial Restructuring – a court-supervised recovery;

c) Bankruptcy – procedure which involves the liquidation of the company's goods, assets and productive resources, including intangible assets, to pay the creditors.

- Both Restructuring Procedures (Extrajudicial and Judicial) may be proposed only by the debtor to introduce a Recovery Plan which may bind all creditors, if approved.

RESTRUCTURING PROCEDURES

Requirements for the insolvent company to enter into a Restructuring Procedure:

- Minimum of two years in business;
- It must have never been declared bankrupt, unless liabilities of a previous bankruptcy have been declared terminated by a final court ruling;
- No recovery procedure may have been granted within the last five years;
- No manager or controlling shareholder may have been convicted of any crimes described under the Brazilian Bankruptcy Law.

EXTRAJUDICIAL RESTRUCTURING

- In the Extrajudicial Restructuring, the debtor and its creditors will negotiate and elaborate a Recovery Plan without court supervision, to solve a liquid problem by suggesting payment extensions or reductions in the amount of the debt, for example. This out-of-court procedure doesn't recover labor and tax claims.
- Contrary to what occurs in Judicial Restructuring, the beginning of out-of-court negotiations to execute a Plan does not suspend an automatic stay-period. As a result, hoping to obtain of time to negotiate, the debtor will need a "standstill" agreement with his creditors.
- A notification must be published by the company in the official press and in a major newspaper to all creditors to offer their oppositions to the Recovery Plan. The company must also notify the creditors, through letters, about the filing of the reorganization claim.

Copyright © 2009 Association of Corporate Counsel

EXTRAJUDICIAL RESTRUCTURING

- There is no need to cover every creditor, nor the need to hold a general meeting of creditors to approve the Recovery Plan. The debtor may submit the extrajudicial Recovery Plan signed by the creditors for judicial ratification.
- At the request of the debtor, the judge may bind to the plan all affected creditors, embracing those who didn't voluntarily join, if more than 60% of each kind of creditors supported the Plan.
- After the approval of the Plan, all obligations must be met. Then, the company files a final report and the procedure is concluded.

JUDICIAL RESTRUCTURING

- The Judicial Restructuring Procedure will start with a Judicial Recovery Request by the debtor, in which it must present some documents to the court, such as: a statement of the causes of the financial distress, financial statements of the last three years of operations, a list of creditors and claims, a list of employees and employee claims, among others. The judge will then approve the Request.
- The approval of the Request by the court triggers an automatic stay. Therefore, all lawsuits against the company will be suspended for 180 days.
- Following the approval of the Request, the debtor has a maximum of 60 days to elaborate a Recovery Plan and submit it to creditors. The Plan must include a report on the debtor's economic financial, a statement of its financial feasibility, and an appraisal of assets and business units signed by a certified professional or specialized company.

JUDICIAL RESTRUCTURING

- Any of the creditors may propose objections to the Plan. In the absence of objections, the Plan is considered approved. However, if there is any objection by the creditors, the judge will call a Creditors General Meeting to vote the Plan. During the meeting, the Plan may be approved, modified (subject to the debtor's authorization) or rejected. In the latter case, the debtor will be declared bankrupt.
- Once the Plan is approved by the debtors and ratified by the judge, the company will remain under court supervision for two years. During this period, the noncompliance of any obligation under the Plan will occasion the conversion of the judicial restructuring procedure into bankruptcy.
- The Judicial Restructuring Procedure is generally financed with the company's own resources. During the procedure, the court will appoint a judicial administrator to be responsible to organize the general framework of creditors and to oversee the management of the company, which is still managed by its directors.

Copyright © 2009 Association of Corporate Counsel

BANKRUPTCY

- The declaration of bankruptcy initiates a process of liquidation. In liquidation, the debtor's assets are collected and sold, and their result is distributed to creditors in the order of priority. The disposal of assets must take place by auction, oral bidding, sealed bids or public proclamation.
- A liquidation procedure can be started by the creditors, the debtor or the bankruptcy court (when the court converts a judicial restructuring procedure into liquidation procedure).
- The approval of the liquidation procedure leads to the selection of a judicial administrator to manage the liquidation and distribute the assets. When the bankruptcy is declared, all of the debts of debtor's become due in advance. The company's liquidation leads the judicial administrator to file a final report and demand the court to terminate the case.

BANKRUPTCY

The Brazilian new Bankruptcy Law establish an order of preference for the creditors to be paid in the liquidation process, as following:

1. Labor Creditors limit to 150 minimum wage and debts arising from labor accidents
2. Secured Creditors
3. Fiscal Creditors
4. Privileged Creditors
5. Unsecured Creditors

CONCLUSION

- The current Brazilian insolvent system has become much more effective for both sides creditor's and debtor's, as long as it has privileged the maintenance of the business and the survival of the production and economic activity, assuring the preservation of the employees, tax payers, market competition, among others benefits to the whole community.

Copyright © 2009 Association of Corporate Counsel

Juan Carlos Luna

FINANCIAL SITUATION FOR MEXICO (LEGAL COMMENT)

I. The most common restrictions for any company to fulfill its payment obligations in México are:

1. Liquidity issues.

Many companies are going through liquidity problems that mean that they're not absolutely 'broke', because they actually have pending collections, or enough assets to fulfill their payment obligations, but not the enough cash to do such payments.

2. Lack of financing.

Financing access has turned into a huge problem to Mexican companies, because traditionally financing is obtained by bank credits, rather than other options such as stock markets, shareholders, etc. Actually the most important financing source for Mexican companies are their own providers, by giving them extended payment terms (from 60, to 90 days), situation that creates a circle which send the providers to point number 1.

3. Exchange rate variations

For years in México the average exchange rate with the US Dollar (USD) was around 10 Mexican Pesos (MXN) for a USD, with minor changes that usually not exceeded 1 MXN above or below that rate. On October, 2008 the exchange rate begun to be more volatile. The peaks reached around 15 MXN for each USD, which means a 50% variation. This situation affected specially those companies that acquired payment obligations in USD, and their main incomes are in MXN. Most critical cases are for those companies that bought specific goods in USD with an exchange rate of 10 or 11 MXN for USD, and sold them in MXN during the peaks, paying around 15 MXN for each USD. The most notorious case was the one of Comercial Mexicana, the largest national retail chain that speculated on the derivative market with USD, situation that forced them to fill their own bankruptcy (the filling was not accepted by the judge, however they faced, and still facing, several payment problems).

II. The Commercial Insolvency Law (México)

Since year 2000, Mexico has a new Commercial Insolvency Law, which replaces the old bankruptcy and payment suspension law. This new law was created accordingly to the UNCITRAL Legislative Guide on Insolvency Law.

Copyright © 2009 Association of Corporate Counsel

This law allows the businesses to reorganize themselves and their past due payments, before going into a bankruptcy process or a liquidation of the companies. The intervention of the government via the Federal Institute of Experts on Insolvency Proceedings (IFECOM) is a very important stage of the reorganization process, because independent consultants and specialists are involved on a general assessment on the financial, legal, accounting and operational situation of the company, and they suggest the better way to reorganize it, or if the damage is too big, the proceed to the bankruptcy and liquidation (Insolvent Business Reorganizations and Insolvent Business Bankruptcies, that is, US Chapter 7 and US Chapter 11, respectively). The main purpose of the law is to achieve the subsistence and success of the companies, the law states on article 1, that it is of general interest to keep companies working and producing, and safe from any damage that the breach of payment obligations may cause them, or third parties related to them.

FAQ about Commercial Insolvency.

1. ***Who can request a*** Commercial Insolvency ***process?***

A. The company that have several liquidity issues; any creditor that suspects that the company has liquidity issues; or the Attorney General of the company's address.

2***. What kind of liquidity issues can be considered for a*** Commercial Insolvency ***Process?***

A. The breach of payment to two or more creditors, and the insufficiency of liquid assets to pay their obligations.

3. ***Who is going to decide if the request is valid or not?***

A. The federal judge that is competent on the company's domicile.

4. ***Are there any preferred creditors under the*** Commercial Insolvency ***Process?***

A. Yes. The employees and the Federal Tax Authorities.

5. ***Once that the process begins, what should we expect?***

A. If the judge, based on the assessment made by IFECOM, considers that the company should begin its organization process, and then a conciliation stage will begin and will last for the following sixty calendar days. The judge may also declare, without a conciliation period that the company must go to a bankruptcy and liquidation process.

Copyright © 2009 Association of Corporate Counsel

During the conciliation, all creditors must submit their request and documents where the debt is contained, and then the conciliator (also designed by the IFECOM) will make an offer to each creditor to pay the debts. If the offers are accepted, then an agreement will be subscribed and the organization process will end, unless any creditor reports the breach of such agreement, then the judge will declare the bankruptcy.

If the bankruptcy is declared, then the IFECOM will designate a trustee, who will take control over the business, will terminate all contracts that are no essential to keep the assets safe, and then liquidate all and each of the assets of the company in order to pay the creditors, as far as the liquidation of assets is sufficient.

6. ***Is there any legal obligation to accept the conciliation agreement proposed by the conciliator***.

A. No, even though there is a minimum of creditors that must approve the agreement so it becomes binding and terminate the organization process, the conciliator can decide to pay the debts to those creditors that refuses to accept the agreement. This payment should be done on the exact same conditions that the credit was on the date that the judge declared the beginning of the organization process. If a creditor refuses to accept the agreement, and the payment is done as stated, then the judge will consider that this creditor accepted the agreement. The creditor cannot refuse to receive the payment under these circumstances.

7. ***What happens if the bankruptcy is over and there were no enough assets to collect our credit?***

A. Then we can claim under the regular procedure the payment; however there won't be any assets to execute and obtain any payment, unless the company obtains this new asset after the bankruptcy process is over.

8. ***Can the management of the bankrupted company be held responsible for criminal behaviors?***

A. Yes. If during the conciliation or bankruptcy process, either the conciliator or the trustee finds that the management tried to hide or disappear any asset (even 240 days prior to the judge declaration), then a criminal process can be requested, as the Commercial Insolvency Law clearly describes some special criminal behaviors and their penalties.

Current Business Atmosphere and Potential Risks in providing financing in LA

- The financing portfolio has been flat during FY/09.

Copyright © 2009 Association of Corporate Counsel

- The credit analysis of customers is more conservative than in other years.
- The pricing is alienated with sovereign risk of each country.
- Defaults have occurred but not as bad as expected.
- Customers are requesting financing in local currency.

Copyright © 2009 Association of Corporate Counsel

INTERNATIONAL BUSINESS TRANSACTIONS WITH BRAZIL

Edited by
Beatriz Franco
Daniel Kalansky
Bianca Soares
Rodrigo V. Vella

Juris Publishing, Inc.

Copyright © 2009 Association of Corporate Counsel

Chapter 28

A GUIDELINE TO TRANSNATIONAL BANKRUPTCY AND THE NEW BRAZILIAN REORGANIZATION LAW

Paulo Cezar Aragão
Laura Mendes Bumachar

Law No. 11, 101/05 governs bankruptcy, judicial reorganization, and out-of-court reorganization proceedings in Brazil ("Corporate Reorganization Law"). The Law has been in force since 2005, and applies to all business proprietors and business companies (business proprietors are *per se* merchants).

In Brazil, foreign creditors have the same status as local creditors in local Brazilian proceedings, although the former may be required, in certain cases, to post a judicial bond with respect to court costs and payment of the indemnity if the request for insolvency is eventually ruled as deceitful, according to article 101 of the Corporate Reorganization Law.[1]

Judicial Reorganization is a court-supervised arrangement intended to make it possible for the debtor to overcome its economic and financial crisis in order to maintain the debtor's business as a source of production and employment of workers as well as to protect the interests of creditors. Essentially, it is a scheduled payment plan proposed by the debtor that applies to almost all debts existing at the time of the filing, and that allows the debtor to continue to manage its business during such proceeding.

Judicial Reorganization may be requested by the debtor before a declaration of bankruptcy, and is seen as a way to avoid the liquidation

[1] "Article 101. Anyone petitioning maliciously for another's bankruptcy shall be sentenced, under the decision that dismisses the petition, to indemnify the debtor, loss and damage to be ascertained upon calculation of the award."

Copyright © 2009 Association of Corporate Counsel

of the business, since the request for *Judicial Reorganization* aims at strengthening the debtor's financial situation to enable payment of all debts.

If the debtor fails to present the reorganization plan or if its plan is rejected by the General Meeting of Creditors, the *Judicial Reorganization* shall be converted into a liquidation procedure (bankruptcy).

In an out-of-court reorganization, the debtor can propose and directly negotiate with its creditors a settlement that must be reflected in a reorganization plan. The court does not take part in this procedure, but can confirm the plan. In that case the plan will bind all creditors covered thereby, provided it is signed by creditors representing over three-fifths of all claims of each kind included in the reorganization.

According to article 161 of the Corporate Reorganization Law, the provisions related to the out-of-court reorganization do not apply to the holders of tax or labor-related claims or to occupational accident claims.

Bankruptcy is the state or situation of the business proprietor or of business companies that fail to pay in time, without a relevant reason, liquid obligations materialized under one or more protested, immediately enforceable instruments, the sum of which exceeds the equivalent of forty minimum monthly salaries, as determined by law.

In Brazil, bankruptcy may occur in two ways. First, any creditor, except those holding credits which cannot be claimed in the bankruptcy proceeding,[2] may commence a bankruptcy proceeding that is essentially a real surrogate for a collection lawsuit (based on the unpunctuality of the debtor in the payment of his debts, which debts must be certain with respect to the quality, quantity and object). Second, bankruptcy may be declared based on the presumption of insolvency that results, according to the law, (i) from the debtor being sued in an execution proceeding and not paying or depositing the amount due, or providing security, or (ii) from other acts listed in the Corporate Reorganization Law, such that,

[2] According to article 5 of Corporate Reorganization Law, the following are not enforceable against a debtor under judicial reorganization or bankruptcy: (i) obligations free of charge; (ii) expenses incurred by the creditors in order to participate in judicial reorganization or bankruptcy, except for court costs arising from litigation with the debtor.

according to said law, a presumption of insolvency is created. In this case, the claimant must present evidence in support of its allegations.

If a creditor starts a bankruptcy proceeding, the debtor has three options: (i) pay the amount of the total claim, plus monetary restatement, interest, and attorney's fees within 10 days, in which event bankruptcy will not be decreed and the proceeding ends; (ii) challenge the debt, either (x) by making a deposit, in which case the proceeding becomes an ordinary execution proceeding or (y) without making a deposit, in which case the Court should declare the debtor bankrupt if its defense is not accepted; or (iii) file for judicial reorganization during the period for filing an answer.

If a Brazilian Court declares a company bankrupt, all of its debts become due in advance, and its rights, credits, assets and operations are put under the custody of a judicial administrator appointed by the Court. The judicial administrator shall be a reputable professional, preferably a lawyer, economist, business manager or accountant, or a specialized legal entity. In addition to other powers, the judicial administrator has authority, under the supervision of the judge and the Committee of Creditors, to examine the debtor's bookkeeping; to list the proceedings and assume the judicial representation of the bankrupt estate; to perform the acts required for realization of assets and payment the creditors; to consolidate the general list of creditors; to represent the bankrupt estate in court.

The bankrupt company's shareholders have no control over the company, although they can engage counsel to follow the procedure and present oppositions to some acts, which may be performed despite the opposition. The bankruptcy proceeding only ends after all of the debtor's property is sold and the proceeds distributed among the creditors.

It is important to note that the bankruptcy court is indivisible and competent to hear all actions involving the bankrupt party's assets, interests and business, with the exception of labor and tax suits and those not regulated in Corporate Reorganization Law, in which the bankrupt figures as plaintiff or co-plaintiff, which means that Brazilian courts have exclusive jurisdiction to decide issues related to the bankrupt estate (the so-called *universality principle*).

Copyright © 2009 Association of Corporate Counsel

According to said universality principle, only one court is competent to foreclose on debtor's assets, no matter where they are located. This principle is also reflected in article 108 of Corporate Reorganization Law, which states that after the decree of bankruptcy the judicial administrator shall collect all the assets and documents of the debtor at the place where they are situated.

Although the universality principle has been considered an effective way to ensure the equal treatment to the creditors, i.e., the *par conditio creditorum*, there is no guarantee that foreign courts would enforce decisions rendered abroad[3] and related with a bankruptcy proceeding of a Brazilian company.

A fundamental principle of the Corporate Reorganization Law, which aims, among other things, at assuring an equitable division of the debtor's assets among all of its creditors and at facilitating the collection of the debtor's assets, is that it only recognizes a sole bankruptcy, judicial reorganization or out-of-court reorganization proceeding, which must be initiated at the debtor's principal place of business. This principle arises from some of the provisions of article three[4] of the Corporate Reorganization Law:

[3] "The advantage of the universality principle is that all assets are administered and distributed by a single forum, thereby preventing unequal treatment of similarly situated classes of creditors (par conditio creditorium) and reducing the strategic importance of preferential transfers across borders. However, the universality principle also has several flaws. First, the country with jurisdiction over the main proceeding will not be able to ensure the enforcement of its orders abroad by unilaterally embracing the universality principle. A foreign court's order will only enjoy full effect abroad if the other jurisdictions also recognize the principle. Second, problems always arise when foreign law dictates the resolution of domestic affairs, such as the distribution of local assets, unless the substantive laws of the jurisdictions involved are largely identical." (Roland Lechner—The new threat to International Commercial Transactions: Cross-Border Insolvency and its impact on the standby letter of credit regime, in National Law Center for Inter-American Free Trade—www.natlaw.com).

[4] The repealed Brazilian Bankruptcy Law had the same principle on article 7 regulating that "The competent judge to decree bankruptcy is the judge in whose jurisdiction debtor has its principal place of business or branch office in case of a company located outside Brazil."

> Art. 3. The court of the place of principal establishment of the debtor, or of the [Brazilian] branch of a foreign company is competent to ratify out-of-court reorganization plans, grant judicial reorganization or decree bankruptcy.

In fact, the Corporate Reorganization Law recognizes only insolvency proceedings which were initiated in Brazil, if Brazil is the debtor's principal place of business. Nevertheless, according to said article three, mentioned above, Brazilian courts have jurisdiction over insolvency cases related to the Brazilian branch of a business company that has its headquarters abroad.

As mentioned, under Brazilian law, the sole court with jurisdiction to (i) declare a company bankrupt; (ii) ratify out-of court reorganization plans; or (iii) grant judicial reorganization is the court of the debtor's main place of business. Although not formally defined in the law, Brazilian courts and commentators are unanimous that the main place of business "is not the one company's by-laws establish as the principal place of business, but the one that concretely forms the living body, the vital center of the main activities of the debtor, the head offices or the center of business in its active material practice." (Federal Supreme Court (STF), Jurisdiction Conflict (CJ) No. 6,025 – SP (Rep. Antonio Neder) (Decided December 2, 1976; Pub. 81 *Revista Trimestral de Jurisprudencia* [Quarterly Caselaw Review] (September 1977), p. 705 et. seq.); Federal Supreme Court (STF), Jurisdiction Conflict (CJ) No. 2,515 – SP (Rep. Vilas Boas) (Decided August 28, 1959; Pub. *10 Revista Trimestral de Jurisprudencia* [Quarterly Case Law Review] (July-September 1959), p. 434) ("the place where the government of debtor's businesses and its active life reside."); Federal Supreme Court (STF), Jurisdiction Conflict (CJ) No. 1,918 – ES (Rep. Nelson Hungria) (Decided July 4, 1951; Pub. 215 *Revista dos Tribunais* [Court Review] (September 1953), p. 456) ("The real domicile prevails over the contractual or statutory domicile."); Federal Supreme Court (STF), Foreign Decision (SE) No. 919, (Rep. Plinio Casado) (Decided August 25, 1933; Pub. 62 *Revista Forense* [Court Review] (January 1934), p. 377 et. seq.) ("although this domicile may be waived by the French Court, it is nevertheless required among us in order to endow the judgment under consideration with

Copyright © 2009 Association of Corporate Counsel

effects in Brazil"); Federal Supreme Court (STF), Extraordinary Appeal (RE) No. 98,928-RJ (Rep. Rafael Mayer) (Decided June 13, 1983; Pub. 106 *Revista Trimestral de Jurisprudencia* [Quarterly Case Law Review] (November 1983), p. 827) ("the judge in whose jurisdiction the debtor has its principal place of business is the one competent to declare its bankruptcy"); Rubens Requiao, 1 *Curso de Direito Falimentar* [Course on Bankruptcy Law] (14th ed. Saraiva 1991), p. 81 ("the place where the head of the business is located, from which the orders and instructions emanate, the place in which the most important financial and commercial transactions are carried out, and where the accounts in general are found."); Sampaio de Lacerda, *Manual de Direito Falimentar* [Bankruptcy Law Manual] (14th ed. Freitas Bastos 1999), p. 61 ("main office is the location in which the merchants or mercantile entities centralize their activities, the center from which all business radiates; it is the place where the accounts of the transactions are kept. It is not, as may seem at first sight, (...), the biggest among company's offices, the most supplied, or that in which the amount of business is more voluminous, but rather where the center of [the] debtor's mercantile activities is located and the place from which he directs and governs the business.").

The jurisdiction of the Court in the debtor's main place of business is exclusive: "the debtor may only be declared bankrupt at the place of its principal place of business." (Dylson Doria, 2 *Curso de Direito Comercial* [Course on Commercial Law] (10th ed. Saraiva 2000), p. 193.) As a result, and as said above, there may be only one bankruptcy proceeding, which must be initiated in the debtor's main place of business. This is clearly stated by Miranda Valverde (*Comentarios a Lei de Falencias* [Comments on the Bankruptcy Law] (4th ed. Revista Forense 1999), p. 136.):

> Within Brazilian territory, the universality principle has full force and effect, due to the exclusive competence of the Court in whose jurisdiction the debtor has its principal place of business to take cognizance of a bankruptcy proceeding.

Other jurists confirm this understanding. (Walter T. Alvares, *Direito Falimentar* [Bankruptcy Law] (4th ed. Sugestoes Literarias S.A. 1971), p. 198 ("no matter how many establishments it has . . . there is only one venue for bankruptcy, the domicile of the principal place of business"); Waldemar Martins Ferreira, *Instituicoes de Direito Comercial* [Commercial Law Institutions] (2nd ed. Freitas Bastos 1948), p. 128 and 529; Manoel Justino Bezerra Filho, *Lei de Falências Comentada* [Bankruptcy Law Annotated] (1st ed. Revista dos Tribunais 2001), p. 91; Oscar Tenorio, *Direito Internacional Privado* [International Private Law] (11th ed. Livraria Freitas Bastos), p. 257.

Although the new Brazilian legislation adopted modern concepts, it is important to note that Brazil did not follow the model law on cross-border insolvency prepared by the United Nations Commission on International Trade Law (UNCITRAL), or adhere to any other treaty dealing with cross-border insolvency rules.

Given, then, that the Corporate Reorganization Law fails to address the enforcement of foreign bankruptcy judgments, that jurisdiction over a debtor can only be exercised by the Court of debtor's main place of business, and that jurisdiction is an aspect of sovereignty, a foreign bankruptcy proceeding over a Brazilian debtor will have no effect in Brazil. (José Maria Rossani Garcez, *Curso de Direito Internacional* [Course on International Law] (Revista Forense 1999), p. 174 ("...the Court in which jurisdiction the debtor has its principal place of business, or a branch—in case of a debtor located outside of Brazil—has jurisdiction to declare its bankruptcy; therefore, it is, in principle, impossible for the decree of a bankruptcy of the parent company of a Brazilian branch to produce extraterritorial effects and be effective in Brazil ....").

In order to produce effects in Brazil, a bankruptcy decision by a foreign Court must, according to article 483 of the Brazilian Code of Civil Procedure, like any other foreign decision, be homologated by the Superior Court of Justice.[5]

[5] The competence of the Superior Court of Justice to rule on the homologation of foreign decisions arises from Article 105, I, 'i' of the Brazilian Federal Constitution, transcribed below:

"The Superior Court of Justice:
I – has original jurisdiction to process and decide:
(...)
i) the homologation of foreign decisions and the granting of exaquatur to letters

Copyright © 2009 Association of Corporate Counsel

"Art. 483. A foreign decision shall not produce effects in Brazil until it has been homologated by the Federal Supreme Court.[6]

Sole Paragraph. The homologation shall follow the rules of the Internal Rules of the Federal Supreme Court."

The homologation of a foreign decision by the Superior Court of Justice requires, among other things, that such decision be final and not contrary to national sovereignty, public order or good morals.[7] Therefore, bearing in mind that jurisdiction is one of the basic elements of the national sovereignty, Brazilian courts will only recognize a bankruptcy proceeding relating to a Brazilian company, or any interim orders issued in such a proceeding, if the proceeding occurs in the district of the debtor's principal place of business.

This principle was conclusively demonstrated in a unanimous decision of the Brazilian Supreme Court. The case involved a company headquartered in Portland, Maine, all of whose business was in Brazil. In addition, the company had issued debentures in France and French law required the election of a domicile in France for the purpose of service of process. A French court declared the debtor bankrupt. The Supreme Court unanimously denied homologation because the French court lacked jurisdiction to declare a company bankrupt whose main place of business was in Brazil. (Federal Supreme Court (STF), Foreign Decision (SE) No. 919, (Rep. Plinio Casado) (Decided August 25, 1933; Pub. 62 *Revista Forense* [Court Review] (January 1934), p. 377 et. seq.)) According to the reporting Justice:

"In these cases, the rulings of Brazilian Law are eminently Territorial, and consequently require strict compliance, particularly as bankruptcy laws are considered to involve public order and security.

(...)

---

rogatory."

[6] Constitutional Amendment number 45 transferred jurisdiction over the homologation of foreign court decisions to the Superior Court of Justice.

[7] Art. 17 of the Law of Introduction to the Civil Code. Article 216 of the Internal Rules of the Federal Supreme Court.

One of the main reasons for not homologating the foreign decision is that it breaches our sovereignty. There could be no decision more offensive to our sovereignty than this, which decrees the bankruptcy of a company established only to operate in Brazil, in business transactions that are exclusively Brazilian, whose real domicile is in Brazil, with its sole establishment here, merely because it owes a French creditor...."

Beat Walter Rechsteiner supports this opinion, emphasizing that the territorial jurisdiction of the bankruptcy proceeding must be observed not only nationally, but also internationally (*Direito Falimentar Internacional e Mercosul* [International and Mercosur Bankruptcy Law] (1st ed. Juarez de Oliveira 2000), p. 94 and 152; *see also* Amilcar de Castro, *Direito Internacional Privado* [Private International Law] (5th ed. Editora Forense 1997), p. 576 and 579):

For decisions in insolvency proceedings filed outside Brazilian territory, the requirement of international jurisdiction for the foreign Court is of vital importance in practice.

This requirement is not met when the principal place of business of the insolvent debtor is located in Brazil. In this case, it is not possible to acknowledge a decision handed down outside the country, as the jurisdiction of the Brazilian Courts is exclusive or absolute.

(...)

The fate of a company with its principal place of business in Brazil is so closely linked to the country and its institutions that the possibility of insolvency proceedings taking place under the direction of a foreign judiciary authority is unimaginable.

In view of the foregoing, no decision of a foreign bankruptcy court over a company whose principal place of business is located in Brazil will be homologated by the Superior Court of Justice and, as a consequence, will have no effect on any property of the debtor located within Brazil.

It should be noted that, besides being a new legislation, the Corporate Reorganization Law is based on the same principle of the

Copyright © 2009 Association of Corporate Counsel

former Brazilian Bankruptcy Law,[8] and has also refused to recognize the authority of foreign courts to exercise jurisdiction over the assets of foreign debtors' branch offices in Brazil.

It is important to note, in this respect, that the old Brazilian Code of Civil Procedure included a specific provision on recognition of foreign bankruptcy decisions, stating in article 786 that bankruptcy decisions issued by foreign courts could not be homologated and therefore would not produce any effect in Brazil.[9] This was part of the general provisions on homologation of foreign judgments, which are no longer in force as a result of a change in our constitutional system that granted the Supreme Court authority to regulate homologation of foreign sentences in its internal rules.

While there is no specific provision with respect to this matter in the internal rules of the Superior Court of Justice, this old provision is still applicable, even after the change in the legislation, as there are no precedents against it. On the contrary, case law is consistent with respect to the fact that only the court with jurisdiction where the business company has its principal place of business has jurisdiction to declare its bankruptcy. (*See* for example Federal Supreme Court (STF), Extraordinary Appeal (RE) No. 98,928-RJ (Rep. Rafael Mayer) (Decided June 13, 1983; Pub. 106 *Revista Trimestral de Jurisprudencia* [Quarterly Case Law Review] (November 1983), p. 827)). If the business company has its principal place of business in Brazil, it follows that even if it has assets or a branch or an agency abroad, foreign courts have no jurisdiction over assets located in Brazil and, therefore, the foreign bankruptcy decision will not be homologated.

---

[8] Article 7 of the repealed Brazilian Bankruptcy Law (Decree 76661/45) had the same principle of article 3 of the prevailing Corporate Reorganization Law (Law 11.101/2005) legislation: "Art. 7°. The competent judge to decree bankruptcy is the judge in whose jurisdiction debtor has its principal place of business or branch office in case of a company located outside Brazil."

[9] Following the tradition of bankruptcy laws, the Code of Civil Procedure provided that the foreign decisions determining the bankruptcy of a Brazilian debtor domiciled in Brazil would not be enforceable in the national territory. Waldemar Martins Ferreira, Instituições de Direito Comercial [Commercial Law Institutions] (2nd ed. Freitas Bastos 1948), p. 525.

In addition to the impossibility of a Brazilian court recognizing or enforcing a foreign bankruptcy proceeding over a debtor whose principal place of business is in Brazil, a Brazilian court will not homologate any foreign judgment purporting to relate to real estate located in Brazil. Pursuant to article 89, I of the Brazilian Code of Civil Procedure, "The Brazilian courts have jurisdiction, to the exclusion of all other courts, to judge lawsuits related to real estate located in Brazil." A foreign decision that goes against the provisions of article 89 must not be homologated.[10] This is the opinion of the Brazilian jurists, which has been adopted by the Brazilian courts in relation to bankruptcy decisions handed down by foreign courts with respect to real estate located in Brazil. (Federal Supreme Court (STF), Foreign Decision (SE) No. 2,492-6, (Rep. Xavier de Albuquerque) (Decided March 3, 1982; Pub. April 2, 1982) (refusing to recognize a German court's decision over a German debtor insofar as it related to real estate in Brazil); Beat Walter Rechsteiner, *Direito Falimentar Internacional e Mercosul* [International and Mercosur Bankruptcy Law] (1st ed. Juarez de Oliveira 2000), p. 156; Dylson Doria, 2 *Curso de Direito Comercial* [Course on Commercial Law] (10th ed. Saraiva 2000), p. 193.)

In this regard, no immovable property of a Brazilian business company can be attached as a result of a bankruptcy foreign decision even if, for the sake of the argument, such decision were accepted in Brazil.

It is important to note that Brazilian courts do not recognize the authority of foreign courts to impose restrictions on assets located within Brazil before a final foreign court decision is duly homologated. Pursuant to article 90 of the Brazilian Code of Civil Procedure,[11] a bankruptcy case pending in a foreign country would not prevent the debtor's creditors in Brazil from separately pursuing whatever rights or remedies they may have under Brazilian law to reach or collect on the

---

[10] Nelson Nery Junior and Rosa Maria de Andrade Nery, Codigo de Processo Civil Comentado [Code of Civil Procedure Annotated] (7th ed. Revista dos Tribunais 2003), p. 474.

[11] Art. 90. A lawsuit filed in a foreign court does not… prevent the Brazilian courts from appreciating the same cause and those connected to it.

Copyright © 2009 Association of Corporate Counsel

debtor's assets, to assert and enforce any liens or to enforce any judgments against the debtor. Irrespective of any immediate effects that a bankruptcy decision would produce in a foreign country, those effects would not be extended to Brazil before (i) the decision becomes final in the country that were rendered and (ii) is homologated by the Superior Court of Justice (even assuming, for the sake of the argument, that it could be homologated). Meanwhile, the debtor would be entirely free to manage its business in Brazil, given that the Brazilian Supreme Court has repeatedly decided that no effects of a foreign court decision may be imported (i.e., acknowledged in Brazil) before it is homologated:[12]

> Moreover, filing bankruptcy proceedings in Brazil in such cases offers practical advantages to the creditors involved.
>
> Homologating a decision handed down outside Brazil would be a lengthy process, with preventive measures against the debtor being possible only from the time when the homologation judgment is before the courts, at least in terms of acts of execution. Meanwhile, the debtor may take steps that could have adverse effects for the creditors, and some of them may file for individual execution against the debtor, with adverse effects on the remaining creditors, resulting in a breach of the principle of equal treatment for the creditors (*par conditio omnium creditorum*).

(Beat Walter Rechsteiner, *Direito Falimentar Internacional e Mercosul* [International and Mercosur Bankruptcy Law] (1st ed. Juarez de Oliveira 2000), p. 95.)

Brazilian procedural law would also impact the functioning of any foreign proceedings and would require the active involvement of the Brazilian judiciary. Service of process by a foreign court upon a Brazilian, in Brazil, must be accomplished through letters rogatory.

[12] Indeed, since the court decision may only be enforced in Brazil after homologation, it would be illogical to grant those effects before homologation when it may not be homologated.

Federal Supreme Court (STF), Foreign Decision (SE) No. 3.408-AgRg, (Rep. Cordeiro Guerra) (Decided August 1, 1984; Pub. 110 Revista Trimestral de Jurisprudencia [Quarterly Caselaw Review] (October 31, 1985), p. 41 et seq.).

(Federal Supreme Court (STF), Foreign Decision (SE) No. 2,736-4, (Rep. Xavier de Albuquerque) (Decided May 14, 1981; Pub. May 29, 1981) ("... it is certain that the case law of this Court consecrates the rule of request to serve process on a Brazilian resident against whom a lawsuit is filed abroad. For this reason it does not accept the service of process via mail.")) In addition, a foreign court seeking to require, in Brazil, the production of documents or the presence of a witness can only do so by means of letters rogatory, to be executed in accordance with the procedures described in the Superior Court of Justice internal rules.

Copyright © 2009 Association of Corporate Counsel

Chapter 29

THE APPLICATION OF THE NEW BRAZILIAN BANKRUPTCY LAW AND PROPOSED REFORMS: *OUR EXPERIENCE IN THE ACQUISITION OF DISTRESSED ASSETS – THE VARIG CASE*

Paulo Penalva Santos
Otto Eduardo Fonseca de Albuquerque Lobo
Daniel Kalansky

I. INTRODUCTION

Brazil's new insolvency law—Law No. 11.101 of February 9, 2005 ("New Brazilian Bankruptcy Law" or "NBRL"), which became effective June 9, 2005, is designed to stimulate the rehabilitation of business enterprises, as long as minimum thresholds of viability and efficiency are met.

The previous Brazilian Bankruptcy Law (Federal Decree Law No. 7.661 "Old Brazilian Bankruptcy Law," issued on June 21, 1945) was generally considered outdated, unnecessarily rigid, and not responsive to the needs of modern businesses.

One of the first major tests of the New Brazilian Bankruptcy Law is the judicial recovery case of Varig, S.A. (known as S.A. (Viacao Aerea Rio-Grandense)) and its affiliates Rio-Sul Linhas Aereas S.A. and Nordeste Linhas Aereas S.A. (collectively, "Varig").

The Varig case is one of the first recovery proceedings of a Brazilian airline company. Prior Brazilian law disallowed recovery proceedings of a commercial airline based on the rationale that it would not be safe for the general public to the extent that aircraft maintenance could be

Copyright © 2009 Association of Corporate Counsel

affected by the financial instability suffered by an airline in recovery. Article 198 of the NBRL disallows recovery proceedings of companies for which the previous insolvency law did not authorize a *concordata*, a former alternative that did not provide for a debt restructuring but only for the postponement of the debt. Nevertheless, Article 199 of the New Brazilian Bankruptcy Law specifically extends to airlines the right to request judicial recovery.

The Varig case is one of the first large cross border cases of a Brazilian company with an ancillary case in the United States under former section 304 of the U.S. Bankruptcy Code. The relief available to a debtor under former section 304 was, essentially, a preliminary injunction protecting the foreign debtor's assets in the United States and prohibiting U.S. creditors, and others subject to U.S. court jurisdiction, from taking action against the foreign debtor outside of the foreign insolvency proceeding. In Varig's case, the debtor sought U.S. court protection principally to enjoin aircraft and engine lessors and financers from repossessing their equipment notwithstanding that Varig was already months in arrears to these creditors in amounts that in the aggregate was in the tens of millions of dollars.

This chapter will analyze the New Brazilian Bankruptcy Law in the light of the Varig case and intends to summarize the most relevant issues regarding bankruptcy in Brazil.

II. THE NEW BRAZILIAN BANKRUPTCY LAW—OVERVIEW

The NBRL replaces the Old Bankruptcy Law and basically provides for three types of insolvency procedures.

The judicial recovery, which is similar to the U.S. Chapter 11 procedure, allows the debtor to propose a recovery plan to rescue a company from financial crisis. Its main objective is to preserve the company and prevent its liquidation.

Within the concept of a judicial recovery, the legislator included a summary recovery procedure for smaller organizations, as provided in Article 179 of the Brazilian Constitution.

The judicial recovery is a new alternative to postpone the debtor's unsecured debts, without the disadvantages of the outdated concordata relief provided by in the Old Bankrptcy Law.

The extrajudicial recovery, which is comparable to the U.S. pre-packaged Chapter 11 procedure, allows the debtor to negotiate with the creditors and directly agree upon a plan with them for its financial recovery. There is no need to include every creditor, nor the need to hold a general meeting of creditors to approve the recovery plan.

The *falência* is an insolvency proceeding for the collection, disposition and liquidation of estate assets carried out by a court appointed trustee (the "*administrador judicial*" or judicial administrator) 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 and recovery relief are available to most types of business organizations. Nevertheless, some debtors involved in trade and business are not eligible for falência and recovery relief, as explained below.

The main objectives of the New Brazilian Bankruptcy Law are:

- the protection of honest debtors, through a proceeding that governs the rehabilitation of the company, known as the recovery procedure (akin to U.S. Chapter 11); with emphasis on negotiation between creditors and debtor so that under its management the enterprise is able to continue as a productive unit of the national economy;
- the acceleration of the liquidation procedure (akin to U.S. Chapter 7) of a debtor that fails to meet the requirements of the recovery procedure;
- the adoption of protective procedures (akin to the automatic stay) such as temporary moratorium for recovery proceedings;
- the appointment of a disinterested, independent administrator and/or a committee to oversee (but not replace) the debtor's management in a recovery proceeding;

Copyright © 2009 Association of Corporate Counsel

- the reformulation of the judiciary's role in the recovery procedure as a supervisor of the negotiations between creditors and debtor;
- the reclassification of priorities of claims and credits; and
- the establishment of a summary recovery proceeding for smaller organizations

III. THE JUDICIAL RECOVERY PROCEDURE

The judicial recovery procedure aims to rescue a company in financial crisis. It applies to almost all debts existing at the time the request for the procedure is filed, even those that have not yet matured. It is a scheduled payment plan, which, among other things, prevents creditors from seeking the debtor's liquidation (*see below, Liquidation (falência)*). The debtor must apply to court for permission to proceed and then propose a debt repayment plan to its creditors, which may or may not approve the plan.

The most important features of the procedure are the delay of the payment of secured and unsecured debts; flexibility in the negotiation between creditors and debtors; and, mechanisms that allow the business to continue under reorganization.

Only entrepreneurs and private companies can apply to the courts for a judicial recovery procedure. The New Brazilian Bankruptcy Law does not apply to: state-owned companies; joint stock companies (*sociedades de economia mista*); financial institutions; credit unions; consortiums; pension funds; institutions that provide healthcare; insurance companies; capitalization companies.

The following can ask the courts for a judicial recovery procedure: the debtor; the debtor's surviving spouse or heirs; the administrator; or the debtor's remaining partner or shareholder.

To be eligible for judicial recovery relief, the debtor must: have been in business for at least two years; have never been declared bankrupt, or if previously declared as such, the liabilities arising out of the bankruptcy must have been declared terminated by a court ruling that is final and conclusive; the debtor must not have been granted a recovery procedure

within the previous five years; and, must not have been convicted, as manager or controlling quota holder/shareholder, of any of the crimes provided by the New Brazilian Bankruptcy Law, for example (sections 171 and 173, Bankruptcy Law).[1,2]

A. The Judicial Recovery Plan

The bankruptcy courts must grant a judicial recovery procedure if all the conditions are fulfilled (*see above*) and the recovery plan is approved by a creditors' meeting (*section 56, Bankruptcy Law*).

The creditors' meeting must be made up of the following classes of creditors: owners of credits derived from labor legislation or labor accidents; owners of security interests; and, owners of subordinated credits with special, general or subordinated privileges.

All classes must approve the judicial recovery plan. The general rule is that the proposal must be approved by creditors representing more than half of the total value of credits present at the meeting and, cumulatively, by the simple majority of creditors present.

---

[1] Such as: withholding or omitting information or rendering false information on the bankruptcy or judicial recovery process; appropriating or concealing assets that belong to the debtor under judicial recovery or to the bankrupt estate.

[2] To request the courts for the recovery procedure, all of the following must be satisfied (section 51, Bankruptcy Law): evidence of where the company's assets are situated must be provided and reasons for the debtor's undergoing financial crisis must be given; the balance sheets for the previous three years, as well as those prepared to justify the request for the recovery procedure, must be provided and must include: the company's balance of assets; the company's cumulated financial results; the company's financial results from the previous year; and a management report on the company's cash flow projection; a complete list of creditors (creditors' list) with their address and details of the nature, classification and amount of the debt must be provided; a complete list of the company's employees, with their respective functions, salaries, eventual indemnifications and any other pending payments must be provided; the company's by-laws and a certificate issued by the commercial board to evidence it is a regular ongoing business must be provided; a list of the of the company's shareholders'/quotaholders' and the managers' private assets must be provided; details of the debtor's current banking information and any financial applications must be provided; reports must be issued by the protest registries (notaries that issue reports on bad credit); and, a list of all lawsuits to which the company is party must be provided.

Copyright © 2009 Association of Corporate Counsel

In the class of the owners of credits derived from labor legislation or labor accidents, the proposal must be approved by the simple majority of creditors present, irrespective of the value of their credits.

The court can authorize the judicial recovery based on a plan that has not been approved in the form provided above if, in the same meeting of creditors, the plan is approved in cumulative form by: creditors representing more than half the value of all credits present in the meeting, irrespective of classes; two classes of creditors in accordance with the terms provided above (or where there are only two classes of voting creditors, the approval of at least one of them); and in the class with a negative vote, the favorable vote of at least one-third of the creditors, counted in accordance with the provisions of the general rule mentioned above.

The judicial recovery procedure lasts for two years. The recovery plan approved by the creditors specifies the terms and deadlines for the payment of debts.

The recovery plan must be submitted for approval to the creditors. Any creditor can object to the plan within 30 days from the publication of the creditors' list (*section 55, Bankruptcy Law*). If a creditor objects, the courts must require the creditors to hold a meeting within 150 days counted from the granting of the processing of the judicial recovery. The court must rule the company bankrupt if the recovery plan is not approved.

The judicial recovery procedure prevents liquidation taking place. The debtor can continue to run its business under the supervision of an independent administrator (or a administrator and a committee) and the court, while it arranges to pay its debts to the creditors (*sections 22 and 52, Bankruptcy Law*).

The credits are stayed once the court grants the processing of the recovery procedure. This ruling is later confirmed by a ruling that grants the recovery of the company according to the approved recovery plan.

B. *Conclusion of Judicial Recovery*

Once the court has granted its permission, the recovery relief can be terminated or converted into a liquidation procedure (*see below, Liquidation (falência)*) on various grounds, including the following: the debtor's failure to present the recovery plan 60 days after the granting of the request for the judicial recovery is published in the official gazette; or rejection of the recovery plan by the creditors' meeting.

After all the obligations set out in the plan have been fulfilled, the courts declare the judicial recovery procedure terminated and: determine the remuneration of the court-appointed judicial administrator; determine the value of the outstanding judicial fees; require the judicial administrator to present a report on the compliance of the recovery plan; dissolve the creditors' committee and remove the judicial administrator; and require the competent commercial board to be notified of this decision.

C. *Case Study: the Sale of Assets under Judicial Recovery – the Varig Case*

(1) Facts

On June 17, 2005, Varig filed for judicial recovery under the New Brazilian Bankruptcy Law to take advantage of the several new mechanisms under the law that make it easier for debtors and creditors to negotiate reorganization plans, backed by the bankruptcy court. On that date, the Brazilian court issued an interim order—a "*medida liminar*" —similar to a temporary restraining order in the United States to specifically prevent aircraft creditors from seizing or interfering with Varig's use of the aircraft and equipment needed to operate its airline business. Also on that date, Varig commenced an ancillary case in the U.S. Bankruptcy Court for the Southern District of New York under section 304 of the Bankruptcy Code, and obtained *ex parte* from the U.S. court a temporary restraining order to enforce the Brazilian Court's interim order in the United States.[3]

On June 22, 2005, the 8ª *Vara Empresarial do Rio de Janeiro* (8th Business Court of Rio de Janeiro, herein "Brazilian Bankruptcy Court") granted the processing of the Judicial Recovery relief

[3] Article published in the ABI Journal of July/August 2007 "Varig Airlines: Flying the Friendly Skies of Brazil's New Bankruptcy Law with Help from Old Section 304" by Paulo Penalva Santos, Otto Eduardo Fonseca Lobo and Rick B. Antonoff.

Copyright © 2009 Association of Corporate Counsel

requested by Varig. On June 27, 2005, after notice and a hearing at which many of the aircraft creditors appeared in opposition, the U.S. court issued a preliminary injunction to continue the relief obtained in the temporary restraining order and to broaden it to other types of creditors.

In July 2006, creditors in Brazil voted to approve Varig's in-court recovery plan which contemplated a sale of the airline's name, operating assets, and business pursuant to article 60 of the Bankruptcy Law after a competitive bidding process. Following two auctions, the Brazilian Bankruptcy Court determined that the prevailing bidder was Varig Logistica S.A., ("VARIG Logistica"), a former Varig subsidiary that was sold during the recovery proceedings to an entity created with the backing of U.S. private equity firm MatlinPatterson. Following the satisfaction of certain conditions to the sale, the Brazilian Bankruptcy Court declared the sale complete on December 15, 2006.

(2) How Article 60 of the New Brazilian Bankruptcy Law Promotes Asset Sales Free and Clear of Claims

On July 20, 2006 a judicial auction was held in the Brazilian proceeding under the auspices of the Brazilian Bankruptcy Court. VARIG Logistica emerged as the winning bidder. The sale to VARIG Logistica comprised substantially all of the assets and operations of Varig (referred to as the Varig Productive Unit or "UPV"), which is now an independent unit, including the trademark for VARIG, S.A. VarigLog, S.A. formed the company VRG Linhas Aereas S.A. ("VRG") to hold and manage the UPV and to operate under the VARIG, S.A. trademark. The UPV also includes, but is not limited to, VARIG's and Rio Sul's Airline Authorization Certificates ("CHETA"), which authorizes VARIG and Rio Sul to operate their routes.

The sale did not include the trademark or CHETA of Nordeste which, under the Plan, will remain assets of old Varig. In addition, the sale excluded the old Varig's real property assets, radio stations, and the Varig Flight Training Center, which will, in part, finance certain payments to the old Varig's creditors required by the Recovery Plan.

On December 15, 2006, the Brazilian Court issued a decision (the "December 15th Decision") holding that pursuant to Article 60 of the NBRL, the sale to VRG, was complete.

The sale of the UPV to VRG pursuant to Article 60 of the NBRL was free and clear of any liens and VARIG Logistica, as purchaser, will not be a successor to any of Varig's obligations, including any tax obligations. Furthermore, pursuant to Article 59 of the NBRL, the Plan, as amended by the Restated Plan, constitutes a binding novation of all debts against the Foreign Debtors arising prior to the commencement of the Foreign Proceedings. Like section 363 of the U.S. Bankruptcy Code, the effects of NBRL Article 60 are intended to allow and foster companies in financial distress to continue in business under new ownership, retain employees and continue commercial relationships with vendors and customers.

In the Varig case, after the sale of the UPV to Varig Logistica, employees of the former Varig asserted that the assets could not be sold free and clear of their labor claims, and that the Labor Court was the proper forum to hear their argument. Varig argued that the court presiding in its judicial recovery should decide whether the assets were sold free of or subject to the labor claims. In support of its position, Varig noted Article 3 of the NBRL which adopts the principle of the "Universal Judge" of the judicial recovery procedure for all suits that may influence the recovery plan (as did the previous law, Decree-Law 7.661 of 1045).

(3) Jurisdiction of Brazilian Courts on Issues Related to Sales Free and Clear of Claims

The rationale of the Universal Judge in Brazil was upheld by the Brazilian Superior Court of Justice. On April 25, 2007 Justice Ari Pargendler of the Superior Court of Justice of Brazil decided that the Brazilian Bankruptcy Court has jurisdiction to rule on issues related to the recovery plan, including a request made by labor creditors in labor court to freeze amounts to pay for labor claims.

Copyright © 2009 Association of Corporate Counsel

"The judicial recovery is guided by other principles, but it seems reasonable to conclude that it would be jeopardized if the assets of the company could be frozen by the Labor Courts."

This was the rationale for Justice Ari Pargendler of the Brazilian Superior Court of Justice to rule on the motion of conflict of jurisdiction that was filed by the Public Attorney's Office in Varig's Judicial Recovery Procedure.

The issue arose when the Labor Court in Rio de Janeiro ordered the freezing of Varig's assets to pay labor claims against the company while, at the same time, the Bankruptcy Court authorized the sale of the assets free and clear. The Public Attorney's Office filed a motion of conflict of jurisdiction at the Brazilian Superior Court of Justice.

Justice Pargendler based his ruling on the fact that Sole Paragraph of Article 60 and Article 141 of the New Brazilian Bankruptcy Law both provide that this type of sale is free of succession and so the bidder will not be responsible for the liabilities of the debtor, including debts for labor and tax claims.

This is one of the very first judgments of the Brazilian Superior Court of Justice on the jurisdiction of Brazilian courts to rule on issues related to the New Brazilian Bankruptcy Law.

(4) Justice Pargendler's Ruling Now Makes It Clear that the Sale of an Independent Productive Unit is Free and Clear of Claims

The ruling also makes clear that bankruptcy courts presiding in judicial recovery proceedings fully understand the issues related to a recovery plan and, therefore, are the appropriate forum for having all matters affecting the plan heard and decided on.

Furthermore, the Brazilian Superior Court ruling supports the proposition that the rehabilitation of a financially distressed company serves a social function, since its objective is to make it viable for the company to surpass its economic social crises and, consequently maintain itself as a source of jobs, as set forth in Article 47 of New Brazilian Bankruptcy Law. What remains to be seen is whether the

lower courts in Brazil will also support this proposition in subsequent cases or, instead, will try to distinguish the Varig case and allow separate courts to render conflicting rulings.

IV. THE EXTRAJUDICIAL RECOVERY PROCEDURE

The extrajudicial recovery procedure was disallowed by the Old Brazilian Bankruptcy Law and several other Brazilian bankruptcy laws that came before it.

The debtor can use the extrajudicial recovery procedure to solve a liquidity problem by proposing to its creditors payment extensions or reductions in the amount of the debt. This procedure aims to give clarity and safety to the negotiations, provided that all creditors receive the same treatment. It is a negotiation between the debtor and some of its creditors.

The extrajudicial recovery procedure allows the debtor to negotiate and agree directly with its creditors a plan for its financial recovery (it can request its creditors for a reduction in, or an extension for the payment of, the debts payable). This procedure cannot be used to recover debts relating to tax, labor relationships, and accidents in the workplace, or if the creditor is the fiduciary owner of movable and immovable assets. The extrajudicial plan cannot consider the anticipated payments of debt or the unfavorable treatment of the creditors that are not subject to the plan.

As with the judicial recovery, only entrepreneurs and private companies can apply to the courts for a judicial recovery procedure. The New Brazilian Bankruptcy Law does not apply to: state-owned companies; joint stock companies (*sociedades de economia mista*); financial institutions; credit unions; consortiums; pension funds; institutions that provide healthcare; insurance companies; capitalization companies.

The debtor must comply with the following prerequisites set out in section 48 of the New Brazilian Bankruptcy Law to propose and negotiate an extrajudicial recovery plan with creditors:

- it must have been in business for at least two years;

Copyright © 2009 Association of Corporate Counsel

- it must have never been declared bankrupt, or if it had been declared as such, the liabilities arising out of the bankruptcy must have been declared terminated by a court ruling that was final and conclusive;
- it must not have been granted a recovery procedure within the previous five years; and
- it must not have been convicted, as manager or controlling quota holder/shareholder, of any of the crimes provided under the New Brazilian Bankruptcy Law.

The New Brazilian Bankruptcy Law does not stipulate a fixed term for the extrajudicial recovery procedure. It is estimated to take up to three months.

The extrajudicial recovery procedure can be requested in two different ways:

- The debtor can request the court's ratification of the extrajudicial recovery plan that has been approved by all the creditors involved (*section 162, Bankruptcy Law*); or
- The debtor can request the court's ratification of the extrajudicial recovery plan, which binds all the creditors if it is executed by creditors owed more than three-fifths of all debts (*section 163, Bankruptcy Law*).

The debtor must request the court's ratification of the extrajudicial recovery plan, by which all the creditors involved are bound. Creditors only become bound if the plan is ratified. An extrajudicial procedure cannot be carried out if the plan is not ratified.

After receiving the request for approval of the extrajudicial recovery plan, the court publishes it in the official gazette and in a national newspaper of sufficient distribution (or in the newspaper distributed where the debtor's headquarters and branches are located). This is to notify all creditors and enable them to dispute the extrajudicial recovery plan. Once judicially ratified the plan binds all the creditors involved.

Approval of the plan does not suspend the creditors' rights, or any cases or execution proceedings against the debtor's assets, nor does it protect the debtor against any liquidation request.

Once all obligations in the extrajudicial recovery plan have been met, the debtor files a final report and the procedure is terminated.

V. THE *FALÊNCIA* LIQUIDATION PROCEDURE

In *falência* liquidation, a court-appointed trustee (judicial administrator) collects, disposes of, and liquidates the debtor's assets and distributes its proceeds to creditors in the order of priority.

Liquidation is available to most types of business organizations. However, some debtors are not eligible for liquidation and recovery relief.

The creditors and the debtor can initiate the liquidation procedure. The bankruptcy court can also convert a judicial recovery procedure into liquidation (see above, Judicial recovery procedure).

Both the debtor and creditors can request of the court that the debtor be liquidated. A creditor can request the declaration of the debtor's liquidation if the debtor, among other things:

- does not pay the amount represented in a valid bond or document, when due and without good cause, provided the amount is not more than 40 minimum monthly wages;
- in case of a collection suit for any net amount, does not pay, does not make a deposit, and does not appoint enough assets for attachment within the legal term;
- liquidates its assets in a wasteful or fraudulent way in order to make payments;
- seeks to defraud creditors or delay payments to them by carrying out fraudulent activities;
- transfers the establishment to a third party, without all the creditors' consent and without keeping enough assets to settle the debts;

Copyright © 2009 Association of Corporate Counsel

- does not fulfill, within the determined term, the obligations assumed in the judicial recovery plan.

The term of the liquidation procedure depends on the amount of debt, the complexity of the company, and the number of creditors involved in the liquidation.

No consents are required to initiate liquidation proceedings. However, the main decisions of the liquidation proceedings are submitted to the creditors for approval.

Once a petition is filed, a judicial administrator is appointed to administer the liquidation and distribute the assets. The declaration of bankruptcy determines the anticipated maturity of the debtor's debts and those of the unlimited jointly responsible partners (section 77, Bankruptcy Law).

When the company is liquidated, the judicial administrator files a final report and requests the court to conclude the case.

VI. INTERNATIONAL CASES AND PROPOSED REFORMS OF THE LAW

The New Brazilian Bankruptcy Law does not contain any cross-border insolvency rules. However, local courts can rule on insolvency cases in relation to the Brazilian branch of a company that has its headquarters abroad (*section 3, Bankruptcy Law*).

The courts do cooperate where there are concurrent proceedings in other jurisdictions. The case involving Varig and its affiliates is the first major Brazilian cross-border insolvency case with a judicial recovery procedure filed in Brazil and a section 304 procedure filed at the U.S. Bankruptcy Court of the Southern District of New York. The Brazilian and U.S. courts have cooperated a great deal throughout the several phases of both procedures.

Brazil is not party to any international treaty on insolvency procedures and/or cross-border insolvency rules.

The New Brazilian Bankruptcy Law does not provide special procedures for foreign creditors, but sets out specific requirements such as Paragraph 2 of section 97, which requires creditors without a

domicile in Brazil to deposit a judicial bond for court costs and indemnify the courts if the request is later ruled as a deceitful request for liquidation.

VII. CONCLUSION

The Varig case demonstrates that the New Brazilian Bankruptcy Law needs to be reformed to create an effective recovery system. Proposals to reform the New Brazilian Bankruptcy Law to address some of the issues raised in the case are being made by commentators, lawyers, and judges. Some of the issues raised are the following:

- The short deadline for the presentation of the recovery plan: Unlike other insolvency systems where the debtor has up to two years to present its recovery plan, the debtor has only 60 days after the publication of the decision allowing the processing of the recovery procedure to present its recovery plan. This is even more pertinent when dealing with large and sophisticated companies.
- To be eligible for judicial recovery relief, the debtor must present good tax standing certificates. This requirement cannot be fulfilled easily, as most companies that file for a judicial recovery relief have pending tax issues that are being ruled by the courts.
- The New Brazilian Bankruptcy Law gives labor creditors one year to receive their credits. It is not clear whether collective bargaining agreements will be held effective as they may provide a longer period for payment.
- There are currently no cross-border insolvency rules, which should be included in the New Brazilian Bankruptcy Law.

Certainly, the New Brazilian Bankruptcy Law has substantially changed bankruptcy proceedings in Brazil, which are expected to become more effective and equitable to both creditors and debtors. It is

Copyright © 2009 Association of Corporate Counsel

essential to closely monitor any changes in this new legislation and the relevant case law developments, as some points may bring different results when a creditor is dealing with an insolvent or pre-insolvent company and/or there is any debt restructuring.

Chapter 30

ARBITRATION IN BRAZIL ON CORPORATE MATTERS

Joaquim de Paiva Muniz

I. OUTLINE OF THE ISSUE

The enactment in 1996 of the new Brazilian Arbitration Law,[1] has significantly improved the applicable legal framework,[2] as there has been significant growth in a number of domestic and international arbitrations in Brazil, especially in the areas of commercial and business law.[3]

---

[1] Law No. 9.307/96, of September 23, 2006.

[2] Prior to the Arbitration Law, the Brazilian legal system was considered as unfriendly to arbitration, for many reasons. The former framework required, as a condition for enforceability of the arbitral award, its ratification ("homologation") by a judicial court. Such a requirement used to significantly hamper the celerity of the arbitration award enforcement, if a party refused to voluntarily comply therewith.

Another issue under the former legal framework refers to the fact that a party was unable to request specific performance of the arbitral clause. That is to say, in case a party refused to participate in the arbitral proceeding, notwithstanding the fact that it had signed an agreement with an arbitration clause, the arbitration could not proceed and the other party could only claim damages.

The Brazilian Arbitration Law of 1996 abolished the requirement of court homologation of arbitration awards issued in Brazil, which shall be considered tantamount to domestic judicial awards for the purposes of enforceability. As to foreign arbitration awards (*i.e.*, awards issued outside of Brazil), enforceability thereof is still conditioned upon an exequatur by the Superior Court of Justice, similarly to foreign judicial awards, but it is no longer required that such award be homologated at the judicial courts of the country where it was issued.

[3] As to international arbitrations, this may be evidenced by the fact that the number of arbitrations involving Brazilian parties that have come before the International Court of Arbitration of the International Chamber of Commerce—ICC, which is the most renowned international arbitration court, increased in the period between 1996-2006 from a small figure to a significant number, placing Brazil at the

Copyright © 2009 Association of Corporate Counsel

ACC Extras

Supplemental resources available on www.acc.com

Doing Business in Latin America.
On-line CLE Program. October 2006
http://westlegaledcenter.com/clickthrough.jsp?name=ACC&direct=/program_guide/course_detail.jsf?courseId=4605125

Please note, these additional resources are provided by the Association of Corporate Counsel and not by the faculty of this session.

Copyright © 2009 Association of Corporate Counsel