

## Increasing transparency in insolvency proceedings in Chile

In 1982 Chile instituted a system of private receivers<sup>1</sup>—moving the receiver practice from the public to the private sector. Two decades later, reform was needed. Corruption scandals revealed that the appointment process and fee schedules of receivers were opaque and lacked oversight. The public’s faith in Chile’s insolvency system was at stake.

Chile found a solution. The government decided that it was time for private receivers to be specially trained, licensed, and appointed through a transparent system. Furthermore, their fees were to be clearly determined and predictable, to avoid corruption suspicions. This was the path Chile embarked on in 2002 and finished in 2005 with the enactment of law 20004, a modern amendment to its 23-year-old insolvency regulations.

### *The failures of the old system*

Before 2005, the receiver profession was poorly regulated and vulnerable to corruption. There were some high-profile cases of judges and receivers investigated by the Supreme Court, some at the request of the Bankruptcy Commission<sup>2</sup>. As a result of one investigation in 2004, a judge was suspended for 4 months for having appointed and paid extraordinarily high fees to the same 2 receivers in 17 large cases. The high-profile scandal contributed to the perception that the system wasn’t working well enough.

What were the problems with the system? There were several weaknesses. First, the appointment of receivers for each insolvency case was at the court’s discretion; creditors had no say. In many cases, receivers lobbied to be appointed to work on large insolvency procedures, when the fees were high. They also lobbied *not* to be assigned to small cases, when the fees were low. Some courts abused their discretionary power, falling prey to lobbying and ethical misconducts.

Second, receivers in Chile were not required to hold university degrees—technical degrees were enough—nor were they examined to start practicing. Once on the job, they were not regularly tested nor were they liable for malpractice.

Third, receiver’s fees were not clearly determined, which led to many complaints. In addition to fees, creditors could be saddled with “extraordinary expenditures,” which receivers were allowed to claim in the course of proceedings. With unpredictable costs, creditors and debtors would shy away from the bankruptcy law for protection.

Forth and finally, receivers were supposed to be subject to the control of the Bankruptcy Commission. But this administrative body had no power to impose sanctions, which left its oversight weak and inefficient.

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<sup>1</sup>“Sindicos”

<sup>2</sup> “Superintendencia de Quiebras”

As a result of these systemic weaknesses and increasingly complex insolvency cases, consensus was that the law needed to be amended.

### *The trigger of reform*

In 2002, as part of a general plan to improve Chile's business environment, then-president Ricardo Lagos held several meetings with the Federation of Chilean Industry (known locally as *SOFOFA*<sup>3</sup>). As a result of those meetings, an agenda called "*Pro Crecimiento*" ("Pro-Growth") was launched in October 2002. Its main purpose was to facilitate business in 7 areas:

1. Promoting private-sector competitiveness (including bankruptcy reform)
2. Modernizing the government via technology
3. Simplifying business proceedings
4. Reforming taxes
5. Improving university credits
6. Increasing employment
7. Boosting exports

To work towards its goals, the agenda included several proposals to modify existing legislation.

Regarding insolvency, "*Agenda Pro Crecimiento*" proposed 3 possible improvements:<sup>4</sup>

1. Improve the system of insolvency receivers;
2. Revise of the treatment of preventive agreements; and
3. Abolish the legislation's punitive approach to the debtor.

The first part of the action plan—improving the receivers system—was the first to be tackled.

Just before this reform push, the efficiency and transparency of Chile's bankruptcy system had become a popular conversation topic. How did that happen? Soccer did it. Chile's passion for soccer was threatened by bankruptcy.

*Colo Colo*—one of Chile's top soccer teams, nicknamed "the popular"<sup>5</sup>—was declared bankrupt on January 23, 2002. At the same time, other teams were struggling with their finances and some were expected to undergo similar procedures. Soon after *Colo Colo*'s bankruptcy procedures started, a Chilean senator filed judicial actions to request an investigation. The senator argued that the bankruptcy proceeding lacked transparency. He also accused the court-appointed receiver of receiving extraordinarily high fees and creating a partnership to steal *Colo-Colo*'s assets.<sup>6</sup>

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<sup>3</sup> SOFOFA is short for "*Sociedad de Fomento Fabril*."

<sup>4</sup> According to a letter dated December 17, 2002 sent by President Lagos to Congress with the bill. This letter and other relevant information about the parliamentary process can be found in Spanish on the website [www.bcn.cl](http://www.bcn.cl).

<sup>5</sup> <http://en.wikipedia.org/wiki/Colo-Colo>

<sup>6</sup> Many Chilean newspapers reported the allegations—including *El Mercurio* (<http://diario.elmercurio.cl/detalle/index.asp?id={3ea05ff4-b746-41c1-a92a-25d23cafd82c}>) and *La Nacion* ([http://www.lanacion.cl/p4\\_plinea/site/20020325/pags/19800101162032.html](http://www.lanacion.cl/p4_plinea/site/20020325/pags/19800101162032.html)).

Even though the senator's accusations were ultimately rejected in court, this soccer scandal contributed to trigger the reform of Chile's insolvency system. The system did not appear to be working as expected. In March 2002, with the case still fresh in lawyers' and citizens' minds, the President appointed a commission of insolvency experts and members of *SOFOPA* to analyze possible reforms. A top priority was increasing transparency in the system of appointing, paying and supervising receivers.

### *The reform process*

The commission appointed by President Lagos in March 2002 finished its first draft of recommendations nine months later, in December 2002. On December 17, 2002, President Lagos then sent a bill to amend Law 18175 (the 1982 insolvency law) to Chile's bicameral congress for analysis. The Bankruptcy Commissioner at that time, Diego Lira Silva, and his counselors participated in many of the congressional sessions—as well as the commission's meetings.

The bill followed a common legislative process. It was analyzed by various commissions of the Chamber of Deputies from March 2002 to October 2003. They discussed and approved the text of the bill with some modifications.<sup>7</sup> On October 1, 2003 the Chamber of Deputies approved the bill unanimously in a special session; there was also a brief, final discussion to incorporate some changes to the wording of the bill.<sup>8</sup>

Once the bill was approved by the Chamber of Deputies, it was sent to the Senate for further analysis. The first step within the Senate was to send the bill to its Economic Commission, which approved it unanimously on May 11, 2004 with some modifications. Then the bill was debated in two separate Senate sessions. The first debate took place in June 9, 2004. The bill was discussed and approved by the Senate in an ordinary session. At that stage, one senator suggested that the current insolvency law should be reworked to encourage reorganizations and rehabilitations instead of liquidations. This suggestion was ultimately rejected and the bill kept on its path to amend the law.

In June 2004 the World Bank conducted a "Report on the Observance of Standards and Codes" (ROSC)<sup>9</sup> at Chile's request, where insolvency experts analyzed the particularities of the Chilean insolvency system and the bill under consideration in Parliament. Published on December 13, 2004, the World Bank's conclusions regarding the bill were positive. "This bill would provide for stricter rules on the admittance to the receivers' office: only civil, commercial or agrarian engineers, accountants and lawyers are admitted to be receivers, while the Bankruptcy Commission is authorized to set up an admittance exam," the ROSC stated. The World Bank's

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<sup>7</sup>It is worth mentioning that one of the modifications approved in the Chamber of Deputies was that the bill require an exam for licensing receivers and that exams must also be administered periodically.

<sup>8</sup>Specifically, Deputy Burgos' proposals amended some minor internal contradictions of the bill. Most of his suggestions were approved after a brief debate. The whole session of the Congress can be read (in Spanish) in the Chilean's Congress website: <http://www.bcn.cl/sil?num=3180-03>

<sup>9</sup> Reports on the Observance of Standards and Codes (ROSCs) provide an opportunity for countries to evaluate provisions in their laws addressing creditor rights, legal frameworks, institutional frameworks, and informal corporate work-outs and restructurings, among other issues. Chile's ROSC is publicly available in English online: <http://siteresources.worldbank.org/GILD/ROSCAssessments/20293918/ChileROSC.pdf>.

recommendation was to: “Enact the currently in Congress Bill introducing amendments to improve the work of receivers, set up an admittance exam for new candidates and reform several aspects of the organization and powers of the Bankruptcy Commission.”

One week later, on December 20, 2004, the Senate heard the bill in a special session. Some minor, formal modifications to the project were approved. The most relevant was an amendment to keep admissions open to new qualified receivers, even when the pool of licensed receivers was large enough to satisfy current demand. After this session, the newly modified bill was sent back to the Chamber of Deputies.<sup>10</sup> The Chamber of Deputies approved the modifications unanimously on January 4, 2005. The bill was then sent to the President for approval. The President signed it into law on February 25, 2005. Finally, it was published on March 8, 2005, becoming Law 20004 in the books.

### ***Features of the law***

#### *Shifting power to creditors and making appointments transparent*

Before the reform, creditors and debtors were suspicious of the way the receiver system worked: The court had the discretion to appoint receivers and lobbying for big cases was common. With the new Law 20004, creditors appoint insolvency receivers instead of the courts. If a creditor files a bankruptcy petition, that creditor suggests the receiver. And if the insolvency procedure is initiated by the debtor, the court calls a hearing with the three largest creditors and they choose the receiver.

#### *More specialization and qualifications for receivers—and fixed fees*

Another noticeable feature of the new law is that potential receivers have to pass an exam to be admitted into the profession. They then pass regular exams in order to keep their licenses. At the same time, the minimum qualifications for the post also increased: Law 20004 requires that candidates have a university degree and at least 5 years of experience. Furthermore, transparency was increased by prohibiting familiar or previous commercial relationship between receivers, debtors and creditors.

Law 20004 also introduced a fixed schedule of receiver’s fees—which finally put an end to the speculation that previously existed. With the new fee schedule, it was now clear that creditors would not have to pay unpredictable fees for professionals hired by the receiver. The law also established that the receivers’ payments would correlate with the creditors’ recoveries, thus aligning their interests. It also created an incentive for quicker decisions, since a faster distribution of assets meant a faster payment to receivers.

#### *Granting the Bankruptcy Commission efficient oversight over receivers*

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<sup>10</sup> In this debate, one senators said: “Regarding receivership, we have to be very rigorous; every day, more and more irregular situations are found. This situation calls for the approval of a law like this one.”

The new law gave the Bankruptcy Commission power to impose sanctions on receivers. Moreover, the Bankruptcy Commission could veto “extraordinary expenditures” requested by receivers. The Commission also administered the licensing tests as well as the regular tests required to stay practicing in the profession.

### ***The results: a better system and no new corruption scandals***

When it comes to judicial procedures, it can be difficult to assess the results of a specific reform right away. The time required for an insolvency procedure is not likely to decrease overnight. However, in Chile’s case, there are some signs that the reform is already having a positive impact.

To quote the House of Lords<sup>11</sup>, it is of fundamental importance that justice should not only be done, but should manifestly and undoubtedly be seen to be done. The corruption scandals mentioned above were generating mistrust in the system. However, since the enactment of Law 20004, things have changed. Transparency immediately increased.

Apart from that, the law introduced some good practices that are generally recommendable (depending on the particularities of the country, of course), such as the following:

Licensing: The examination requirements to be admitted as an insolvency administrator, or to maintain the position, are fully in force. After an open selection process, the Bankruptcy Commission delegated the administration of the receiver’s test (as of November 14, 2007) to a renowned university in order to ensure its independence and fairness. The tests are prepared by university professors on the topics chosen by the Commission. The process is rigorous: One third of receivers were suspended for not attending or failing the first examination.<sup>12</sup>

Positive results for financial creditors: Creditors can now appoint a receiver to ensure a transparent and just process. This should inspire their confidence in the system—and help facilitate access to credit.<sup>13</sup> Lawyers at financial institutions have expressed their approval of the reform in Chile.

Predictable costs: The fact that receivers are paid according to a fixed schedule of fees—and only after the assets are sold or distributed to repay creditors—has helped creditors. They no longer fear unpredictable, out-of-control costs.

Overall increase in the transparency of the system: Even though it is impossible to guarantee that all traces of corruption have been eliminated, the law has introduced several features that discourage it. Those features include—as we mentioned above—a new procedure to appoint receivers, professional licensing, fixed fees and predictable costs, and stronger oversight by the Bankruptcy Commission.

### ***What’s next for Chile?***

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<sup>11</sup> Lord Hewart's dictum, *Rex v. Sussex Justices, Ex parte McCarthy* [1924] K.B. 256, 259.

<sup>12</sup> [http://www.universia.cl/html\\_estatico/portada/actualidad/noticia\\_actualidad/param/noticia/bcfdgb.html#](http://www.universia.cl/html_estatico/portada/actualidad/noticia_actualidad/param/noticia/bcfdgb.html#)

<sup>13</sup> Djankov et al, *Debt Enforcement Around the World*, *Journal of Political Economy*, Dec. 2008.

Law 20004 has been an important step to the right direction. However, many more steps remain ahead. At a seminar in September 2008, insolvency specialists concluded that Chile needs to further amend its current legislation in order to better promote economic development. These specialists proposed reforms that would grant creditors and receivers better tools to help viable businesses emerge from bankruptcy as going-concerns.

Local specialists and published reports have also concluded that Chile needs to focus on the restructuring or rehabilitating of an insolvent firm, instead of simply punishing debtors and liquidating assets. In fact, small and medium enterprises in Chile rarely use the insolvency law as a mechanism to try and rehabilitate their company. In the last four years there have not been more than 150 bankruptcy cases per year, which is extremely low when compared to similar economies<sup>14</sup>.

Finally, Chile needs to eliminate the backlog that delays bankruptcy procedures. The improvements brought out by Law 20004 should help speed up procedures, but it is still too soon to declare victory.

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<sup>14</sup>Official statistics available in [www.squiebras.cl](http://www.squiebras.cl)