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The effects of a reorganization on the pending contracts of the debtor

By: Ricardo Reveco
Carey y Cía. Ltda
Chile

Law 20.720 *On the reorganization and liquidation of companies and individuals*, enacted in Chile in 2014, regulates different insolvency proceedings applicable to companies with financial difficulties, allowing the restructuration of their assets and liabilities or their liquidation (bankruptcy). Both the start of a reorganization proceeding ("Reorganization") and the approval of a Reorganization Agreement, have substantial effects on the debtor's contracts, especially concerning the remedies available to its counterparties (mainly regarding *ipso facto* clauses). These effects will be briefly analyzed in this article.

With the filing by the debtor of the motion for the start of the Reorganization, the court issues the Reorganization Resolution that opens the so-called Insolvency Protection Period (which lasts at least 30 working days extendable to up to 90 days depending on the support received from creditors). The Reorganization Resolution - among other effects- suspends executions and liquidation claims against the debtor (*stay order* similar to that established in Chapter 11 of the US Bankruptcy Law), and also orders that contracts maintain their terms and conditions of payment, prohibiting their termination due to the start of a Reorganization.

Below, we will review the main effects of the start of the Reorganization for the creditors of the debtor.

First, during the Insolvency Protection Period, judicial enforcement of contracts against the debtor is restricted: specific performance is restricted because the debtor will not be able to encumber or dispose of his assets, except in the ordinary course of business; and starting foreclosure proceedings against the debtor is also restricted. The exercise of *ipso facto* clauses, that is, those that pursue the automatic termination of a contract, the acceleration of credits or the execution of guarantees, is also restricted.

Chilean law – faced with the dilemma of authorizing or forbidding the early termination of contracts due to the start of a Reorganization – has opted for an intermediate solution. Thus, it impedes creditors from early terminating contracts due to the start of the Reorganization, but allows them to early terminate for different reasons. In this way, Chile recognized the *principle of preservation of business* of the company, expressed in the maintenance of the current contracts of the debtor company. The sanction to the creditor who infringes the legal prohibition is even more drastic than the nullity of the early termination. The infringer is postponed in the payment of its claims until both unsecured creditors and related entities creditors have been fully paid. If we consider that the average recovery in Chile in bankruptcy liquidations is less than 35% of the capital, this legal sanction means that, as a general rule, the infringer creditor will never be paid.

A second relevant effect of the Insolvency Protection Period is the creation of new general preferences that affect all assets and creditors of the debtor, creating a *"super preference"* in favor of suppliers and financiers that allow the company to continue during the negotiation of the terms of an eventual Agreement. These incentives benefit suppliers of goods and services that are necessary for the operation of the Company; those who finance foreign trade operations; and loans contracted for the financing of its operations. All these contractors have in their favor, as creditors, a first-class preference in the payment of their credits, even higher than workers' and tax credits, in the event that the reorganization is frustrated and results in liquidation.

Third, the law implemented the principle of *subjective universality*, by which the Reorganization Agreement will be a collective agreement affecting all creditors, whether secured or unsecured, making a radical change to the previous legislation that in principle was only binding for unsecured creditors. Therefore, if the Agreement is approved, all the credits that are part of the proceeding will be understood to have been remitted, novated or renegotiated, as appropriate, for all legal purposes, which means that the debtor's and its creditors' patrimonial relationships are modified. In this way, the contracts will have to be adjusted to the conditions agreed in the Reorganization Agreement, whether related to the enforceability of the obligations (due to their renegotiation) or to the extinction of these (either by remission, cancellation, etc.1).

Fourth, given that the approved Reorganization Agreement is universally binding to creditors, the credits of creditors benefiting from collateral and personal guarantees affecting essential assets of the debtor company are also bound by its terms. Therefore, if a guarantee falls on an essential good, i.e. an asset which is necessary for the debtor's business, the credit will be bound by the terms of the Agreement. On the other hand, if the guarantee falls on a non-essential good, the creditor may separately foreclose its guarantee and be paid preferably from that foreclosure.

With the four effects described, Law 20.720 seeks to consolidate the *principle of preservation of the company*, establishing benefits for the debtor and allowing the debtor company to continue with its business by means of the reorganization of its assets and liabilities through the Agreement with its creditors. This regulation undoubtedly allows Chile to adjust its insolvency proceedings to international standards, since the initiation of a bankruptcy proceeding in our country is no longer synonymous with the termination of the debtor's economic activities and the termination of its contracts.

[1] To encourage the creditor to remit his credit in a Reorganization Agreement, the law authorizes the deduction of the remitted credit from income tax.