
REPORT ON OBSERVANCE OF STANDARDS & CODES

CHILE

INSOLVENCY AND CREDITOR RIGHTS SYSTEMS

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Executive Summary

The legal and institutional framework governing creditor rights and insolvency proceedings in Chile reasonably complies with expectations of a modern, credit-based economy, although some shortcomings affect the full effectiveness of credit risk management and resolution. Financial institutions over-rely on real estate as collateral. Pledges are not enough developed because legislation on secured interests over movable assets is fragmented and the publicity and registration mechanism for pledges are not sufficiently reliable. Individual enforcement proceedings are lengthy and complicated, both for secured and unsecured creditors. Enforcement proceedings using executory instruments take 1 to 3 years, whereas creditors not enjoying such instruments should utilize ordinary proceedings whose duration is even longer (3 to 5 years).

Insolvency legislation integrates with the country's broader legal and commercial system, providing a liquidation proceeding whose average duration, however, is 2 to 3 years. The Insolvency Law also governs judicial reorganization proceedings but classification of creditors for voting is not allowed, which may be underscored as a relatively significant rigidity in an environment where most financial credit is secured. Treatment of contractual obligations in insolvency is not sufficiently developed in the Insolvency Law, which also lacks clear provisions on how to deal with subordination debt agreements and financial contracts in bankruptcy. Provisions to deal with insolvency cases of a cross-border nature are fairly antiquated and not responsive to solve main problems typically present in those cases. Utilization of corporate workouts would be significantly increased if out-of-court plans approved by a majority of creditors were able to be converted into prepackaged restructuring plans binding dissenting minorities.

The judicial framework for commercial enforcement and insolvency proceedings is generally perceived as being independent and reliable, although most courts deal with excessive number of processes. Notwithstanding, there are no commercial nor insolvency specialized courts in Chile. Insolvency administrators are independent professionals supervised by the Bankruptcy Commission, a body meeting the requirements of an independent regulatory institution.

The Bill on Second Capital Market Reform, submitted to Congress, is a relevant step in the right direction to make the Chilean creditor rights and insolvency system more effective.

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I. INTRODUCTION

1. The World Bank assessed the Chilean insolvency and creditor rights systems pursuant to a joint IMF-World Bank initiative to develop *Reports on Observance of Standards and Codes* (“ROSC”). The review was carried out based on the World Bank *Principles and Guidelines for Effective Insolvency and Creditor Rights Systems* (“Principles”).² The assessment was performed by a World Bank team in parallel with a financial sector assessment mission (FSAP) in December 2003.

2. The assessment team interviewed a cross section of country stakeholders concerning the effectiveness of the legal infrastructure and its implementation supporting debtor-creditor relationships, corporate insolvency and credit risk management and resolution practices. The conclusions in this assessment are based largely on a review of the Bankruptcy Law, the Civil Code, the Commercial Code, the Civil Procedures Code and other applicable legislation³. In addition to the review of legislation, regulation and related information, the conclusions in this assessment are based on a wide range of meetings with a cross section of country stakeholders and institutions in the public and private sectors.

² World Bank, *Principles and Guidelines for Effective Insolvency and Creditor Rights Systems* (April 2001), http://www.worldbank.org/ifa/rosc_icr.html.

³ The primary legal texts governing creditor rights and insolvency in Chile (including available security rights for these creditors) are as follows: (1) **Civil Code**, whose adapted, amended and systematized text was set by Statutory Decree No. 1 of the Ministry of Justice and was published in the Official Gazette on May 30, 2000 (“**CC**”); (2) **Commercial Code**, published in the Official Gazette on November 23, 1865 (“**CdC**”); (3) **Civil Procedures Code** (Law No. 1552), published in the Official Gazette on August 30, 1902 (“**CPC**”); (4) **Bankruptcy Law** (Law No. 18,175), published in the Official Gazette on October 28, 1982 (“**LQ**”). Other Codes and Certain Special Laws, including especially the following: (5) **Statutory Decree No. 252** of 1960, whose adapted, amended and systematized text was set by Statutory Decree No. 3 and was published in the Official Gazette on December 12, 1997 (“**LGB**”); (6) **Statutory Decree No. 251**, published in the Official Gazette on May 22, 1931, on insurance companies (“**DFL 251**”); (7) **Law No. 18,680**, which, among others, replaced Book III of *CdC* (regarding Navigating and Maritime Trade), published in the Official Gazette on January 11, 1988 (“**Law N° 18,680**”); (8) **Aeronautical Code** (Law No. 18,916), published in the Official Gazette on February 8, 1990 (“**CAr**”); (9) **Mining Code** (Law No. 18,248), published in the Official Gazette on October 14, 1983 (“**CM**”); (10) **Water Code** (DFL 1122), published in the Official Gazette on October 29, 1981 (“**CAG**”); (11) **Law No. 18,092**, Regulations on Bills of Exchange and Promissory Notes, published in the Official Gazette on January 14, 1982 (“**Law No. 18,092**”); (12) **Law No. 4,097**, on Chattel Mortgage on Farm Machinery and Livestock Contracts, published in the Official Gazette on September 25, 1926 and August 25, 1927 (“**Law No. 4,097**”); (13) **Law No. 18,690**, Law on General Bonded Warehouses, published in the Official Gazette on February 2, 1988 (“**Law No. 18,690**”); (14) **Statutory Law No. 776**, on Realization of Pledges, published in the Official Gazette on December 22, 1925 (“**DL 776**”); (15) **Law No. 18,112**, Issues Regulations on Chattel Mortgages without Conveyance, published in the Official Gazette on April 16, 1982 (“**Law No. 18,112**”); (16) **Law No. 4,287**, Law on Bearer Security Pledges made out to Banks, published in the Official Gazette on February 23 and 29, 1928 (“**Law No. 4,287**”); (17) **Law No. 5,687**, Law on Chattel Mortgage Contracts, published in the Official Gazette on September 17, 1935 (“**Law No. 5,687**”); (18) **Law No. 4,702**, Law on Purchase and Sale of Goods and Chattels on an Installment Basis, published in the Official Gazette on December 6, 1929 (“**Law No. 4,702**”); (19) **Law No. 18,045** on the Securities Market, published in the Official Gazette on October 22, 1981 (“**Law No. 18,045**”); (20) **Law No. 18,046** on Public Corporations, published in the Official Gazette on October 22, 1981 (“**LSA**”).

II. DESCRIPTION OF COUNTRY PRACTICE

3. **Chilean national financial system's health is rooted, up to a certain extent, in the effectiveness of the insolvency and creditors' rights system.** Predictable mechanisms for debt enforcement and insolvency proceedings contribute to the development of a modern market economy. Such predictability also fosters confidence that fuels investment, credit, lending and commerce and contributes to a constructive credit-delivery competition. An effective insolvency and creditor rights system plays an important role in creating and maintaining the confidence of both domestic and foreign investors. The general public perception as to the predictability and effectiveness of said insolvency and creditor rights systems not only contributes to the capital flows to Chile but also to the cost decrease of credits. Moreover, the ability of Chilean's financial institutions to adopt effective credit practices to resolve or liquidate non performing loans depends on having reliable and predictable mechanisms that provides a means for more accurately pricing recovery and enforcement costs.

4. **Chilean's corporate insolvency system reasonably complies with what is expected from a modern, credit-based economy:** (i) integration with Chile's broader legal and commercial system; (ii) aiming to maximize the value of a firm's assets by providing an option to reorganize; (iii) striking a balance between liquidation and reorganization; (iv) provision for equitable treatment of similarly situated creditors; and (v) provision for a transparent procedure in which all creditors should be reasonably informed. Although specialized commercial or insolvency courts do not exist in Chile, courts of general civil and commercial jurisdiction apply the Insolvency Law in a reasonably consistent manner. In each insolvency proceeding an independent third party is appointed (the receiver) to represent the general interests of the creditors, the insolvent debtor (if they are of interest to the bankruptcy estate) and administrate the assets of the bankruptcy estate.

A. CREDITOR RIGHTS AND ENFORCEMENT PROCEDURES

5. **Financial institutions over-rely on real estate as collateral.** Although Chilean legislation provides for several security mechanisms, mortgage (*hipoteca*) over immovable assets is the security preferred by financial institutions⁴. This mortgage is governed by the Civil Code, and is typically authorized by a notary and registered at the Registry of Mortgages and Liens of the Real Estate Register of the community where the property of the collateralized immovable asset is registered. Not all Real Estate Registries are interconnected and most use the traditional "book's method". However, users of the system are generally satisfied with its reliability⁵. In addition, most costs associated with the creation and registration of mortgages are considered reasonable⁶.

⁴ Other less frequent mortgages used in practice are: (i) Mortgage on mining claims established by the Mining Code; (ii) Mortgage on ships governed by Law No. 18.860; and, (iii) Mortgage on aircrafts governed by the Aeronautics Code.

⁵ In recent years, and particularly since 1995, in Santiago the registration system has been modernized to a certain extent, incorporating computer technology to the recording process, leading to enhanced efficiency and transparency. Nonetheless, inquiry mechanisms are still quite antiquated and cumbersome. In fact,

6. The list of assets that could serve as basis of a security interest seems to be broad enough to state that the Chilean legal regime recognizes security over most types of movable –tangible and intangible- assets. The enumeration include accounts receivables, intellectual property rights, debtor’s credits against third parties, proceeds (with limitations), future and to-be-purchased assets. On the other hand, Chilean legal regime does not admit the creation of collateral over a shifting pool of assets nor the possibility to take security on a global basis.

7. Financial institutions also accept pledges on movables, but at a higher interest rate than with real estate collateral because various difficulties with the related formalities increase the risk of such securities for banks. Pledges (*prendas*) on movable assets are considered less secure guaranties⁷, so that borrowers must pay higher interest rates than those applied to credit secured with mortgages. This is a matter of special concern to small and micro enterprises because most of these businesses lack immovable assets, and therefore are not able to obtain low-cost mortgaged credit. The Civil Code and the Commercial Code provide for pledges with transfer of the possession of the encumbered asset to the creditor. In practice, only shares and negotiable or credit instruments are collateralized as possessory pledges. Non-possessory pledges, meaning the assets remain in the possession of the borrower, are more widely used as contemplated by numerous special statutes⁸. As legislation on pledges is fragmented, formalities to create these securities vary widely according to the applicable law. Means of publicizing securities over movable assets is also problematic as not all pledge laws provide for registration of this class of security. Moreover, where registration is required not all pledges are filed at the same registry. The mentioned circumstances –fragmented legislation, different formalities and publicizing methodologies, and, lack of single registry for pledges- bring about uncertainty to pledges and lower the value of movable assets as collateral⁹.

8. Guaranties other than right *in rem* securities are also used, but in most cases to reinforce the latter. Personal guaranties such as bonds (*fianza simple*), joint-and-several guaranties (*fianza y codeuda solidaria*) and guarantee by endorsement (*aval*), and other security legal methods like leasing contracts (*arrendamiento financiero*), are also

there are no computerized mortgage inquiry mechanisms (only certificates). However, an automation project is now under study and expected to improve service.

⁶ The fees charged by the registrars are fixed by the Ministry of Justice. At present, these fees have a ceiling of CH\$259,000 for acts or contracts in excess of CH\$128,000,000. In the case of indeterminate acts or contracts, fees equal 2 or 3 per thousand of the fiscal appraisal value of the asset in question and, for want of such a value, they are set at CH\$2,585.

⁷ Several interviewed lenders mentioned pledges as “second class guaranties”.

⁸ Namely: (i) pledge without conveyance (Law No. 18.112); (ii) industrial pledge (Law No. 5.687); (iii) farming pledge (Law No. 4.097); (iv) pledge on bearer securities in favor of banks (Law No. 4.287); (v) pledge on commercial paper and credit instruments (Law No. 18.092); (vi) pledge in bonded warehouses or warrants (Law No. 18.690); (vii) pledge on chattels sold on credit (Law No.4.702); and, (viii) pledge on creditor monies or assets delivered to be administrated by the manager in charge of a long term debt securities issue and pledge on publicly offered securities, coins, silver and gold bullion or other bearer securities or credit instruments, intended to secure obligations of stock brokers among themselves or with stock exchanges or their clients or any of these with the former, for securities brokerage operations or supplementary activities authorized by law (Law No. 18.045).

⁹ Bank regulations establish that financial institutions using movable assets as collateral should consider only 50% of the appraised value of the asset as truly covering or securing the loan.

usual in financial transactions. However, these do not tend to increase the borrowing capacity of the borrowers, but rather to complement other guarantees already provided. Guaranty trusts (*fideicomiso de garantía*)¹⁰ are not utilized in the current market practice.

9. The proposals in the Bill for Capital Markets II Reform Law seem adequate to address current shortcomings of pledge legislation. The Bill addresses the current fragmentation into several codes of the legislation for pledges of movable collateral and the similar fragmentation of the formalities to create security with movables. The draft law would also boost access to finance by creating a single registry for pledges.

10. Enforcement proceedings are lengthy and complicated (both for unsecured and secured creditors). Effective and efficient procedural rules only apply to foreclose banking claims secured by a mortgage performed with the issuance of a letter of credit¹¹ and some specific pledges also enjoy abbreviated enforcement proceedings. Aside these special cases, all enforcement proceedings are generally slow and costly. They are governed by the Civil Procedures Code. There are two categories of proceedings, depending on whether the obligations are evidenced in executory instruments (*título ejecutivo*)¹². If an execution paper exists, specific rules of execution apply (*juicio ejecutivo*), which in theory are brief and coercive. However, this proceeding is in fact a tedious process, where numerous defenses and several appeals may be proposed by the debtor (1 to 3 years). The execution phase –auction of collateral- is also lengthy and complicated. In the absence of execution papers, creditors must resort to ordinary proceedings (*proceso ordinario*), which are even longer (3 to 5 years)¹³. These judicial proceedings are generally quite costly.

11. Chilean legislation does not provide alternatives to judicial enforcement. It can not be contractually agreed in a mortgage that a creditor is granted self hand repossession. The enforcement system is only judicial and non-judicial enforcement methods have not yet been legally admitted. Nevertheless, it is worth mentioning that not only payment default triggers the enforcement mechanism but any other event agreed upon by the parties in the respective agreement. Anticipated enforcement is admitted if payment is accelerated. Acceleration clauses are normally stipulated. In addition, there are factual (non regulated by law) collection instances that have generally proven effective. For instance, there are specialized firms that collect unpaid loans for financial institutions.

¹⁰ *Fideicomisos* in general are not regulated by Chilean legislation.

¹¹ *Ley General de Bancos*, articles 91-111 (*Operaciones hipotecarias con letras de crédito*).

¹² Unsecured creditors may use this process where they can produce the following documents as evidence of their cause of action: (1) Obligations rendered in a public deed before a Notary Public; (2) Obligations documented by bills of exchange, promissory notes and checks (basically, negotiable instruments ruled by the Commercial Code); and, (3) Statements of accounts, where executed by a bank and accompanied by a certification of the financial institution's accountant regarding amount owed. Moreover, through a pretrial motion and procedure (*diligencia prejudicial*) a debtor can be brought before a judge to confess the obligation; once confessed, this pretrial evidence can be used as the basis for an action under the executive proceeding.

¹³ Ordinary suits are protracted since they entail a greater number of procedural stages in which both creditors and debtors assert their rights and defenses, since this presupposes the existence of a questioned or disputed right, not conclusively ascertained to exist.

B. LEGAL FRAMEWORK FOR CORPORATE INSOLVENCY

12. **Chilean insolvency legislation reasonably integrates with the country's broader legal and commercial system.** The Insolvency Law embraces a nearly all-inclusive approach to eligibility. As a general rule, insolvency regulations apply to all natural persons and legal entities. Exceptions are made with banks, financial institutions and insurance companies. As for State owned enterprises, there is a general consensus among scholars that the Insolvency Law does not apply to entities in which the State is the sole owner or the majority shareholder.

13. **Commencement of the general bankruptcy procedure may be applied for by the debtor himself or by one or more of his creditors.** However, "qualified debtors" are bound to file for their own bankruptcy within 15 days after suspension of payment of a mercantile obligation. A debtor that files for his own bankruptcy must submit several documents and pieces of information. In connection with the creditors' filing for bankruptcy, they must specify the grounds for their application and the facts constituting those grounds, attach the documents supporting their statements and furnish the necessary proof. To deter creditors from abusing of their right to request the bankruptcy of the debtor, the Insolvency Law states that in the event the filing and bankruptcy request be finally rejected, the debtor may demand indemnification for damages if proved that said creditor has guilty or wrongfully acted.

14. **Mortgagees and secured creditors can reasonably uphold their rights notwithstanding the existence of an insolvency procedure.** Even though one of the immediate effects of the bankruptcy liquidation commencement is that it stays the creditors' right to individually execute the insolvent debtor's assets, mortgagees and secured creditors are authorized to file or implement actions separately to alienate goods encumbered as security for their respective credit claims. The Insolvency Law, however, provides for a stay period of 90 days, encompassing secured creditors, if a reorganization plan is submitted with the affirmative vote of a majority of creditors representing at least 51% of the debtor liabilities.

15. **The insolvency law provides for a traditional bankruptcy liquidation proceeding, which in practice is quite inefficient.** Bankruptcy proceedings encompass all the assets and liabilities of the debtor (even if not past-due), except for such assets and liabilities expressly excluded by law (e.g., mortgaged or pledged assets). The bankruptcy adjudication has certain immediate and retroactive effects.¹⁴ Realization of the bankruptcy estate, in theory, should be promptly completed so as to satisfy creditors claims with the proceeds thereby obtained. In practice, however, liquidations are lengthy

¹⁴ Noteworthy among the immediate effects are the following: (i) dispossession of the debtor's property, to be administrated by the receiver (*síndico*); (ii) irrevocable establishment of the rights of the creditors; (iii) suspension of the rights of creditors to individually demand payment from the bankrupt (except in the case of mortgage and pledge creditors, unless they consent to the debtor's continuation of its business activities or to the sale of the bankruptcy estate as a business unit); and (iv) suspension of all pending legal action against the bankrupt (save in exceptional cases). In turn, the retroactive effects of the bankruptcy adjudication relate to certain courses of action that the law allows for the receiver and the creditors to void certain acts, contracts or preferences carried out, entered into or created by the debtor prior to the bankruptcy adjudication, when such acts, contracts or preferences have been carried out, entered into or created in bad faith, or else, in the case of gratuitous acts or contracts, to the benefit of relatives, affiliated companies and certain specific creditors.

processes. Its average duration is 24-36 months. Once privileged and secured claims are paid, unsecured creditors (*acreedores valistas o sin privilegio*) typically receive very low distribution rates. As the law does not provide for the treatment of subordinated claims in insolvency proceedings, the effect of a debtor's bankruptcy on subordination debt agreements is uncertain.¹⁵

16. **The current legal treatment of setoff and netting of financial contracts in bankruptcy is doubtful.** The adjudication of bankruptcy bars any setoff not previously effected by operation of law between the reciprocal obligations of the debtor and his creditors, except in the case of related obligations arising under a single contract or a single negotiation process, and even if they are due in different timeframes (Insolvency Law, article 69)¹⁶. This legal provision is not clear as to whether netting and setoff of financial contracts (mainly forwards and swaps) are to be excluded from the general prohibition of setoff after commencement of the insolvency case. Legal interpretation of the mentioned rule is specially dubious or unpredictable when a financial contract has been done under a general framework establishing the conditions ruling all derivatives transactions between the parties ("open contract" or *convenio / contrato marco*).

17. **After bankruptcy is adjudicated, the administration of the property conforming the bankruptcy estate is handed over to an independent third party.** This person is referred to as the receiver and is responsible for, among other things, administrating the goods of the insolvent debtor, continuing his line of business, representing him legally and realizing his assets. Receivers are reasonably qualified independent court-appointed officials selected from a national list of persons, appointed by the Ministry of Justice, who are suitable and have at least three years of attested experience in the fields of economics, commerce or law.

18. **The insolvency law provides for judicial reorganization proceedings but classification of creditors for voting purposes is not allowed.** Formal (in-court) reorganization plans (*convenio judicial preventivo*) may be proposed by the debtor to prevent the commencement of a bankruptcy liquidation process (*quiebra*). After the commencement of the latter, the debtor and its unsecured creditors may still negotiate in-court and approve a plan to lift the bankruptcy adjudication (*convenio simplemente judicial*). All formal (in-court) reorganization plans approved by a legally defined double majority of unsecured creditors (calculated in number of persons and percentage of claims) bind dissenting minorities. According to the law the plan is negotiated only with unsecured creditors. Secured creditors only vote if they become unsecured by relinquishing their security status. The lack of legal provisions allowing classes of creditors for voting purposes may be underscored as a rigidity of the formal reorganization system. This is specially relevant in a context where most financial

¹⁵ According to article 147 of the Insolvency Law, "creditors shall be paid in the form and order of preference established by the laws". Subordination of claims is not regulated by the Chilean legislation.

¹⁶ The Insolvency Law also provides that any set-offs implemented from the date of suspension of payments through the date of bankruptcy adjudication may be rendered void if made with credits acquired against the bankrupt debtor by virtue of an assignment or endorsement, the only requirement being that the assignee must have been aware of the suspension of payments affecting the debtor at the time of the assignment or endorsement.

corporate credit is secured. Moreover, the current law does not provide for a commercially sound form of priority for the ongoing business needs of the debtor in reorganization.

19. **Chilean insolvency system is ill-equipped to deal with cases of a cross-border nature.** The Code of Civil Procedures lengthy provisions on *exequatur* are clearly insufficient to deal with main issues typically present in current cross-border cases (i.e.: access of foreign creditors and insolvency administrators to the local court; easy and speedy recognition of foreign insolvency proceedings opened in accordance with internationally recognized standards of jurisdiction; cooperation between local and foreign courts and administrators, with the goal of maximizing the value of the debtor's worldwide assets, protecting the rights of the debtor and creditors, and furthering the just administration of the proceedings). On the other hand, the International Treaty of La Habana (1928)¹⁷, ratified by Chile, is fairly antiquated, its provisions are insufficient and have limited scope as regards the number of countries bound by them.

C. REGULATORY FRAMEWORK FOR CREDITOR RIGHTS AND INSOLVENCY

20. **Regardless of the fact that Chilean legislation does not provide for judges specialized in commercial or insolvency cases, there is a general perception that insolvency regulations are properly applied by courts.** As the insolvency process is highly complex and demands a specific understanding of and familiarity with financial and business arrangements and finance standards and practice, the judge appoints a receiver from an official list with suitable experience to cope with such complexities.

21. **Courts of general civil and commercial jurisdiction, however, deal with excessive number of commercial enforcement procedures.** Even in cities that are large commercial centers, courts are not specialized so as to have competence in commercial law cases. This is affecting the effectiveness of the courts as a significant number of cases are filed every year. Each civil and commercial court of first instance in Santiago received approximately 9,000 cases in 2003, which is clearly excessive for a single judge. At the appeal level, an aggravating factor is that in several jurisdictions courts of appeals are competent also in labor and or criminal cases. Moreover, courts should apply numerous obsolete civil procedural rules to commercial enforcement proceedings and –though the process for appointment of judges is perceived to be objective and sound- judges are not always selected taking into account the candidate's knowledge of commercial law and related business issues (accounting, business administration, finances).

22. **Excellent continuing education of judges and judicial staff is granted through mandatory courses provided by the Judicial Academy of Chile.** Chilean bankruptcy courts are organized so that all interested parties –including the administrator, the debtor, and all creditors- are dealt with reasonably fairly, objectively and transparently. The regulations relating to the organization of the courts can be found in the Political Constitution of the Republic, the Code of Court Organization, the Civil Procedures Code and other special statutes. The courts are composed of the respective judge and the clerk

¹⁷ Also known as “*Código Bustamante*”.

(who acts as an authenticating officer and depository of the case files and documentation and papers filed with the court). The judge is also aided by various clerical personnel.

23. **The competence, quality and standards of the courts' resolution are supervised by the Court of Appeals whereas the receiver's activity is subject to the oversight and control of the Bankruptcy Commission.** This autonomous institution supervises and controls the activities of receivers in all technical, legal and financial aspects of their receivership and is subject to the supervision of the General Comptroller's Office solely with regard to the examination of its income and expense accounts.

24. **The establishment of the Bankruptcy Commission meets the requirement of an independent regulatory and supervisory institution.** The authority given to said Bankruptcy Commission seems specific and broad enough to enable it not only to have a general overview over bankruptcy proceedings in Chile but also to contribute to a further development of the respective legal framework.

25. **The fact that the Supreme Court be ultimately responsible of supervising the conduct of the judges and the Bankruptcy Commission be the direct supervisor of the receivers' conduct fosters the concept of having a transparent insolvency system requiring for the integrity of all participants.**

D. CREDIT RISK MANAGEMENT / INFORMAL WORKOUTS

26. **Maximum interest rate limits prevent banks from penetrating higher risk segments, in particular riskier micro firms.** Chile's law imposes maximum interest rates (*tasa máxima convencional*) on financial transactions. These rates vary according to the nature and amount of the transactions involved. For micro loans, the highest interest rate allowed was 39 percent at the end of 2003. This rate is lower than interest rates generally charged by specialized institutions on micro loans. Since rates tend to be differentiated according to borrowers' own level of risk, the maximum rate which these institutions charge to their riskier borrowers is even higher. Therefore, capping interest rates at 39 percent prevent Chilean banks to offer micro loans to riskier classes of micro firms¹⁸.

27. **The stamp tax levied on almost all financial transactions also penalizes borrowing by micro and small firms.** Chile levies a stamp tax of maximum 1.7 percent (*impuesto de timbre*) on nearly all financial transactions^{19, 20}. This tax penalizes small

¹⁸ Chile is in fact an outsider in Latin America in this regard as most countries have now completely liberalized interest rates, including Brazil, Argentina, Peru, Bolivia, Mexico, and Ecuador. In addition, the experience of several of these countries has shown that consumer protection measures work better to prevent abuses while allowing banks to penetrate riskier segments.

¹⁹ According to the law, the stamp tax is levied on the issuance of promissory notes and other similar commercial papers. Notwithstanding, this tax is charged on all financial transactions because in practice banks request all debtors to sign a note, which is an executory instrument (*título ejecutivo*), so as to allow the bank the eventual use of an enforcement proceeding in case of the debtor's default.

²⁰ The stamp tax is progressive and depends on the loan amount and its maturity. It varies from 0.14% per month to a maximum of 1.7% of the credit value.

value loans that are renewed often as the credit history of new small borrowers is being built with the bank. As such it creates a distortion in favor of larger loans, which usually go to large firms.

28. **The quality and trustworthiness of the financial statements of micro, small and medium firms is a key obstacle for them accessing any type of financing.** Credit bureaus function well, so that bankers often prefer relying on scoring systems (and offering consumer loans to small entrepreneurs) than having to look at their financial statements. The latter indeed completely lack credibility in the eyes of bankers. They are not homogeneously presented, are not audited by anyone, and exist usually in various versions depending on whom they are designed for.

29. **Informal workouts and restructuring (non-judicial reorganizations) are briefly regulated in the Chilean Insolvency Law.** Debtor and creditors may enter into such agreement providing the terms and conditions they deem appropriate as long as, among other requisites: (i) the restructuring agreement is approved unanimously; and (ii) the debtor details the state of his business affairs as set forth in his balance sheet or inventory (as applicable).

30. **Though workouts are used in practice, a significant shortcoming of the current system is that it does not provide for an expeditious way to convert a workout approved by a majority of creditors into a prepackaged restructuring plan binding dissenting minorities.** The mentioned feature would explain why some creditors prefer formal (in-court) reorganization plans so as to be sure that all unsecured creditors –including hold-outs– are encompassed by the restructuring agreement.

E. DEVELOPMENTS

31. **Last year, the Executive submitted a Bill to the Congress to reform the capital market (“Second Capital Market Reform Bill”), including new regulations on pledges without conveyance and to provide for the creation of a Sole or Unified Registry of Pledges.** Provisions of the Bill will replace four different laws on pledges currently in force. Once these regulations come into force, the pledges without conveyance shall be granted and redeemed by means of a public or private deed, which signatures certified by a public notary. Furthermore, these pledges shall have to be registered in the Sole Registry of Pledges to be created by this bill. Pursuant to the proposed draft, the pledges shall be acquired, proven and maintained with this registration. All kind of obligations, present or future, whether determined or not as of the date of contract could be secured. The legislative project also admits the possibility of successive pledges over the same pledged item. Pledges may be furnished on all kinds of tangible chattels, securities or rights the disposition of which is not forbidden as of the date of execution of the contract. The enhancement of types of structured products that can be created with legal certainty is expected to establish the legal basis for the proper development of a lending and borrowing facility for securities and for more standard repurchase agreements that involve the pledging of securities in exchange for cash.

32. **As regards set-off in insolvency proceedings, Second Capital Market Reform Bill expands the concept of related obligations to include those arising from swaps**

or financial derivatives operations (*operaciones de canje o de derivados financieros*).

It requires those transactions to be entered into under a single master offset and engagement agreement for financial derivatives, and that the terms and conditions of this agreement reflect generally accepted provisions officially determined by a generally-applicable rule of the SBIF (Superintendence of Banks and Financial Institutions). Also falling under the definition of related obligations are those resulting from the offsets conducted under the above master agreement if more than one financial contract or derivative is conducted under said master offset and engagement agreements. Financial derivatives operations conducted in the manner described above shall be deemed due and payable and terminated as of the date of the bankruptcy declaration and offsets to be conducted per this provision shall be executed and calculated simultaneously on that date. Likewise, unless the parties provide for the early settlement of their expenses relating to the financial derivatives in questions, direct damages or loss of profits, or the manner in which these must be automatically calculated in case either party goes bankrupt, these amount shall not be included in the calculation of the offsets regulated hereby. Finally the Central Bank of Chile will be empowered to issue the necessary rules to determine and detail the manner and scope of offsets for related obligations.

33. Second Capital Market Reform Bill also amends the Insolvency Law introducing provisions on subordination of credits. These will contribute to clarify the treatment and effects in bankruptcy of subordination debt agreements quite frequently used in syndicated loans or project finance credits.

34. Furthermore, another draft Bill has been submitted to the Congress to strengthen the transparency of private reorganizations, the work of receivers and the Bankruptcy Commission. 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 Bill also provides for a broader number of instruments for the Bankruptcy Commission to observe and interfere with insolvency proceedings. The Bankruptcy Commission may apply and interpret the laws and instruct administrators receivers and impose sanctions (i.e. suspension, fines or rebuke them) in the event receivers don't follow the instructions.

III. SUMMARY OF ASSESSMENT FINDINGS AND CONCLUSIONS

35. **Some shortcomings in the legal framework and in its implementation poses challenges to having a fully effective and efficient creditor rights regime.** Priority should be placed on the following:

- **Enforcement procedures.** Enforcement proceedings are lengthy and complicated, both for secured and unsecured creditors (1-3 years). Creditor rights are weakened when creditors have to resort to even more lengthy (3-5 years) and unpredictable ordinary civil proceedings, though these process are less widespread than executive proceedings. No alternatives to judicial enforcement are legally established although there are factual collection instances that have generally proven effective.
- **Collateral legislation.** Several areas of security legislation are broadly consistent with best practices, but the system as a whole presents some shortcuts. This is specially relevant in the case of pledges over movable assets as a result of: (i) current fragmentation of the pledge legislation; (ii) lack of a single registry for pledges; and, (iii) lack of registration of some non-possessory pledges. Bill for Law on Capital Markets Second Reform seems adequate to address mentioned shortcomings of the legislation for pledges.
- **Registries.** Registration of property rights and secured interests on immovable assets is generally reliable and cost-effective, although the adoption of computer technology in all registries would lead to enhanced efficiency and transparency. In the case of secured interests on movable assets, the lack of a single unified registry causes uncertainty to pledges and lower the value of movable assets as collateral. This deficiency of the current system would also be properly addressed if the Second Reform to Capital Markets Bill is enacted.

36. **Regulations on corporate insolvency proceedings generally provide for a balance between the interests of the debtor and the different creditors.** Legal features deserving special attention are underscored as follows.

- **Director and Officer Liability.** The Chilean Bankruptcy Law only provides for director and officer liability in case the bankruptcy is qualified as fraudulent or tortuous.
- **Insolvency proceedings in general.** Chilean legislation on insolvency does not apply to State owned enterprises. In liquidation cases, assets realization is lengthy and quite inefficient. Its average duration is 24-36 months and distribution rates to unsecured creditors is typically very low.
- **Management.** Chilean Law provides for the substitution of management by an independent receiver. Most of these administrators are perceived to be independent and enough skilled to exercise such position.
- **Creditors supervision.** The law does not establish creditors' committees but creditors interests are reasonably safeguarded by establishing a creditors' meeting that enables creditors to actively participate in the insolvency process and that allows the creditors to monitor the process to ensure fairness and integrity.

- ***Treatment of contractual obligations.*** Chilean Bankruptcy Law does not contain a provision allowing for interference with contractual obligations that are not fully performed to the extent necessary to achieve the objectives of the insolvency process, whether to enforce, cancel or assign contracts. There is no provision for a commercially sound form of priority for the ongoing business needs of a debtor in reorganization.
- ***Treatment of financial contracts and subordination claim agreements.*** Current legal provisions are not clear as to whether netting and setoff of financial contracts are to be excluded from the general prohibition of setoff after insolvency proceedings commencement. The effect of a debtor's bankruptcy on subordination debt agreements is also doubtful. Both shortcomings would be largely addressed by the Second Capital Markets Reform Bill.
- ***Treatment of Secured Creditors.*** Secured creditor rights are reasonably protected in insolvency proceedings. Reorganization plans, whether judicial or non-judicial ones, generally have no binding effect on secured creditors. Only secured creditors who have waived their respective rights may take part in the creation of reorganization plans, which binds them in this case.
- ***Reorganization Plan.*** The lack of legal provisions allowing classification of claims for voting is a rigidity of the current system.
- ***Cross-border Insolvency.*** Current legal provisions on international aspects of insolvencies are insufficient and outdated.

37. **The institutional and regulatory framework for creditor rights and insolvency is perceived as sound and reliable though courts of general civil and commercial jurisdiction deal with excessive number of commercial enforcement procedures.**

- ***Role of Courts.*** Chilean judiciary does not enjoy courts specialized in commercial or bankruptcy matters. Knowledge of commercial law and related business issues is not always considered in judges selection process.
- ***Court organization and performance.*** Courts are generally well organized and reasonably staffed. Judges performance is annually evaluated by higher courts.
- ***Supervising Bodies. Receivers.*** The so-called Bankruptcy Commission is an independent and rather efficient regulatory and supervisory institution.

IV. POLICY RECOMMENDATIONS

38. Several measures should be taken to make the Chilean creditor rights and insolvency system more effective. Such measures should operate on both legal and institutional frameworks. A summarized list of the key issues to be addressed is as follows.

Creditor rights and enforcement

- Implement non-judicial means of seizure and sale of collateral providing adequate safeguards for debtor's ensuring their rights are considered and not hindered.
- Improve the civil proceedings efficiency, streamlining formalities and shortening terms in which the debtor may present his evidence and defense.
- Improve the legal and institutional framework for security interests on movable assets, by enacting the Bill on Second Capital Market Reform. Main measures to encourage greater use of pledges would be:
 - ✓ creating a new unified and modern legal regime for pledges;
 - ✓ creating a modern, single and effective registry system for all secured interests on movable assets;
 - ✓ providing adequate staff and sufficient budget to the new registry and taking all relevant steps to its sound, speedy, reliable and cost-effective functioning;
 - ✓ ensuring the bank supervisory authority treats loans secured by pledges adequately;
 - ✓ eliminating or diminishing the stamp tax on loans secured by pledges.

Insolvency legislation

- Consider the possibility of heightening the standards required to directors, managers and officers, achieving the proper balance between reasonable risk taking and responsible conduct towards stakeholders.
- Include state owned enterprises as subjects eligible to insolvency proceedings.
- Provide for third-party independent administration or supervision during the interim period of filing for bankruptcy and bankruptcy adjudication to grant additional protective measures to creditor interests.
- Provide for a timely and efficient advancement of the realization of assets in liquidation. This could be attained through the incorporation of swift and reasonably rigid time limits, necessary to ensure that the process is conducted without delay.
- Incorporate a provision providing for a commercially sound form of priority for the ongoing business need in reorganization. For example, by authorizing the use of existing cash that may be pledged or constitute security or to obtain new funding with assurances and safeguards for the eventual repayment of this funding.
- Allow classification of creditors for voting in reorganization. Voting rights could also be simplified establishing voting by amount of debt rather than number of creditors should be preferred.

- Enhance the participation of creditors in insolvency proceedings, encouraging the creation of creditors committees in reorganization and liquidation.
- Modernize legal treatment of contracts and obligations in insolvency proceedings, by: (a) Designing a specific and predictable system for the debtor-in-possession to continue contracts with pending obligations, including regulation on judicial authorization, if pertinent; (b) Clarifying the role of the counter party for cases where the receiver does not indicate the will neither to continue nor to reject the contract, including the provision for a time-bound rule for the receiver to act on the issue; and (c) Defining the system for repayment by the estate of performances by the counter party after commencement of proceedings and pursuant to judicial authorization of continuity of contract.
- Provide for a clear legal treatment of claim subordination agreements in insolvency proceedings, as established by Second Capital Market Reform Bill.
- Introduce modern rules dealing with the treatment of set-off and netting of financial contracts in insolvency proceedings. As currently drafted, Second Capital Market Reform Bill is an advancement on the current regime. However, regulation to be issued after the enactment of said Bill should incorporate several provisions to make the system fully workable (see: Annex 2 attached to this Report).
- Adopt modern rules –like the UNCITRAL Model Law on Cross-Border Insolvency- to deal with international aspects of cross-border insolvencies.

Regulatory framework

- Assign jurisdiction on commercial enforcement and insolvency matters exclusively to specialized courts in cities that are large commercial centers.
- Encourage the use of alternative techniques such as arbitration or mediation to resolve disputes in insolvency proceedings.
- 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.

Informal corporate restructurings

- Reform the Insolvency Law providing for an expeditious way to convert a workout approved by a relevant majority of creditors into a prepackaged restructuring plan binding dissenting minorities upon court approval.