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Why are distressed LatAm companies seeking US insolvency protection?

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Dan Moss and María Luisa Cánovas

As companies continue to be pinched by pressures brought about by the covid-19 crisis, María Luisa Cánovas and Dan Moss explain why US insolvency protection can offer struggling Latin American corporations a lifeline.

In 2016, Peru's top producer of fishmeal and fish oil, China Fishery Group, filed for Chapter 11 bankruptcy protection in New York, following in the tracks of TMT Shipping, Omega, Marco Polo and Global Ocean. All of them are non-US shipping enterprises with main operations and assets outside the US. But what started as a trend among shipping companies is no longer unusual in other industries and among a wide variety of international players. Since April this year, three of Latin American's largest airlines – Aeromexico, LATAM and Avianca – and one of Mexico's largest retail groups, Grupo Famsa, have filed petitions in the US Bankruptcy Court for the Southern District of New York, seeking relief under Chapter 11 of the US Bankruptcy Code.

Chapter 11 can give Latin American borrowers with US governed debt or a substantial US presence a tactical edge they may not have in restructuring proceedings at home. Chapter 15, a tool for recognising non-US restructuring cases, can also confer significant tactical advantages on borrowers and has increasingly been sought by Latin American companies. Significant recent cross-border restructuring cases of Latin American companies seeking US bankruptcy protection under Chapter 15 include those of Brazilian companies Odebrecht, Oi, Lupatech and Schahin; Mexican builders Geo, Urbi and Homex; Colombian company Pacific Rubiales; and the aforementioned Peruvian company China Fishery Group.

The following Q&A explores why non-US companies consider US bankruptcy protection, and whether your company should be looking into this option.

1. Your company is in financial distress and you have assets in the US. Is it eligible for a reorganisation under Chapter 11?

If your company has any property in the US, such as a single bank account, or has issued securities in the US (under Rule 144 A or Regulation S), it may be eligible to take advantage of the benefits of US restructuring laws. It is not an impediment to seeking relief under the US Bankruptcy Code if your company is organised in, and predominantly operates in, other jurisdictions. Also, there is no requirement that your company be insolvent before seeking relief from US bankruptcy courts. Notwithstanding this low threshold for entry, once your company is in Chapter 11 proceedings, the orders of the US bankruptcy court will have global reach, which is particularly effective if your Latin American company has a significant number of US creditors or contractual counterparties, or operations subject to US jurisdiction.

2. Assuming your company is eligible for a reorganisation under Chapter 11 of the US Bankruptcy Code, why would you consider it?

US law provides debtors with protections that are unavailable under many other jurisdictions around the globe, and even if they are available, they have not been tested as extensively or successfully as in the US. The country with the most experience in dealing with cross-border proceedings is Brazil, the largest economy of the region, which saw the limits of its bankruptcy law tested by several large bankruptcies in 2015, including those of OGX, Oi and Odebrecht.

In Chile, the use of their relatively new insolvency law has been limited to a few debt restructurings (but no restructurings of international bond debt). Mexico, Argentina, Colombia and Peru have also seen few cross-border insolvency matters or debt restructurings in the past five years.

Court specialisation and speed are also differentiating factors. Chapter 11 is overseen by special courts with specific expertise in corporate reorganisations and a mandate to ensure all creditors are treated fairly. This is not the case for most jurisdictions in Latin America, including Mexico and Brazil (except for state courts in São Paulo and Rio de Janeiro), which may create unpredictable outcomes. With respect to the proceedings' timeframe, as a general matter, a traditional Chapter 11 restructuring may take a little more than a year depending upon the scope of financial and operational restructuring necessary, but in many countries in Latin America the process would take multiple years.

What follows are some of the essential elements of Chapter 11 that make it an attractive option for restructuring companies operating in Latin America:

Existing management continues to control the company unless removed for cause (which includes fraud, dishonesty or incompetence). Although this is a common feature in major Latin American jurisdictions, the amount of "control" available to management varies widely. In Brazil, for example, although management continues to run the company, it does so under the supervision of a judicial trustee, the court and the creditor's committee. Also, the creditor's committee can remove the management by a simple majority in a general meeting, which significantly constrains the ability of the management to effectively control the company.

Upon the filing of a Chapter 11 proceeding, an automatic injunction against all creditor actions against the company goes into place, and all creditor actions in the world (subject only to limited exceptions) must cease. Any actions in violation of the stay will be deemed void or voidable by the bankruptcy court (and the actor will be subject to possible sanctions). This automatic stay is not available in many Latin

American jurisdictions, and even where available, as in Argentina, it may not be effective until published (which may take months) or does not apply to secured claims.

The company may terminate executory contracts and leases, which might be particularly helpful to Latin American companies that want to reorganise operations with US-based counterparties. In Mexico, for example, only the receiver may terminate executory contracts or leases. Similarly, in Brazil, the termination of executory contracts or leases by the company is not contemplated under applicable law, although local courts generally prevent landlords from evicting tenants from premises that are deemed necessary to the restructuring process.

The company may borrow money and incur debts to fund its operations while its bankruptcy case runs its course. This type of financing, known as debtor-in-possession (DIP) financing, usually has priority over existing debt, equity and other claims. DIP financing is not contemplated in Argentina, for example, but is available in Mexico, Brazil and Colombia.

The company can sell assets free and clear of encumbrances and claims, such as successor liability claims, and provide clean title to purchasers. Also, all internal affairs of the company in Chapter 11 proceedings continue to be governed by the laws of the jurisdiction in which the company is organised. Although several jurisdictions in Latin America have similar rules, Colombian bankruptcy law for example, does not expressly allow debtors in reorganization proceedings to sell their core assets free and clear of liabilities. Under Brazilian law, it is unclear whether a buyer is liable for any compliance or corruption wrongdoings or environmental matters (although new legislation currently under review may address these issues). In Mexico, although sales of assets are permitted, secured creditors have the right to participate in a concurso without having to release their collateral, which they are entitled to foreclose on, even if such collateral is essential to the survival of the business, which may affect the viability of some restructurings. Also, as a general rule, asset sales in Mexico must be conducted through a public, court-sanctioned, auction process.

For a substantial time, the company’s management has the exclusive right to propose a plan of reorganisation to end the Chapter 11 case. For the proposed plan to be approved, a creditor class comprised of two-thirds of the amount of claims and half of the number of claims must support it. This is not the case in Peru or Colombia, where in certain circumstances creditors can submit their own reorganisation plan, or in Mexico, where the general rule is that the plan of reorganisation is submitted by the receiver. In addition, several jurisdictions in the region have higher approval thresholds.

At the end of a successful reorganisation, debts are discharged and the management is usually released and exculpated from liabilities relating to the restructuring. Again, this is not the rule in many Latin American countries, where a release is the exception instead of the norm.

3. What does a Chapter 11 look like?

There are three general categories of Chapter 11 cases: (i) pre-packaged, (ii) pre-arranged, and (iii) traditional. In a pre-packaged bankruptcy, before filing, the entity and its creditors agree on a plan of reorganisation that generally only adjusts the entity's finances (largely leaving operations alone); the voting on the Chapter 11 plan in a pre-packaged case is commenced before the bankruptcy filing. In a pre-arranged bankruptcy, before filing, the entity and a sizeable number of its creditors agree on a plan to adjust the entity's finances. Setting this process apart from a pre-packaged case, in a pre-arranged bankruptcy the entity may restructure operations by rejecting contracts or selling non-core assets (referred to as a "363 sale") during the course of the case. Also in contrast to pre-packaged bankruptcies, in a pre-arranged case voting is done during the bankruptcy. Lastly, in a traditional Chapter 11 the entity files for bankruptcy and then engages in negotiations with creditors and stakeholders regarding financial and operational restructuring considerations.

4. Is there a "typical" timeframe for a Chapter 11?

Generally, a pre-packaged Chapter 11 can be completed in one day or it may take as long as 60 days and a pre-arranged Chapter 11 can take between four and nine months. In both cases, it typically takes approximately two to six months of negotiations between and among the debtor and its various creditors and other stakeholders leading up to the bankruptcy filing. A traditional Chapter 11 case can take anywhere from six to 12 months (possibly longer), depending upon the scope of financial and operational restructuring necessary.

5. If your company does not qualify for Chapter 11, are there other US options?

Yes, Chapter 15 of the US Bankruptcy Code allows a US bankruptcy court to recognise and oversee a US Chapter 15 proceeding ancillary to either a foreign "main" or "non-main" proceeding. A foreign main proceeding is a proceeding outside of the US where the entity's main interests (eg, assets, creditors, operations) are located. A foreign non-main proceeding is a proceeding in a jurisdiction where the entity does not have its main interests.

The type of relief available in a Chapter 15 proceeding will vary based on whether it is ancillary to a non-US main or non-main proceeding.

A Chapter 15 proceeding, by itself, cannot be utilised to effectuate a restructuring. Rather, Chapter 15 proceedings provide relief ancillary to non-US restructuring proceedings. An entity might choose to file a Chapter 15 proceeding to, among other things, obtain formal US court recognition of the entity's foreign restructuring (thus binding US-based creditors) or facilitate lawsuits (eg, for recovery of property) against parties or property located in the US.

6. What should non-US entities consider when evaluating Chapter 11 or local restructuring laws as potential venues?

First and foremost, the entity must ensure that the necessary jurisdictional requirements in the US are satisfied. If entities manufacture jurisdiction, the court, creditors, or other stakeholders may challenge the veracity of the jurisdiction. Other important considerations include, among others, finding answers to the following key questions: what are the goals of the restructuring – ie, are they merely financial or financial and operational? And what law governs such financial instruments? Where are the operations of the company physically located? Does the company require new investment? What creditors will support (or oppose) the contemplated restructuring, and where are they located? What other parties need to be bound by the restructuring, and are those entities subject to US court jurisdiction? What does the debtor need to do to protect assets in foreign jurisdictions? Is it possible for foreign creditors to commence insolvency proceedings in foreign jurisdictions? Will obtaining recognition or cooperation from relevant non-US courts be necessary or possible?

The specific goals, facts and circumstances of the company in distress will need to be carefully evaluated by a team of experienced financial and legal advisors to chart the path forward.

7. What fiduciary obligations do I need to be mindful of if my company is in distress?

Generally, under US law and precedent, boards and management should consider the interests of shareholders and secured and unsecured debt holders and take actions that maximise overall enterprise value. Directors need to ensure that they are fully appraised as to their respective statutory and fiduciary duties in each relevant jurisdiction. More generally, it will be important to hold regular board meetings and ad hoc meetings as circumstances warrant.

Lastly, retention of restructuring specialists (ie, counsel, financial advisors, investment bankers) is important to ensure the board and management have proper professional advice.

After going through the above exercise, it may not make sense for your company to go ahead with a US restructuring, but at least you will have explored all options open to you and your shareholders. Although Chapter 11 and Chapter 15 proceedings can be costly, the expediency and predictability of the US proceedings, along with the rights to continue to manage your company, obtain financing and sell assets during the process, may make such proceedings worth the cost. Taking advantage of the US Bankruptcy Code can not only save your company, but provide it with a fresh start.

María Luisa Cánovas and Dan Moss are partners in Jones Day’s New York and Washington, DC, offices, respectively. The views and opinions set forth herein are the personal views or opinions of the authors; they do not necessarily reflect views or opinions of the law firms with which they are associated.

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Country: Peru, Brazil, Mexico
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