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Colombia: Creditor Rights and Insolvency Proceedings

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ABSTRACT

This article analyzes the legislation and institutions connected with creditor rights and insolvency proceedings in Colombia. It aims to contribute to the debate on the conditions required to restore the vitality of the Colombian credit environment. In relation to creditor rights, there is a particular emphasis on mechanisms for establishing security interests used in granting corporate credit. The analysis identifies the principal factors affecting the efficiency of security interests. These include deficiencies in substantive and procedural law, as well as in registry organization. The paper goes on to analyze the legal, institutional and regulatory framework for insolvency proceedings, identifying weaknesses and highlighting strengths that insolvency reforms should aim to preserve. The need for attention to corporate workouts and prepackaged reorganization agreements is also addressed. The paper concludes with prioritized recommendations for a plan of legal and institutional reform intended to improve the credit environment, creditor protection and enable the establishment of a more balanced insolvency system. Applying the recommendations to Senate Bill 207/05 (Insolvency Regime) makes it possible to identify the strengths of the Bill, as well as refinements that might be considered so as to reduce the legal uncertainty, which limits the growth of banking credit in Colombia, and to achieve a reduction in credit costs, particularly for small and mid-sized companies.

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SUMMARY

GENERAL CONSIDERATIONS

In Colombia, there is currently a widespread perception that the risks faced by credit providers are high, even where a creditor holds security interests. This perception is based on the existence of legal and institutional factors which act as obstacles to the creation of a favorable environment for credit expansion at an accessible cost. This situation affects a wide range of users, especially small and mid-size businesses which face serious difficulty in obtaining credit in the regular financial market.

Secured creditors have little confidence in the various security interest mechanisms provided by Colombian law. This is a severe problem, for in developing countries secured credit plays a particularly important role because capital markets are usually less mature than credit markets. As a result, most financing (in particular, for small and mid-size firms) is obtained in the form of debt, and lenders routinely require security to reduce the risk of default and insolvency.

Notwithstanding the use of collateral, the risk of default is not adequately reduced. Colombian individual enforcement mechanisms are notoriously flawed and there is marked bias against creditors' rights in insolvency proceedings. The rigidity of the security interests regime, the diminished priority attached to such interests by the civil law and weaknesses in the registry systems, all contribute to the low regard in which collateral is held in Colombia.

The establishment of reasonable creditor protection, especially in relation to secured loans, basically requires: drastic correction of shortcomings related to individual execution against debtors; replacement of the current insolvency system by a new one granting more balanced treatment to the interests and rights of all parties affected by insolvency; reform of the existing substantive law; and improvement of the registry systems.

The initiative of the Colombian authorities to replace the existing insolvency legislation with a new law is to be welcomed. However, there is significant potential for the further improvement of Senate Bill 207/05 on the Insolvency Regime. If this potential is exploited, it would bring the Colombian insolvency system into line with the best international practices, with the resulting benefit for the credit environment and the national economy.

SUBSTANTIVE LEGISLATION ON SECURITY INTERESTS

In Colombia, mortgages and pledges (with or without transfer of possession) are regulated following the usual schemes developed in countries of Roman-Germanic legal tradition. They are widely used in corporate credit, where the increasing use of trusts-in-guarantee is also noticeable. Conditional assignments of credit are used for the settlement of guarantees on creditor rights, and intellectual property and similar rights. Security interest mechanisms, specifically restricted to financing the acquisition of assets (such as reservation of title and leasing) are legally feasible in Colombia, but their use is restricted almost exclusively to the acquisition of motor vehicles.

An important weakness in the Colombian regime on security interests is the limited priority assigned by the civil law to mortgaged debts or pledges. In the ranking of priorities for

collection, these claims are assigned a lower priority than labor and tax claims. This means that mortgagors and pledgees can recover only after the debtor's labor and tax claims have been fully paid (with the proceeds of the mortgaged or pledged assets). This scheme discredits security interests for whatever the value of the mortgaged or pledged asset, it is very difficult, -if not impossible, to estimate in advance the degree of coverage granted by the collateral. To be clear, the reason for this is that labor, tax and other contingent claims, that cannot be estimated in advance, are recoverable in priority to mortgages and pledges when the execution of the collateral and the distribution of proceeds take place.

Other weaknesses of the legislation on secured interests include: (i) the requirement of an excessively detailed description of the asset operating as collateral, which limits the possibility of pledging assets which cannot be fully identified (e.g. generic products, fungible goods or raw material susceptible of transformation); and (ii) the underlying idea that pledges are settled on things (tangible assets) rather than on intangible assets. This restriction is not explicit in the law, but it may implicitly derive from the description requirements contained in the Code of Commerce. These requirements, for example, raise reasonable doubts about the possibility of settling pledges on intangibles in an autonomous way (i.e. separated from the commercial establishment).

REGISTRIES OF SECURITY INTERESTS

In real estate registries, the system of chronological recording in bound books still prevails. There is a long way to go until a complete computerization of the system is achieved. Consequently, procedures are slow by contemporary standards and the information stored is less secure. The geographic fragmentation of real estate registries, and the fact that they lack any interrelationship, also complicates access to information and so increases the costs involved (e.g. because physical travel between registries is required).

Charge registries (movable assets) are more advanced as regards computerization, but they suffer the same defect of geographic fragmentation and lack of electronic interconnection. This severely complicates access to information, increasing the costs involved not to mention the risk of duplicating charges on the same movables.

ENFORCEMENT OF CLAIMS

Another root cause of the lack of effectiveness of security interests is the notorious inefficiency of enforcement and collection mechanisms. The users of the system are united in the opinion that if enforcement mechanisms are not improved, other legislative and institutional reforms related to credit would be worthless.

The principal factors operating against efficient collection of unpaid debts are: (i) private enforcement mechanisms (such as enforcement of pledge bond) provided in Colombian legislation operate in very restricted areas, have limited effectiveness (accelerated judicial proceedings by banking institutions), or their effectiveness is seriously threatened by insolvency legislation (as is the case with trusts-in-guarantee); (ii) Colombian legislation does not provide for enforcement mechanisms with minimum judicial intervention (i.e. that would allow secured creditors to require the action of a judge with the sole purpose of obtaining the quick possession of the asset and having it sold privately); (iii) judicial enforcement mechanisms, whose prototype is the executory proceeding (used by the majority of creditors) involve a long and arduous process whereby debtors can propose defenses that lead to extreme delays on collection (reported delays vary between 4 and 7

years). The abusive use of procedural mechanisms of defense is seldom sanctioned with sufficient effectiveness so as to discourage the practice.

INSOLVENCY PROCEEDINGS

The Colombian insolvency legislation puts secured creditors in a very unfavorable position. It shows a marked bias against secured creditors, divesting collateral of its primary function of protecting creditors against the debtor's insolvency. Indeed, the insolvency legislation has the potential to destroy any system of security interests provided for in the civil or commercial law. In insolvency proceedings, the priority of claims with a pledge or mortgage (*per se* diminished in civil law) is virtually eliminated. First and foremost, this results from the voting system in reorganization agreements, in which the ranking of creditors' claims is not respected. Furthermore, majorities made up of categories of unsecured creditors, in addition to the category of the so-called "internal creditors" (the name given by Colombian insolvency law to those who, not in fact creditors, are merely shareholders of the insolvent company), can decide on the fate of secured creditors without their consent, alter their priorities and modify the conditions of their claims. The situation of trusts-in-guarantee is no different, for in insolvency proceedings they are converted into security interests (mortgages or pledges).

The current framework for insolvency proceedings was reformed in 1999, when Law 550 introduced major changes in order to accelerate the very protracted and ineffective *Concordato* proceedings. Law 550, still in force, was passed as a temporary law for an emergency period. However, its expiration has been postponed to December 2006. The focus of legislative policy at the time the Law was passed seems to have been the protection, at all costs, of debtors in financial distress or insolvency. This naturally prejudiced creditors' interests. Outside the crisis context, an insolvency law excessively skewed against creditors is detrimental to credit expansion and therefore, to the development of the Colombian economy.

There are positive features of the current Colombian insolvency system that, with necessary adjustments, any reform should aim to preserve, namely:

- ✓ The generic integration of the insolvency law system with other domestic laws, which avoids conflicts between legislative orders, and gives the insolvency law priority over non insolvency law in insolvency situations;
- ✓ The existence of a reorganization proceeding for viable, and a liquidation proceeding for non viable, businesses;
- ✓ The transparency of insolvency proceedings (reorganization and liquidation) as secured by clear rules, public access to the procedures, supervision of the jurisdictional authority, and availability of information and statistics on insolvency proceedings;
- ✓ The real information disclosure about the debtor's financial statement and businesses, both through his contribution and by means of statistics and reports provided by the Superintendent of Companies;
- ✓ The non discriminatory treatment of foreign creditors vis-à-vis local creditors;

- ✓ The prevention of the premature dismemberment of the debtor’s assets, achieved by staying the creditor’s individual enforcement actions after the opening of the reorganization or liquidation proceedings (“stay”).

The main adverse features of the current Colombian insolvency system, where the attention of legal reform should be focused, are:

- ✓ The system relating to classes of creditors, that includes shareholders of the insolvent company as “internal creditors”;
- ✓ The system relating to voting in reorganization agreements, that does not respect the rank of classes nor priorities regarding the respective claims;
- ✓ The possibility of altering the legal priority of claims, establishing the so-called “consensual priorities” via a reorganization agreement imposed by creditors of a lower rank (and shareholders) on secured creditors, whose own priorities are altered without their consent;
- ✓ The lack of preservation of effectiveness in trusts-in-guarantee (in insolvency proceedings), whose beneficiaries are virtually converted into mortgaged or secured creditors;
- ✓ The lack of a reasonable temporal limit to the stay of execution of secured claims;
- ✓ The lack of creditors’ standing to request the opening of the debtor’s insolvency liquidation proceedings;
- ✓ The lack of effectiveness of actions seeking to establish personal liability on the part of directors and officers;
- ✓ The insufficient regulation of the effects of the proceedings on executory contracts, and the excessive sanctions that can be currently applied to the party trying to enforce the cancellation of the contract (another aspect reflecting bias against creditors);
- ✓ The delays in the recognition of contentious claims;
- ✓ The lack of modern rules to deal with problems in proceedings with foreign elements;
- ✓ The lack of institutional independence of the Superintendent of Companies, an administrative entity with judicial authority in insolvency proceedings;
- ✓ The lack of judicial control over the vast majority of decisions ruled on by the administrative authority in insolvency proceedings;
- ✓ The limited effective qualifications and other defects in the system of remuneration for Promoters;
- ✓ The limited utilization of corporate workouts to solve the financial difficulties or the insolvency of companies;
- ✓ The non existence of legal regulations addressing prepackaged reorganization agreements.

The ongoing reform of insolvency laws provides a clear opportunity to incorporate the most successful international standards into Colombian law, consolidating its current strengths and modifying factors that weaken the present system. Bill 207/05 on the Insolvency Regime improves certain aspects of the existing insolvency system, but as yet issues that are fundamental to the improvement of the Colombian system (as outlined by the recommendations made in this paper) have not been addressed.

RECOMMENDATIONS

Numerous and detailed reforms are needed in the legal and institutional framework of creditor rights and insolvency proceedings. That said, undertaking a complete reform of civil and commercial legislation so as to establish an integrated, completely new regime for security interests is not a priority. Taking this latter approach would probably lead to inconclusive debates, which would delay urgent and essential reforms. This view does not rule out the possibility of starting a debate on the advisability of deepening the changes to the substantive legal regime on security interests, preferably after having assessed the results of reforms classed as priorities 1 and 2 in our recommendations.

Priority 1

- ❖ Secured creditors must have higher priority in the ranking or legal hierarchy of secured claims.
- ❖ Out-of-court enforcement mechanisms must be expanded so that they can be used in relation to every class of security, on movables and immovables, used as collateral for corporate credit granted by regular financial entities. Existing rules preventing the out-of-court effectiveness of trusts-in-guarantee must also be suppressed.
- ❖ Enforcement mechanisms with minimum judicial intervention should be created.
- ❖ The procedural legislation must be reformed so that executory proceedings lead to genuine enforcement, mainly by the limitation of defenses and appeals, simplification of the procedure for the seizure and auction of assets, and provision of sanctions against malicious litigants.
- ❖ Insolvency legislation should be significantly reformed, introducing at least the following reforms, aiming at:
 1. Eliminating the class of the so-called “internal creditors”;
 2. Respecting creditor priorities in insolvency proceedings;
 3. Suppressing or eliminating “consensual priorities”;
 4. Preserving the validity of trusts-in-guarantee so that in insolvency proceedings they are not converted into mortgages or pledges;
 5. Establishing, for creditors with a right *in rem*, reasonable temporal limits to the stay of execution, granting them suitable safeguards during the stay;
 6. Granting the possibility of approving, in a fast-track procedure, the reorganization plans approved by a significant majority of creditors during informal negotiations held with the debtor;
 7. Enabling creditors to request the commencement of liquidation proceedings;

8. Streamlining, and encouraging the use of, actions seeking to establish personal liability on the part of the directors and officers of the insolvent company;
9. Adopting a modern system for the integrated and balanced treatment of the effects of insolvency proceedings on pending contracts;
10. Simplifying and speeding up the procedure for the recognition of contentious claims;
11. Adopting modern rules for the international aspects of insolvencies;
12. Establishing the independence of the administrative authority with jurisdiction over insolvency proceedings;
13. Strengthening the right to defense at trial pursuant to due process and allowing appeals from the decisions of the Superintendent of Companies to the courts of the judicial branch the decisions of the Superintendence of Companies; and
14. Establishing a system for the selection, training, remuneration and removal of Promoters to ensure their effective performance.

Priority 2

- ❖ Relaxing the legal regulation of possessory pledges, so that the possibility of settling that security interest on every type of movable, tangible or intangible, is clear.
- ❖ Computerizing the registries involving immovables and filings related to movables, and interconnecting them.
- ❖ Creating a favorable environment for amicable or informal negotiations of out-of-court agreements, in order to resolve severe financial difficulties or corporate insolvency.

SENATE BILL 207/05 ON INSOLVENCY improves some aspects of the current insolvency system, but does not yet address recommendations fundamental to the improvement of the Colombian insolvency system. As to the 14 recommendations suggested in this paper - which focus on those aspects of the Colombian system that are most different from best international practices - the Bill completely fulfills four recommendations (“Observed”) and represents significant progress in relation to another two (“Largely Observed”). The Bill does address six of the recommendations (“Not Observed”) and in fact, worsens the existing state of affairs in relation to two of the recommendations (“Materially Not Observed”). The eight recommendations in these last two categories relate to critical aspects of the insolvency system. In order to bring the proposed legislation into line with the best international practices, creating a balanced insolvency system contributing to the restoration of the confidence in the Colombian institutional and legal framework on credit rights, it is therefore necessary to introduce some modifications to the Bill.

INSOLVENCY RECOMMENDATIONS		
AND		
BILL 207/05		
Observed: 1st, 6th, 10th, and 11th	4	O
Largely Observed: 3rd and 8th	2	LO
Materially Not Observed: 2nd and 9th	2	MNO
Not Observed: 4th, 5th, 7th, 12th, 13th and 14th	6	NO

I. INTRODUCTION

1. **The legal system’s effective regulation of creditor rights is an important element of financial system stability, contributing to the creation of a sound environment where credit is extensively provided at an accessible cost.** This is vital for economic growth. A sound credit environment helps a larger number of people and companies, particularly small and mid-size firms, to gain access to affordable loans with reasonable interest rates. Contrarily, when there is high legal risk, the access to credit is hindered or is unattainable for many users who need it.

2. **High legal risk, whether real or perceived, produces negative effects on credit including:**

- ✓ Increasing excessively the cost of credit;
- ✓ Leading to disproportionate requirements for security interests that many credit users cannot meet;
- ✓ Leading credit providers to withdraw credit lines from most of small and mid-size firms.

3. **Both the design of laws (legal framework) and the operation of institutions (institutional framework) recognizing, regulating and enforcing credit agreements are closely related to credit flow and cost. Thus:**

- The **legal framework** must:
 - ✓ Enable the **creation** of security interests in all types of assets—movable and immovable, tangible and intangible.
 - ✓ Provide efficient **publicity and registry** rules adaptable to every type of property.
 - ✓ Establish clear rules of **priority** between claims and interests of a plurality of creditors over the same assets of the debtor.¹
 - ✓ Provide for predictable, transparent and affordable **collection and enforcement systems**. This requires the following: (i) if the debtor is not under an insolvency proceeding, effective **collection and individual execution mechanisms** (judicial, non-judicial or mixed mechanisms); and (ii) if the debtor is insolvent,

¹ As used here, the term “priority” refers to the creditor’s right to be paid in a preferential manner (out of the proceeds of the sale of the debtor’s asset or assets) as against other creditors of the same debtor. In this sense, the word “priority” can be considered as a synonym of “preference” and “privilege”. Creditors having no “priority” (called “without priority”, “common” or “ordinary”) recover only after the priority credits have been paid. Priority credits can have different priorities according to the “degree”, “rank” or “class” ascribed by the law; hence, creditors with priority are arranged into a hierarchy. For example, a creditor with a security interest on an immovable (mortgage) has a priority as against common or ordinary creditors, but that might not be the case as against labor or tax creditors. This is the situation under the existing Colombian law, which provides that labor and tax creditors with a higher priority than others with secured claims: Civil Code, Articles 2488-2511, see in particular Articles 2495 to 2499, transcribed in Annex 2.

reliable **insolvency proceedings**² (both reorganization and liquidation). Such systems (individual execution and insolvency proceedings) must be designed to work in harmony.³

- The **institutional framework** is essential in order to implement the provisions of the legal framework. They must be implemented through independent, stable, predictable and efficient institutions. If the institutional framework does not lead to predictable application of the legislation, efforts to improving credit laws will have very little impact on the flow of credit and the cost of credit. Thus, in every reform program concerning these areas the following institutions are crucial:
 - ✓ The **registries** of security interests on movables and immovables;
 - ✓ The competent **administrative and judicial institutions**, in individual creditor enforcement proceedings or in insolvency proceedings.

4. **In Colombia, there is a widespread perception of high legal risk for credit delivery, even when the creditor holds security interests. This affects a wide group of users who remain beyond the possibility of access to credit in the regular financial circuit.** In the Colombian credit regime, the extremely unfavorable situation of creditors and particularly of secured creditors has been identified as the principal problem. It is a severe problem. In developing countries, secured credit plays a particularly important role because capital markets are usually less mature than credit markets. As a result, most financing – particularly for small and mid-size firms - is obtained in the form of debt. In markets with fewer options and higher risks, lenders routinely require security to reduce losses associated with risks of default and insolvency. Due to the fact that holding collateral does not ensure swift and efficient recovery in Colombia, credit interest rates are not significantly affected by the provision of security. The excessive protection of debtors therefore results in reduced credit availability, even to companies that can offer high-quality security. This legal uncertainty is probably one of the factors that have promoted the formation of mixed corporate groups, as institutional alternatives to the lack of legal certainty concerning security interests.

5. **Colombian substantive law (particularly, the Civil Code and the Code of Commerce) provides for a variety of security interests on movables and immovables, but in practice the secured transactions system does not protect creditors.** This is because there are very distinct shortcomings in mechanisms for collection and individual execution, as well as in insolvency proceedings. The consensus among system users is that executory mechanisms and insolvency proceedings are the main problems with the existing regime for secured transactions. There are also some rigidities in the legal regime concerning collateral, as well as weaknesses in the registry systems. These contribute to the low regard in which security interests are held in Colombia. Reasonable creditor protection, especially in relation to secured loans, requires: (i) that shortcomings related to

² In this paper, the terms “bankruptcy proceedings” and “insolvency proceedings” are used as synonyms, as a genus comprising both “reorganization” (or “reorganization proceedings”) and “liquidation” (or “liquidation proceedings”).

³ The legal framework for corporate insolvency, striking a careful balance between liquidation and reorganization, must emphasize the importance of acknowledging the creditor’s rights and respecting its priorities by means of a predictable and impartial process.

individual executions and insolvency proceedings are urgently addressed, (ii) that additional reforms are made to the existing substantive law and (iii) that registry systems are improved.

6. Colombian insolvency proceedings are biased against creditor’s rights, in particular the rights of secured creditors. The main reason for this is that the current reorganization Law 550 was passed within the context of a severe crisis. It was conceived as a temporary, emergency law. However, its anticipated life-span has already expired and current economic conditions no longer resemble those that prevailed at the time that Law 550 was drafted. It is therefore appropriate to adopt a more balanced approach in future insolvency legislation. In a period of greater economic normality, when concerns about credit expansion should be the central focus, the excessive bias against creditor rights is harmful.

7. This paper suggests that with the restoration of a more favorable environment for credit, tangible results benefiting users in need of credit, at reasonable costs, could be achieved. This would promote economic growth. Hence, the core objectives of this study are to:

- ✓ Identify and describe the major problems connected with the current legislation, and the institutions, related to creditor rights and insolvency proceedings;
- ✓ Recommend an adequate, coordinated and sustained set of actions, relating to the legal and institutional framework, to address the main factors underlying the current widespread perception about the weakness of creditors’ rights in Colombia; and
- ✓ Evaluate Senate Bill 207/05 on the Insolvency Regime, with a focus on those aspects where the existing Colombian system is most different from the best international practices, and the extent to which the Bill fulfils the recommendations aimed at a holistic improvement of the insolvency system.

8. A comprehensive and new regime for security interests? Introducing a comprehensive regime of security interests to substitute the current legal framework would demand the abolition of numerous institutions and norms of the Civil Code and Code of Commerce. These have a long tradition and are deeply-rooted in Colombian legal culture and commercial practice. Consequently, whole scale reform is likely to be met with many objections, as well as the likelihood of lengthy and inconclusive debates which would delay the urgent and essential reforms discussed in this paper. Furthermore, while such extensive reform might lead to an integrated regime of new security interests, it is not clear that the overall effect would be favorable for the credit environment unless the other major priorities that are discussed here were also addressed. These include considerably improving the priority of secured claims, enforcement mechanisms and insolvency proceedings. Consequently, we conclude that a complete reform of the civil and commercial law on security interests is not an urgent priority. Nevertheless, it might be widely considered and discussed in due course, after assessing the results of the reforms that we recommend as priorities.

9. This work contains several Parts and Annexes. Following this Introduction, Part II analyses creditor rights, with special emphasis on the security interest mechanisms used in granting corporate credit. This section also identifies the main factors affecting the efficiency of security interests, including deficiencies in the substantive law, registry

organization, and procedural and insolvency legislation. Part III focuses the analysis on insolvency proceedings, identifying the system's strengths that should be preserved by the insolvency reform, and analyzing in detail the main weaknesses to be corrected in the legal, institutional and regulatory framework. The need to draw attention to corporate workouts and prepackaged reorganization agreements is emphasized. Part IV describes, in terms of priority, the recommendations deemed to be fundamental and convenient for a plan of legal and institutional reform intended to improve the credit environment, creditor protection and the establishment of a more balanced insolvency system. In the Annexes, first, there is an evaluation of aspects of the Bill on the Insolvency Regime, by reference to recommendations (discussed in the body of this paper) based on international standards; and (ii) there is a transcription of the current legislation on creditor priorities, deemed relevant for a more complete understanding of the present system.

10. **Several sources have been used in the preparation of this work.** This document draws on various written sources in addition to several interviews conducted in Colombia. The ICR ROSC (*Insolvency and Creditor Rights Report on the Observance of Standards and Codes*) program was carried out within the framework of this study, and related to a financial system assessment mission (FSAP) that took place during the latter half of 2004. Further interviews with users and experts on the corporate credit system were held in the course of another World Bank mission in Colombia in mid-October 2005. Besides the works cited herein, previous works of the World Bank, as well as of other international organizations have been consulted and considered.⁴ Successful international practices and standards in the area of creditor rights and insolvency proceedings are frequently cited - expressly or implicitly - throughout this document. The two leading sources for the identification of such practices are: *Principles for Effective Insolvency and Creditor Rights Systems* (World Bank, revised version 2005), available at www.worldbank.org/gild) and *Legislative Guide on Insolvency Law* (United Nations Commission on International Trade Law (UNCITRAL), available at www.uncitral.org).

⁴ These include: Colombia Land Policy in Transition Reform, Report No. 27942-CO, World Bank, January 29, 2004; Colombia Rural Finance – Access Issues, Challenges and Opportunities, Report No.27269-CO, World Bank, November 2003; Colombia: Expanding Access to Credit – Case Study on Secured Transactions, by Heywood W. Fleisig & Nuria de la Peña, CEAL, Washington, DC, September 2005; Colombia: *Plan de Manejo para Fortalecer los Derechos de Propiedad*, USAID, July 6, 2005; Do Reorganization Costs Matter for Efficiency? Evidence from a Bankruptcy Reform in Colombia, by Xavier Giné & Inessa Love, World Bank 2006.

II. CREDITOR RIGHTS

II. 1. GENERAL ISSUES

II. 1.1. Contractual rights

11. **The Colombian legislation and jurisprudence recognize rights derived from contracts.** Contractual rights are enforceable in the courts. The courts recognize that a contract is “the law between parties” and that the “principles of legitimate good faith and reciprocal trust must be respected in civil and commercial transactions”.⁵ It is worth noting that the 1998 crisis led to a legislative⁶ and jurisprudential interference with credit agreements.⁷ Bank loan agreements with rights on households, in particular, were revised. This interference could set a precedent for a future intervention in legislation related to contracts. That said, for now there is reasonable confidence in the practical application of contractual rights because it is accepted that the interference with lending contracts for house building resulted from a crisis situation.

II. 1.2. Unfavorable Situation of Secured Creditors

12. **In the legal area related to credit, the main problem detected in Colombia is the extremely unfavorable situation of secured creditors.** Various operators of the credit system point out that, although most loans are dependent on the provision of security interests, in fact these do little to improve the situation of secured creditors in the case of the debtor’s default. The lack of a more favorable situation for secured creditors as against other creditors is evident in individual enforcement proceedings and, perhaps even more so, in insolvency proceedings. Users frequently refer to this situation as being very serious. Many agree that the current operation of the security system produces little benefit as regards the cost of credit: the lowering of the interest rate due to the provision of securities

⁵ S. T-202/00

⁶ Decrees N° 2330/2331 and Law N° 546 “*Ley de Vivienda*”

⁷ The Constitutional Court of Colombia declared that the revisions of contracts carried out by the Administration were constitutionally valid in an emergency situation (Decision N° C-136/99). Basically, the revisions were contained in Law 546, supported and, in some cases, modified by decisions of the Constitutional Court. Therein, it was determined that debts were to be liquidated in accordance with maximum interest rates fixed by the Superintendent of Banks (declared valid by S.C.485/95; S.C-136/99; S.T. 1157/00; A.V.C. 479/01) and that creditors were compelled to accept hypothecated real estate in total payment and cancellation of outstanding debts. Normal banking interest rates are determined by the Superintendent of Banks (“certified interest”) (art. 83, Law 795/2003, Decree 663/93), 884 Code of Commerce; 305, Penal Code, art. 191, Code of Civil Procedure). Periodically they are fixed by the Superintendent; e.g. Resolution N° 1527 fixed it for the period Sept. 1.04 onwards, at 19.50%). Banks cannot agree interest rates - whether for the use of monies or as penalties for default - over and above maximum rates fixed by the Superintendent, and this restriction operates also for mercantile persons (persons habitually operating in business transactions) (Council for the State - “*Consejo de Estado*”, decision of Sept. 18, 1988, Expt. Nr. 8531, opinion of Hon. Germán Ayala Mantilla). Usury laws condemn interest one-half over the certified rate (art. 305, Penal Code). In a business contract, in case parties have not provided specifically for interest in their obligations, then the interest shall be the normal bank rate. Penalties for default shall be limited to one half over the normal bank rate. Interest fixed at rates over and above those specified, shall entail forfeiture of all interest to the creditor (art. 111, Law 510/1999 modif. art. 884 Code of Commerce).

is scarce and, at the same time, there are expenses for its creation and registry. There is a general perception that the risk differential faced by secured and non-secured lenders is negligible and irrelevant. For this reason, this paper emphasizes the need to change those factors which reduce the efficacy of security interest mechanisms. We attempt to identify the main adverse elements and to recommend a prioritized, remedial course of action aimed at improving on the current legal and institutional state of affairs.

II. 2. USUAL SECURITY INTERESTS MECHANISMS

II. 2.1. The Colombian law provides for various security interests

13. **In spite of the variety of security interest mechanisms offered by the current Colombian law, there is general consensus that the system does not effectively ensure the repayment of credit. Nor are secured creditors afforded genuinely preferential treatment in insolvency proceedings.** The unfavorable situation of creditors having a security interest or an equivalent security mechanism is the result of a series of concurrent factors analyzed throughout this work. This next section describes the most commonly used securities in corporate credit practice.

Mortgage

14. **The mortgage is a security interest with a right *in rem* on real property, ships or aircraft, which remain in the debtor's possession.**⁸ The mortgage grants creditors the following: (i) a preference, over the proceeds of the sale of secured assets, vis-à-vis the majority of the rest of creditors, except (basically, in relation to corporate credits) legal costs incurred in the general interest of creditors, labor and tax claims;⁹ (ii) a right to execute against the mortgaged assets, by means of a special executory proceeding, in order to procure the collection of monies;¹⁰ this right can be exercised notwithstanding a transfer of the ownership of the encumbered asset by the debtor to a third party¹¹. Thus, security interests grant a right to collect, over the proceeds of the encumbered asset, which is superior to that of other creditors without such a security interest. In principle therefore, insolvency proceedings should not affect creditors with rights *in rem* as does the current Colombian insolvency system (as discussed in detail below), for they are substantially different from the rest of creditors. According to the notion of equality - a general principle of law, as reflected by international conventions - only those who are equal are treated in an equivalent way and, in turn, those who are essentially dissimilar are treated differently. Mortgages can be granted on present or future obligations ("*hipotecas abiertas*"). The security interest may not exceed twice the value of the debt. This ratio is reduced to one-and-a half times in insolvency proceedings. The creation of a mortgage over immovable

⁸ Mortgages on immovables are regulated in the Civil Code (art. 2342-2457). The mortgage on big ships (arts. 1904-1909) and aircraft (arts. 1570-1577) is regulated in the Code of Commerce.

⁹ Arts. 2494 to 2511 Civil Code set out in Annex 2.

¹⁰ The so called "*juicio ejecutivo con título hipotecario o prendario*" (arts. 554/560, Code of Civil Procedure). A feature of the execution of hypothecated rights is that, in case the third auction fails because of the lack of bidders, the secured creditor may request for himself the transfer of that title to the assets, taking the price of the valuation made, which shall be set-off against his claim plus interest (art. 557, par. 3, Code of Civil Procedure).

¹¹ This right can be exercised even if the immovable asset would have been transferred to third parties (art. 2452, Civil Code).

assets must be recorded in a public deed and filed with the Office for Registration of Public Instruments.

Pledges

15. **Pledges are a security interest with a right *in rem* on movable assets.** Pledges grant creditors, in relation to pledged assets, a preference and executory rights similar to those of mortgagors. Consequently, several of the issues raised in the previous paragraph are also applicable here. The Civil Code regulates possessory pledges (by which possession of the pledged asset is transferred to the creditor), and the Code of Commerce regulates possessory and non-possessory pledges of the asset given as collateral.¹² The creation of possessory pledges does not require particular formalities. The creation of non-possessory pledges requires a private document, which shall be recorded in the register operated by the Chambers of Commerce.¹³ Non-possessory pledges can be created over any kind of movable, provided it is apt for the pursuance of an economic venture and destined for such venture, or are the result of such manufacture.¹⁴ A commercial establishment as a whole¹⁵ may be subjected to a non-possessory pledge.¹⁶ Pledges may also be created over sales of goods when the price is to be paid in installments and where the assets involved are non-fungible movables. Non-possessory pledges can be settled as collateral for future obligations, provided the amount and the duration of the contract are clearly specified.¹⁷

Assignments in Guarantee

16. **Rights against third parties can be assigned conditionally, giving rise to a form of security interest.** This security mechanism, though used, is of no great significance because it can only be used to constitute security interests related to a limited number of assets. Credits can be used as security interests by means of their conditional assignment; such assignment requires notice to the assigned debtor.¹⁸ Rights derived from a contract can also be assigned as security interests.¹⁹ Likewise, an establishment as a whole can be the object of a conditional assignment.²⁰ It should also be noted that the legal instrument

¹² Arts. 1200-1203, Code of Commerce.

¹³ The competent Chamber of Commerce shall be that of the place where the assets shall be permanently located according to the contract (art. 1210, Code of Commerce).

¹⁴ Art. 1207, Code of Commerce.

¹⁵ A commercial establishment or enterprise as a whole comprises all assets, including: the right to trade names, patents, trademarks, merchandise in stock or products under process, furniture, rights to leases, rights derived from illegal competition practices, and rights to contracts entered into by the company (arts. 515/516 Code of Commerce). The execution sale of a pledge on a commercial establishment shall be made by preference as a unit, and only in case of impossibility, in parts (art. 517, Code of Commerce).

¹⁶ Art. 532, Code of Commerce.

¹⁷ Art. 1219, Code of Commerce.

¹⁸ Arts. 1960-1961 Civil Code. The assignment includes all collateral annexed to the assigned claim, but personal defenses of the assignor shall not be transferred to the assignor (art. 1964, Civil Code).

¹⁹ A special form of assignment is provided for in the Code of Commerce: the assignment of all or part of rights derived from contracts (arts. 887/-896). This requires notice to the other party to the contract (art. 894, Code of Commerce). The assignment shall include all actions, priorities and legal actions derived from the contract (art. 895, Code of Commerce). The debtor under the assigned contract shall have available all defenses derived from the contract, and all defenses against the assignor if he made express reservation at the time of notice of the transfer (art. 896, Civil Code).

²⁰ Art. 533, Code of Commerce.

used to grant security interests on intellectual property²¹ and industrial property rights,²² would be a conditional assignment of those rights rather than a pledge.²³

Reservation of Title and Leasing

17. **The seller is entitled to retain title to sold assets until the buyer has paid the price in full. This operates as a security interest mechanism in relation to the credit extended in contracts of sale based on installments.**²⁴ In Colombia, leasing is also possible. Reservation of title is possible both in the sale of movables²⁵ and real estate.²⁶ Where title is reserved, the buyer only acquires title to the assets sold once the last installment of the price has been paid. Thus, as long as the seller does not receive the payment, he retains ownership of the assets. If he is not paid, the seller has priority - in his capacity as owner - vis-à-vis the rest of the buyer's creditors. In order to be valid against third parties, and whatever the substance of the assets might be, reservation of title requires filing in the pertinent registries (movables, real estate and automobiles). In case of the buyer's default in paying the price on the agreed terms, the seller will be entitled to the recovery of the sold asset and the buyer will have the right to restitution in proportion to the price he paid.²⁷ In order to exercise the right of recovery, default must be more than one-eighth of the price. Buyers are prohibited from selling assets subject to reservation of title.²⁸ According to current Colombian practice, leasing and reservation of title are limited to the acquisition of assets, mainly consumer goods, particularly vehicles. They are not frequently used to obtain corporate credit in general.²⁹

Guarantee Trusts

18. **Trusts can be used as a security mechanism.**³⁰ The commercial trust is the form of trust typically used as a security interest. In order to guarantee one's own obligations or those of a third party, a person referred to as the "settlor" transfers the ownership of certain

²¹ Regulated by the art. 671, Civil Code and the art. 61, Political Constitution of Colombia.

²² Decl. 85 of the Accords of Cartagena/Decree N° 1190/1978; Decree 575/1992; Decl. 344 Accords of Cartagena/Decree 117/1994; Decl. 486, Accords of Cartagena/Decree 2591/2000; and Resolutions of the Superintendent of Industries N° 210/2000 and 17.585/2001.

²³ Information gathered during the ICR ROSC mission.

²⁴ Art. 951, Code of Commerce.

²⁵ Where the assets sold are movables, they must not be fungible nor apt for resale in the same conditions as when acquired (arts. 953-954, Code of Commerce). Reservation of title cannot be made on inventories (arts. 954, Code of Commerce).

²⁶ Art. 952, Code of Commerce.

²⁷ Arts. 948 and 952, Code of Commerce.

²⁸ In case he does, the seller shall have an action of replevin, or, on election, to claim the total price. Besides, the debtor shall incur penal sanctions (art. 955, Code of Commerce). The seller can also oppose seizure by other creditors (art. 964, Code of Commerce). In case of default, the seller can start an action to recover the sold assets, but the buyer shall have the right of redemption for three months (art. 966, Code of Commerce). A good faith third party, who has acquired assets under reservation of title clauses in a public sale, auction, or in open market, shall be obliged to return them to the seller, but all expenses paid shall have to be reimbursed (art. 960, Code of Commerce).

²⁹ Current research has yet to establish what accounts for the restricted use of these financing securities for the acquisition of assets. System users have suggested the lack of cultural familiarity with these mechanisms, as well as the need to resort to judicial proceedings to obtain the possession of the asset from the debtor in case of default, are the main factors that limit the use of leasing and reservation of title.

³⁰ The fiduciary property is regulated in arts. 793-822 of the Civil Code and the commercial trust in arts. 1226-1244 of the Code of Commerce.

assets to another known as the “trustee”. In case the debtor does not pay, the creditor (called “beneficiary creditor”) can order the settlor to effect the private sale of all or part of the assets given in trust, so that the debt is paid with the proceeds obtained. Assets in trust constitute an estate separate from the general estate of the debtor, which is not liable to be executed by other creditors.³¹ In the commercial trust, the trustee must be a company specifically organized to this effect (“*sociedades fiduciarias*”), authorized and supervised by the Superintendent of Banks.³² The trust must be executed in a contract drafted and filed with a licensed notary public.³³

II. 3. SUBSTANTIVE LEGISLATION ON SECURITY INTERESTS

II. 3.1. Securities Interests in the Civil Code and in the Code of Commerce

19. **In the Colombian substantive law, the regulation about mortgages and pledges follow the usual scheme developed in countries of Roman-Germanic legal tradition. There is little deviation from the regular scheme, though the system itself is regarded as having specific weaknesses.** The Colombian Civil Code establishes basic legal rules concerning rights *in rem* (of property and security interests) on immovable assets, as is usually the case in countries of similar legal heritage. The standard civil pledge (or pledge with transfer of possession) is regulated by the same code. Also, following the usual private law lineaments of continental European origin, the Code of Commerce legislates in respect of commercial pledges, with or without transfer of possession. It is a positive feature that the Colombian Code of Commerce regulates the creditor’s non-possessory pledge in a relatively broad and clear way and in a brief number of provisions contained in articles 1207 to 1220. However, within the substantive legal framework of security interests contained in the two aforementioned codes, some relatively important weaknesses regarding possessory pledges can be identified, as well as a serious problem related to the priority of credits with security interests affecting both movable and immovable rights *in rem*. The next section discusses these issues in greater detail.

II. 3.2. Some of the Weaknesses of the Legislation on Non-Possessory Pledges

20. **The following can be said to be relatively important weaknesses of the legislation on pledges:**

- ✓ **The excessive thoroughness required by the law for the description of the asset operating as a security interest.**³⁴ This limits the possibility of pledging assets which cannot be fully identified, such as some generic products, fungible goods and raw materials susceptible of transformation; and

³¹ Art. 1227, Code of Commerce. This separate estate is not a legal entity or a legal person in itself.

³² Law 45/1995

³³ Art. 1228, Code of Commerce. A trust has a maximum duration of 30 years (art. 800, Civil Code, applicable according to art. 2, Code of Commerce).

³⁴ Art. 1209, Code of Commerce: “The wording of a non-possessory pledge contract shall contain, at least, the following specifications: 5) The detail of the pledged species, indicating its quantity and every other circumstance useful for its identification, such as mark, model, number of the series or manufacturing if related to machinery; quantity, class, sex, mark, color, race, age and approximate weight if related to animals; quality, quantity of bushes or seeds planted and time of production, if related to fruits or crops; the establishment or industry, class, mark and quantity of products, if related to industrial products, etc; ...”

- ✓ **The underlying idea that pledges are created in respect of things (tangible assets), rather than intangible assets.** This restriction is not clearly stated in the law, but it can be implicitly derived from description requirements contained in the Code of Commerce.³⁵ Thus, under the current legislation, there are reasonable doubts about, for example, the possibility of creating pledges, autonomously, on intangible assets (separated from the commercial establishment).³⁶

II. 3.3. Diminished Priority of Security Interests in General

21. **The diminished priority that the substantive law establishes for secured creditors with pledges or mortgages is the most significant and critical weakness of the Colombian regime on security interests.** Both mortgagors and pledgees have priority only after the debtor's labor and tax claims have been paid (with the proceeds of the mortgaged or pledged premises), with no limits at all.³⁷ Thus, the inherent risks of the uncertainty of collection, derived from an inefficient executory system and from an insolvency system with a bias against secured creditors (analyzed below) are added to the structural uncertainty entailed by every security interest. For this reason, when the execution of the collateral and distribution of the proceeds take place, it is very difficult, if not impossible, to estimate beforehand the degree of coverage granted by the security interest, no matter what the value of the mortgaged or pledged asset. This is because other contingent claims (labor and tax), of *ex ante* uncertain significance and existence, – are to be paid prior to mortgagors or pledgees.

22. **Although when extending the credit, the creditor obtains a security interest on a “clean” asset (free of registered liens), in the event that it becomes necessary to execute against the collateral, other creditors (e.g. labor and tax creditors) may have a higher priority and collect the proceeds resulting from the asset sale, ousting the secured creditor.** Those labor or tax claims are, in fact, equivalent to a higher-ranked encumbrance than the one of the secured creditor. This is the case in spite of the fact that, when establishing the security interest, the prior claims of labor or tax nature were not evident because: (i) they are not registered; (ii) in most cases, they are not reflected in account books; and (iii) may not have existed prior to the establishment of the security interest. The implicit risk of the potential existence of such priority claims (effectively “hidden liens”) results in costs for borrowers, mainly in higher interest rates. This is a key explanation for the fact that the cost of credit is not substantially reduced by security interests in Colombia.

23. **Thus, in Colombia, the actual ranking of priorities, in fact, produces the same effects as in a system where “hidden liens” are expressly acknowledged.** Hidden liens are legal preferences or priorities neither registered nor publicized so that they may be known when third parties grant credit to debtors, whose assets - currently or potentially - are or will be subject to them. In systems which admit priorities resulting from hidden liens (in any legal form), they openly affect the effective rank of the remaining priorities (and

³⁵ See previous note.

³⁶ During the ICR ROSC mission we have been informed that, in fact, there are no securities registered as the one described.

³⁷ The legal regulation on priority classes or ranks is contained in arts. 2494-2511 Civil Code, set out in Annex 2.

thus, the effective protection granted by security interests). Therefore, a modern system for the creation, registration and enforcement of security interests does not suffice to grant protection to creditors, and consequently, expand credit and lower its costs. Moreover and above all, it is absolutely necessary that the legal system as a whole, beyond security interests legislation, establishes and assures the effective priority of secured credits.

24. **There is a close relationship between the priority given by a system to security interests and the amount of recovery of secured credit or the extent of losses suffered by creditors.** By a comparative study of the systems of South American countries, it can be demonstrated that: (i) in countries where secured creditors hold first priority (such as Argentina and Uruguay), they usually recover the total or most of their claims, even in cases of the debtor’s liquidation or insolvency, while (ii) in countries where creditors with rights *in rem* are postponed (by labor and/or tax claims) to the second or third priority (as in Ecuador, Peru and Brazil (in Brazil’s case, prior to a 2005 insolvency reform), they generally suffer heavy losses (sometimes up to 100%) of their claims in case of debtor’s insolvency.³⁸ Since this was regarded as one of the key factors behind insufficient and expensive banking credit in Brazil,³⁹ that country recently modified the insolvency priority system, limiting the categories of labor claims that have priority and downgrading the priority of tax claims. This relationship between the priority of security interests and the amount of recovery for secured credit (or the extent of losses suffered in practice), is a factor that contributes to explain why in a system of “diminished” or “washy” securities there is no significant reduction in the cost of credit.

II. 4. REGISTRIES OF SECURITY INTERESTS

II. 4.1. Main Components of the Registry System

25. **Security interests are registered in different offices, according to the nature of the encumbered assets.** Thus:

- ✓ **Immovables and their collaterals are registered at the Office of Public Registries.** The Office of Public Registries (real estate) is an agency dependent on the Superintendent of Notaries and Registries. It is organized by municipalities, and in some cases, there are various sections per municipality.

³⁸ These conclusions arise from a survey carried out during the Forum on Insolvency in Latin America (FILA), organized by the Legal Vice Presidency of the World Bank in Rio de Janeiro, Brazil, June 2004, as well as from the reports on insolvency systems and creditor rights, related to countries in the region, presented in that Forum.

³⁹ The New Brazilian Bankruptcy Law: Insolvency System Reform and Access to Credit Initiative, by Ana Carla Abrão Costa and Eduardo Luis Lundberg (unpublished): “In Brazil, under the old law, secured credits were third priority on bankruptcy. Labor credits had first priority, with no limits, followed by fiscal credits. The consequence was that collateral was useless when it was most necessary, when the company was insolvent and incapable of meeting its obligations. Together with other imperfections of the insolvency and judiciary system, **this was one of the most important reasons to understand why banking credit is insufficient and expensive in Brazil.** This scenario was altered by the priority rules of the new bankruptcy law that settles labor credit ceilings and ranks secured credits before fiscal responsibilities”. (p.19, emphasis added).

The information is limited to each office. The cost of a mortgage registry entry is 0.5% of the loan value plus a tax of 1%.⁴⁰

- ✓ **Security interests over movable assets are registered with the local Chamber of Commerce; vehicles and their consequent collaterals are registered with the Traffic Secretary.** The Chamber of Commerce of Bogotá, a private entity with public duties, provides an efficient service of registration, with computerized information with easy and free public access. The Chambers of Commerce are located in different cities in Colombia. According to anecdotal evidence they operate in a similar way. Registration is made in the office by adding the data using a computer program. The cost of a pledge registry entry is Col. \$22,000 plus 0.7% of the debt amount.⁴¹ The Traffic Secretary (“*Secretaría de Tránsito*”) registers documents related to automotive vehicles.

II. 4.2. Main Weaknesses of the Registry System

26. **Weaknesses in the registry system of secured rights demand a distinction between security interests over immovable assets (mortgages) and those encumbering movable assets (pledges).** Thus:

- **In the case of Real Estate Registries:**
 - ✓ **There still prevails the system of chronological recording in bound books, and there is a long way to go until a complete computerization of the system is reached.**⁴² This delays any procedure and means that the records are less secure than is normally the case with those held on computer. Documents filed in the real estate registrars have to be notarized and are kept in the office in paper deeds (“*Folios de Matrícula Inmobiliaria*”), in bound volumes carried in chronological order.
 - ✓ **Access to information kept in the bound volumes requires the physical presence of the interested person, and the real estate registries are spread throughout the country.**⁴³ This fact makes access to information difficult and increases its costs because of, among other factors, the traveling involved.
- **Registries for Movable Assets:**
 - ✓ **These are more advanced as regards computerization, but suffer the same problem as regards geographic fragmentation.** The geographic dispersion is a particular problem because there is no centralized system of information for these registries. In order to determine the existence of secured interests on movable assets located in the various cities of Colombia, even the largest ones, it is necessary to consult each separate office, and to travel to the place where it is located. The geographic fragmentation and the lack of electronic

⁴⁰ According to the information received during the interviews held at the ICR ROSC mission, this cost is not perceived as excessive by system operators.

⁴¹ According to the information received at the interviews held during the ICR ROSC mission, system operators did not perceive this cost as excessive.

⁴² Data is not computerized, although the office is beginning to send some information via the internet.

⁴³ Even in Bogotá, there are three sections of this registry, located in different areas.

interconnection among registrars have a more severe impact in the case of registries of movables, than registries of real estate. By definition, the location of immovables is known in advance. On the other hand, movable assets can move from one place to another; therefore, it is more difficult to identify the registry that an interested party should attend. This further increases travel costs.

- ✓ **The lack of centralized information creates the risk of doubling security interests on the same movable assets.** In an area so sensitive to risk, this factor potentially increases uncertainty as well.
- ✓ **The case of automobiles is much the same. The municipal Traffic Secretary offices register vehicles, without a centralized system of information.** Even in nearby municipalities, investigations must be carried out in each of the offices of the different municipalities.⁴⁴

II. 5. ENFORCEMENT OF CLAIMS

II. 5.1. Collection mechanisms are not effective

27. **In the event that the debtor does not honor its debt, creditors lack effective collection mechanisms. This is another factor behind the lack of efficiency of security interests held in Colombia. Unless the problem is solved, other reforms are unlikely to have much effect.**⁴⁵ The main factors which affect the possibility of efficient collection of unpaid claims are the following:

- ✓ The inadequacy or inefficient operation of **private enforcement mechanisms**;
- ✓ The non-existence of **enforcement mechanisms with minimum judicial intervention**;
- ✓ The lack of efficiency of the **judicial enforcement proceeding**; and
- ✓ The adverse legal provisions of legislation on **insolvency proceedings**.

II. 6. ENFORCEABILITY OF CREDITS OUTSIDE INSOLVENCY PROCEEDINGS

28. **When the debtor is not party to insolvency proceedings (because he is, at least theoretically, a solvent debtor), several elements contribute to the ineffectiveness of collection. These tend to interact in a vicious circle that is difficult to break.** The following section comprises a summary description of the main elements that conspire to reduce the effectiveness of the collection system.

II. 6.1. Out-of Court Enforcement Mechanisms

29. **There are no effective private credit enforcement systems of general application in Colombia. Stipulations intended to allow creditors to take possession of the pledged assets, other than as authorized by law, can not be contractually**

⁴⁴ For example, there is a Secretary in Bogotá and another one in the neighboring city of Chia.

⁴⁵ This opinion is shared by all the referents consulted at the various interviews held during the ICR ROSC mission.

established through a credit agreement.⁴⁶ Thus, in principle, Colombian legislation is reluctant to accept private or out-of-court enforcement mechanisms. Besides, there is no widespread use of these kinds of remedies. That aside, in theory and with some exceptions, a private enforcement mechanism might prove an effective tool in some areas.

30. The identified special private enforcement systems are the following:

31. *Enforcement of the pledge bond.* The pledge bond is a document representing a credit with a pledge, which can only be settled on goods placed in General Bonded Warehouses. The depositor of goods receives credit by granting the pledge to the creditor and handing over the pledge bond to him. In the event of default, the creditor (the holder of the bond) can require the Warehouse to auction the goods, so that the credit is repaid with the proceeds obtained. The pledge bond is theoretically attractive as a way of avoiding the judicial enforcement proceeding. Its main limitations lie in the facts that: (i) it can only be used to pledge goods deposited in General Bonded Warehouses and not on movable assets in general; and (ii) commissions charged by such Warehouses are considered high; this has significantly limited the use of this security interest .

32. *Accelerated judicial proceeding by banking institutions.* Law 45 of 1923 established that banks could privately execute assets pledged as collateral for granting credit.⁴⁷ Currently, this procedure is only used to sell privately pledged bonds, notes and other commercial papers, endorsed in guarantee to banks, which have possession of those bonds. Private executions are not used for non-possessory pledges, because a judicial order (issued after a trial) is required so as to take possession of the assets in the debtor's hands. This reverts back to the judicial system of pledge enforcement. There are also some interpretations holding that the private enforcement of banking pledges would not have force because, when the 1970 Civil Procedure Code was approved, all preexisting norms opposing it were derogated by the regulation of the pledge executory proceeding.⁴⁸

33. *Enforcement of the trust-in-guarantee.* Trusts-in-guarantee have a private enforcement mechanism.⁴⁹ To a great extent, this advantage explains the increasing use of trusts as against traditional security interests (mortgages and pledges). Theoretically speaking, the other great advantage of trusts, as opposed to mortgages and pledges, is that when transferring the settlor's assets to an autonomous estate such assets cannot be executed by the other debtor's creditors, nor does the fiduciary creditor have to compete with other creditors over the proceeds of the sale of assets in trust. Thus, in theory, the fiduciary creditor would not encounter the problem of the mortgagor or pledgee's lower priority as against labor and tax creditors.

⁴⁶ Art. 1203, Code of Commerce: "Every stipulation that, directly or indirectly, in an evident or hidden way, tends to allow the creditor to dispose or appropriate the pledge for himself by means different than those provided by law, shall produce no effect at all".

⁴⁷ Art. 102, Law 45: "If having passed twenty days following the expiration date of an obligation secured by a pledge, the debtor has not cancelled, the bank will be able to auction the pledge, with prior notice to the debtor, and must hand to the borrower the residue from the proceeds of the auction after the deduction of the capital, interests and expenses."

⁴⁸ Reinforcing this interpretation, it must be added that the Code of Commerce, subsequent to the aforementioned Law 45, does not provide for the powers of a private execution, nor are these established in the 1990 financial reform.

⁴⁹ See description in paragraph 17, *supra*.

34. Nevertheless, trusts-in-guarantee lose the above mentioned advantages precisely when the creditor has greatest need, in the event of the debtor's insolvency:

- ✓ In reorganization proceedings, the beneficiaries of trusts, settled in guarantee and derived from autonomous estates comprising immovables, are obliged to accept their substitution by hypothecated rights settled on such immovables.⁵⁰
- ✓ In liquidation proceedings, the Superintendent of Companies may declare the trusts terminated and order the sale of assets comprising the autonomous estate, whose proceeds are applied to the payment of every debtor's creditors, according to the legal order of priorities. The beneficiary creditor of the trust is placed at the same level of priority as a mortgagor or pledgee (according to whether the assets transferred to the trust were immovable or movable).⁵¹

35. In insolvency proceedings, the legal treatment of trusts-in-guarantee means that they lose their comparative advantages against traditional security interests, for in case of the debtor's insolvency they are ranked at the same level.⁵² Even in the absence of insolvency proceedings, the substantive legislation in force causes such a degree of uncertainty as to the status of the trust that, in practice, the value of the concept is diminished, as is its use as a security mechanism. Article 1238 of the Code of Commerce reads as follows: "*The settlor's creditors shall not be able to seek assets subject to the trust unless their claims are previous to the settlement of such trust. Creditors to the beneficiary shall only be able to seek yields obtained by such assets. Interested parties shall be able to impugn the trust settled in fraud of third parties*".⁵³ Such obscure wording has given rise to recent judicial interpretation, whereby the first sentence of article 1238 of the Code of Commerce has been held to entitle any creditor - acting in such capacity prior to the establishment of the trust - to terminate such trust by the mere fact of being a prior creditor, notwithstanding the

⁵⁰ Art. 34, para. 5, Law 550

⁵¹ Art. 69, Law 550

⁵² In Brazil, where security interests were ineffective under the previous insolvency law, the alternative mechanism allowing the reduction of such inefficiency was a form of reservation of title called "fiduciary sale" (*alienação fiduciária*). Creditors trusted this legal mechanism that became widespread because it gave them legal standing as owners of the sold property and brought about, among other consequences: (i) rapid enforcement where the price was not paid; and (ii) competition with labor or tax claims was not necessary such that there was an indemnity against the effects of insolvency. This reference to them is appropriate, for trusts in Colombia could achieve a similar result. In fact, apparently the use of such trusts is increasing because there is the belief that the Brazilian situation exists in Colombia. However, unlike the Brazilian precedent, Colombian insolvency law is not in line with the legal status corresponding, in theory, to the trust beneficiary (contrarily, in the Brazilian *alienação fiduciária* the seller who provides financing gains this status), because in Colombia, in the event of the debtor's insolvency, trusts become security interests.

⁵³ Being a legal rule containing references to an *actio pauliana*, the obscure wording of this norm hampers the clear appreciation of its provisions. That is to say, the legal effect of the trust (constitution of an autonomous estate whose assets become invulnerable, from the moment of the establishment of the trust to the "persecution" of creditors who constitute it): (i) can be impugned in case of fraud (in order to invalidate such patrimonial division); and, (ii) creditors preceding the establishment of the trust are "interested" (in the legal sense, this means "legitimated") to formulate such impugnement, since creditors following such establishment gave credit to the trust constituent at the moment the trust assets no longer constituted the patrimony of the latter (therefore, they were not able to take into consideration such assets when assessing the debtor's solvency in order to grant the credit).

existence of fraud and/or damage.⁵⁴ In case this interpretation is consolidated, it is certain that the trust would offer very little protection as a security mechanism for it would be very simple to obtain its nullity on petition of any prior creditor to the establishment of the trust. In the shadow of nullity, which can be easily declared, the security loses all value.

II. 6.2. Enforcement mechanisms with minimum judicial intervention

36. In Colombia, enforcement mechanisms with minimum judicial intervention have not been identified. This kind of enforcement - a hybrid between the purely private execution and judicial executory proceedings - is useful in security interests where the debtor retains possession of the encumbered asset. With this kind of execution, the creditor is allowed to sell or have the encumbered asset sold in a private way. Nevertheless, there is a minimum judicial intervention required to take possession of the encumbered asset. Such judicial intervention is limited to confirmation of the formal legality of the collateral and to the subsequent judicial order granting the creditor possession of the encumbered asset. That minimum judicial control does not imply a contradictory judicial procedure. The judge simply verifies the above-mentioned formal legality of the security interest and orders the debtor's dispossession, the only requirement being the creditor's petition and the presentation of the documents required by law.⁵⁵ These mechanisms have the obvious advantages of speed and economy.

II. 6.3. Judicial Enforcement Mechanisms: the executory enforcement procedure

37. Enforcement of rights is governed by the Civil Procedure Code ("CPC"), applicable throughout Colombia. According to the title they hold, creditors must use different judicial procedures. Some creditors can use the executory enforcement procedure,⁵⁶ while all others have to resort to ordinary proceedings. The latter are

⁵⁴ This is the interpretation which can be apparently inferred from the judgment of the April 28, 2003, delivered by the Civil Courtroom of the Higher Court of the judicial district of Boyacá. The judgment concerned an ordinary proceeding filed by the *Corporación Financiera de Boyacá – Corfiboayacá*, currently *Corporación Financiera Colombiana S.A.*, vs. *Carlos Hernando Acosta Pabón y otros*; and the denial of the Court of Civil Cassation of the Supreme Court of Justice, of the appeal for cassation filed against such judgment by *Fiduciaria Empresarial S.A. Fiduempresa S.A.* (currently, *U.C.N. Sociedad Fiduciaria S.A.* in liquidation) (14th December 2005, File No. 1997-01208-01).

⁵⁵ An example of this kind of enforcement, used with very few difficulties for some sixty years, can be found in the Argentine law on security interests. Art. 39 of the Decree-Law 15.348 of 1946, Argentine Republic establishes: "Whenever the creditor is the State, its agencies, a bank, a financial entity authorized by the Central Bank of the Argentine Republic or an international banking or financial institution, and such institutions have obtained no previous authorization nor established domicile in the country, the judge shall order the seizure of assets and its delivery to the creditor, and the debtor will not be entitled to promote recourse when presenting the pledge certificate. The creditor shall proceed to the sale of the pledged assets, as provided by art. 585 of the Code of Commerce, without affecting the debtor's rights to claim before the creditor in an ordinary proceeding. The procedure of the out-of-court sale prescribed in this article shall not be stayed because of the debtor's seizure of assets or insolvency proceedings, disability or death." Another example of enforcement with minimum judicial intervention can be seen in the "special regime on mortgage enforcement" of the Argentine Law N° 24.441, articles 52-67.

⁵⁶ The "accelerated proceeding (or procedure)" is also called "executory proceeding (or procedure)", because each of the creditors individually procures the execution of the debtor's assets in order to collect one or several credits from a single creditor. This is in opposition to the "collective or insolvency execution", frequently called "insolvency" or "insolvency proceedings" as well, where all creditors, related to a common debtor, appear before the liquidation proceedings of the latter's assets and collect claims achieved through the distribution (in proportion and according to priorities) of the proceeds obtained from such liquidation.

procedures where there are no restrictions regarding the discussion of issues or evidence offered and produced by the parties.⁵⁷ Theoretically, the executory enforcement procedure should be shorter than the ordinary proceeding. However, in Colombia the executory enforcement proceeding is also protracted and inefficient as a means of judicial collection of claims (the reasons for this are discussed below).

38. Creditors having security interests with rights *in rem* can also use executory enforcement proceedings. Unsecured creditors can use executory enforcement proceedings if they hold documents constituting full evidence originating from the debtor expressing a clear and mature obligation. The main instruments qualifying for executory proceedings are: (a) court decisions ordering the payment of monies (including those derived from a confession of the debtor, transactional compromise or set-off); (b) obligations to pay liquidated and certain sums (or sums ascertainable by a simple arithmetic operation) of monies, drafted in a notarized document or in a document with executory force (such as bills of exchange, promissory notes and checks). Creditors not holding an executory instrument can also use executory proceedings in certain cases, if they have previously followed a procedure to have the document acknowledged by the debtor.

39. The executory proceeding works very slowly, notwithstanding procedural reforms carried out in 2003. Anecdotal evidence⁵⁸ suggests that experiences differ, but there is general agreement that executory proceedings are excessively slow. Reported delays vary from 4 to 7 years. Although in 2003 Law 794 introduced several reforms to the Civil Procedure Code related to the executory proceeding, in an attempt to make it more effective, anecdotal evidence indicates that up until now creditors have not been afforded an effective judicial proceeding for collection of debts.⁵⁹

40. The executory nature of this proceeding is distorted by the procedural legislation itself, due to the range of defenses that debtors can raise in such proceedings. One of the most striking characteristics of the Colombian executory proceeding, which makes it different from similar procedures existing in countries with the same legal tradition, is that debtors are not limited to raising only specific defenses. In Colombia, debtors are entitled to raise all available and imaginable defenses.⁶⁰ In fact, the lack of restrictions to admissible defenses in executory proceedings makes the supposedly executory proceeding result in an ordinary, protracted, and inefficient procedure. This is one of the principal causes of delay in this procedure that, in theory, should be a judicial summary mechanism for collection but which, in practice, does not work effectively. There

⁵⁷ The lack of restrictions on argument, and of limits on admissible means of proof, mean that the ordinary proceedings should technically be called “procedures of full cognizance”.

⁵⁸ Obtained in interviews held during the ICR ROSC mission.

⁵⁹ According to the statistics of the Colombian Institution of Housing and Savings (*Instituto Colombiano de Ahorro y Vivienda*), the average duration of the procedures necessary to execute a mortgage security is four years. Reasons for this long duration include a persistent backlog of cases before the courts, as well as the numerous defenses and nullities raised by debtors. These factors mean that the important modifications introduced in Law 794 of 2003 have not resulted in a shorter period for procedures (work presented by María Mercedes Cuellar, ICAV, at the Seminar on “The Financial System in Colombia: Future Reforms”, organized by the Ministry of Finance and Public Credit, and ASOBANCARIA, Bogotá, May 8, 2006).

⁶⁰ Thus, besides defenses based on documents, others related to the underlying relationship can be raised (e.g. defenses based on the invalidity of the loan contract, the lack of a valid cause under the executory instrument, or failure to fulfill an obligation of the creditor). The debtor may also raise defenses based on error, malice, constraint, fraud and extension of the contract terms.

are also other aspects of the system which delay the collection of claims where the executory proceeding is used, as explained in the following paragraphs.

Executory proceedings are widely used in judicial practice. Research on executory proceedings, published by a Colombian organization (“*Informe de Coyuntura de la Justicia: Análisis de los Juicios Ejecutivos en Colombia*”, published by the “*Corporación por la Excelencia de la Justicia*”, December 13, 2000 - that is, before the reforms of Law 794 of 2003) revealed that executory proceedings were found to have historically constituted 65% of all civil litigation. This amount rose to nearly 80% in the 1990s. These observations are corroborated by anecdotal information from civil court practitioners and judges. Similar sources have indicated that, out of these totals, 36% are related to hypothecated rights’ executions and 56% to unsecured creditors. The Excelencia Report also confirms that collection agencies use civil litigation as their principal instrument of collection, and that the number of promoted executory proceedings increased steadily in the eight years between 1992 and 2000 (the research period). At the time of the research, executory proceedings represented at least 800,000 cases a year; after the crisis of 1998, it increased a further 21%.

According to the Supreme Council of the Judiciary, at the end of 2004 procedures filed before the civil justice system amounted to 1,400,000 prior to judgment, of which 1,300,000 were executory proceedings (of every kind) prior to judgment.⁶¹

II. 6.4. Seizure of assets subject to execution

41. **Other delays in the judicial enforcement manifest themselves after the executory decision has been obtained. They typically occur at the time of the seizure of assets subject to execution.** Once the decision in executory proceedings is obtained, the forced sale of seized assets or of those subject to a right *in rem* must be ordered. To this end, it is necessary to take possession of those assets and a public officer called the “*sequester*” (“*secuestre*”) is in charge of this duty.

42. **The workload of the *sequesters* is such that anecdotal evidence suggests that it often takes one to three years for possession to be achieved.** Given the congestion in the office of the *sequesters*, judges have resorted to appointing police officers⁶² to act as *sequesters*. But resorting to this has proved no solution: police officers have other functions besides granting possession of assets sold in auctions and, in turn, the police office has become congested, resulting in equally long delays.

43. **The performance of *sequesters* brings about various complaints related to their inefficiency and also, to corruption.** There is anecdotal evidence from users of the judicial system that the *sequester* often instigates some controversy related to his fees, and until such controversy is settled, no other activity is fulfilled on his part. What is worse, there is also anecdotal evidence from various users of the system, claiming that assets often deteriorate in the hands of *sequesters*, who do not account until all expenses have been paid or after any controversy has been settled. There have also been reports of *sequesters* having leased the seized assets, and it has been difficult to obtain any explanations or accounts.

⁶¹ María Mercedes Cuellar, ICAV, work cited above.

⁶² They are dependent on the Executive Department and not of the Judiciary.

II. 6.5. Forced sale of assets subject to execution

44. **At the culmination of the execution, there are also significant delays when auctioning the executed assets.** After the decision ordering payment has been entered in the executory proceeding, seized assets are to be sold by public auction,⁶³ in order to pay the creditor with the money thereby obtained. Major obstacles encountered in this final stage of the execution are:

- ✓ A valuation of assets has to be made prior to the sale in auction.⁶⁴ The valuation may be subject to controversy, and in order to settle it, a judicial decision must be obtained, resulting in more delays.⁶⁵
- ✓ The exact amount of the claim, payment of which was ordered by the judicial decision, must also be established before the auction takes place.⁶⁶ A controversy may arise over the accuracy of the liquidated amount, and in order to settle it, a judicial decision subject to appeal must be obtained.⁶⁷ The public auction can only be ordered later.⁶⁸
- ✓ Bidding at public auctions is subject to strict rules. It shall start at a fixed date and time though, and in order to continue after 4 pm, a specific authorization of the judge is required in each case. It shall not be continued on the next day even if there are still bidders at closure. A new date shall have to be fixed as auctions can only take place on the appointed date.⁶⁹ If there are no bidders in the first auction for 100% of the appraised value, such value shall be reduced by 30%. A second auction shall allow bids for 50% of the appraised value. A third auction shall allow them for 40% of the appraised value. As will be noted, there are numerous delays due to the interval required between sales after the first one has failed. If there are still no bidders after reductions are made, or if bidding is still going on at the end of the first day, there has been anecdotal evidence that there are delays when fixing a new date and that this can take more than one year. With regards to the second and

⁶³ Art. 523 CPC

⁶⁴ The valuation is regulated by art. 516 CPC, according to the modification introduced by Law 794/2003. The valuation is to be made by an expert registered with the court. The plaintiff may present such valuation after the decision ordering payment is entered, and in case of default, the defendant is entitled to do so. If none of the parties produce the appraisal, then the judge appoints an independent expert, except in the cases of automobiles or real estate, which have their own specific method of appraisal. In cases of real estate and automobiles, the appraisal shall be made by increasing in 50% the value established by the State for the payment of real property tax or automobile tax, unless parties disagree with that value, in which case an expert's opinion may be introduced stating that the assessment has been caused by grave error.

⁶⁵ Art. 238 CPC

⁶⁶ To begin with, the plaintiff must determine exactly the amount of the claim liquidated by the decision. In the event that the creditor fails to do so, the defendant is entitled to do it. If none of the parties determines the exact amount of the claim, then the court clerk shall do so.

⁶⁷ Arts. 351, para. 5, and 521, CPC

⁶⁸ A notice of the auction will be published in a newspaper of wide circulation in the place and on a local radio station (art. 525 CPC modified by Law 794, 2003). All prospective bidders must deposit, in cash, 40% of the value appraised. The plaintiff creditor may be exempted from such deposit if his claim represents 20% or more of the value appraised (art. 526- Law 794/2003). The creditor is allowed to be a bidder in the auction, and if the highest bidder is the creditor himself, then he is entitled to set-off the amount of his claim against the bid (art. 529, para. 4, Code of Civil Procedure).

⁶⁹ Jaime Azula Camacho, “Manual de Derecho Procesal”, t. IV, Temis, 4a ed, 2003, p.210.

third auctions (with reductions of the appraised value), according to system users, each of the delays for the appointment of a new date can take a full year.

II. 6.6. Ineffectiveness of sanctions against the outrageous use of defense procedural mechanisms

45. **Sanctions against defendants for malicious litigation are not applied so as to be effective, or are not applied at all.**⁷⁰ This worsens the problems associated with: (i) an executory proceeding having no clear limits regarding admissible defenses, and (ii) an ample system of constitutional injunctions (or defenses)⁷¹ allowing the stay of judicial decisions even in judicial executory proceedings. The widespread judicial tolerance to the indiscriminate, excessive and frequently malicious use of defenses and constitutional injunctions, largely explains the long duration of these procedures. Some Latin American countries have obtained good results by imposing a fine on those defendants who raise malicious defenses. In Brazil, for example, the fine can be as much as 20% of the amount claimed in the action, and must be paid to the plaintiff creditor.⁷²

II. 7. ENFORCEABILITY OF SECURED CLAIMS IN THE EVENT OF INSOLVENCY PROCEEDINGS

II. 7.1. General Considerations

46. **Where the debtor is insolvent, the application of the Colombian insolvency legislation emphasizes the unfavorable situation of secured creditors considerably more than is the case in the domestic laws of most other countries.** In insolvency proceedings, the priority of claims with a pledge or mortgage (already diminished by nature in civil law)⁷³ is significantly diluted. In particular, this is the result of the voting system in reorganization agreements, where the creditor priorities are not observed. Furthermore, majorities made up of other categories of unsecured creditors, in addition to the category of so-called “internal creditors” (in fact, the shareholders), can decide on the fate of secured creditors without their consent, alter their priorities and modify the conditions of their claims.

⁷⁰ Information gathered during the ICR ROSC mission from users of the Colombian judicial system.

⁷¹ Art. 86, Political Constitution: “Every person shall be entitled to judicial injunction to claim before judges the immediate protection of his fundamental constitutional rights whenever the latter are violated or threatened because of the action or omission of any public authority, at any moment and place whatsoever, by means of a preferential and summary proceeding, acting on his own or by the person representing him. The protection shall be that of an order so that the person for whom the injunction is requested acts or forbears from doing so. The court decision, which shall be immediately accomplished, can be impugned before the acting judge and, eventually, he shall send it to the Constitutional Court to have it revised later. This action will only take effect in case the affected person has no other means of judicial defenses, except the latter is used as a provisional mechanism to avoid an irremediable damage. Under no circumstances there shall pass more than ten days between the request of injunction and its resolution.

The law shall establish the cases where the judicial injunction is valid against individuals in charge of the provision of public services, or whose conduct affects seriously and directly the collective interest, or regarding those to whom the applicant is subordinated or defenseless.”

⁷² Art. 133 of Law 222 provides for specific sanctions in cases of malicious litigation, imposing a fine of up to 100 minimum salaries. In Brazil: arts. 600-601, *Código de Processo Civil*.

⁷³ See paragraphs 21 to 23, *supra*.

47. **The Colombian insolvency legislation shows such bias against secured creditors that, in practice, collateral loses its primary function: the protection of the creditor against the debtor’s insolvency.** Thus, the current insolvency legislation has the potential to destroying any system of security interests established by the civil or commercial law. The situation of trusts-in-guarantee is no different because in insolvency proceedings they are converted into mortgages or pledges.⁷⁴ This failure of the insolvency legislation to take into accounts the preferences and priorities afforded to secured creditors, and theoretically inherent to creditors with a right *in rem*, has a serious impact. It limits access to credit, increases its cost or worse, creates incentives to use the insolvency systems inadequately with costs for the general economy. The insolvency system is analyzed in detail in the next part of this work.

⁷⁴ See paragraphs 34 and 35, *supra*.

III. INSOLVENCY PROCEEDINGS

III. 1. GENERAL ISSUES

III. 1.1. Bias against Creditors

48. **Colombian insolvency proceedings show marked bias to creditor’s rights. The adverse bias is particularly evident with respect to secured creditors.** The current framework for insolvency proceedings was reformed in 1999, when Law 550 introduced major changes in order to accelerate the protracted and ineffective *Concordato* proceedings.⁷⁵ Law 550, which is still in force,⁷⁶ was passed as a temporary, emergency law.⁷⁷ In this emergency context, the focus of the legislative policy seems to have been to protect, at all costs, debtors in financial distress or insolvency. Naturally, this had a detrimental effect on creditor’s interests. The crisis having passed but the biased law remains in place. This is detrimental to credit expansion and therefore to the development of the Colombian economy.

III. 1.2. Opportunity to Reestablish the Balance

49. **The current improvement of the economic conditions in Colombia provides the opportunity to revise some aspects of the institutional and legal framework in order to reestablish a more balanced approach on insolvency and protection of creditor rights.** The ongoing reform to insolvency laws⁷⁸ provides a clear opportunity to incorporate international standards into Colombian law, consolidating its current strengths and modifying factors that are widely acknowledged to weaken the present system. These negative factors can be identified in the following aspects of the existing system:

⁷⁵ As regards the improvement resulting from Law 550 in relation to duration of insolvency proceedings, vis-à-vis the evident inefficacy of the previous insolvency system, Xavier Giné and Inessa Love’s recent work is pertinent: *Do Reorganization Costs Matter for Efficiency? Evidence from a Bankruptcy Reform in Colombia* (http://siteresources.worldbank.org/DEC/Resources/Do_Reorganization_Costs_Matter_for_Efficiency.pdf). Structural defects in Colombia’s current insolvency system, the subject of our study, are beyond the scope of the above mentioned paper.

⁷⁶ The Colombian insolvency legislation basically comprises Law 222 of December 20, 1995, regulating liquidations, and Law 550 of December 30, 1999, concerning reorganizations. Law 550 modified the provisions contained in Law 222 regarding reorganizations. Both laws contain most of the insolvency norms (procedural and substantive) and are very detailed (so much so, that they are so complex as to be difficult to understand in parts). Law 550 is applicable to legal persons, mainly to private companies, though also some public entities (“entes territoriales”, or political divisions of the State, such as provinces or municipalities), mixed-economy corporations, and State universities. It is not applicable to physical persons. Nor is it applicable to financial institutions (both banking or saving and loan companies), insurance companies, nor to stock exchanges or stock-exchange brokers. Law 222 is applicable both to private corporations under the supervision of the Superintendent of Companies and to natural persons, but not to public corporations. There is no information regarding conflicts between insolvency laws and other domestic laws. In a hypothetical situation of conflict, the insolvency law shall prevail.

⁷⁷ Law 550 was intended as a provisional law in force until December 31, 2004. However, Law 922/2004 extended the life of Law 550 until December 31, 2006.

⁷⁸ Bill 207/5 Senate, whereby the insolvency regime of the Republic of Colombia is established. Considerations on this Project are made in Annex 1 of this work.

- ✓ Design of insolvency legislation (**legal framework**); and
- ✓ Institutional and regulatory structure of insolvency proceedings (**institutional framework**).

III. 2. GENERAL STATEMENT OF STRENGTHS AND WEAKNESSES OF THE CURRENT INSOLVENCY SYSTEM

III. 2.1. Positive Features

50. **The main features of the current Colombian insolvency system that, with necessary adjustments, should be preserved in a legal reform are:**

- ✓ The generic integration of the insolvency law system with other domestic laws, which avoids conflicts between legislative orders, and gives the insolvency law priority over non insolvency law in insolvency situations;
- ✓ The existence of a reorganization proceeding for viable, and a liquidation proceeding for non viable, businesses;
- ✓ The transparency of insolvency proceedings (reorganization and liquidation) as secured by clear rules, public access to the procedures, supervision of the jurisdictional authority, and availability of information and statistics on insolvency proceedings;
- ✓ The real information disclosure about the debtor’s financial statement and businesses, both through his contribution and by means of statistics and reports provided by the Superintendent of Companies;
- ✓ The non discriminatory treatment of foreign creditors vis-à-vis local creditors;
- ✓ The prevention of the premature dismemberment of the debtor’s assets, achieved by staying the creditor’s individual enforcement actions after the opening of the reorganization or liquidation proceedings (“stay”).

III. 2.2. Negative Features

51. **On the other hand, the main adverse features of the Colombian insolvency system, where the attention of legal reform should be focused and analyzed in detail in the next paragraphs, are:**

- ✓ The system relating to classes of creditors, that includes shareholders of the insolvent company as “internal creditors”;
- ✓ The system relating to voting in reorganization agreements, that does not respect the rank of classes nor priorities regarding the respective claims;
- ✓ The possibility of altering the legal priority of claims, establishing the so-called “consensual priorities” via a reorganization agreement imposed by creditors of a lower rank (and shareholders) on secured creditors, whose own priorities are altered without their consent;

- ✓ The lack of preservation of effectiveness in trusts-in-guarantee (in insolvency proceedings), whose beneficiaries are virtually converted into mortgaged or secured creditors;
- ✓ The lack of a reasonable temporal limit to the stay of execution of secured claims;
- ✓ The lack of creditors' standing to request the opening of the debtor's insolvency liquidation proceedings;
- ✓ The lack of effectiveness of actions seeking to establish personal liability on the part of directors and officers;
- ✓ The insufficient regulation of the effects of the proceedings on executory contracts, and the excessive sanctions that can be currently applied to the party trying to enforce the cancellation of the contract (another aspect reflecting bias against creditors);
- ✓ The delays in the recognition of contentious claims;
- ✓ The lack of modern rules to deal with problems in proceedings with foreign elements;
- ✓ The lack of institutional independence of the Superintendent of Companies, an administrative entity with judicial authority in insolvency proceedings;
- ✓ The lack of judicial control over the vast majority of decisions ruled on by the administrative authority in insolvency proceedings;
- ✓ The limited effective qualifications and other defects in the system of remuneration for Promoters;
- ✓ The limited utilization of corporate workouts to solve the financial difficulties or the insolvency of companies;
- ✓ The non existence of legal regulations addressing prepackaged reorganization agreements.

III. 3. MAIN WEAKNESSES OF THE INSOLVENCY SYSTEM: LEGAL FRAMEWORK

III. 3.1. Classes of Creditors and the so-called “Internal Creditors”

52. **The Colombian insolvency law⁷⁹ provides for five classes of creditors, among which there is a class including shareholders of the insolvent company (called “internal” creditors). A separate category for secured creditors is not contemplated.** The five classes of creditors are:⁸⁰ (1) internal creditors; (2) workers and pensioners; (3) public entities and social security corporations; (4) financial institutions;⁸¹ (5) the rest of external creditors. Secured creditors are not considered an individual class or exempted from the effects of an approved plan, even when the approval is achieved exclusively with the votes of unsecured creditors. The “internal” creditor class is made up of shareholders,

⁷⁹ Art. 19, Law 550.

⁸⁰ Art. 29, Law 550.

⁸¹ And other institutions under the supervision and vigilance of the Superintendence of Banks, whether they are private, public or mixed-economy.

partners, members, holding companies, etc. who can show a demonstrable and quantifiable contribution to the company's development.⁸²

53. Classes established by the insolvency law have no relation at all to the ranking of creditors, according to the priority that the civil legislation has assigned them.⁸³

Thus, although the insolvency law establishes its classes with the sole purpose of organizing the voting system of the reorganization agreement, in practice this results in the distortion of the intrinsic hierarchies related to claims (according to civil legislation). When voting, those hierarchies have no legal relevance whatsoever. The vote of a shareholder in an insolvent company⁸⁴ has the same power of decision on the agreement as the vote of a creditor holding a mortgage or pledge.

III. 3.2. Voting of the Reorganization Agreement

54. Due to the voting system related to the agreement, votes of shareholders in the insolvent company (known as “internal creditors”) have a significant influence in reorganization. In order to appreciate the impact of this category in obtaining the requisite majorities for the approval of a reorganization plan, it must be understood that a reorganization plan is only deemed to have been approved if it is passed by a plurality of internal or external creditors representing, at least, an absolute majority of all allowed claims.⁸⁵ Such a majority must be further ratified with votes of creditors belonging to at least three of the five classes provided for in the law. In the event that there are only three classes of creditors, then votes are required from at least two of the classes. Where there are only two classes of creditors, votes are required from both classes. Consequently, as shareholders are considered to be members of a class with equal voting power to that of creditors, their will can be a deciding factor in the direction of the reorganization. This is another indication of the weakness of the creditors' influence in reorganization proceedings. It is even weaker in the case of secured creditors for their priorities can be terminated as described below.

III. 3.3. Modification of Secured Creditors' Priorities

55. The priority of creditors with rights *in rem* can be modified, weakened or terminated without their consent, by decision of creditors of a lower rank and shareholders of the insolvent company. According to the Colombian insolvency legislation, priorities (established by the Civil Code and other laws) for payment to creditors can be modified by a reorganization agreement approved by a majority

⁸² Art. 19, Law 550, establishes that: “*Son acreedores internos los accionistas, socios, asociados o cooperados del empresario que tenga forma jurídica asociativa; el titular de las cuotas de la empresa unipersonal; el controlante de la fundación; y en general, los socios, controlantes o beneficiarios reales que hayan aportado al desarrollo de la empresa en forma demostrable y cuantificable*”

⁸³ Arts. 2494-2511 Civil Code, transcribed in Annex 2.

⁸⁴ Art. 22, Law 550. “*Cada uno de los acreedores internos de los empresarios privados o mixtos de forma asociativa, tendrá un número de votos equivalente al valor que se obtenga al multiplicar su porcentaje de participación en el capital, por la cifra que resulte de restar del patrimonio las partidas correspondientes a dividendos, participaciones o excedentes decretados en especie, así como a revalorización del patrimonio, sea que éste haya sido o no capitalizado. En el evento en que el patrimonio del empresario tenga un valor negativo, cada uno de los acreedores internos tendrá un valor equivalente a un peso*” (par. 3°).

⁸⁵ Art. 29, Law 550.

(representing 60% of the allowed claims)⁸⁶ of three of the five classes of creditors (internal and external). Priorities voted and approved in the reorganization agreement replace those established by the Civil Code and other laws; in this way, priorities can be diluted in the context of the debtor's insolvency. This is precisely the time at which a creditor has the greatest need of the protection of security interests. Only priorities related to pension plans, tax, labor, and social security claims and consumer creditors cannot be modified. The modification of the priorities of secured creditors can take effect during the plan or later, in a subsequent liquidation (if the company fails to fulfill the terms of the plan).⁸⁷

56. In certain cases, the class of “internal creditors” has had decisive influence over the priorities of secured creditors. Since secured creditors (including mortgagors, pledgees and beneficiaries of guarantee trusts) have to vote the agreement *pari passu* together with common creditors (shareholders, unsecured creditors, employees and tax authorities), there is a possibility that a majority of creditors (indistinctly added, regardless of hierarchy and including - as “creditors” - the shareholders of the insolvent company) can invalidate the priority of secured creditors, thereby eliminating the value of the collateral obtained when credit was extended. According to anecdotal evidence,⁸⁸ secured and/or financial creditors can suffer delays of up to ten years in attempting to enforce their security and collect their claims, as a result of modifications established in reorganization agreements. Moreover, this is due to the aggravating circumstance that the law does not expressly offer the possibility of recourse against abusive agreements, entered into by other categories of creditors, to the detriment of the secured creditors.

III. 3.4. Loss of Effectiveness of Trusts in Guarantee

57. In insolvency proceedings, creditors whose claim was secured by the settlement of trusts-in-guarantee (on debtors' or third parties' assets) suffer an alteration of their rights and a change in their priorities, without any right of recourse. In reorganization proceedings, the Colombian law⁸⁹ provides for the cancellation of real property rights established under a trust for the purpose of a guarantee.⁹⁰ A mortgage is then substituted for the cancelled real property rights, which may then be reduced⁹¹ to one-and-a-half the value (or presumed value) of the secured obligation.⁹² The debtor has the right to request cancellation of the real property trust. Such a request is made to the Superintendent of Companies. He is the only authority with jurisdiction to hear such a request. The affected creditor has no right to object to or appeal the decision rendered. In liquidation proceedings, trusts established for the purpose of guarantee may be cancelled and the trust assets sold by

⁸⁶ Art. 34, par. 12, Law 550.

⁸⁷ Id.

⁸⁸ Interviews held during the 2004 ICR ROSC mission.

⁸⁹ Art. 34, para. 5, Law 550.

⁹⁰ The rule has as a precedent in the case decided by the Superintendent of Companies in “*Fiduciaria Anglo S.A. - Acerías Paz del Río*”, Decision N° 3480, June 4, 1997, where a trust settled in accordance with art. 1266, Commercial Code (“*fiducia mercantil*”) by *Acerías Paz del Río* in favor of *Fiduciaria Anglo* over shares of *Cementos Paz del Río S.A.* was cancelled. Such decision was based on the argument that the trust could only be executed while the debtor was not under insolvency proceedings. There were no fraud allegations nor formal nullities involved in the case.

⁹¹ Art. 34, par. 4, Law 550.

⁹² This reduction is also applicable to every mortgagor (art. 34, par. 4, Law 550)

the trustee.⁹³ Proceeds from the sale must be allocated for payment of claims in accordance with the pertinent priorities. Creditors who were to be paid under the trust may see their claims converted into mortgage or pledge credits (depending on the nature of the assets involved). Such secured creditors, by law, must respect the existing legal priorities or those arising after the establishment of the trust. As a consequence and during insolvency proceedings, creditors, who prior to the insolvency proceeding thought they were protected by a trust, are subordinated to labor and tax claims and legal costs, just like mortgagors and pledgees.⁹⁴ This is equivalent to the derogation of the legal effect of the trust, which is the establishment of an autonomous estate, separated from that one of the debtor and which shall not be subject to enforcement by his creditors.⁹⁵ According to the insolvency law and in order to be consistent with the principle established in the commercial legislation, the trust assets should not be subject to the insolvency proceedings, with the exception of the case in which, during the proceedings and owing to a fraud action (“*actio pauliana*”), a specific trust is left with no effect.

III. 3.5. Absence of a Temporal Limit to Stays on Enforcement of Secured Interests

58. **The unlimited stay of enforceability of security interests brings about another curtailment of secured creditors’ rights during reorganization proceedings.** In Colombian reorganization proceedings, actions of secured creditors aimed at enforcing their security rights may be subjected to a stay of unlimited duration.⁹⁶ Though there is little basis on which to criticize insolvency proceedings during which a stay is imposed on every individual execution of the necessary assets for reorganization (including encumbered assets in favor of creditors with security interests), the Colombian law is unbalanced as between the objectives of reorganization proceedings and the protection of security interests. A comparative study of the systems of South American countries in general establishes that most of them (except Colombia, and to a lesser extent, Peru) establish definite and fairly brief temporal limits to the stay on enforcements of secured credits related to the insolvent’s assets. In the most recent insolvency reform in the region,⁹⁷ Chilean legislation currently provides that in reorganization proceedings⁹⁸ all executions are stayed (included those of hypothecary or pledge creditors): (i) for 90 days if the formal reorganization plan proposal is presented with the support of two or more creditors, representing more than 50% of the total debt; or, (ii) beyond those 90 days, until the day fixed for the meeting where the agreement is approved or rejected, if the creditor’s support (previously mentioned) represents more than 66% of the total debt.⁹⁹ In contrast, the Colombian insolvency law:

⁹³ Art. 69 of Law 550 (decr. 628 of 2002)

⁹⁴ Art. 2495, Civil Code

⁹⁵ See paragraph 18.

⁹⁶ Reports received in interviews held during the ICR ROSC mission account for cases of creditors whose claims would have been stayed for a period of up to ten years.

⁹⁷ Law No. 20.073 of the Republic of Chile, published on November 20th, 2005 in the Official Gazette, modifying Law No. 18.175, on Insolvencies, related to insolvency agreements.

⁹⁸ Called “*Convenio Judicial Preventivo*”.

⁹⁹ Articles 177 bis and 177 quater, Law No. 20.073 of the Republic of Chile.

- ✓ does not discriminate on the basis of whether encumbered assets, whose execution is stayed, are necessary or not for the continuation of the activity of the insolvent company;
- ✓ maintains the stay throughout reorganization proceedings and even afterwards, until the agreement is completely fulfilled (unless otherwise stipulated);¹⁰⁰ and,
- ✓ does not provide for a creditor, affected by the stay of the enforceability of his security, to request the jurisdictional authority to order the end of such stay.

III. 3.6. Creditors cannot petition liquidation

59. **Creditors cannot apply for insolvency liquidation proceedings of the insolvent debtor; the law establishes that only the debtor can apply for liquidation or the Superintendent can do it at its own discretion (“ex officio”).**¹⁰¹ This rule runs contrary to international standards which generally hold that creditor-petitioned insolvency liquidation proceedings as an essential part of the protection of credit.¹⁰² Making such petitions unavailable to creditors gives undue protection to debtors, which may be understandable in the context of a systemic crisis but ought to be discarded in a normal credit environment. The “shadow of bankruptcy” principle, that is, the possibility for creditors to petition liquidation proceedings is an important counterbalance for the availability of a reorganization proceeding for debtors, allowing them to avoid liquidation in cases where the business is viable. Shielding non viable companies makes the insolvency system less credible and reduces incentives for the early reorganization of distressed companies, denying the creditors’ the opportunity to petition for their liquidation. One of the aims of insolvency legislation should be to strike a proper balance between the debtor's and the creditor's rights. This ensures the exercise of a disciplinary function by the existence of a sound insolvency system. This situation cannot occur when the system is unbalanced, as is currently the case in Colombia.

**UNCITRAL Legislative Guide on Insolvency
Recommendation 14: Persons entitled to petition**

The insolvency law must specify the parties entitled to petition the commencement of an insolvency proceeding, which must include the debtor and any of its creditors.

III. 3.7. Liability of Social Officers

60. Although Colombian legislation contains rules intended to make effective the officers' liabilities for damage caused to the company, in insolvency proceedings there are few cases of personal liability actions against directors. In most companies, equity is family-owned. Besides, although equity interests that could be legally exercised by shareholders can also be promoted by creditors, creditors are only entitled to exercise such rights and promote this kind of action when they represent 50% of the total indebtedness of

¹⁰⁰ Art. 34, num. 3, Law 550

¹⁰¹ Art. 149, Law 222

¹⁰² See the following chart, which includes a non-official translation of the official English text of Recommendation 14 of the Legislative Guide on Insolvency Law (UNCITRAL, from United Nations Commission on International Trade Law), published at www.uncitral.org

the company, and the assets of the company are insufficient to meet their claims.¹⁰³ This represents a clear obstacle for actions entered by third parties – who are not shareholders – such as creditors in the event of a company’s insolvency). Nor are there any specific rules in the insolvency context which improve the Liquidator’s position in relation to actions to make directors responsible for caused to the insolvent company and/or its creditors. Thus, the insolvency system does not foster high standards for company management since it does not give rise to a credible threat of sanctions against irresponsible management behavior.

III. 3.8. Contracts under Performance

61. **In reorganization proceedings, Colombian law imposes continuity of contracts being performed. Termination or assignments of those contracts are not considered as alternatives. Moreover, any creditor who incorporated a contractual clause against such continuity is excessively sanctioned: his claim is subordinated vis-à-vis all other claims and his collateral canceled.** In Colombian legislation, the treatment of executory contracts (those being performed with reciprocal obligations pending), after the opening of insolvency proceedings, is only addressed in art. 15 of Law 550¹⁰⁴, which is:

- ✓ Insufficient in respect of alternatives, and
- ✓ Excessive in respect of sanctions.

62. **The only available course of contractual continuity is not sufficient to cover the complete range of different situations to be found in insolvency proceedings.** This rule is insufficient to cover the complete range of pending contractual situations. General international standards in this area of insolvency law indicate that, in order to achieve the objectives of insolvency proceedings, interference in contracts can imply the continuation, the termination or the assignment of contracts.

63. **Additional sanctions imposed by law on a party who included a provision that runs contrary to contractual continuity, are excessive.** When contractual stipulations which terminate the contract in the event of insolvency proceedings are simply held to be invalid or unenforceable,, Colombian law functions similarly to the general international standard that enable a choice between (i) the contractual continuity (that such stipulations

¹⁰³ Art. 25, Law 222.

¹⁰⁴ Art. 15, Law 550: “*Continuidad de contratos. Por el hecho de la promoción o iniciación de la negociación de un acuerdo de reestructuración, no podrá decretarse la caducidad administrativa de los contratos celebrados entre el Estado y el empresario; y se tendrá por no escrita la cláusula en que se pacte que dicha promoción o iniciación sea causal de terminación de los contratos de tracto sucesivo. Son ineficaces, sin necesidad de declaración judicial, las estipulaciones que formen parte de cualquier acto o contrato y que tengan por objeto o finalidad impedir u obstaculizar directa o indirectamente la promoción, la negociación o la celebración de un acuerdo de reestructuración, mediante la terminación anticipada de contratos, la aceleración de obligaciones, la imposición de restricciones y, en general, a través de cualquier clase de prohibiciones, solicitud de autorizaciones o imposición de efectos desfavorables para el empresario que negocie o celebre un acuerdo de los previstos en esta ley. Las discrepancias sobre la ineficacia de una estipulación en el supuesto previsto en el presente artículo, serán decididas a solicitud del empresario o de cualquier acreedor por la Superintendencia de Sociedades, en ejercicio de funciones jurisdiccionales, mediante el procedimiento verbal sumario. De verificarse la ocurrencia de la ineficacia, el pago de los créditos a favor del correspondiente acreedor quedará legalmente postergado a la atención previa de todos los demás créditos, y la Superintendencia ordenará la cancelación inmediata de todas las garantías que hayan sido otorgadas por el empresario o por terceros para caucionarlos*”.

try to prevent); and, (ii) the termination or assignment of the contract (options not considered in the Colombian legislation). The additional sanction established in the same rule of art. 15 in Law 550 is excessive because, besides invalidity or unenforceability, it establishes that a creditor, making a claim on the basis of a contract with such a clause, shall be legally subordinated to the rest of the creditors. Furthermore, all sureties in favor of that creditor shall be cancelled. In practice, this penalty amounts to declaring the credit contract entirely void. This runs contrary to the commonly accepted rule in the law of contracts whereby “the non validity of a clause does not affect the validity of the contract” unless the clause is essential for the performance of the contract.

III. 3.9. Sluggish Insolvency Proceedings

64. **The duration of most insolvency proceedings exceeds the maximum periods specified by law. It is difficult to determine the reasons for this.** System operators state that the long time required for the recognition of contentious claims is one of the factors that results in the sluggishness in insolvency proceedings. This opinion is not shared by the Superintendent of Companies however. Anecdotal evidence indicates that objections to the recognition of claims (which occur frequently in liquidation)¹⁰⁵ and reorganization proceedings¹⁰⁶ result in genuine disputes that can take up to two years to be resolved by the Superintendent of Companies. However, information provided by the Superintendent states that the resolution of objections to a decision by the Promoter, regarding allowance of claims, does not take longer than three or four months. The period of time required for a decision about controversial claims aside, it is clear that insolvency proceedings experience

¹⁰⁵ After the opening of liquidation proceedings, and up and until twenty days after the last notice has been published, creditors shall appear before the Superintendent, supporting their claims with summary evidence (art. 158, Law 222). If the liquidation proceeding is opened as a consequence of a failed reorganization proceeding, creditors allowed in such proceeding shall be considered as having been allowed in the subsequent liquidation proceeding (id.id.). Creditors whose claims have arisen after the opening of the reorganization proceeding has been opened, shall have to produce summary evidence of their claim (art. 158, Law 222). No provision is made for late-comers to appear after the period indicated in the summons has lapsed. In the art. 160, Law 222, there is a reference to objections related to the decisions of the Superintendent, although there are no specific rules related to the pertinent procedure.

¹⁰⁶ In reorganization proceedings, art. 20, Law 550 provides for a duty of the debtor to deliver to the Promoter a list of creditors, obtained from the financial statements of the company, up to the last day of the last month previous to the petition for reorganization -if debtor petitioned- or of the commencement of negotiations if by a creditor or the Superintendent. Art. 22 Law 550 provides for the Promoter to determine the allowance of claims based on the summary evidence produced and, particularly, on the list of creditors presented by the debtor. Within four months of his appointment, the Promoter shall summon a “meeting to determine claims and debts”, where such list shall be made known to all participants (art. 23, Law 550). The summons shall be published in notices. From the date the notices are published the promoter shall make available to every creditor the pertinent information and the list of creditors he has prepared. Creditors shall be able to examine the list and the supporting documents, as well as requesting explanations and making objections. In case of conflicts, the Promoter shall act as a mediator but his decisions are subject to the Superintendent’s revision (art. 25, Law 550). Five days after the closing of the meeting, objections to the inclusions or exclusions of the list shall be made by any creditor, whether internal or external, or they shall be presented by the debtor himself before the Superintendent, who shall enter a final decision without any recourse. Decisions entered by the Superintendent cannot be appealed before the judiciary. Objections related to alleged nullities or fraud in allowance of claims are only decided by ordinary judges and are not to be resolved by the Superintendent. Creditors whose claims have been objected by ordinary judges shall be bound, however, by the decision of the majority and, provisionally, shall be deemed conditional. A reserve shall be made to pay for them upon final decision. Objections presented before the Superintendent shall be decided before the voting, in order to approve or reject the plan.

significant delays, according to the statistical information provided on the webpage of the Superintendent of Companies.¹⁰⁷

III. 3.10. Insolvency proceedings with foreign elements or with cross-border impact

65. In Colombian insolvency legislation there are no specific provisions adequately regulating the international aspects of insolvency proceedings. Legislation does not address problems often posed by cross-border insolvency.

- ✓ There are no specific legal provisions referring to the recognition of foreign claims, although anecdotal evidence indicates that there are no restrictions, and the allowance of foreign claims is common. Likewise, there are no legal restrictions preventing foreign creditors from commencing reorganization proceedings in relation to a debtor.¹⁰⁸
- ✓ Judicial decisions in foreign insolvency proceedings are not generally recognized, in a certain or effective manner, according to the rules of the Colombian Code of Civil Procedure on the recognition foreign decisions.¹⁰⁹
- ✓ Although Colombia has adopted the 1889 Montevideo Treaty related to cross border insolvencies, the treaty only binds six countries, all located in South America. It cannot be said, therefore, that problems arising in insolvency proceedings with international elements or cross-border impact receive general and universal treatment.

III. 4. MAIN WEAKNESSES OF THE INSOLVENCY SYSTEM: INSTITUTIONAL AND REGULATORY FRAMEWORKS

III. 4.1. Lack of independence of the entity with jurisdictional authority in insolvency proceedings

66. Despite performing judicial duties in insolvency proceedings, the Superintendent of Companies lacks the independence inherent to judges. For this reason, the Colombian institutional system strays from general international standards. The seriousness of this issue is explained in the following paragraphs.

¹⁰⁷ <http://www.supersociedades.gov.co>

¹⁰⁸ As indicated supra, no creditor may commence a liquidation insolvency proceeding.

¹⁰⁹ The Code of Civil Procedure contains provisions concerning the recognition of foreign decisions. Though they make no specific reference to foreign insolvency orders, they require an “*exequatur*” procedure to be filed before the Supreme Court (arts. 693-695, CCP), and provide the following rules for recognition: (a) the country issuing the judgment to be recognized must itself recognize Colombian judgments (reciprocity); (b) the foreign order must not affect real estate located in Colombia at the time the judgment was entered; (c) the matter involved in the foreign judgment must not be attributed exclusively to the jurisdiction of Colombian judges (art. 694 CCP). These last two rules effectively conspire against the recognition of foreign insolvency judgments, as: (i) these insolvency orders often involve immovables as part of the estate of the debtor; and (ii) when the matter is attributed exclusively to Colombian judges, the rule denying recognition of foreign judgments may affect insolvency matters. The fact that insolvency laws may lead to issues relevant to “*ordre public*” (e.g. the setting aside or modifying of contractual rights) can mean that a *doctrinaire* or jurisprudential construction will lead to the conclusion that the insolvency issue is a matter affecting sovereignty. As such, the recognition of foreign insolvency orders might affect “*ordre public*” such that they should not be recognized.

67. **The Superintendent of Companies is an administrative agency; it therefore belongs to the executive, and not the judicial, branch of government. Nevertheless, the Superintendent acts as a judge in reorganization and liquidation insolvency proceedings.**¹¹⁰ Art. 116 of the Political Constitution of Colombia of 1991 allows the law, “in exceptional cases”, to assign judicial functions to administrative authorities in precise matters.¹¹¹ In 1995, Law 222 established that, with certain exceptions, it is for the Superintendent of Companies to exercise such powers in insolvency proceedings governed by that law.¹¹² In 1999, Law 550 did not alter the allocation of judicial powers to the Superintendent of Companies, which continues in the role of an insolvency judge. However, there is virtually no recourse to other judicial organs against his decisions.¹¹³

¹¹⁰ The Council for the State (“*Consejo de Estado*”) of Colombia confirmed the decision of the *Tribunal Administrativo de Cundinamarca, Sección Primera, Subsección B*, in a decision rendered on November 21, 2003. It ruled that the decisions of the Superintendent of Companies have a judicial nature, and cannot be reviewed by the Judiciary, citing art. 90 of Law 222 and art. 116, para. 3 of the Constitution of Colombia. The Council of State has the ultimate power of decision on administrative matters (arts. 236/238 of the Constitution of Colombia).

¹¹¹ “Exceptionally, the law shall be entitled to assign jurisdictional functions to administrative authorities in precise matters”. The Legislative Act (“*Acto Legislativo*”) of December 3, 2002, ratified this attribution.

¹¹² “*La Superintendencia de Sociedades asume la función jurisdiccional en uso de la facultad concedida en el art. 116, inciso 3 de la Constitución Política. Será competente de manera privativa para tramitar los procesos concursales de todas las personas jurídicas, llámense sociedades, cooperativas, corporaciones, fundaciones, sucursales extranjeras, siempre que no estén sujetas a un régimen especial de intervención o liquidación. Los jueces civiles especializados, o en su defecto, los jueces civiles de circuito, tramitarán los procedimientos concursales de las personas naturales*”

¹¹³ Art. 37, Law 550: “*Settlement of controversies*. The Superintendent of Companies, exercising its judicial functions and according to the provision of section three, article 116 of the Political Constitution, in first instance and by means of a summary verbal proceeding, shall have competence for the judicial resolution of controversies related to the occurrence and recognition of any of the invalidity procedures provided for in this law. Claims related to the existence, efficacy, enforceability and validity, or to the achievement of an agreement or of some of its clauses, can only be filed before the Superintendent, by means of the required procedure, by creditors who voted in opposition, and within two (2) months following the date of the agreement.

The Superintendence of Companies shall also be competent to resolve, in first appeal, by means of a summary verbal proceeding, any difference between the businessman and the parties, between these parties, or between the businessman and the parties with the company administrators, because of the enforcement or termination of the agreement, different from the occurrence of an inefficacy procedure provided for in this law. Those referred to the occurrence of causes related to termination of the agreement shall be included among those differences.

The Superintendent, exercising the functions provided for in this article, shall be able to order the seizure of assets or the filing of the claim or any preventive measure whatsoever deemed to be useful for the litigation in the event it is deemed to be appropriate, *ex officio* or *ex parte* petition, and settling no sureties. These measures shall also be subjected to the corresponding dispositions of the Code of Civil Procedure”.

The Superintendent has wide authority and, in some instances, ample discretion to commence and adjudicate both liquidations and reorganizations. Among its various powers, the Superintendent decides whether to commence a mandatory liquidation; he rules on the participation of creditors, their claims and their priorities; and he resolves all objections filed by the debtor and/or the creditors.¹¹⁴ In addition, he may order the commencement of mandatory liquidation procedures on his own initiative: (a) in cases of grave and serious difficulties for the debtor, if liquidation is necessary in order to meet his obligations in due time; or (b) when there is reasonable doubt that any such situation will occur in the future.¹¹⁵ The Superintendent also has very important functions in the reorganization procedure, such as commencing the procedure (also possible on his own initiative)¹¹⁶ and resolving objections made by the debtor and/or creditors regarding allowance of claims. Note that there is virtually no recourse against his decisions.

68. The Constitution directs that judges are to remain independent of the executive branch of government. However, the authority of the Superintendent of Companies, which functions as a judicial authority in insolvency proceedings, is less independent of the executive than judges in the courts. The Superintendent of Companies is appointed and removed at the discretion of the President of the Republic.¹¹⁷ In other words, the officer charged with adjudicating, without recourse, the rights of the debtor and his creditors in liquidation and reorganization insolvency proceedings is a political appointee of the President. There are neither laws nor regulations establishing objective conditions for the appointment or removal of the Superintendent, nor any guarantees related to his security of tenure in the post. Consequently, the Superintendent, in his capacity as adjudicator, has no independence from the executive branch of the government. However, such independence - a basic principle in of modern democracy - is conferred by the Political Constitution of Colombia on all members of the Judiciary.

The Constitution asserts: “The Administration of Justice is a public function. Its decisions are independent.” Besides: “Judges, in their decisions, shall be bound only by the law.” It is up to the Supreme Council of the Judiciary (“*Consejo Superior de la Judicatura*”) to administer judicial careers and to confirm the lists of candidates for appointment as judges.¹¹⁸ In order to qualify as a judge, candidates must go through a specific selection process, which includes testing and education. Judges are also expected to take continuing legal education courses. The Report presented by the Supreme Council of the Judiciary to Congress, for the years 2003-2004¹¹⁹ confirms that the procedure for the selection of judges is intended to ensure the independence and qualifications of nominees drawn from the list of

¹¹⁴ With the exception of cases of fraud and nullity that shall be decided only by ordinary judges (art. 133, Law 222).

¹¹⁵ Art. 91, Law 222: “*Si se teme razonablemente que llegue a cualquiera de las dos situaciones anteriores*”. This is an important power, but vaguely expressed here.

¹¹⁶ Art. 6, Law 550

¹¹⁷ Art. 189, par. 13 of the Political Constitution. “*Corresponde al Presidente de la República como Jefe de Estado, Jefe de Gobierno y Suprema Autoridad Administrativa: nombrar a las personas que deben desempeñar empleos nacionales cuya provisión no sea por concurso o no corresponda la otros funcionarios o corporaciones, según la Constitución o la Ley. En todo caso, el gobierno tiene la facultad de nombrar y remover libremente a sus agentes*”. The present Superintendent was appointed by Presidential Decree N° 3197 of December 27, 2002, according to the specific provisions of para. 13, of art. 189 of the Constitution.

¹¹⁸ Article 256, pars. 1 and 2 of the Constitution. Such functions are regulated by Law 270 of 1996 (“*Ley Estatutaria de la Administración de Justicia*”).

¹¹⁹ *Consejo Superior de la Judicatura, “Informe al Congreso de la República”, 2003-2004*, p. 165.

eligible candidates (National Register of Eligibles or "*Nacional de Elegibles*"). The Report of the Supreme Council identifies different stages of candidacy: (a) the opposition phase: when candidates take various tests in order to demonstrate their aptitude and knowledge; (b) the education phase: when successful candidates attend pertinent courses; and (c) nomination: when an order of merit is drafted and submitted to the National Register of Eligibles.¹²⁰ According to the Constitution, the Supreme Council of the Judiciary is responsible for examining the conduct of members of the Judiciary and sanctioning any misconduct.¹²¹ Those duties have been assigned to the Disciplinary Division of the Supreme Court of the Judiciary, whose object is "to optimize and guarantee the efficiency, quality and transparency of the human talent employed in the Judiciary." During the year 2003, 92 sanctions were imposed on judicial agents, a category including officials who are not judges.

69. The lack of institutional independence of the authority in charge of judgments in insolvency proceedings – made more significant by the virtual absence of rights to appeal to the judiciary - is the essential weakness of the Colombian institutional framework as regards insolvency proceedings. It represents a marked departure from international standards. Removing this weakness would bolster confidence in insolvency proceedings and ensure they resemble the best international practices.¹²² That is to say, when non judicial authorities are in charge of the cognizance and decision of insolvency proceedings, those authorities must be subject to the same standards of impartiality and independence that apply to judges.

Principles for Effective Insolvency and Creditor Rights Systems

Principle D.1 - Role of Courts

Independence, Impartiality and Effectiveness. The system should guarantee the independence of the judiciary. Judicial decisions should be impartial. Courts should act in a competent and effective manner.

Role of Courts in Insolvency Proceedings. Insolvency proceedings should be overseen and impartially disposed of by an independent court and assigned, where practical, to judges with specialized insolvency expertise. Non-judicial institutions playing judicial roles in insolvency proceedings should be subject to the same principles and standards applied to the judiciary.

Jurisdiction of the Insolvency Court. The court's jurisdiction should be defined and clear with respect to insolvency proceedings and matters arising in the conduct of these proceedings.

Courts Exercise of Judgment in Insolvency Proceedings. The court should have sufficient supervisory powers to render, efficiently, decisions in proceedings in line with the legislation, without assuming a governance or business administration role for the debtor, which is typically assigned to the management or the insolvency representative.

Role of Courts in Commercial Enforcement Proceedings. The general court system must include components that effectively enforce the rights of both secured and unsecured creditors outside of insolvency proceedings. If possible, these components should be staffed by specialists in commercial matters. Alternatively, specialized administrative agencies with that expertise may be established.

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¹²⁰ *Informe al Congreso*, p. 188

¹²¹ Art. There is also a chart including a non official translation of the official English text of the Recommendation 138 of the Legislative Guide on Insolvency Law (UNCITRAL, from United Nations Commission on International Trade Law), published at www.uncitral.org-

¹²² See the following chart containing the transcription of Principle D.1 on Role of Courts in Insolvency Proceedings, according to the 2005 version of the World Bank's Principles for Effective Insolvency and Creditor Rights Systems, published at www.worldbank.org/gild There is also a chart including a non-official translation of the official English text of the Recommendation 138 of the Legislative Guide on Insolvency Law (UNCITRAL, from United Nations Commission on International Trade Law), published at www.uncitral.org.

Recommendation 138: Right to Appeal

The insolvency law must specify that a party in interest may appeal from any order of the court in the insolvency proceedings that affects its rights, obligations or interests.

III. 4.2. Performance and Remuneration of Promoters

70. **Regarding the regulatory framework, there have been countless complaints about the Promoters' actual qualifications and the system of remuneration of their duties.** When a business is to be reorganized, the law prescribes that, at the opening of the reorganization procedure, the Superintendent of Companies appoints a Promoter, either on the petition of the debtor or on the Superintendent's own initiative.¹²³ Promoters' functions are crucial to reorganization. This is conspicuous from the various duties they fulfill, and the fact that their performance must be insured by bonds and insurance coverage. The Promoter's remuneration is regulated in detail by law, based on a scheme that takes into consideration the total value of the firm assets, the complexity of the problem, the number of creditors and the total debts, as well as the other factors related to the nature of the correspondent negotiation.¹²⁴ These are the parameters for determining the Promoter's monthly fees. Nevertheless, in practice there are complaints about Promoters, alleging that:

- ✓ The qualification of most Promoters, in particular their knowledge concerning the debtor's affairs and his business are unsatisfactory to creditors, and tends to leaves too much leeway and power in the hands of the debtor.
- ✓ The mechanism for the remuneration of Promoters, which is made by means of monthly periodical payments, provides an incentive for the delay of reorganization proceedings.¹²⁵

III. 5. MAIN WEAKNESSES OF THE INSOLVENCY SYSTEM: WORKOUTS AND PREPACKAGED REORGANIZATION AGREEMENTS

III. 5.1. Workouts

71. **In Colombia, so-called informal (or out-of-court) workouts for the resolution of serious corporate financial difficulties or corporate insolvency are not extensively**

¹²³ Candidates must be natural persons, partners or officers of local or foreign companies whose corporate objects are similar to those of the company under reorganization. Candidates must comply with the conditions established by the President of the Republic (Decree N° 90 of February 2, 2000) in terms quite similar to those for Liquidators. In addition, Promoter candidates must be educated or experienced in mediation, conciliation or amicable compositions in business matters, as well as holding a university degree in administration, finance, engineering, economy, law, or be qualified as a certified public accountancy. The candidate must also demonstrate proof of his or her moral standing.

¹²⁴ These include (a) preparing the financial statements of the company under reorganization; (b) preparing reports for the creditors on the company cash flows, with information related to the operations of the company, finances, market, administration, legal position, and bookkeeping; (c) determining the creditors' voting rights; (d) preparing and making the proposals to creditors for reorganization of the company and evaluating proposals that may be presented during negotiations; and (e) participating as a member in the Steering Committee ("*Comité de Vigilancia*") of the approved reorganization plan. In order to ensure proper performance of these functions, the law requires Promoters to post bonds. Consequently, candidates must obtain an insurance policy that covers, inter alia, any incidents of malpractice or negligence in the performance of the Promoter's duties specifically imposed. The Promoter's responsibilities include a duty to inform the Superintendent if the company under reorganization and its creditors fail to meet an agreement.

¹²⁵ Informally received in interviews held during the ICR ROSC mission.

used. These informal mechanisms imply amicable collective negotiations (outside the formal system of insolvency proceedings) between the debtor and all or some of its creditors. These take place with the aim of achieving reorganization of the debts in a swift, discreet and economical way.¹²⁶ Thus, despite not being substitutes for formal reorganization and liquidation insolvency proceedings, they complement significantly the formal system of settlement of corporate insolvency. It can be said that they function “in the shadow of formal legislation”, emphasizing the fact that they do not replace insolvency proceedings and also that informal mechanisms work optimally in systems with effective formal insolvency proceedings. In addition to strong insolvency system, adequate incentives in tax legislation and banking regulations also create an environment which favors the informal settlement of serious financial distress and corporate insolvency. Finally, international experience in the last decade has made it clear that it is essential for the relevant legislation to establish that informal workouts, achieved with certain majorities, can be quickly turned into real, prepackaged reorganization agreements binding the minority constituted by dissenting creditors.¹²⁷

The concept behind workouts is to encourage agreements between a troubled debtor and his creditors, rather than binding dissenting creditors by a majority decision. This is encouraged by the grant of a short stay of execution and other legal actions to allow for negotiations. In other cases, when the state is less involved, major creditors agree among themselves on a stay. Alternatively, the state may grant advantages (like tax rebates or accounting advantages) to banks or creditors participating in this sort of agreement. Such inter-creditor agreements often include the appointment of a creditor’s steering committee and a chairman to conduct negotiations, as well as contractual clauses specifying that once a majority accepts an agreement, the dissenting minority shall be bound by such decision. In these cases, a common clause is also the one stipulating that differences between the debtor and its creditors are to be settled by arbitration before a specified arbitrator. The so-called London Approach was a pioneer movement in this field, originally put forward by the Bank of England as an informal recommendation to banks. A variation on these procedures is a public agency (such as a central bank) or a private institution (such as a Chamber of Commerce) administering quasi-structured procedures between a troubled debtor and its creditors. The agency or institution acts as something like a mediator ensuring that (a) creditors are furnished with appropriate information at the beginning of the procedure and (b) creditors receive a proposal which will then be discussed, together with them, at specific times and places. While negotiations take place, a stay is granted for a short period of time (e.g. three months) after which it expires.

72. Although it is not a widely established practice, sometimes workouts – (meant to restore an enterprise to financial viability) have been used with success in Colombia. There have been some cases where the basic principles inherent to workouts have been applied: for example, agreement of a group of creditors in order to take collective action; stays on executions; appointment of a manager in a group of creditors; and directives for the obtainment of decisions within the group. These agreements were based on contract law and in fact, were no more than informal, unwritten agreements between the creditors. Such bilateral negotiations, carried out between a group of creditors and the debtor, based on an underlying multilateral informal agreement were successful and

¹²⁶ In American English such mechanisms are generally known as “workouts”.

¹²⁷ Generally known in American English as “prepackaged reorganization plans”.

well received by the operators.¹²⁸ Though isolated cases, they confirm the possibility of carrying out informal agreements. This practice should be encouraged in order to complement the formal insolvency system with this informal and dynamic mechanism.

III. 5.2. Prepackaged reorganization plans

73. **Colombian law does not recognize so-called prepackaged reorganization plans.** Although Uruguay introduced in its legislation the “*concordato preventivo extrajudicial*” in 1916,¹²⁹ and Argentina introduced its own version¹³⁰ in 1983 as the “*acuerdo preventivo extrajudicial*” (APE, in Spanish),¹³¹ the concept of filing private agreements, between a majority of creditors, with a court such that they bind dissenting creditors (“prepackaged agreements”), is still foreign to Colombian law. As an exception, in the context of a liquidation proceeding, art. 205 in Law 222 provides for the possibility of an out-of-court agreement (“*acuerdo concordatario*” or “*acuerdo por fuera de audiencia*”) between the debtor and 75% of allowed creditors. Such agreement must be confirmed by the Superintendent of Companies. Though exceptional, such out-of-court agreement (“*acuerdo concordatario*”) could be seen as signaling the possibility of establishing, in future reforms, adequate regulation of prepackaged reorganization plans.

¹²⁸ During the ICR ROSC mission, we received information about a relatively recent case. Three enterprises belonging to the same group had engaged in a workout with a group of bankers, some of them foreigners. A multilateral agreement was entered into by the group, one of the foreign banks was appointed by the group as an agent of the creditors involved, and those creditors relinquished their rights to act individually against the debtor. It was also agreed that some write-offs could be made in case of timely payment. Providing the workout was successful, we understand that the debtor enterprises would be restored to viability.

¹²⁹ Arts. 1524-1530 of the Uruguayan Commercial Code

¹³⁰ Arts. 69-76 of the Argentine Bankruptcy Law (“*Ley de Concursos y Quiebras*”) No. 24.522 of the Argentine Republic.

¹³¹ In both countries, a stay is granted when the debtor files before the court an agreement reached between the debtor and a qualified majority of creditors. In Uruguay, a qualified majority is comprised of 3/4 of the total debt, including 3/4 of the trade debts originated in the ordinary course of business of the debtor, and in Argentina the “qualified” majority is actually an absolute majority of common creditors, representing 2/3 of the total unsecured debt. Upon filing of the requisite document, the judge orders a stay and the publication of notices. Dissenting creditors can lodge their opposition within specified deadlines. Once the objections are resolved – and provided other requisite conditions are met – the agreement is confirmed by the judge and will be binding, even upon the dissenting creditors. In Argentina, the new law of 2002 also introduced lower costs, as no administrators are appointed and besides, a special low-cost system was introduced for professional fees. This system has been widely applied by debtors in the wake of the 2001/2002 crisis.

IV. RECOMMENDATIONS

74. **Numerous reforms are needed in the legal and institutional framework for creditor rights and insolvency proceedings. These can be categorized according to a variable order of priorities.** Our review of the legal and institutional framework applicable for security interests (their creation, priority, registration and enforcement) and insolvency (reorganization and liquidation insolvency proceedings) in Colombia, leads us to the conclusion that it is very important to undertake a number of reforms. In line with that, we have drawn up several recommendations. We hope that these recommendations will be submitted for the consideration of the major players in the Colombian financial and corporate system, leading to the preparation of drafts for concrete legal reforms and plans for the achievement of instrumental improvements in institutions. Given the seriousness of the diagnosis, we recommend that action is taken on every front in pursuit of the recommendations. It would obviously be unrealistic to expect the simultaneous adoption of all the suggested reforms. For this reason, they are separated into two categories, according to the following order of priority:

- ✓ **Priority 1:** those fields and issues most in need of reform, without which any substantial, tangible and effective improvement in the existing credit environment is unlikely. The reforms should ideally be carried out within 12-18 months from now.
- ✓ **Priority 2:** reforms that would contribute to make the system considerably more effective, but which are not as essential or urgent as those classed as Priority 1. These reforms should ideally be carried out within 36 months from now.

Priority 1

75. **The priority of secured creditors must be improved.** In order to expand credit and lower its cost, it is essential to modify the current rank of priorities so that secured creditors are more highly ranked among creditors. Since the ranking is regulated by the Civil Code,¹³² this reform demands the modification of substantive legislation contained in that code. Alternatively, so as to obviate the need for changes to the Civil Code, the application of its priority regime could be limited to situations where creditors in insolvency proceedings agree that it should be applied. This could be achieved by establishing a system for priority of creditors in the Colombian insolvency law, governing the creditors' agreement in insolvency proceedings. Similar provisions can be found in the Argentine legislation¹³³ and Spain's recent insolvency legislation.¹³⁴ Improving the priority

¹³² Arts. 2494 to 2511 Civil Code (see Annex 2).

¹³³ Insolvency Law N° 24.522 of the Argentine Republic, article 239 (beginning): "When there is an insolvency proceeding, privilege shall only be given to claims listed in this chapter, and according to their dispositions".

¹³⁴ In commenting on the new Spanish Insolvency Law (LC), in force as of September 2004, Pilar López Molina states: "Within the framework of insolvency proceedings, the current system for priority of claims is contained in the LC. This law designs a system for priority of claims certainly innovative with respect to the one applied in our country, for more than a century, in insolvency proceedings. The LC excludes, in case of an insolvency proceeding, the application of the general regime for priority of claims of the CC (Civil Code)."

of creditors with a right *in rem* implies the introduction of changes that would impact labor and/or tax claims (both of which are currently ranked more highly secured creditors).

- **Priority of tax claims.** Regarding tax claims, the current legislative trend,¹³⁵ also recommended as an international standard,¹³⁶ is that they should not have priority over secured creditors. This is because giving them such priority limits access to corporate credit and/or increases its costs. This, in turn, has a detrimental impact on the economy in general, and indirectly therefore, the state's tax revenue. Furthermore, giving a significant priority to tax claims often acts as a disincentive for tax collection agencies to diligently collect taxes on time. Germany eliminated the priority of tax claims in its new insolvency law, which came into force in January 1999. Spain's law also follows that trend.¹³⁷ Brazil's recent insolvency law also modified the previous priority system (which was similar to the Colombian system) placing secured claims over tax claims in creditor rankings.¹³⁸
- **Priority of labor claims.** With respect to labor claims, in order to avoid the effect currently produced by the priority of labor claims over secured claims, and in turn preserve (and even improve) the maximal protection of labor claims, it should be possible to implement a system to eliminate the concurrence between them. This ideal approach is achieved by establishing a guarantee fund as a resort for labor creditors to obtain payment of the totality or a significant part of labor obligations

(Pilar López Molina in Alberto Palomar Olmeda, ed., "Comments on the Insolvency Law" (*Comentarios a la Legislación Concursal*), (Madrid, Editorial Dykinson, S.L., [2005?]), p. 806-807.

¹³⁵ "There is an unmistakable trend to reduce tax priorities, both in developed and transition countries as part of more general insolvency law reform efforts, which is in line with the recommendation in the UNCITRAL Guide that insolvency laws minimize the priorities accorded to claims that are not based on commercial bargains", International Insolvency Institute – Committee of Tax Priorities in Bankruptcy, "Governmental Tax Priorities in Insolvency Proceedings", (March 2006), available at www.iiiglobal.org

¹³⁶ World Bank, *Principles for Effective Insolvency and Creditor Rights Systems*, (Revised, 2005). Principle A2: "...The typical hallmarks of a modern mortgage system include the following features: ...Clear rules of ownership and priority governing competing claims or interests in the same assets, eliminating or reducing priorities over security interests as much as possible"; Principle A3: "...A mature secured transactions system enables parties to grant a security interest in movable property, with the primary features that include: ...Clear rules of priority governing competing claims or interests in the same assets, eliminating or reducing priorities over security interests as much as possible"; Principle C12.3: "Following distributions to secured creditors from their collateral and payment of claims related to costs and expenses of administration, proceeds available for distribution should be distributed *pari passu* to the remaining general unsecured creditors, unless there are compelling reasons to justify the priority status of a particular class of claims. Public interests generally should not be given precedence over private rights. The number of priority classes should be kept to a minimum" (see <http://www.worldbank.org/gild>).

¹³⁷ Commenting on Spain's 2004 Insolvency Law, it has been said: "Current insolvency legislation in countries in our region, specifically within the European Union, show a general tendency to the reduction of credit claims, to the progressive limitation of prerogatives of claims in Public Administrations and to a better administration of the company in distress directed to its eventual viability, preventing insolvency proceedings from being inevitably bound to the liquidation of the insolvent company" (Pilar López Molina, *op. cit.*, p. 808) The advantages and disadvantages of the tax privilege were also analyzed at the time of the Spanish insolvency reform. The conclusion arrived at was that laws which treat the government as an ordinary or unsecured creditor promote greater efficiency (Rocío Albert-López and Joaquín Artés-Caselles, "*Bankruptcy Proceedings and Government: Should Bankruptcy Law Grant Privileges to Treasury?*", (2003) German Working Papers in Law and Economics: Vol 2003: Article 9, available at <http://www.bepress.com/gwp/default/vol2003/iss1/art9>).

¹³⁸ See the works cited in the following footnote.

left unmet by insolvent employers. Thus, labor creditors are not required to participate in insolvency proceedings, and in fact, have better protection than they would have had through such proceedings. In turn, secured claims would have a significant and effective priority over other creditors. Germany has established a protection system such as the one described. Its labor claim guarantee fund came into force after the insolvency reform of the second half of the 1990s. Another option, having less impact but still resulting in an improvement to the current situation, is the one recently adopted by Brazil. In this reform, labor claims maintain a higher rank than secured claims, but their priority is only effective up to a legally established maximum amount. When the amount is beyond the legal ceiling, the labor claim has no priority over the secured claim.¹³⁹

76. Enforcement mechanisms for security interests must be expanded and the effectiveness of the existing mechanisms must be improved. Without effective enforcement mechanisms allowing creditors to collect on secured claims, other reforms to the securities regime will have little or no effect. This implies reforms to the current insolvency legislation and, eventually, the preparation and approval of a new procedural law. In line with the conclusions of our review, the main recommendations are as follows:

- **Out-of Court Enforcement Mechanisms.**
 - Eliminate current insolvency rules that hinder the effectiveness of the enforcement system for guarantee trusts (converting them into security interests in the event of insolvency proceedings); and,

¹³⁹ Ana Carla Abrão Costa and Eduardo Luis Lundberg, *The New Brazilian Bankruptcy Law: Insolvency System Reform and Access to Credit Initiative*, (unpublished): “Two important bankruptcy priorities were reviewed to encourage creditor participation and develop governance in insolvency procedures: setting ceilings for labor credits and strengthening secured credits, now with precedence over fiscal credits. The first change intends to restrict owners, managers and other persons connected to the insolvent firm granting themselves high labor salaries and compensations, while the second is intend to improve credit and make banks and financial institutions more active during insolvency procedures. Insolvency best practices recommend no fiscal priorities, encouraging the involvement of suppliers and other creditors, but we expect that a deeper use of secured instruments will probably cover this gap”. (p. 12). “Nevertheless, one of the most relevant points that made Brazilian bankruptcy legislation different from the best international practices was the priority of secured credit. In most countries, collateral are not part of bankruptcy estate such that secured creditors have precedence over other creditors. In Brazil, under the old law, secured credits had third priority on bankruptcy. Labor credits had first priority, with no limits, followed by fiscal credits. The consequence was that collateral was useless when it was most necessary, when the company was insolvent and incapable of meeting its obligations. Together with other imperfections of the insolvency and judicial system, this was one of the most important reasons to understand why banking credit is insufficient and expensive in Brazil. This scenario was altered by the priority rules of the new bankruptcy law that settles labor credit ceilings and ranks secured credits before fiscal responsibilities. It is important to notice that the purpose of the 150 minimum wages ceiling per worker was not to suppress or eliminate labor rights, but just to change the bankruptcy priorities. The limit was important to avoid fraudulent withdrawals from the estate disguised as labor credit. In other countries, the existing labor priorities are always limited, protecting salary arrears and other liquid and right labor credits”. (p.19). See further: Thomas Benes Felsberg, Steven Kargman and Andrea Acerbi, “Brazil overhauls restructuring regime”, (January 2006) *IFLR International Financial Law Review*, 40 onwards.

- Establish out-of-court enforcement mechanisms, applicable to movable and immovable security interests relating to loans given by regular financial agencies to corporate debtors.
- **Enforcement mechanisms with minimum judicial intervention.** It is suggested that enforcement mechanisms demanding only minimum judicial intervention be created and put into effect as an alternative, complementing out-of-court enforcement mechanisms mentioned in the previous paragraph. Using such mechanisms, judicial intervention would only be to confirm the formal regularity of the collateral and to make an order that the creditor be given possession of the encumbered asset. The rapid dispossession of the debtor ordered by a judge in a summary manner (with argument permitted between the parties) would allow the creditor to proceed to the sale of the collateral. This private sale would avoid the delays and costs associated with the judicially forced sale of assets, currently experienced in judicial executory proceedings. The procedural protection of the debtor's rights should be limited to the possibility of filing a claim against the creditor after execution. Such a mechanism, also limited to certain claims of regular financial entities, would allow the substantial shortening of the long periods currently involved in the recovery of secured claims.
- **Judicial Enforcement Mechanisms.** It is essential that the judicial enforcement proceeding takes on a real executory character. Opportunities for the debtor to use procedures to postpone the payment of credits must be reduced or removed. A revision of the procedural legislation regulating enforcement procedures is recommended to this effect. This would allow the introduction of, at least, the following reforms:
 - Limiting the admissible defenses in the executory proceedings, preventing argument on subjects related to the cause of the loan or the executory instrument, as well as on any matter regarding the substance of the loan (or of the “underlying relationship” that led to the instrument being executed). Admissible defenses in the executory proceedings should be limited to formal defects invalidating the instrument or the collateral, and discharge of the debt (by duly evidenced payment or equivalent means for debt cancellation). In an executory proceeding, prohibited defenses should be dismissed by the judge without further argument. Argument on such points should be postponed to the debtor's instigation of a subsequent proceeding post-execution.
 - Significantly limiting or eliminating the possibility of appeals or other forms of recourse, or actions with equivalent effects (such as constitutional injunctions), against judicial decisions ordered during executory proceedings. Any such claims should be deferred to an appeal against the executory decision and/or eventually, to subsequent proceedings of full cognizance. In order to maintain the speed of executory proceedings, appeals must not have a staying effect on the judicial decisions rendered in such proceedings.

- Establishing fines to be applied by judges or courts as sanctions against those litigating maliciously.
- Simplifying the procedure for the seizure of the assets to be executed and for the procedure related to their forced sale. This should enable the realization of seized assets, or of those subject to a security interest, to take place after the executory decision - within a brief period, in a single act and with no previous valuation. The immediate distribution of the creditor's or correspondent creditors' proceeds should also be carried out. Matters concerning the exact amount of the claim recognized by the decision should be settled separately, without any delay to, or suspension of, the forced sale of assets.

77. **The legislation regulating the insolvency system must be significantly reformed.** The tremendously unfavorable impact of existing Law 550 on creditors' interests, particularly secured creditors, leads to the emphatic recommendation to replace the current system, always intended to be a temporary reaction to a crisis, with another insolvency law. This law should be more appropriate to situations of relative economic normality and in line with the best international practices. Detailed consideration of the general principles and recommendations in the most recent international documents on this subject is recommended.¹⁴⁰ Any new insolvency law should reform, at least, the following aspects of the current regime:

- **Internal Creditors.** Removal of the class of "internal creditors", eliminating shareholders' legal status as creditors (merely for being shareholders).
- **Observance of Priorities in Reorganization Plans.** Ensure observance of the priority of claims recognized in insolvency proceedings, including as regards voting for reorganization agreements and in the relative sacrifices that such agreements could impose on the different classes.
- **Consensual Priorities.** Removal of "consensual priorities" and prohibiting other creditors, or other classes of creditors, from modifying the priority of secured creditors without their consent.
- **Trusts-in-Guarantee.** Preserving the validity of trusts-in-guarantee by repealing the rules that provide for their conversion into security interests after the commencement of insolvency proceedings.
- **Safeguards for Secured Creditors during Stays of Executions.** Establishing reasonable and temporal limits to the stays of execution made against creditors with a right *in rem*. Further, enabling creditors to secure the end of such stay when there is a proof that secured assets are not necessary for reorganization or where as a result of the protracted stay, the collateral has deteriorated causing serious damage to the creditor.

¹⁴⁰ In this respect, the basic documents for consultation are World Bank, *Principles for Effective Insolvency and Creditor Rights Systems*, (Washington, World Bank, 2001, revised 2005), (available at <http://www.worldbank.org/gild>), and UNCITRAL, *Legislative Guide on Insolvency Law*, (Vienna UN 2004) (available at <http://www.uncitral.org>)

- **Prepackaged Reorganization Plans.** Establishing the possibility of reorganization plans negotiated and approved by a significant majority of creditors outside a formal insolvency proceeding, being converted into formal reorganization plans with all their legal effects, binding dissenting creditors. For this purpose, a fast-track procedure must be instigated before a court, ensuring the transparency and formal regularity of the agreement.
- **Petition of Liquidation by Creditors.** Entitling creditors to make an application for commencement insolvency liquidation proceedings relating to the debtor.
- **Liability of Directors and Officers.** Establishing provisions to streamline and encourage actions seeking to establish personal liability against directors and officers of the insolvent company.
- **Insolvency Effects on Executory Contracts.** Adopting a modern system for the comprehensive treatment of the effects of insolvency on executory contracts; fostering alternatives for the continuation, termination or assignment of contracts; and repealing the existing sanctions against contracts stipulating termination clauses due to insolvency (without discounting the possibility that the law should invalidate such clauses).
- **Recognition of Controversial Claims. [? Contentious claims]** Simplifying and accelerating the procedures for the recognition of controversial claims; adopting, in insolvency proceedings, mechanisms for the alternative resolution of such disputes, such as arbitration and mediation.
- **Cross-Border Insolvencies.** Adopting modern rules for the treatment of the aspects of insolvencies with cross-border impact, such as those provided by the Model Law on Cross-Border Insolvency.¹⁴¹
- **Independence of the Jurisdictional Authority.** Establishing by law the independence of the Superintendent of Companies, providing objective criteria for the selection and removal of its officers, and ensuring that they shall not be removed without following the same procedures that guarantee the independence of judges in Colombia.
- **Guarantee of defense and possibility of recourse.** Establishing the possibility of appealing before the courts of the judicial branch all the decisions taken by the Superintendent of Companies, which have an irreparable effect on the substantive rights of persons involved in insolvency proceedings, as a means of making effective the guarantee of defense.
- **Effectiveness of the Promoters' Duties.** Establishing a system for the selection, training and removal of Promoters, ensuring the effectiveness of their performance and modifying the remuneration mechanism so as to remove incentives for the delay of insolvency proceedings.

Priority 2

¹⁴¹ UNCITRAL Model Law on Cross-Border Insolvency, see <http://www.uncitral.org>. The Model Law was adopted in Latin America by the Mexican *Ley de Concursos Mercantiles* in 2000.

78. The legal regulation of non-possessory pledges should be made more flexible.

All the precautions preventing, hindering or making uncertain the use of security interests that are not susceptible of detailed identification should be removed from the Code of Commerce, so that the possibility of creating pledges on all types of assets is unquestionable. This would widen the type of assets susceptible to being pledged, removing doubts about the possibility of pledging generic products, fungible goods, raw materials susceptible of transformation, estates, intangible assets, and so on.

79. Registries for real estate, and filings involving movables, must be improved.

The improvement of registration systems results in immediate advantages: facilitating the creation of secured interest, improving its safety and reducing, thereby, the cost of secured lending. Our recommendations can be summarized in two words: computerization and interconnection. The complete computerization of registries would eliminate the lack of security in the storage of information, as well as the risk of duplicating secured interests on the same movables. It also speeds up the entry and recovery of registered data, lowering registration costs in the medium term. The interconnection of the different registries would allow credit providers to accurately retrieve information, without having to travel from one regional registry to another. Such a system should also contribute to the prestige of security interests and to the lowering of the cost of secured credits.

80. Creation of a favorable environment for amicable or informal negotiations of out-of-court agreements to resolve severe financial difficulties or corporate insolvency.

Apart from the essential reforms to be introduced in the legislation governing formal insolvency proceedings, the possibility of creating a legal and regulatory environment to induce corporate debtors, in severe financial distress or insolvency, to attempt an informal reorganization with some or all creditors through out-of-court negotiations, should be considered. If required to bind dissenting creditors, it should be possible for such informal workouts approved by significant majorities to follow a formal fast-track procedure. This procedure should be designed to such agreements the same status as those contained in reorganization plans, achieved in a formal insolvency proceeding. Generally, it is essential to revise and consequently introduce reforms in the tax legislation, and in norms of banking regulation, to encourage informal solutions in corporate insolvency. These are intended to create an environment fostering the informal resolution of severe financial difficulties or corporate insolvency. At the same time, the “shadow” of effective and formal insolvency legislation will provide an incentive for such informal negotiations.

ANNEX 1 - SENATE BILL 207/05 ON INSOLVENCY REGIME

**EVALUATION AND SUMMARY ANALYSIS
 OF
 INSOLVENCY RECOMMENDATIONS AND THE PLANNED REFORMS**

81. **While Senate Bill 207/05 ("the Bill") improves certain aspects of the current insolvency regime, it does not yet respond adequately to several of the key recommendations for the regime's significant improvement set out in Part IV of this document.** Part IV comprises fourteen core recommendations, each of which relates to discrepancies between the Colombian system and the most successful international practices. This Annex provides an evaluation and a summary analysis of the reforms contained in the Bill, in the light of our recommendations. In some cases, the proposed rules are entirely in line with the recommendations ("Observed"), or substantially in line with them ("Largely Observed"). Other of the recommendations, however, do not sound at all in the Bill ("Not Observed") or, where there is relevant reform of the current system, it is not substantially in line with the recommendations ("Materially Not Observed"). There are very important aspects of the planned insolvency system that fall into the two last categories. In order to align the system with the most successful international practices, and in doing so, create a balanced insolvency system contributing to the restoration of confidence in the Colombian institutional and legal framework for creditor rights, it would be necessary to introduce some modifications to the Bill, as indicated below.

INSOLVENCY RECOMMENDATIONS AND BILL 207/05	Number	Category
Observed: 1st, 6th, 10th, and 11th	4	O
Largely Observed: 3rd and 8th	2	LO
Materially Not Observed: 2nd and 9th	2	MNO
Not Observed: 4th, 5th, 7th, 12th, 13th and 14th	6	NO

RECOMMENDATION	Internal Creditors. Remove the class of “internal creditors”, eliminating shareholders’ legal status as creditors (merely for being shareholders).	1st
EVALUATION	Observed. In the Bill, shareholders are not considered “internal creditors” merely for the fact of their share-holding.	O
RECOMMENDATION	Observance of priorities in reorganization plans. Observe the priority of claims recognized by the substantive law of the country in insolvency proceedings. This requires respect for the hierarchy of creditors, both when voting for reorganization agreements and in the relative sacrifices that such agreements may impose on the different classes.	2nd
EVALUATION	<p>Materially Not Observed. For voting purposes, article 34 of the Bill establishes five classes of creditors. One consists of “creditors with a security interest or trust” other than financial institutions (literal 1.d). Another is made up of “financial institutions” (literal 1.c), regardless of the priority rank held by the respective credits of the various financial institutions appearing in a particular reorganization proceeding. Therefore, the priority granted to security interests by the legislation does not represent a criterion defining classes of creditors for the purpose of voting on reorganization plans.</p> <p>Article 34 of the Bill also establishes that the plan be approved by an absolute majority of votes, requiring favorable votes from: (i) three classes, when there are five or four; (ii) two classes, if there are three; and (iii) both classes, if there are two. Votes are indistinctly added up; therefore, creditors with a lower rank than secured creditors can constitute an absolute majority and thus impose a binding agreement on secured creditors. This is notwithstanding the fact that secured creditors theoretically, and according to civil legislation, have a superior priority.</p> <p>The risk of imposing notoriously detrimental reorganization agreements on secured creditors is lessened, to an extent, by Article 36 of the Bill. It establishes a stricter majority (75% of the total votes related to the class whose credits shall be affected) when the agreement contains conditions entailing a uniform reduction on the value of capital related to credits provided by one class.</p> <p>Art. 37 of the Bill further provides that stipulations of the reorganization agreement “shall respect, as regards payments, the priority, privileges and preferences provided for in the law”. Nevertheless, no provision prevents stipulations in the</p>	MNO

	<p>agreement being more onerous on creditors with a right <i>in rem</i>, than on lower-ranked creditors.</p> <p>Art. 40 (section four) of the Bill provides that the adjudication agreement must respect “in any event” the priorities of law.</p>	
RECOMMENDATION	Consensual Priorities. Remove “consensual priorities” so as to prohibit other creditors, or other classes of creditors, from modifying the legal priority of a secured creditor without his consent.	3rd
EVALUATION	Largely Observed. Article 44 of the Bill provides that “the priority of claims can be modified in the agreement”. Nevertheless, paragraph 3 of that Article provides a safeguard, establishing that the alteration of a priority will depend on the fact that “no class of creditors will be downgraded; rather, the category of those submitting fresh resources or adopting, in general, conduct that will contribute to the improvement of the working capital and the debtor’s recovery will be enhanced”. At this stage, it is difficult to say whether future practice related to this safeguard will suffice to protect the priorities of secured creditors, whose claims arose prior to the reorganization proceeding.	LO
RECOMMENDATION	Trusts-in-Guarantee. Preserve the validity of trusts-in-guarantee by repealing the rules that provide for their conversion into security interests after the commencement of insolvency proceedings.	4th
EVALUATION	Not Observed. In both reorganization proceedings and in the payment and discharge procedure (Articles 20, 41, 46 and 53 of the Bill), there are rules suspending the enforceability of trusts-in-guarantee and their automatic conversion into security interests (movables or immovables, as appropriate).	NO
RECOMMENDATION	Safeguards for Secured Creditors during Stays of Execution. Establish reasonable and temporal limits to the stays of execution of creditors with a right <i>in rem</i> . Additionally, enable creditors to claim the end of such stay when there is proof that secured assets are not necessary for reorganization, or that, as a result of the protracted stay, the collateral has deteriorated causing serious damage to the creditor.	5th
EVALUATION	Not Observed. Article 46 of the Bill provides for the suspension of the enforceability of “encumbrances, security interests and trusts settled by the debtor” while the agreement is “in force”. Apparently, the expression “in force” refers to the reorganization	NO

	agreement, until it is “terminated”. Termination, according to Article 48 of the Bill, normally occurs only when the “discharge of contracted obligations” in the agreement has taken place (or earlier, in case of breach of the agreement). Consequently, the suspension of the enforcement of collateral, except otherwise specifically provided for in the plan, would last until all agreed obligations have been satisfied. This situation might result in the suspension of enforcement against secured assets for very long periods (periods of around ten years can be anticipated). The Bill makes no provision for suspension to be discontinued neither in the event that the collateral has deteriorated nor in the event that suspension is not considered strictly necessary for reorganization.	
RECOMMENDATION	Prepackaged Reorganization Plans. Provide for the possibility of reorganization plans negotiated and approved by a significant majority of creditors, outside a formal insolvency proceeding, being converted into formal reorganization plans with all their legal effects, binding dissenting creditors. For this purpose, a fast-track procedure must be implemented before the judicial authority, ensuring the transparency and formal regularity of the respective agreement.	6th
EVALUATION	Observed. Article 88 of the Bill provides for the possibility of the judicial validation of out-of-court reorganization agreements.	O
RECOMMENDATION	Petition of Liquidation by Creditors. Entitle creditors to make an application for commencement of the debtor’s insolvency liquidation proceedings.	7th
EVALUATION	Not Observed. Article 52 of the Bill, regulating the opening of the liquidation procedure (“ <i>proceso de pago y extinción inmediata</i> ”), does not entitle creditors to make an application for commencement of such procedure by themselves. A plurality of creditors, holding at least 50% of the debt, is permitted to petition for the opening of liquidation proceedings in case of failure of imminent payment, but only to the extent that such petition is filed “jointly” with the debtor.	NO
RECOMMENDATION	Liability of Directors and Officers. Establish provisions to streamline and encourage actions seeking the establishment of personal liability on the part of directors and officers of the insolvent company.	8th
EVALUATION	Largely Observed. Article 85 of the Bill establishes that administrators (and other similar officers) who, with malice or negligence worsened the “creditors’ common pledge” (assets	LO

	<p>constituting the estate of the insolvent person), will be held individually liable. This means that they will have to pay any portion of the debtor’s liabilities (vis-à-vis the creditors) not satisfied with the realization of the insolvency estate. This rule aims to improve the creditors’ standing, effectively replenishing the estate (that is to say the creditor’s “pledge” or common guarantee), when it suffered loss due to the malicious, or other culpable behavior, of the company’s administrators.</p> <p>Article 86 of the Bill provides for the disqualification (from participating in business transactions, for up to twenty years) of administrators and shareholders of the insolvent legal entity or insolvent natural persons. The requirements for applications for such disqualification are described in the Article, in a list of reprehensible conduct - having expository character (literal 10.) Disqualification amounts to a real sanction (personal, rather than against the estate) of a non-penal character. In Article 5, literal 6 of the Bill, competence for decisions on applications for disqualification is ascribed to the Superintendent of Companies. There is no provision for the appeal, of what is a very serious decision, before the courts of the Judicial Branch is not established (apparently, the first paragraph of Article 6 does not apply to decisions on disqualification).</p> <p>Article 87 of the Bill establishes a penal sanction of up between 5-10 years maximum imprisonment for various officers (including social administrators) who participate in acts tending to defraud creditors.</p> <p>It is advisable that decisions of this seriousness be subject to the competence of the judicial body owing to the grave consequences involved, in particular the personal liability of third-parties.</p>	
<p>RECOMMENDATION</p>	<p>Insolvency Effects on Executory Contracts. Adopt a modern system for the comprehensive treatment of insolvency effects on executory contracts, providing for the continuation, termination or assignment of contracts. Further, repeal the existing sanctions for cases of contracts with clauses that provide for termination on insolvency (without discounting the possibility that such clauses should be invalidated).</p>	<p>9th</p>
<p>EVALUATION</p>	<p>Materially Not Observed. Article 24 of the Bill, regulating the continuity of contracts in reorganization proceedings, permits the debtor to apply for authorization from the Superintendent of Companies to terminate contracts, when renegotiation is unsuccessful. The impact of such termination for the other party</p>	<p>MNO</p>

	<p>to the contract is not clear however. The Bill simply states that “the correspondent compensation shall be subject to the results of the reorganization proceeding” (Article 24, final sentence).</p> <p>Article 19 of the Bill maintains as sanctions the subordination of claims and cancellation of collateral, applicable to those creditors who try to make enforce contractual clauses that provide for unfavorable consequences for the debtor on the opening of reorganization proceedings.</p>	
RECOMMENDATION	Recognition of Controversial Claims. Simplify and accelerate the procedures for the recognition of contentious claims, adopting, in insolvency proceedings, mechanisms for the alternative resolution of these disputes, such as arbitration and mediation.	10th
EVALUATION	Observed. The Bill discards the verbal and summary procedure formerly required to resolve objections related to the recognition of claims. Currently, there is an ongoing project for the establishment of an accelerated summary procedure, whereby every objection would be resolved in a unique hearing (Articles 32 and 33 of the Bill).	O
RECOMMENDATION	Cross-Border Insolvencies. Adopt modern rules for the treatment of the aspects of insolvencies with cross-border impact, such as those provided by the Model Law on Cross-Border Insolvency.	11th
EVALUATION	Observed. Title III. “On Cross-Border Insolvency” (articles 89 to 120 of the Bill) incorporates regulations from the UNCITRAL Model Law.	O
RECOMMENDATION	Independence of the Jurisdictional Authority. Establish by law the independence of the Superintendent of Companies. Provide objective criteria for the selection and removal of its officers, and ensure that they shall not be removed arbitrarily or without following the same procedures that guarantee the independence of judges in Colombia.	12th
EVALUATION	Not Observed. Although the judicial powers of the Superintendent of Companies are maintained (and even increased), its officers are not made subject to the same principles and rules applicable to the independence of the judicial branch. The Bill does not make provision for a procedure, based objective criteria, for the selection and appointment of the Superintendent’s officers. Its officers have no guarantees as to their security of tenure. The system does not	NO

	guarantee the institutional independence of the authority with jurisdiction in insolvency proceedings, in spite of the fact that the planned regime is not characterized its emergency and provisional nature as was Law 550. This means that the allocation of judicial powers to an administrative entity, having no institutional independence, would no longer be “exceptional”, but regular and permanent.	
RECOMMENDATION	Guarantee of defense and possibility of recourse. Establish the possibility of appealing before the courts of the judicial branch all the decisions taken by the Superintendent of Companies, which cause an irreparable burden to the substantive rights of persons involved in insolvency proceedings, as a means of making effective the guarantee of defense.	13th
EVALUATION	Not Observed. Article 6 of the Bill provides for final rulings in the insolvency proceedings to be made by the Superintendent of Companies. Only “decisions of civil responsibility shall be subject to appeal with deferred effect, before the Superior Court of the Judicial District of the debtor’s domicile” (Article 6, first paragraph). All other resolutions of the Superintendent of Companies are considered immune from appeal before the judicial branch.	NO
RECOMMENDATION	Effectiveness of the Promoters’ Duties. Establish a system for the selection, training and removal of Promoters, ensuring the effectiveness of their performance and modifying their remuneration mechanism so as to remove incentives for the delay of insolvency proceedings.	14th
EVALUATION	Not Observed. The Bill does not resolve the matter. The rules provide that the Executive is charged with regulating “matters related to promoters and liquidators, including requirements for their registration in the list, appointment, functions, burdens, settlement of legal bonds, fees, grounds for recusation and removal, dismissal, among others” (Article 70, last sentence).	NO

ANNEX 2 - PRIVILEGE REGIME

CIVIL CODE OF THE REPUBLIC OF COLOMBIA

ARTICLE 2494. <SECURED CLAIMS>. Claims of the first, second and fourth classes have priority.

ARTICLE 2495. <FIRST-CLASS CLAIMS>. The first-class claims include those resulting from the following:

1. Judicial costs caused in the general interest of creditors.
2. The required funeral expenses of a deceased debtor.
3. Expenses related to the disease resulting in a debtor's death.

If the disease lasted more than six months, the judge shall set the sum for the privilege, according to the circumstances.

4. <Paragraph amended by article 36, Law 50 of 1990. The new text is the following:> Wages, salaries and every provision arising from the labor contract.

5. The necessary articles for the subsistence provided to the debtor and his/her family in the past three months.

On petition of creditors, the judge shall have the power to assess this expense if he considers it excessive.

<VALIDITY NOTE: UNENFORCEABLE has been crossed out. Subsection added by article 134, Decree 2737 of 1989. The new text is the following.> Alimony claims, in favor of minors, are included in ~~the fifth cause of~~¹⁴² first-class claims and are regulated by norms of the present chapter. Where not provided for, by norms contained in the Civil Code and in the Code of Civil Procedure.

6. Tax agencies claims and those pertaining to municipalities, arising from fiscal or municipal accrued taxes.

ARTICLE 2496. <ASSETS SUBJECT TO FIRST-CLASS CLAIMS>. Claims listed in the previous article affect all the debtor's assets. In case they cannot be completely covered there will be preference over others according to their numbers, whichever the date might be, and those included in each number shall share it *pro rata*.

Claims listed in the previous article shall not pass, in any case, to third parties.

¹⁴² Crossed out section has been declared UNENFORCEABLE by the Constitutional Court, by Decision C-092-02 of 13 February, 2002, Acting Judge Dr. Jaime Araújo Rentería. In this decision, the Court declared CONDITIONALLY unenforceable the rest of the disposition: "that is to say, whenever it is understood that the children rights prevail over the other rights and the claims for alimony in favor of minors prevail over the rest of the first class."

ARTICLE 2497. <SECOND-CLASS CLAIMS>. Second-class claims are held by the following persons:

1. The innkeeper, on properties introduced by the debtor into the inn, as long as they remain there and until covering the debt for lodging, expenses and damages.
2. The carrier or transport businessman, on the carried goods remaining in his hands or in those of his agents or employees, until the debt for transport, expenses and damages is covered, provided those goods belong to the debtor. Presumptively, the properties introduced into the inn, or the goods carried by the debtor are considered his property.
3. The pledgor on the pledge.

ARTICLE 2498. <EXCLUSION OF RECIPROCAL CLAIMS>. When affecting a same object, first-class and second-class claims, the latter ones will exclude the previous ones. If the remaining assets were insufficient to cover first-class claims, these will have priority as regards the deficit and shall concur in such object, according to the order and manner stated in the first subsection of article 2495.

ARTICLE 2499. <THIRD-CLASS CLAIMS>. The third-class of claims includes mortgages.

On petition of the respective creditors or any of them, a separate insolvency proceeding can be filed for each of the mortgaged properties, so that they receive immediate payment with the corresponding proceeds according to the order of the date stated in their mortgages.

Priority for mortgages settled on the same date and on the same property will be given according to the order of their registration.

In this insolvency proceeding, the resulting judicial costs will be paid in first place.

ARTICLE 2500. <EXTENSION OF FIRST-CLASS CLAIMS TO MORTGAGED PROPERTIES>. First-class claims shall not be extended to mortgaged properties, except in case the debtor's assets prove to be insufficient so as to cover these claims in full.

Thus, the deficit shall be divided among the mortgaged properties, in proportion to their value, and the corresponding portion shall be covered accordingly in the order and manner stated in article 2495.

ARTICLE 2501. <ENFORCEMENT OF MORTGAGED CREDITS>. Mortgagors shall not be obliged to await the results of the general insolvency proceeding in order to perform their actions against the respective properties: the deposit of a reasonable amount shall suffice to pay first-class claims, according to their corresponding portion, and the remainder shall be returned to the estate after covering their actions.

ARTICLE 2502. <FOURTH-CLASS CLAIMS>. Fourth-class claims include:

1. Those held by tax agencies against collectors, administrators and auctioneers of revenues and public property.

2. Those of charitable or education organizations, financed by public funds and those of the “*corregimientos*” *, which are in charge of collectors, administrators and auctioneers, of their revenues and assets.
3. <Ordinal repealed by article 70 of Decree 2820, 1974.>
4. Those related to minors, whose assets are administered by their father, on the latter’s assets.
5. Those of persons under guardianship or curator ship, against their respective guardians or curators.
6. <Ordinal repealed by article 70 of Decree 2820, 1974.>

ARTICLE 2503. <PRIORITY AMONG FOURTH-CLASS CLAIMS ACCORDING TO THE DATE>. Claims listed in the previous article each have preference, without distinction, according to the date of their case, namely:

The date for the appointment of administrators and collectors or the auction date regarding claims contained in numbers 1 and 2.

The one related to the respective matrimony in claims described in numbers 3 and 6.

The one corresponding to the child’s birth, in those referred to in number 4.

The one related to the judicial appointment of guardianship, in number 8.

ARTICLE 2504. <EXTENSION OF THE FOURTH-CLASS PRIORITY>. It is understood that preferences related to numbers 3, 4, 5 and 6 are settled in favor of real estate or the related rights *in rem*, brought by the woman to the marriage; or of real estate or the related rights *in rem* owned by the respective minors, or of persons subject to guardianship or curatorship, and passed to the husband, father, guardian or curator; and in favor of all assets where the rights of the same persons are justified by solemn inventories, wills, distribution acts, adjudication orders, public deeds referred to antenuptial settlements, donations, sale or barter, or others attesting equal authenticity.

Fourth-class priority also includes rights and actions of a wife against her husband; or those of minors and persons under guardianship or curatorship against their parents, guardians or curators, because of malice or negligence in administrating the respective assets; charges are to be proved in an irrefutable way.

ARTICLE 2505. <JUDICIAL CONFESSION AGAINST CREDITORS>. <Article modified by article 67, Decree 2820 of 1974. The new text is the following.> The confession of the bankrupt father, mother, guardian or curator shall not represent, in itself, evidence against creditors.

ARTICLE 2506. <SCOPE OF FOURTH-CLASS CLAIMS>. Priorities related to fourth-class claims affect every debtor’s assets, although rights are not conferred against third parties. And they can only be granted after claims involving the first three classes have been covered, regardless of their date.

ARTICLE 2507. <HEIRS’ ASSETS SUBJECT TO FIRST AND FOURTH-CLASS PRIORITIES>. Assets of the deceased debtor subject to first-class priorities shall affect the

* Translation note: a name given to some magistrates or mayors in Ancient Spanish.

heir's assets accordingly, unless the latter has accepted the inheritance exercising the right of inventory, or in the event that creditors have the benefit of separation, for in both cases inventoried or separate assets shall be affected.

The same rule shall be applicable to assets related to the fourth class. They shall keep the date on every heir's assets whenever the rights of inventory or separation are accepted, and they shall only keep it on inventoried or separate assets, in case the respective benefits take place.

ARTICLE 2508. <RESTRICTION OF PRIORITY ACTIONS>. The law does not recognize other priority actions than those established in the previous articles.

ARTICLE 2509. <FIFTH-CLASS CLAIMS>. The fifth and last class includes assets with no priority.

Fifth-class claims will be covered *pro rata* with the residue of the estate, despite their date.

ARTICLE 2510. <NON-COVERED CLAIMS>. Priority claims which cannot be fully covered using the resources indicated in previous articles shall pass to fifth-class assets because of the deficit, on a *pro rata* basis.

ARTICLE 2511. <INTERESTS IN SECURED CLAIMS>. Interests shall be valid until discharge of debts and will be covered with the priority corresponding to their respective capitals.