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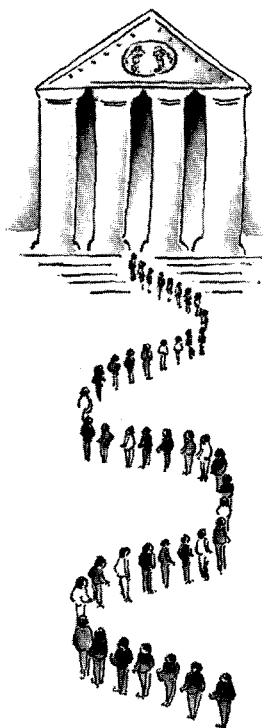
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Bankruptcy Reform—Breaking the Court Logjam in Colombia

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Ideally, bankruptcy policy should encourage the reorganization of companies whose liquidation value is smaller than their value as a going concern, and the liquidation of companies for which the opposite is true. In addition, it should encourage a speedy resolution of financial distress. The longer a company stays in bankruptcy, the greater the loss of value and the more difficult it becomes to rehabilitate the company and to pay off its creditors. The crucial issue in bankruptcy is designing a process that will distribute decisionmaking authority among the debtor, the creditors, and the oversight agency in a way that achieves these objectives. When that process gives the debtors too much power, they can simply delay in order to force concessions from creditors, with the result that firms that should be liquidated may end up being reorganized. And when it gives creditors too much power, too many liquidations may occur, leading to the loss of going concern values.

Recently, Ramachandran (1995) has suggested that the allocation of decisionmaking power in bankruptcy law affects only the tactics of the parties involved and not the eventual outcomes.¹ The view taken here is that if changes in the bankruptcy law, procedures, and institutional structure can help speed the pace at which companies move out of bankruptcy, outcomes are likely to improve. As Colombia's experience shows, that pace can be determined by the rules governing the process. Before undertaking reform in 1989, Colombia provided a good example of the kinds of problems and inefficiencies that arise when debtors are granted excessive power, there are multiple forums for dealing with bankruptcy, and the judicial system suffers from a lack of skills and limited processing capacity. The reform introduced an innovative institutional

solution to these problems: it shifted the bankruptcy procedures from the traditional judicial system to a credible administrative agency with more expertise in handling workouts.² The result was a process with more authority, more flexibility, and more speed. Colombia's reform provides a workable model for other countries suffering from congested courts.

Prereform: Two judicial forums, confusion, and high cost

In common with other countries, Colombia had two insolvency procedures. The first, the *concordato*, was basically a financial reorganization procedure, designed to reach a conciliatory agreement between a company experiencing financial difficulties and its creditors, with the purpose of rehabilitating the debtor's business. The second, the *quiebra*, was a liquidation procedure. Once a company entered *quiebra*, its assets were sold and the proceeds distributed to creditors. However, and in contrast to most other countries, Colombia had two institutions dealing with bankruptcy—the court system and the Superintendency of Companies. The Superintendency was mainly a watchdog agency that monitored companies' compliance with company law. It had oversight of firms with more than 100 workers, firms with foreign liabilities exceeding a third of their assets, and firms that were more than 50 percent government owned.

Reorganization procedures were of two types. The first was optional. It was used mainly by small and medium-size companies, and the competent authority was the district judge. By contrast, the larger firms under the supervision of the Superintendency of Companies had to go through a mandatory *concordato* if they





were unable to repay their debts. These firms could not be liquidated until after a reorganization had been attempted, overseen by the Superintendency.

Delays easy and disruptive

In mandatory *concordatos*, the debtor retained the management of the company unless fraud was established. Following admission to the process, the first step was to validate the list of claims. Any objections raised by the parties involved had to be resolved at this time. Once disagreements were resolved, the parties were convened in a hearing in which they voted on a proposal to reorganize the liabilities (and, in principle, the assets) of the company. If an agreement was reached, it went to the district judge for confirmation. If there was no agreement, the procedure was declared failed and a *quiebra* was initiated.

The *concordatos* were typically plagued by delays. From a sample of 190 firms that had entered bankruptcy between 1982 and 1989, there were 82 cases in which no agreement had been reached by May 1989. Of these, 54 had been going on for more than two years, 36 for more than three years, and 16 for more than five years.³ Most delays occurred during the validation of claims, a part of the process vulnerable to opportunistic behavior. Although the validation of claims was overseen by the Superintendency, objections had to be resolved by the district court. As a result, the resolution of bankruptcy procedures often depended on the lengthy resolution of several additional, parallel cases in different courts. Debtors wanting to delay procedures, in order to extract concessions from creditors or to strip the assets of the firm, could easily find excuses for filing objections. For example, the law required from the creditors “at least summary proof” of their loans; the fact that many loan documents, especially for smaller creditors, were inadequately prepared helped the debtors in that respect. There were no measures in the law to penalize debtors or creditors for filing objections simply to gain time or to disrupt the process.

There were other ways to delay bankruptcy procedures. To cause a hearing to be postponed, debtors could simply fail to show up, behavior against which the creditors had no remedies. The parties could appeal almost every decision of the judge or the superintendent. Objections could also be raised by creditors who were free-riding, that is, black-mailing other creditors to gain favorable treatment in the negotiations. The limited processing capacity of the court system contributed to the delays. It could take judges a long time to confirm a plan already agreed to by the creditors and the debtor. In May 1989, of the sixteen cases in which an agreement had been reached and needed only to be confirmed by the judge, nine had been awaiting confirmation for more than a year.

High cost

As a result of these delays, bankruptcy procedures often failed to yield efficient outcomes. Firms that needed to be liquidated often ended up being reorganized. And firms that were liquidated often ended up with all their assets stripped, so that there was nothing left to repay creditors.

After a financial crisis in the early 1980s, mandatory reorganizations reached an economically significant scale in Colombia. In 1986 and 1987, for example, about 60 of the 1,000 or so manufacturing companies supervised by the Superintendency were under reorganization. These companies held assets valued at about 12 percent of the country's total manufacturing assets, and as much as 20 percent of the assets in some sectors, such as textiles. Thus, the performance of the companies in bankruptcy weighed heavily in the performance of their industries.

Reform of the *concordato*: One forum and no delay tactics

In the 1989 reform of the mandatory reorganization procedures, the most significant change was the designation of the Superintendency as

the sole competent authority. The Superintendency was thus endowed with the authority to decide on matters that had previously gone to the district judge. Most important, it was given the authority to resolve disputes arising from objections raised during the validation of claims. It was also authorized to confirm any agreements reached between the parties. Granting these judicial powers to an administrative authority created a constitutional controversy, resolved only when a new constitution was introduced that permitted an administrative authority to assume the functions of a judge.

The reform also introduced time limits for the different stages of reorganization. For example, as soon as the Superintendency approves an application for a *concordato*, all evidence of claims on the firm must be provided within twenty days. The parties then have five days to object to the claims and must attend a preliminary hearing within the next fifteen days. The rules governing the final hearing are also quite strict. If the debtor does not show up and cannot justify his absence within three days, a new hearing is convened during which an agreement may be approved by vote of only the creditors. If the creditors do not show up or an agreement is not reached, the hearing can be convened only once or twice more, after which the *concordato* is declared failed.

In another move to expedite the process, the reform ruled out appeals for many decisions of the competent authority. Where appeals are possible, they do not suspend the process. The reform also allows the creditors to establish mechanisms for control and monitoring during the procedure. It requires the formation of a creditors committee of representatives of different classes of creditors (including workers, public agencies, and financial and nonfinancial creditors). It also requires the appointment of an examiner of the property, credits, and affairs of the debtor. Both the committee and the examiner have extensive functions. In particular, both can request that the competent authority remove the debtor from the management of the firm.

TABLE 1 DURATION OF REORGANIZATION PROCEDURES

Duration (months)	Procedures initiated before the reform	Procedures initiated after the reform
12 or less	28 (18)	8 (32)
13 to 24	51 (34)	7 (28)
25 to 48	44 (29)	2 (8)
49 or more	17 (11)	—
Unfinished	12 (8)	8 (32)
Total	152 (100)	25 (100)

Note: Figures in parentheses are percentage shares of the total. Prereform figures cover the decade prior to reform. To make the results more comparable, the second column concentrates on those cases initiated between May 1989 and the end of 1991. Without the cutoff more recent cases would not have had enough time to come to closure and so the ratio of unfinished cases under the new code would have been biased upwards.

Source: Colombia Superintendency of Companies.

Impact and lessons

With the reform still relatively new, it is hard to evaluate its overall impact. But it seems that bankruptcy cases are being resolved more quickly. The proportion of cases in which an agreement is reached within a year has increased from 18 percent to 32 percent (table 1). Before the reform, only 52 percent of cases resulted in an agreement within two years; this ratio has now increased to 60 percent. These percentages probably underestimate the real benefits of the reform. Since parties dissatisfied with the way the Superintendency handles the procedures have some room to appeal,⁴ in principle, the gains described above should be contrasted with any additional delays caused by appeals. But data on appeals are not available. However, the business community, including both creditor banks and debtors, have generally welcomed the reform, suggesting that improvements are real and substantial.⁵

No comparable data exist for the optional cases that still take place in the traditional court system. But there is a general consensus among



professionals, lawyers, and the business community that, even though these cases are governed by similar legislation, it takes much longer to reach agreements in the optional *concordatos* under the court system than in the mandatory *concordatos* under the Superintendency. There are several reasons for this dif-

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ference. First, giving the Superintendency the sole legal authority to handle the entire bankruptcy process effectively prevents delays due to frivolous but time-consuming appeals. Second, the Superintendency staff are competent in analyzing the financial situation of companies, they are more likely than the courts to rule on the merits of the claims, and they are better mediators. Third, setting time limits for each step in the process, together with the elimination of several judicial forums, has speeded the entire bankruptcy process.

Colombia's experience could teach other countries some useful lessons. First, setting time limits for the steps in the bankruptcy process has advantages—although, of course, unrealistic deadlines should be avoided. They are likely to be violated often, allowing appeals on procedural grounds. Second, when traditional court procedures for bankruptcy are difficult to change, an attractive alternative is to legally empower another entity to handle the entire process. In doing so, governments should guard against implicitly allowing multiple legal forums by permitting interim steps to be appealed in the traditional courts. The strength of a chain is determined by its weakest link, and allow-

ing the traditional courts into any step of the process would slow the entire process. Not every country has an entity like the Superintendency ready to step into the breach. An important—and sometimes rare—attribute of the Superintendency is its reputation in both the banking system and the business community as an impartial and competent institution free from politics. When there are entities that, with a bit of nurturing, could assume a role like that of the Superintendency, deciding whether to improve the traditional court system or to switch to the alternatives by giving them the necessary legal powers is a matter of judgment. The greatest danger lies in creating parallel courts with overlapping jurisdictions.

Illustration by Ruth Sofair Ketler.

- ¹ Ramachandran (1995) concentrated mainly on the transition economies of Eastern Europe and the former Soviet Union.
- ² This approach is an example of the out-of-court institutional solutions mentioned by Fleisig (1995).
- ³ In the United States, where bankruptcy reorganizations are also considered lengthy, the process is estimated to take an average of one and a half to two years between filing and resolution. In France and the United Kingdom, the period is shorter.
- ⁴ Ramachandran (1995) points out that one result of moving procedures out of the court system may be an increase in appeals.
- ⁵ Since in the new system most appeals cannot delay negotiations, objections cannot be used as a tactic. Thus, under the new system, frivolous objections intended to delay the process are less likely.

References

- Fleisig, H. 1995. "The Power of Collateral." FPD Note 43.
 Ramachandran, S. 1995. "Bankruptcy's Role in Enterprise Restructuring: A Hammer to Turn a Screw?" FPD Note 38.

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