

# **How the Uruguayan Insolvency and Bankruptcy system reacted to the 2002 Economic Crisis**

*By Héctor Ferreira\**

## **1) INTRODUCTION**

In 2002 Uruguay suffered one of the most important economic crises of its history.

Nevertheless, it is also true that in other periods of its history, Uruguay had other economic, social and financial problems which shook the bases of its economy.

One example was the well remembered “Quiebre de la Tablita” in 1982, situation which occurred when the Uruguayan Government established an artificial equivalence (without considering what happened in the Capital Market) between the “Pesos Uruguayos” and the American Dollars. In 1982 this equivalence was broken for the inevitable weight of the international market.

Another case was the important 1965 banking crisis when the “Banco Transatlántico” and other banks, fell as a consequence of the economic crisis.

Since several countries in Latin America suffered an economic financial crisis before 2002 (e.g. the crises of Mexico and Brazil), the Uruguayan 2002 crisis could have been predicted and avoided, but it was not. This was due to the fact that these crises did not affect the Uruguayan economy as hard as to foresee what coming next.

At that time, Argentina continued with the parity between Argentinean Pesos and American Dollars (1 per 1). Nevertheless, when the problems in Argentina began, with restrictions in money operations in Argentinean banks and transaction limitations in consumer’s access to their deposits, Uruguay should have expected serious consequences in its banking market (due to its dependence on the Argentinean market).

Uruguay began 2002 without any suspicion that such an important crisis was coming, in apparent tranquillity and with an economy with acceptable Economic Indicators.

It was only when Argentinean citizens crossed the “Río de la Plata” to withdraw, in many cases, all the money from their deposits, that Uruguay finally felt the effects of the crisis.

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In order to present some facts related to the Uruguayan 2002 crisis, it is important to point out that:

a) Local Currency: in January, 2002, Uruguayan citizens exchanged 14 Uruguayan Pesos per 1 American Dollar, while in September, 2002, they exchanged 31 Uruguayan Pesos per 1 American Dollar. That is, the value of the American Dollar was doubled.

b) Unemployment: in that same period, the Uruguayan unemployment increased from 14% to 19%.

Uruguay lived difficult moments at that time. Several Uruguayan banks and companies that Uruguayans felt were extremely strong went bankrupt.

In order to give another example, in 2000 Uruguay had more than 40 banks in its market and currently, there are only around 25. The image that Uruguay was “the Switzerland of America” fell to the ground together with its banks.

In this context, the Uruguayan legal system and mainly its Insolvency and Bankruptcy system had to provide solutions to banks, depositors, creditors, debtors, consumers, and so forth.

## **2) URUGUAYAN INSOLVENCY AND BANKRUPTCY SYSTEM BEFORE THE 2002 CRISIS**

Fortunately, a year before, in 2001, Uruguay modified its Insolvency and Bankruptcy system which had been written between the middle of XVIII century and the beginning of XIX century.

The modifications were materialized in the Act 17.292, passed by the Congress on January 25, 2001. In general terms, with this Act; the Uruguayan Government tried to transform the restructuring and bankruptcy proceedings, reducing their term and making them more effective and useful for debtors and creditors.

In Uruguay, up to when these modifications were introduced, business reorganization proceedings like “Concordatos” (Chapter 11 of the U.S. Bankruptcy Code) or Bankruptcies, took a very long time and in general could not resolve enterprises crises.

On the other hand, at that time companies in a reorganization proceeding continued working for decades without solutions to the debts included in the proceeding.

Professor *Camilo Martínez Blanco*<sup>1</sup> stated that: “(...) frequently, the agreement obtained between the debtor and his creditors in reorganization proceedings is not fulfilled or, in the best of the cases, is considered for the creditors as non-compliance because the debtor paid in an irregular way (...). This proceedings stagnancy affects not only other companies and creditors but also the credibility of the system”.

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<sup>1</sup> Martínez Blanco, Camilo, “Enmiendas Concursales, Ley 17.292, Sección IV”, BDF, Montevideo 2001, Page 36.

Another important change of the Uruguayan system in 2001 was the fact that Uruguay created two specialized Courts (“Juzgados Letrados de Concursos”) with competence only in Reorganization and Bankruptcy proceedings, which have been very useful for the system.

Professor *Israel Creimer*<sup>2</sup> stated in the same sense: “The specific competence of these Courts is very important for the proceeding and its resolution. Since this proceeding considers the entire debtor’s patrimony, it has to be only one and analyze all the relations, assets, interests and business that the debtor had.”

This new system indeed, had an important “test” with the crisis of 2002 and the results were in general, considering the terrible consequences of the crisis, positive.

### **3) URUGUAYAN INSOLVENCY AND BANKRUPTCY SYSTEM IN THE 2002 CRISIS**

In the summer of 2002 some Uruguayan banks had serious problems with its reserves, due to the withdrawing of all the money by Argentinean citizens, from their deposit accounts in Uruguay instead of doing it in Argentina, since Argentina’s Government prohibited the free access to the deposits in Argentineans banks.

Two of these banks (Banco Galicia Uruguay S.A. and Compañía General de Negocios) had to find a solution for their situation in an Insolvency and Bankruptcy System that, in general, did not consider restructuring proceedings for banks.

It is necessary to point out that in Uruguay, banks are corporations (“Sociedades Anónimas”) in terms of its business organization. However, they are corporations with important peculiarities, such as that they are controlled by the Uruguayan Central Bank (“Banco Central del Uruguay”).

In fact, many Uruguayan Acts related to Insolvency and Bankruptcy proceedings were created to face specific issues associated with corporations and in some cases Uruguayan banks (mainly their liquidation). However, no banks before 2002 had filed a restructuring proceeding to pay its debts (deposits) as a common corporation in an economical crisis.

In February 2002, two banks, first Banco Galicia Uruguay and later Compañía General de Negocios, filed a very unusual proceeding, a restructuring proceeding one, in order to avoid bankruptcy through an agreement with their depositors.

“Banco Galicia Uruguay” (hereinafter “the Bank”) obtained an agreement with its depositors (creditors). This Agreement was a leading case in the Uruguayan Jurisprudence, as it will be analyzed later, but the other bank did not comply with the legal requirements and was liquidated in a bankruptcy proceeding.

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<sup>2</sup> Creimer, Israel, “Derecho Concursal”, FCU, Montevideo 2001, Page 18.

### **3.1) Judicial Reorganization Proceedings filed by banks**

Firstly, the Bank filed a “Moratoria” which is a reorganization proceeding in which the debtor (the bank) only requests a waiting period to pay its debts and is only available to corporations.

Secondly, the Bank changed its original request, and demanded a “Concordato” which is another reorganization proceeding that implies a proportional decrease in the debtor’s debts and/or a waiting period to pay them.

The two Reorganization Proceedings mentioned (“Moratoria” and its transformation in a “Concordato”) are regulated by Act 2.230.

The Uruguayan Judge, Ms. Teresita Rodríguez Mascardi, (“Juez Letrado de Concursos de 1° turno”) accepted her competence in the case, while on the contrary, some Commercial Law Professors, stated that the proceeding had to be administrative (not judicial) and controlled by the Uruguayan Central Bank.

It is important to point out, that there is an Act in the Uruguayan Law (15.322) passed in the context of the crisis of 1982, which regulates the liquidation of banks through an administrative proceeding.

Considering this solution the Uruguayan Central Bank and not the Judiciary is responsible for the liquidation of banks in Uruguay.

However, this Act does not provide solutions for reorganization of a bank, i.e. it makes it impossible to reorganize a bank administratively.

That is why it was possible for the Judge in charge to declare herself competent in the Judicial Reorganization of the Bank.

For the Uruguayan justice the proceedings referred to were a real “challenge”. It was not easy to adapt regulations that were designed for other kind of corporations, to bank restructuring proceedings.

Because of that, it was necessary to use imagination and common sense to carry out a proceeding with more than one peculiarity.

Some of the peculiarities of the analyzed proceeding were among others the following:

a) The hearing with the creditors – depositors – (“Junta de Acreedores”) was in a stadium and not inside a Court office, because of the big number of depositors who attended.

b) The Receiver was the Uruguayan Central Bank and not creditors.

c) In a solution that was strongly criticized by some Commercial Law Professors, the Bank did not file before the Court the list of its creditors in the ordinary way. Alternatively, the Bank presented the list only to the Judge for him to use it on an extremely confidential basis. Therefore, the Bank not only complied with the “bank secrecy” obligation, but also met the legal requirement by providing the list. This decision was based on the fact that in Uruguay (Act 15.322, article 25), banks have bank secrecy (Professional Secret), which forbids them to reveal the names and other data of its creditors.

Despite the fact that many Commercial Law Professors did not accept the solution because the Law was clear when stating that all companies must present a list with the name of its creditors available for the debtor’s creditors; the Judge accepted the presentation of the Bank and carried on the proceeding.

In conclusion, the experience of the reorganization proceeding filed by a bank was successfully finished with the approval of the Bank’s proposal and the formalization of an agreement to obtain its restructure, subscribed by the Bank and the legal majority of its creditors (depositors), with the consent of more than 75% of its creditors.

### **3.2) The voluntary relinquish of some rights to save a company in crisis**

Another reaction of the Uruguayan Insolvency and Bankruptcy system to the crisis, was from the point of view of the creditors.

As well as banks, a lot of hospitals, medical centers and other kind of private enterprises created by doctors to provide medical assistance had economical problems in the 2002 crisis.

It had not been usual to see in Courts doctors, nurses, etc. demanding a solution for their enterprises.

As it occurred with the banks, the crisis of the health companies had an effect on the creditors but also on the people surrounding them who were interested in finding a solution to the Uruguayan system (e.g. patients, sick people, employees (doctors) and the State, since “Public Health” is an essential service, according to the Uruguayan Constitution).

In one of the cases, a health company, named “GREMCA”, filed a reorganization proceeding before Court, in order to avoid bankruptcy through a judicial proceeding.

Another fact is that, according to the Uruguayan Law, the employees of a company that met some requirements established by law have a preference in the collection of the debts, receiving their payments before the common creditors.

Nevertheless, if a person, who has this “preferential right” in the collection of this debt, decides to participate in the agreement presented by the debtor, in the context of a

reorganization proceeding, he immediately loses his preferential right and becomes a common creditor.

In fact, to obtain the majority established by law, to reach an agreement between the debtor and its creditors in this reorganization proceeding, an important number of employees (doctors who worked in “GREMCA”) waived their preferential right to collect their debts and add their signatures to achieve the majority required by law. These persons preferred to refuse a preference in the collection inside the reorganization proceeding, or even in a bankruptcy proceeding, in order to cooperate with the company.

This was a clear example in which employees considered the company as a “source of work”, and therefore, were willing to give up their right to collect first (as workers) in order to maintain their working position.

Hence, the crisis showed that in the context of the Uruguayan system it is possible that the employees refuse to some privileges to maintain the company “alive”.

#### **4) SOLUTIONS FOUND IN THE CONTEXT OF THE CRISIS**

As we stated, the Uruguayan Insolvency and Bankruptcy System had to confront the 2002 crisis with tools designed for general situations, but which did not provide complete answers to the different problems that appeared day after day.

However, as it has been stated, the system accepted the “challenge” and not only Judges but also lawyers, professors, and so forth had to use their imagination to adapt the Law to the new scenario.

As a consequence of that, some structures and principles that were originally bases of the Uruguayan Insolvency and Bankruptcy system were not considered. One example of this was the principle named in Latin “Par Conditio Creditorum”.

This principle implies that in the context of a reorganization or bankruptcy proceeding, all the common creditors (creditors without any privilege - i.e. without pledges or mortgages - and without any preference in the collection – like the employee’s right mentioned above-) have to receive the same treatment in the proceeding.

In the Uruguayan Law, there are two contradicting principles, which apply in different proceedings.

The general principle named in Latin “prior in tempore pothier in jure” is exactly the opposite of the principle of “Par Conditio Creditorum” because the first gives benefits to the creditors who act faster than the others.

In the context of a Preliminary Proceeding (executive proceeding) for instance, the order in which the different creditors will collect their credits depends on the moment in which the general attachment on rights and credits of the debtor, was registered.

The creditor who first registers the general attachment in the Register will collect all his credit (if the debtor's patrimony is enough) before the others. The second creditor will collect his credit from the rest of the patrimony and the others in the order in which registration of their general attachments was made.

Hence, the two principles are in a clear opposition and if a debtor files a reorganization proceeding and the Court accepts it, the applicable principle changes. The applicable principle is "prior in tempore pothier in jure" until the moment the Court accepts the reorganization proceeding.

#### **4.1) Flexibility of the principle of "Par Conditio Creditorum"**

As we have already said, the principle of "Par Conditio Creditorum" was one of the most important stones on which the Uruguayan Insolvency and Bankruptcy system was built.

According to *Professor Rodolfo Mezzera*<sup>3</sup> this principle is an expression of the Equality Principle, which means that all the assets of the debtor must be used to pay his debts in an equal way.

This principle is regulated by the Uruguayan Law in the Uruguayan Commercial Code (Article 1571), Act 2.230 (Article 29) and Act 16.462. In all cases, the principle appears as something absolute and without room for exceptions.

Professor *Camilo Martínez Blanco*<sup>4</sup> stated that to grant a different treatment of a creditor in relation to the others who are in the same category implies a violation of the principle of "Par Conditio Creditorum".

##### i) Categorization of Creditors

In 2003 "Casa de Galicia", a medical company, filed a reorganization proceeding which was approved by Uruguayan Courts.

This company presented a proposal to its creditors, which was approved by the majority established in the Uruguayan Law. The proposal categorized the creditors and offered different solutions for the different categories.

According to the proposal, inside the category, all creditors were treated in an equal way. However, the proposal of one category could have been better than the others, which could have violated the principle of "par conditio creditorum", also considering that Uruguay did not have any regulation about it.

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<sup>3</sup> Mezzera Alvarez, Rodolfo, quoted by *Dra. Adriana Bacchi*, "La vigencia del Principio Par Conditio Creditorum a la luz de un caso práctico – La Tribuna del Abogado N° 139", page 5, Montevideo 2004.

<sup>4</sup> Martínez Blanco, Camilo, "Manual Teórico Práctico de Derecho Concursal", AMF, page 46, Montevideo, 2003.

On the contrary, Argentina, which had the same problems as Uruguay in relation to the principle under study, changed its regulations in 1995 with Act 24.522, which authorized the classification of creditors in categories.

Before this Act, some important Professors in Argentina<sup>5</sup> (e.g. Alberto Bonfanti and José Alberto Garrone, “Concursos y Quiebras”, page 57) said that this principle is something that is “old fashioned” a rule that is “a myth”.

In conclusion, at that time there were no regulations in the Uruguayan Insolvency system that allowed for the violation of the principle of “par conditio creditorum”.

However, in the context of the 2002 crisis, Uruguayan Courts decided to accept the categorization of creditors, considering this solution as the unique way to avoid the bankruptcy of some companies with different kinds of creditors.

#### ii) The application of the Constitution before extreme cases

Another case, in which the principle of “par conditio creditorum” was not taken into account by the Judge, was in the restructuring proceeding of “Banco Galicia Uruguay” that we have already analyzed.

Since a bank instead of “creditors” has “depositors”, who in the case of the checking account holders or of the time deposit holders, expect to receive the deposited amount at whatever time in the first case and in the corresponding date in the last, a reorganization proceeding that implies a proportional decrease in the debtor’s debts and/or a waiting period to pay them, was difficult to accept.

If a bank files for reorganization proceedings and reaches an agreement with the legal majority of their creditors, by which the Bank compromises to pay 100% of the credits in instalments in a period of time (9 years in the case that we are analyzing), it is possible that some creditors want or really need the total of the deposit in a shorter period or immediately.

In this case, it happened that some elderly creditors (in some cases older than seventy), or creditors with serious illnesses (cancer for example), requested the Court the payment of an important percentage of their credits, to pay medical treatment or operations.

In principle, as we explained in the last point, the principle of “Par Conditio Creditorum” forbids the differentiation among creditors in all cases. Hence, the Court could not have applied different solutions, even in the extreme cases mentioned above.

However, when the Judge in charge, analyzed the situation, she considered that the right to live and to live with dignity, the right to receive health care, and other “Fundamental Rights of the first generation” regulated by the Constitution of the República Oriental del Uruguay (Article 7), applicable to the analyzed situations, were more important than the principle of “Par Conditio Creditorum”.

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<sup>5</sup> Bacchi Argibay, Adriana, “La vigencia del Principio Par Conditio Creditorum a la luz de un caso práctico – La Tribuna del Abogado N° 139”, page 8, Montevideo 2004.

Based on the Constitution and before these extreme cases, the Judge in charge decided to pay an important percentage of the credits to some of the creditors, who proved that their situation was extreme and that they really needed an important part of their deposits.

In these cases, the Judge did not consider the principle, applying directly the Constitution and paying an important part of the corresponding credits outside the terms of the agreement arrived in the context of the reorganization proceeding. These situations were dealt with on a case to case basis.

It is important to point out, that some Court Decisions of the Judge in this sense, were appealed by the Bank and, in second instance, the Court revoked them, mainly based on the understanding that the situations did not have all the requirements to be considered as “extreme situations”.

## **5) MODIFICATIONS IN THE SYSTEM BECAUSE OF THE CRISIS**

### **5.1) Act 17.613 – Fortification of the Banking System**

As we have already analyzed in the introduction and the different points of this paper, the 2002 crisis affected not only banks and health companies, which were the clearest examples of the power that the crisis had, but also the market in general.

Also, the modifications have not only come in a formal way, but as new concepts or interpretations of some parts of the Uruguayan system, as it was analyzed in the last point.

Nevertheless, all the legislative modifications in Uruguay as a consequence of the crisis attempted to resolve the situation of the banks which had not filed a reorganization proceeding (as the Bank) and were suspended by the Uruguayan Central Bank or were in Liquidation.

There were a lot of facts to consider, because five Uruguayan banks, hundreds of depositors, a lot of employees of the suspended and liquidated banks, international markets, etc. waited for a solution from the Uruguayan Government.

In fact, in December, 2002, the Congress of Uruguay passed Act 17.613, which attempts to the fortification of the banking system and to resolve some specific problems derived from the crisis.

In this paper, we will only consider some aspects of the Act that implied modifications to the Uruguayan Insolvency and Bankruptcy system in relation to banks.

i) Administrative Liquidation: All of the bank liquidation proceedings must be carried out before the Uruguayan Central Bank. It was not a new rule, because the Acts 15.322 and 16.327 had already regulated this point in the same terms. The objective of this

legislative reaffirmation was to avoid all possible doubt in relation to which is the competent office for this kind of proceeding.

ii) Agreements between the Uruguayan Central Bank and the depositors: An important change was that as from this Act, the Uruguayan Central Bank could reach agreements with the depositors of the bank in administrative liquidation.

It is a specific newness in terms of reorganization proceedings only available for banks and controlled by the Uruguayan Central Bank.

In order to achieve an agreement in the referred case, the Uruguayan Central Bank needs to obtain the consent of 66% of the total debt involved except in the case of debentures when the Uruguayan Central Bank needs the consent of the absolute majority of the issued capital.

Professor *Camilo Martínez Blanco*<sup>6</sup> said that the required majority is too low in comparison with other kinds of reorganization proceedings. Also, the possible opposition from creditors that had not supported the agreement, the moment in which the agreement is confirmed, among others, are items not regulated by the new Act.

iii) Possibility to create categories among the creditors:

As a consequence of the solutions that were found in the context of the crisis and continuing with the tendency of other countries like Argentina, the new Act authorizes the Uruguayan Central Bank to reach agreements with the creditors of the banks in liquidation. Because of that, the Central Bank can create categories of creditors and present different proposals to them, in all cases maintaining the equity among the creditors which are in the same category.

This regulation incorporated to the Uruguayan Insolvency and Bankruptcy system, is an exception to the principle of “par conditio creditorum” (at least in administrative liquidation proceedings for banks), which authorized the differentiation among creditors.

## **5.2) Project of modification of the Insolvency and Bankruptcy System**

The 2002 crisis did not only leave terrible consequences for the Uruguayan Economy, but also generated experience and creative solutions that were important “to save” some companies.

This experience, which was materialized in the Act 17.613 that has already been analyzed, encouraged the Ministry of Economy of Uruguay to propose a new modification of the Uruguayan system.

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<sup>6</sup> Martínez Blanco, Camilo, Op. Cit, page, 384.

Nowadays, the Ministry of Economy and the Law schools of Uruguay are organizing academic events, in order to share opinions among judges, lawyers, citizens, etc. and to specify the topics in which the Uruguayan system has to improve.

There are some problems that were showed by the crisis and probably will be considered by the projected modification:

- a) Need of unification of the proceedings with same rules for all of them;
- d) Possibility to create categories of creditors inside a reorganization or bankruptcy proceeding;
- c) Other exceptions to the principle “par conditio creditorum”;
- d) Reconsideration of the legal majorities to obtain agreements between the debtor and his creditors.

## **6) CONCLUSIONS**

i) The economic 2002 crisis affected in a very serious way the Uruguayan economy and its market as well as its banking system.

It showed that the Uruguayan Insolvency and Bankruptcy system was not designed for some situations occurred in the context of the crisis.

ii) Judges and lawyers had to create alternative ways “to save” enterprises and banks in crisis or at least to liquidate them efficiently.

iii) Employees waived, in some cases, preferential rights given by the system in order to save their enterprises which were considered (as their source of work) like something more important than individual problems.

iv) To obtain viable agreements, the principle of “par conditio creditorum”, which was unquestionable as part of the Insolvency and Bankruptcy System, was not taken into account in some cases, e.g. creditors who needed an important percentage of their money because were in a very extreme situation.

v) The 2002 crisis left lessons that were materialized, so far, in the Act 17.613 and in other projects which are being analyzed nowadays.

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