Secured Financing Issues in Chile

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Secured lenders normally face important issues in financing transactions involving Chilean companies and/or Chilean assets. Such issues are described below:

A. Mandatory Applicability of Chilean Law:

Article 16 of the Chilean Civil Code sets forth that all goods located in Chile are subject to Chilean law, even if their owners are foreigners and do not reside in Chile.

Therefore, pursuant to the above-mentioned provision, any collateral over any asset located in Chile must be granted pursuant to Chilean law, including, for instance, shares of Chilean companies. This means that in order to obtain a collateral over assets located in Chile by foreign lenders the requirements of Chilean law must be fulfilled. Otherwise, the validity of such collateral may be contested. Likewise, any foreign judgment based upon a collateral granted pursuant to foreign law may be not be enforced if Chilean law was not fulfilled.

B. Execution of a Contract:

Chilean law derives from civil law tradition whereby a security interest or lien is deemed as an accessory obligation to a main secured obligation and is created pursuant to a "contract" or agreement entered into between the party providing the security, which may or may not be the debtor, and the secured lenders. Therefore, in order to get collateral secured lenders must execute a security agreement. ¹

Upon (i) the execution of the relevant contract providing for the creation of the security interest over a certain asset; and (ii) the due performance of the applicable formalities, a security interest is duly created and will attach on such asset. In certain cases, no further formality is necessary, requiring only the delivery of the pledged asset by the pledgor to the pledgee.

The pledge will generally entitle the secured party to:

¹ As set forth below, Chilean law does not contemplate collateral agents and, therefore, all lenders should execute the relevant collateral agreement or grant a power of attorney to the collateral agent with all the formalities required by Chilean law.
(a) Cause the foreclosure and judicial auction of the asset upon default of the secured obligation. Thus, pursuant to Chilean law, the secured party may not take title over the secured property but, rather, trigger a judicial foreclosure of such asset by means of a public auction;

(b) Claim the proceeds of the foreclosure up to the amount necessary to satisfy in full the secured obligation, including legal costs and expenses; and

(c) In case of insolvency of the owner of the asset, claim the applicable statutory priority in payment vis-à-vis the other creditors of the owner. Also, in case of bankruptcy of the debtor, Chilean law authorizes the pledgee to separately foreclose on its valid pledge security interests, but only up to the extent of the amount secured by such pledge. In the event of any amount in excess of such amount and not covered by such pledge, the creditor must concur with all other creditors to the bankruptcy proceedings. Consequentially, his/her claims may be reduced in consideration to the other creditor’s claims. The same bankruptcy court will carry out the separate foreclosure and the trustee in bankruptcy will act as a depositor. In such case, in order to be effectively paid, the trustee in bankruptcy must guarantee the payment of preferential credits.

The scope, nature, extent, formalities and requirements applicable to each type of security interest available under Chilean law is specifically provided for in the relevant statute that governs the particular type of security interest; e.g., there is no “uniform” commercial law or code generally governing the matter.

C. Types of Pledges Currently Available Under Chilean Law:

Security interests available in Chile regarding movable assets include, among others, the following types of pledges:

1. Possessory Pledges:

   (a) Prenda Civil or “Civil Pledge”: applicable to all kinds of movable property, in order to secure any kind of obligations. Assets subject to this pledge must be properly identified, including both tangible and intangible assets (hence, it is possible to create a pledge over rights and credits), but pledge over genders or stocks is not allowed. This pledge is perfected by the delivery of the asset to be secured by the pledgor to the pledgee, without requiring any kind of registration;

   (b) Prenda Comercial or “Commercial Pledge”: applicable to all kinds of movable assets, in order to secure any kind of commercial obligation. Assets subject to this pledge must be properly identified, including both tangible and intangible assets (hence, it is possible to create a pledge over rights and credits), but pledge over genders or stocks is not allowed. This pledge is perfected by the delivery of the relevant asset by the pledgor to the pledgee, without requiring any
kind of registration. However, in order to benefit from the preference over credits, the pledge must be evidenced in a public deed (*escritura pública*) or in a notarised private document, and it must set forth the amount of the secured obligation and a description of the pledged assets. Pursuant to this pledge, the debtor can secure its own or third party’s obligations; and

(c) **Prenda de Valores Mobiliarios en Favor de Bancos** or “Pledge of Securities in Favor of Banks”: applicable to any kind of securities delivered to a bank in order to secure the transactions and agreements executed or to be executed in the future among the parties. In order to perfect such pledge, the debtor shall deliver the securities to the bank2 (if the securities have been issued to the bearer), duly endorse them as guarantee (if the securities have been issued to the order of the holder) or execute the pledge agreement by means of public or private deed, notified to the company through a Notary Public (if the pledge is created over shares).

Pursuant to this pledge, the debtor can only secure his/her own obligations but not third party obligations.

The foreclosure of this pledge is a very straightforward procedure, without need to initiate legal actions. The collateral is sold in a stock exchange seven days after the notification of the debtor and upon a written order of the lender. Due to this reason, this type of pledge is the most common collateral used in bank financing.

2. **Non-Possessory Pledges:**

(a) **Prenda sin Desplazamiento** or “Pledge Without Conveyance”: applicable to all kinds of movable assets, in order to secure its own obligations or obligations of third parties, but keeping the pledgor the possession and use of the pledged assets. This pledge is perfected by executing a public deed (*escritura pública*), and, in order to be enforceable vis-à-vis third parties, an abstract of such deed must be published in the Official Gazette. Such publication must be made within 30 business days after the date of the public deed, on the 1st or 15th day of the month, or the following business day if such day is a holiday;

(b) **Prenda Industrial** or “Industrial Pledge”: applicable only to tangible and movable assets that are part of an industry (i.e., machines, tools, raw materials, etc.), in order to secure any kind of obligations created in relation to an industrial activity. This pledge is perfected by executing a public deed or a private deed (in this latter case, the signatures of the parties must be certified by a Notary Public), bearing an undisputable date, and in order to be enforceable vis-à-vis third parties, an abstract of such deed shall be registered at the Special Industrial Pledge Registry of the place where the respective pledged assets are located;

2 Such securities shall be deemed as pledged by the sole delivery thereof, unless it is evidenced that the delivery was purported for a different effect.
(c) **Prenda Agraria** or “Farming Pledge”: applicable only to certain tangible and movable assets including animals, animal products, machines, seeds, etc., in order to secure obligations only related to farming and cattle activities. This pledge is perfected by executing a public deed (*escritura pública*) or a private deed (in this latter case, the signatures of the parties must be certified by a Notary Public), bearing an undisputable date, and in order to be enforceable vis-à-vis third parties, an abstract of such deed shall be registered at the Special Farming Pledge Registry of the place where the respective pledged assets are located; and

(d) **Prenda en Contrato de Compraventa de Bienes Muebles a Plazo** or “Pledge in Purchase Agreements of Movable Assets”: applicable only to movable assets that were sold and where the payment will be made in instalments, in order to secure the buyer’s obligation to pay the relevant price thereof, keeping the pledgor the possession and use of the pledged assets. This pledge is perfected by means of a public deed (*escritura pública*) or a private deed (in this latter case, the signatures of the parties must be certified by a Notary Public) and the proper registration of such pledge in the Special Registry of the place where the respective pledged assets are located.

3. **Other Types of Pledges:**

(a) **Prendas en Almacenes Generales de Depósito** or “Pledge on Warrants”: applicable only to warrants or warehouse certificate deposits to secure any obligations due to any person by endorsing the pledge voucher. However, with respect to third parties, the pledge shall be effective only upon the annotation of the endorsement in the Register of Documents handled by the warehouse.

(b) **New Non-Possessory Pledge**

Currently there is a bill of law (the “CM2 Bill of Law”) under discussion at the Chilean Congress,\(^3\) which will amend the current regulations of non-possessory pledges as well as other capital market regulations. The amendments to the pledge regulations are based in the fact that due to the limitations of certain pledges (type of obligations and kind of assets to be pledged) and the different formalities provided by law in order to perfect such security interests, it is extremely difficult for a creditor to acknowledge if a certain asset has already been pledged in favour of a third party.

Pursuant to the CM2 Bill of Law there will be only one regime for creating non-possessory pledges (and not several as currently), which will be also registered in a single national registry to be handled by the Civil Registry (*Registro Civil*). New provisions shall also

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\(^3\) The CM2 Bill of Law has been already fully discussed by the House of Representatives (*Cámara de Diputados*), but it is still pending its discussion by the Senate.
allow the creation of security interest over inventories, securities, contractual rights and agreements, which currently cannot be subject to non-possessory pledges.

The main characteristics of this new non-possessory pledge are the following:

1. **Creation:** The pledge agreement will be perfected by means of (x) public deed; or (y) private deed, in which case the signatures of the parties shall be authorized by a Notary Public and the agreement shall be notarised in the proper registries of the same Notary Public. Such agreement shall provide, at least:

   a) An individualization of the parties;

   b) An indication of the secured obligations or the exact reference to the documents in which such obligations are described. In case such documents are not public deeds, they shall be notarised together with the pledge agreement. The parties may also agree that the pledge shall secure all the obligations that currently exist or the ones that may exist among the parties in the future;\(^4\)

   c) A detailed individualization of the assets subject to pledge; and

   d) The amount to which the pledge has been granted in relation to, only if such pledge has been limited to a certain amount.

In order to perfect this non-possessory pledge it will be necessary also to register said pledge at the Registry of Pledges to be maintained by the Civil Registry (*Registro Civil*) within 5 business days as from the date of the public deed or the date of notarisation of the private deed.

2. **Secured Obligations:** The pledge may secure any kind of obligations, whether currently existing or to exist in the future, even if they are not determined at the time of execution of the pledge agreement.

3. **Pledged Assets:** As general rule, the pledge may be created with respect to any kind of movable assets, securities or rights which transfer is not prohibited by law, including but not limited to public concessions (including toll roads, sanitary and other concessions), contractual rights, securities, assets or rights that may exist in the future, assets that have not entered into the country; and inventories or stock (merchandise, raw materials, group of assets of the same kind, elaborated or semi-elaborated products, spare parts, etc.).

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\(^4\) This will solve one important problem: currently it is required to include in the pledge agreement a complete description of the secured obligations and, in case of amendments to such obligations, it is required to amend the security agreements as well.
4. Rights of the Secured Creditor and Obligations of the Pledgor: Pursuant to this new non-possessory pledge the secured lenders and the debtor will have the following rights and obligations:

   (i) **Priority:** Credits secured by this pledge will be deemed as “second class” credits, and shall prefer to any other credit that is not a “first class” credit, as explained in Section E below. If the same asset has been pledged to several creditors, preference will be granted to the ones that have a prior registry in the Registry of Pledges maintained by the Civil Registry (*Registro Civil*). If the parties have provided in the pledge agreement that the pledgor may not dispose or create further liens over the relevant asset, a breach of such obligation authorizes the creditor to immediately foreclose the pledge, considering the secured obligation as due and payable.

   (ii) **Possession:** As this kind of pledge will not require conveyance, the general rule is that the pledgor shall maintain the possession of the assets, bearing all costs of conservation. However, if such pledgor abandons the pledged assets, courts can allow the creditor to take possession of them and appoint a depositary or foreclose the pledged assets, considering the secured obligation as due and payable.

   (iii) **Location and Use:** The parties may provide in the pledge agreement a specific place where the pledged assets may be located or a specific use of them by the pledgor. In case of breach of such obligations, the creditor may foreclose the assets, considering the secured obligation as due and payable.

   (iv) **Inspection:** The creditor is entitled to inspect, at any time, by himself or by means of a representative, the pledged assets. In case the creditor cannot exercise the right due to the opposition of the pledgor, the creditor may foreclose the assets considering the secured obligation as due and payable, if the pledgor insists in his opposition when judicially requested.

   (v) **Foreclosure:** As from the moment in which the secured obligations are due and payable, the secured creditor may foreclose the pledge, but always pursuant to a judicial procedure set forth by law.

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5 Foreclosure shall be the carried out according to the summary procedure (*juicio ejecutivo*) contained in the Civil Procedure Code, with certain special rules such as (i) there are only a limited amount of admissible defenses, such as payment or forgiveness of the debt; and (ii) once the debtor has been notified, the lender can request immediate foreclosure of the pledge, notwithstanding that the debtor may have filed any defense (the court shall rule taking into consideration the debtor’s opinion and may require the granting of certain guaranties by the lender).
(vi) **Assignment:** The creditor can assign its credits secured by the pledge, but it is necessary to register such assignment in the Registry of Pledges.

5. **Criminal Sanctions:** The CM2 Bill of Law sets forth certain criminal offences regarding pledges, including the fact of transferring the assets without indication of the existence of the pledge and the transformation, hiding, substitution and disposal of the assets without the creditors’ consent. Such criminal figures require a fraudulent activity by the pledgor.

6. **Existing Pledges:** The CM2 Bill of Law purports to abrogate all existing regulations applicable to non-possessory pledges. However, such provisions shall still be applicable regarding pledges created before the date the CM2 Bill of Law is effective. Notwithstanding the aforesaid, within the term of one year from such effective date, the parties may agree that the pledge previously created pursuant to the former rules will be subject to the new regulations. If the parties do not agree to transform it according to the new regulations, the pledge will still be valid and enforceable, and regulations applicable to it shall be the former ones.

D. **Default of Secured Obligations:**

Upon default of a secured obligation, the creditor may foreclose the asset pursuant to the regulations of a summary proceeding as set forth in the relevant rules, where the defendant may submit very limited defenses. The Court may order immediate seizure of the debtor’s assets.6

E. **Priorities under Chilean law:**

Pursuant to Chilean law, the creditors rank *pari passu* except as provided by law. In case of credits secured by any kind of pledge the law grants them priority as “second class” credits, and therefore they shall prefer to any other credit that is not a “first class” credit. First class credits are the following:

(i) Judicial costs incurred in the general interest of the creditors;
(ii) Necessary funeral expenses of the debtor;
(iii) Sickness expenses of the debtor;
(iv) Bankruptcy expenses (mainly, administration and foreclosure of the assets);
(v) Employees’ salaries (capped);
(vi) Employees’ social security payments;
(vii) Necessary supplies for living of the debtor and his/her family;
(viii) Employees’ severance payments (capped);
(ix) Taxes owed to the Chilean government or its agencies; and,
(x) Others expressly contemplated in special statutes.

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6 However, as set forth above, a judicial procedure is not required in the case of the “Pledge of Securities in favor on Banks”
F. Secured Lenders in Bankruptcy Proceedings

1. Limitations to Creditor’s Agreements with Bankrupt: Chilean bankruptcy law favors the liquidation of the bankrupt’s assets rather than the execution of creditor’s agreement with the debtor. Indeed, only the debtor can propose to creditors the execution of agreement (with several restrictions) but the creditors cannot request the former to submit such a proposal. Secured lenders can attend the creditor’s meetings to discussing a creditor’s agreements but they cannot vote unless they quit to their preference.

2. Foreclosure by Secured Lenders: A secured creditor is generally able to foreclose the collateral and apply the proceeds raised upon such foreclosure to the amounts owed and secured thereby. In fact, a secured creditor usually does not need to return such proceeds to the bankruptcy estate or wait until the completion of the bankruptcy proceeding to receive them.

In certain cases, however, whenever it appears that claims for preferred credits (i.e., statutory priorities under Chilean law) would not be satisfied in full from the proceeds of the sale of other assets of the debtor in bankruptcy, the secured creditors who have foreclosed on their collateral may be required to deposit a portion of the proceeds obtained therefore to cover the existing deficiency or to otherwise secure payment thereof in full. If such credits cannot be satisfied with the proceeds obtained in the liquidation of other assets of the estate, such deposits would be applied to set off any existing deficiency and the secured creditors could be even required to return additional amounts if the deposits thus made are not sufficient to cover the existing deficiency, up to, along with the previously deposited amount, a total aggregate amount equal to the proceeds raised upon such foreclosure. Otherwise, the proceeds on deposit would be returned to the secured creditors up to the actual sum of money owed to them.

However a secured creditor is barred from foreclosing the collateral in the following circumstances:

(i) If creditors holding at least 2/3 of outstanding claims with right to vote (i.e., holders of claims which have been recognized by the bankruptcy court) decide that the debtor in bankruptcy should continue carrying on its business, a secured creditor which voted for the continuation of the business would be barred from foreclosing on the assets securing its credit if contemplated in the business continuation;

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7Currently there is a bill of law at Congress that contemplates important amendments to Chilean Bankruptcy law in this regard. Chilean Government seeks to have a modern bankruptcy legislation that favors the execution of creditor’s agreement with bankrupt rather than the liquidation and bankruptcy of companies.
(ii) If creditors holding more than one half of the outstanding claims decide that all or a portion of the assets of the debtor in bankruptcy shall be sold as an economic unit and such unit encompasses assets covered by a mortgage, pledge or another security interest, a secured creditor cannot separately foreclose thereon. Instead, such secured creditor would have a first priority claim against the proceeds of the sale of the assets concerned; and

(iii) If a majority of creditors holding an amount at least equal to 51% of the outstanding claims support a proposal made by the debtor of a creditor’s agreement for the reorganization of his/her businesses, secured creditors would be barred from foreclosing for a period of 90 days from the date on which the order of the bankruptcy court summoning all creditors to a creditors meeting to discuss the proposal is notified.

3. **Revocation or Rescission of Collateral:** In case of bankruptcy, certain acts or contracts made by the debtor within certain period\(^8\) in fraud of the creditors may be rescinded, revoked or declared null and void. In case of onerous contracts, security agreements or payments made in favor of certain creditors, it is necessary that the debtor and his/her counterpart knew about the insolvency of the debtor.

The statute of limitations to request the revocation or annulment of these acts or contracts was recently extended from 1 year to 2 years from the date of the act or contract.

G. **Subordination Agreements**

Although subordination agreements may be valid between lenders, they are not binding before the bankruptcy trustee should the borrower be declared bankrupt. The bankruptcy trustee can only apply the priorities set forth in the law as mentioned above. Therefore, the bankruptcy trustee will pay to the lenders without regard to any subordination agreements and senior lenders will have a claim against junior lenders.

CM2 Bill of Law purports to recognize binding effect of subordinations agreements entered into between non-secured lenders before the bankruptcy trustee.

H. **Collateral Agent:**

Chilean law does not recognize the figure of the “collateral or administrative agents”. Therefore, certain issues regarding the representation of all the lenders (including the future ones) by the collateral agent may arise should the financing include several secured lenders. CM2 Bill of Law intends to solve these issues recognizing the figure of the collateral agent and providing

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\(^8\) Up to 1 year and 10 days before the date de debtor is declared bankrupt.
for certain basic regulation therefore. In such sense, it defines the collateral agency agreement as a contract by which one or more secured creditors appoint an agent that shall represent them in the common exercise of their rights under the relevant security agreement, and for purposes of the proper creation and perfection thereof. Pursuant to the new regulation, the collateral agent shall accept the collateral in its own name, but on behalf of the secured lenders (including such creditors that may acquire any participation in the loan in the future). The registration of the collateral, if applicable, shall not require the designation of all the creditors, but only the identification of the collateral agent and of the collateral agency agreement.

The collateral agent shall also concur to any amendment, substitution or release of the collateral, and, in case the collateral refers to a possessory pledge, the collateral agent shall receive the pledged asset. Also, any notification or service of process that must be practiced according to the law to any secured creditor shall be deemed as fulfilled upon the notification of the collateral agent.

The appointment and replacement of the collateral agent shall be made by means of a public deed or a notarised private document (whether granted in Chile or abroad). The replacement of the collateral agent and the assignment of its rights and obligations shall be made, with or without its consent, according to the terms set forth in the collateral agency agreement, and, if no such provisions were agreed upon, the replacement shall require the consent of the majority of the secured creditors.

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