Testing the Limits and Strengths of Restructurings in Mexico

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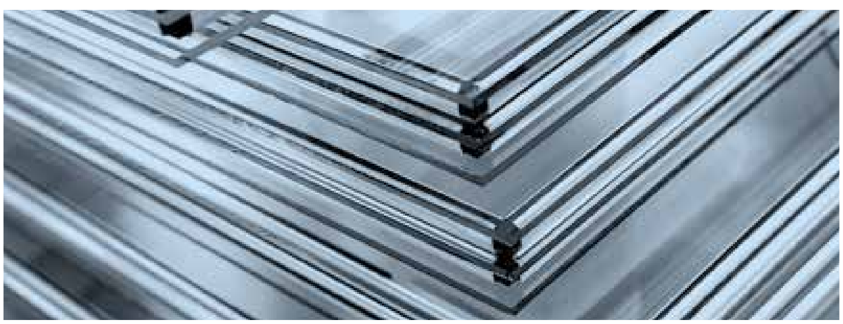


It has been 17 years since "*Ley de Concursos Mercantiles*" ("LCM"), the Mexican insolvency law, was promulgated on May 12, 2000. This paper is a retrospective with my views on the development of the LCM and with it, in great part, the restructuring legal work in Mexico. To this date, the LCM is still subject, alongside the Mexican judicial system, of dire criticism. A good portion of it is well deserved but, by sharing my views and experiences throughout 20 years of practice in the insolvency and bankruptcy field, I have come to conclude that the shortcomings and failures in restructuring processes under the LCM result from lack of expertise and training of professionals in the field, including those who are charged with interpreting and applying the law, and many times from ill-oriented objectives of professionals.

LCM Enactment – Policy Drivers and Early Reception

When the LCM was first enacted back in 2000, the Mexican government had few very clear ideas of its purpose. Mexico had to quickly enter the globalized world following the experience of the NAFTA. Unbeknownst at the time, but eventually not a shock to anybody, the approximately 70 years of single-party rule in Mexico (the *Partido Revolucionario Instiucional*, or PRI) was coming to an end. The younger political class, mostly technocrats who received their education outside of Mexico, realized that a change was needed to hold on to power and swiftly pilot the country into the new millennium.

Both abroad and locally, one of the main objectives for Mexico was to achieve just that: providing certainty to the rule of law and fighting corruption as means of attracting foreign investment and stabilizing the country. This general sentiment eventually ousted the PRI from power few months after the LCM came into effect.

The LCM was clearly aimed at achieving a restructuring and reorganization of a company with the least amount of litigation possible.

In this context, Mexican legislators (also with PRI majority both in congress and the senate) did not take the time to actually discuss the incredible burdens and issues under the outdated insolvency law that preceded the LCM, which only provided for interminable litigation thus laying the grounds for either abuse (most of the time, fraudulent) or liquidation of the debtor.

Naturally, there was also no time to consider all of the factors that would come to affect Mexico's free trade, which included a deep need for international financing because Mexico simply did not have the resources to fund the ambitious projects to modernize the country and how such international financing would end up complicating debt service when liquidity was scarce and the exchange rate between the peso and the US dollar put pressure on the Mexican economy.

So the legislature did what was natural and basically adopted the principles of the UNCITRAL Model Law on Cross-Border Insolvency, with few modifications. This approach had proven successful in other areas of Mexican law and did increase the level of certainty of the restructuring legal framework. In the end, the LCM was clearly aimed at achieving a restructuring and reorganization of a company with the least amount of litigation possible.

The first criticism of the LCM was that it was overly beneficial to financial institutions, namely Mexican banks that, based on Mexican banking regulation, virtually always obtained security for loans. The LCM provides that secured creditors may avoid altogether the insolvency proceeding and, prior to its two subsequent amendments in 2007 and 2014, were not even included in the general stay of enforcement at the beginning of the process.

Secured creditors could enforce their collateral with no risk of seeing their claim impaired by a majority of creditors and could even be unsecured for the unrecovered amount of their claim.

The LCM also included a provision that required any company that entered a "*concurso mercantil*", the Mexican insolvency process equivalent to the U.S. Chapter 11, to either reach a restructuring plan within one year of the commencement of the process, and even then only if it had the support of a substantial majority of creditors, or face liquidation.

So, companies were not necessarily keen to use the *concurso* process given that it took away from them a great deal of control over their future and Mexican banks could not care less on account of their security.

It is no surprise then that the law went unnoticed for a few years and was virtually unused. No more than 70 cases were filed during the first five years of its life. The law remained untested and the legal framework around it could not provide any data as to whether it would end up being a useful tool for the restructuring industry and prove to be up to the test of giving certainty to both ends of the equation.

First Testing and Lessons Learned

One learns to fight by fighting and so, it would all come to change in 2005 when, in a bold move, a Mexican company opted to use the Mexican *concurso* process in lieu of a long negotiated pre-packaged Chapter 11 in the US.

In the beginning, the process was expected to be contested and so it commenced but much to the benefit of the LCM, the parties eventually reached an agreement and agreed to implement the restructuring of the Company within the *concurso* process.

This provided the opportunity to show that the LCM did work and was an effective, and cheaper, tool to do a swift, in-court restructuring of debt that superseded US$1 billion, almost unprecedented in Mexico.

The fact that the company and its creditors were able to achieve a fast restructuring in a court located in Northern Mexico, provided the confidence the LCM needed to be considered in future cases. Also, that the Mexican plan was later recognized under an ancillary proceeding under Section 304 of the U.S. Bankruptcy Code (the predecessor to Chapter 15) gave further confidence to the market that the process would yield a result fair enough to be confirmed abroad, i.e., the international acceptance that was one of the objectives of the law. This success was going to be later put to the test too.

For all of its positive results, including the fact that this case was the example for a section to be included in the first amendment to the LCM in 2007 which provided for a pre-packaged *concurso*, this case also brought about certain concerns and exposed potential weaknesses of the LCM, including: (i) the ability to use under the LCM for a debtor to vote intercompany claims to confirm its own plan; (ii) since the restructuring occurred only at the parent company level, trade debt was not addressed and the question of whether the LCM could be effective to process trade claims remained open and (iii) the lack of ability for creditors to dilute shareholders of the company within the *concurso* process.

Yet, for all of its problems, the case provided grounds for the LCM to be re-utilized and for the first time, discussions around a restructuring of a Mexican company with foreign debt started to include the Mexican process instead of a Chapter 11, which is still true today.

Relevant in this context is the case of Satelites Mexicanos. Similar to the 2005 case discussed here, Satelites Mexicanos was negotiating a restructuring of its bond debt when it decided to file for *concurso*, only to end up going to the United States to finalize it. Notwithstanding the magnitude of the debt at stake, the case was not contested in Mexico and it waltzed through the courts uneventfully, which also helped boost confidence in the Mexican process.

When it's Not the LCM's Fault – The True Reasons behind the Mexicana de Aviación Debacle

MEXICANA

That is, until the Mexicana de Aviación case in late 2010. Mexicana de Aviación had been struggling financially for some time. Liquidity was scarce and costs were hurting the company. However, this was hardly their biggest problem. With a strong, long-standing union, their employee debt was increasing and negotiations were going nowhere. The Mexican constitution, marking a century this year, is a social constitution. Labor claims are privileged and preferential to any other claims. Naturally, the LCM had to respect that privilege.

Not to overly simplify the issue but, when the decision was made to put the company and some of their operating subsidiaries in *concurso* with the aim to negotiate and obtain new investors, both the company and the union were not seeing reality; the former by making the decision and the latter by not stopping it through adopting a more flexible position. Mexican banks did what they were supposed to and enforced their security. In addition, most of the aircraft engines were re-possessed by the lessors and quickly, the case was about employee debt, trade debt and consumers. No investors came about and the employees did not see any money until much later and even then, with a deep discount.

Among the various wrong legal procedural aspects that emerged from this case, including the company obtaining provisional protection that was nowhere to be found in the text of the law, two stood in the spotlight: (i) for reasons chiefly political, although the company did not secure a plan with its unsecured creditors within the permitted time of one year, Mexicana was not forced into liquidation as it was required under the LCM and remained in that status for a few years; (ii) the Supreme Court of Justice "interpreted" a section of the law to categorize consumers, which under the text of the law are unsecured, as privileged creditors. If there was no money to re-pay employees, one can imagine what would happen to the passengers who bought a ticket.

Mexicana never flew again. Very few lucky employees got jobs in other airlines; most of them had to pursue jobs outside the industry. Many never got a new job and ended self-employed. Sadly, some ended in the streets.

However, not one of these issues might be attributed to the LCM. Certainly, a more robust law could have provided grounds to entice investors. Surely, a better classification of creditors would have helped but the bad decision process and wrong interpretation of the law is the responsibility of the people using the law, not the law itself.

Comerci – When the Law Actually Worked

Amidst the wrong impression caused by the Mexicana de Aviación case, the wave of the mortgage crisis in the United States in 2008 hit Mexico hard. There is a saying that when the United States gets a cold, Mexico gets pneumonia. There was not a well-developed mortgage security market in Mexico so the problem did not start there. Back in 2006, Mexico had had its first election after ousting the PRI from the presidency. Very low in popularity, there was a big question as to whether the conservative PAN could get a second term with the left-wing party PRD pushing its way in the polls by the hand of the perceived "populist" Lopez Obrador.

Many big companies hedged against the Mexican Peso, so when the PAN did take the presidency following a legal battle, trust in the country was regained. Coupled with an increase in the oil prices, the Mexican economy became stronger and may of these companies were losing money fast in their hedges and decided to short their positions. When the mortgage crisis weakened the U.S. economy, the Mexican pneumonia came with the plummeting of the Mexican peso. Overnight, these companies saw their debt grow by billions of dollars.

Comercial Mexicana, a large Mexican retail store, entered into a crisis. It attempted to get into *concurso* twice and was rejected both times. This caused the company to pause and commence negotiations with its creditors: (i) Mexican banks; (ii) international banks for the derivatives and (iii) bondholders both in the United States and in Mexico.

Two years of negotiations ensued before all of the parties decided to file for *concurso mercantil*. On the other side of the spectrum from the Mexicana de Aviación case, in this instance negotiations had secured a plan for the company and the majority of its creditors to navigate through *concurso* with significant control over the process and with the aim of implementing a very complex financial restructuring.

A good understanding of the LCM provided the necessary tools to achieve this goal. The company found strength in the fact that Mexico could be the only jurisdiction where a plan could be implemented and found relief in the fact that the shareholders could not be diluted or deprived of their control over the company, a demand quickly made by creditors at the beginning of the negotiations. On the other hand, creditors understood that the LCM would give them the certainty of a process that would treat them fairly and that the company was not going to able to linger in *concurso* for longer than it had to .

This case was registered as a success, together with the Iusacell case which used *concurso* to restructure its bond debt, both in record times, to date still undefeated.

Intercompany Voting – The Infamous "Vitro Issue"

However, three issues were still looming: (i) the fact that until then, no big company had done a contested restructuring in a Mexican *concurso* proceeding; (ii) that only cases of restructuring at the parent level had been tried and, (iii) the recurring matter of a debtor's ability to use intercompany claims to confirm its own restructuring plan.

Although the intercompany claims were actually used to confirm a plan in a hostile environment only a few times, this issue remained in the spotlight for several years and professionals even developed contractual instruments to protect lenders and structure around these provisions (or lack thereof) of the LCM. The Vitro case is probably the most relevant in respect of the ability to use intercompany claims to confirm a debtor's plan. Putting aside the outcome of the Chapter 15 filing where the Mexican plan was not confirmed because it provided for the release of the guarantees without the guarantors being debtors in the *concurso* proceeding, this case triggered the amendment to the LCM which limited the use of intercompany claims to confirm a plan, except when such claims voted with the majority of third party creditors or represented less than 25% of the total amount of claims.

Vitro, a big industrial company north of the country, had been negotiating its debt for some time in the US and when those discussions broke, it decided to commence a *concurso* proceeding in Mexico. A highly contested case, it served the purpose to show that the LCM could also be used to confirm a plan within a reasonable time period (below 9 months) in a litigious scenario. Although not confirmed in the US, the Mexican plan stood its ground in Mexico and paved the road for a negotiated settlement post-*concurso*. Together with the Comercial Mexicana case, it showed the ability of judges to comprehend and process complex claims and plans.

Certain calm succeeded the Vitro case until the housing loan market started to collapse and saw the case of Hipotecaria Su Casita. Although having reached well above the majority required under the LCM to confirm a plan, the majorities requested by the Mexican government to accept the restructuring were not reached and the company had to be put in liquidation. With little litigation, the liquidation process under the LCM got to play its role and produced recoveries above the standard under the prior law.

Mexican Homebuilders – Testing the Limitations of the LCM (and of the Courts Interpreting it)

With the experience gained during the prior 14 years, practitioners considered that a somewhat uniform practice in the insolvency and restructuring market had been achieved for the future. That is, until the homebuilders' financial crises exploded.

Sitting on a considerable volume of land that mostly ended up useless for building low-income housing complexes due to a 360º change in government housing politics and norms, these homebuilders faced the most challenging of the restructuring processes in recent history.

With scarce liquidity that became zero liquidity pretty fast, these companies had debts almost impossible to pay.

All three of these companies, GEO, Homex and Urbi had only one plan to offer: capitalize all debt with significant dilution of the shareholders, only for both creditors (new shareholders) and existing shareholders to see a second dilution when the new investors injected funds to the company to keep it in the business.

In the case of Corporación GEO, this had to be done not only at the parent level but also with 15 other subsidiaries which entailed, among other things, having to process trade and consumer claims numbering in the tens of thousands with virtually no cash.

These three companies had planned on receiving DIP financing during the process relying on a 2014 amendment of the LCM which simplified and clarified the DIP financing rules. Again, through no fault of the LCM, this financing did not happen, mostly because banking regulations made it incredibly cumbersome for banks to lend to bankrupt companies.

In the case of GEO, restructuring plans were all filed on the verge of the deadline and all got approved shortly thereafter.

There are many reasons to consider these cases a success, although it may take some time for that to happen. The LCM met one of its final tests: its ability to do a case with significant amount of trade, financial and consumer debt. It also proved to be a very helpful tool to process tax debt using, for the first time, tax regulations that allow the government to be treated *pari-passu* with unsecured creditors under very specific circumstances.

But when everything seemed glaring, an appellate court using a provision in the liquidation section of the LCM, which application is questionable, reversed the approval of the GEO parent company plan on purely formalistic grounds. Not rejecting the substance or the fairness of the plan, the court held that no approval of a plan could be made if appeals in respect of the claims (recognition and ranking of credits) were pending, notwithstanding that the LCM provides for very specific mechanisms to accommodate changes in the amount of debt recognized.

The controversy around this opinion by the appellate court lies in the fact that it could cause extensive litigation before a plan may be implemented, which is the very problem the LCM intends to avoid. The GEO plan was re-approved three months later with no significant consequence other than increasing legal costs. However, the re-approval did not come in hand with a reversal of the opinion that created the whole issue. It just so happened that the challenges against the recognition of the claims (credits) of GEO were resolved almost simultaneously, thus clearing the way for re-approval of the plan per the appellate court's own criteria.

Although the Mexican courts are not bound by this opinion, there is no assurance that they will not actually follow it in the future.

What Needs to Change?

A new test is in front of everybody concerned with the insolvency and restructuring practice. It is necessary to make the changes that the LCM does need.

Some LCM Amendments Needed:

1. Divide the unsecured creditor class into separate classes (trade/consumer/financial debt)
2. Allow debtor to better operate its business during *concurso* (e.g. participation in public bids)
3. Create specialized bankruptcy courts

One of these amendments should be the possibility to divide the unsecured creditor class into different classes so that trade and consumer debt may have different treatment. Today, the LCM requires that any unsecured creditor that does not support a plan receives the same treatment as the best treatment afforded to the required majorities of unsecured creditors that voted for it. This prevents companies from giving trade and consumer debt treatment akin to its nature that often requires different forms of payment, e.g., payment to consumers in full for social reasons.

Under the current statute, financial debt that does not support a plan would have to be treated *pari passu* with trade and consumer debt. To avoid this, the restructuring plans that are being filed today opt to treat trade and consumer debt in the same way as other financial debt, which is not necessarily an efficient and equal treatment as was seen in the case of GEO.

Among all the experiences and lessons, one stands out clearly: ethics have to be applied across all aspects of the practice to make it what it is supposed and needs to be.

Another important amendment would be to provide better rules so that a company is not frozen by the mere declaration of *concurso*. Albeit the LCM allows a debtor to continue to run its business after the declaration of insolvency, often companies in *concurso* find themselves with vague rules for payments in the ordinary course of business. Another example of better rules for not paralyzing companies in *concurso* is to include provisions that expressly allow them to continue participating in public bids if certain conditions are met.

However, any changes made to the LCM will not mean anything and will not change anything if the courts are not trained in this discipline and special bankruptcy courts are finally created. The most compelling task today is to have specialty courts, the lack of which is due to lack of enough funding for such an institution.

I started this piece by saying I would share my views on the development of the LCM. Among all the experiences and lessons, one stands out clearly: ethics have to be applied across all aspects of the practice to make it what it is supposed and needs to be. ■

1. Names omitted due to confidentiality commitments.
2. With the exception of Ahmsa, albeit the latter was tried under the prior law and all would agree is hardly a restructuring case, or for praise, or certainty; if anything, Ahmsa is about all that was wrong with insolvency work in Mexico.
3. Under the LCM, a simple majority of over 50% of unsecured creditors, is required to confirm a plan of reorganization.
4. Under the LCM the unsecured class is only one class and treatment may not vary amongst this class.
5. In 2007, the LCM was amended to provide clearer and definite language in the sense that a debtor had to be liquidated if it did not reach a plan within 365 days as of commencement of concurso and made the judges personally liable for going beyond this period.
6. From horizontal sprawl to vertical concentrated development, thus changing the value of the "land banks" held by the homebuilders.
7. In constitutional proceedings known as "amparo".

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