The Intersection of Derivatives and Insolvency under Mexican Law

By **EUGENIO SEPÚLVEDA**

The Mexican Insolvency Law, or *Ley de Concursos Mercantiles*, allows for the termination and closing out netting of individual and multiple derivative transactions under the relevant framework agreements, and the application of certain collateral to the payment thereof, upon a party's insolvency.

Financial Derivatives under the Mexican Insolvency Law

Contracts for difference (CFDs), futures contracts and other financial derivative transactions are executory contracts grouped and treated in the same manner by the Mexican Insolvency Law. Other than general contract law, tax law and certain regulatory rules applicable to banks and other financial intermediaries, derivatives instruments are mostly unregulated.

While CFDs or futures contracts are not specifically defined under Mexican law, these can be distinguished from ordinary purchase agreements because of their special characteristic that, when the contract term expires, instead of the seller transferring title to an asset against payment of the price, one of the parties pays to the other the difference in value of the underlying asset. This feature broadly encompasses all cash settled financial derivatives.

A financial derivative transaction, pursuant to the Mexican Insolvency Law, is one where the parties are obligated to pay money or to surrender other property based on an amount tied to the value of an underlying financial asset. There is no substantive difference between this legal concept of financial derivative transaction and that of CFDs.

Under Mexican law, financial derivatives also include those agreements deemed as such by Banco de México (Mexico's central bank) through its rules of general application. Pursuant to these rules, Banco de México recognizes futures, options, swaps and credit derivatives (including credit default derivatives, total return derivatives and credit linked securities) as derivative transactions.

Ipso Facto Clauses

Mexican courts will not recognize the validity of an ipso facto clause in a contract that gives a party the right to terminate such contract or impose additional costs or burdens in the event of a petition or demand for, or declaration of, *concurso* of the other party.

The court appointed conciliator may, however, reject a contract on grounds that rejection is in the best interest of the estate. While such authority appears to be seldom exercised in practice, there is no reliable information to support this given the difficulty in accessing public dockets of insolvency cases in Mexico.

The continuation of contracts and the conciliator's powers to reject them are general principles applicable to all contracts. However, derivative transactions and other specifically designated contracts are subject to special rules.

Treatment of Financial Derivatives in *Concurso*

On the date of the declaration of *concurso*, each individual derivative transaction and multiple derivative transactions under a framework agreement are automatically terminated and netted out. Unless the derivatives contract provides its own rules concerning liquidation and close out netting of amounts owed thereunder, the value of the underlying assets or claims will be determined at their market value on the *concurso* declaration date. Any contract governed under the ISDA Master Agreement or its Mexican version, which in practice will be the case for most transactions, will include such rules. In the event there is no available or demonstrable evidence of market value, the conciliator may entrust a third party expert in the field to assign a value to such underlying assets or claims.

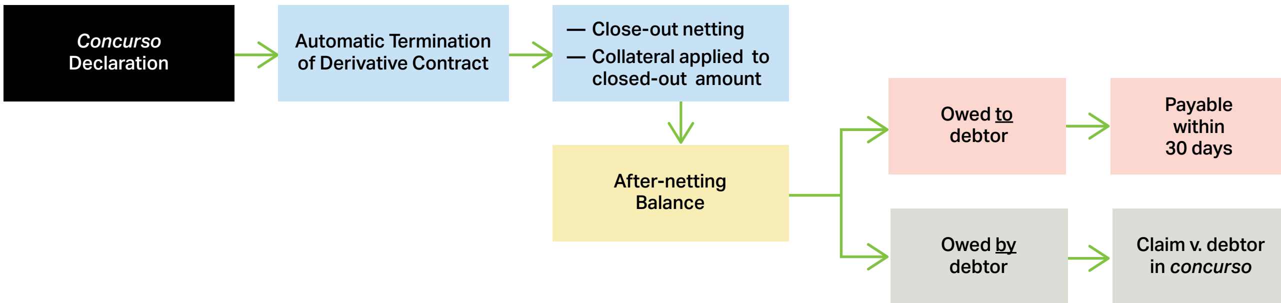
The after netting balance, if in favor of the debtor, shall be payable to the debtor within 30 days of the *concurso* declaration date or, if against the debtor, shall constitute a claim against the debtor subject to the *concurso* proceedings.

In principle, clauses providing for the automatic termination of derivative transactions following the declaration of a *concurso* proceeding would not be recognized by a Mexican bankruptcy court. However, such provision would be unnecessary since termination of derivative transactions operates *ipso jure* on the moment of the declaration of *concurso*, or, in the case of a liquidation of a commercial bank, within two business days after the publication of the revocation of the bank's charter.

Similarly, there is a contractual right for consent by the non debtor counterparty to transfer the debtor's assets, which requires the court appointed receiver, or *síndico*, to ask each non debtor counterparty to decide whether to continue or reject a contract in light of the sale of the debtor's estate being carried out as a transfer of the enterprise or parts thereof as a going concern. Failure of a non debtor counterparty to respond within ten business days shall be deemed as consenting to the continuation and transfer of the contract.

While this provision, which is applicable to all executory contracts, allows for a certain level of protection to the non debtor counterparty, in the author's view, the impact is irrelevant in

Concurso



the case of financial derivatives transactions in light of the *ipso jure* early termination of such transactions of the debtor. That is, by the time the debtor is declared insolvent, the derivative transactions in question would have terminated. There would be no contract to assign.

Collateral; Exception to the Automatic Stay

As a general rule, once the court enters a *concurso* judgment, the attachment and foreclosure on the debtor's assets are generally stayed during the reorganization stage. This stay of execution operates only during the reorganization stage, or *conciliación*, and not during the liquidation stage, or *quiebra*.

An exception to this principle, the close out netting of derivative transactions as a result of the *concurso* declaration results in the automatic application of the collateral to the payment of the close out amount, provided that such collateral consists of a security instrument where title is transferred to the pledgee (e.g., pledge of cash or other fungible assets).

Recognition and Ranking

The Mexican Insolvency Law provides for the recognition and ranking of creditor claims, and for the distribution of proceeds from the sale of estate assets to be made in accordance with that ranking. No creditor from a lower rank can be paid until all creditors of a higher priority are paid in full.

The after netting balance of a financial derivative transaction or of multiple derivative transactions under their respective framework agreements, if owed by the debtor, shall constitute a claim against the debtor subject to the *concurso* proceeding. Depending on the level of collateralization of the after netting balance against the debtor, the claim may qualify as a secured claim (with relative seniority) or an unsecured claim. Partially secured claims would qualify as secured only to the extent covered by the collateral.

Costs and Expenses

An unresolved issue is whether the post termination payment would include obligations or amounts in excess of the market value of the derivative transaction (e.g., costs and expenses).

The fact that the Mexican Insolvency Law allows a derivatives contract to set its own rules concerning liquidation and close out netting of amounts owed, strengthens the argument that additional costs and expenses should be included in the calculation of amounts due if they were foreseen based on the terms of the derivatives contract.

On the other hand, the fact that Mexican courts will not recognize the validity of a clause in an agreement that gives the non defaulting party the right to impose additional costs or burdens over the defaulting party in the event of a petition or demand for, or declaration of, a *concurso* proceeding, suggests that any amount in excess of the market value of derivative transaction will be disallowed, if such amount arose solely out of a termination from a bankruptcy related event. As such, even if the ISDA Master Agreement (or its Mexican equivalent) provides for the payment of costs and expenses in connection with the close out netting of a derivative, such payment may not be permitted by the Bankruptcy court.

The Avoidance Powers of Courts

Some derivative transactions entered into before the *concurso* declaration can be set aside by the courts. Only courts have such avoidance power since other interested parties, such as creditors, must bring a suit or petition to the court to avoid them. All pre commencement *per se* fraudulent transactions are avoidable. Other pre commencement avoidable transactions can be set aside if carried out within the clawback period and include cases of constructive fraud, objective preferences and subjective preferences. Cases of constructive fraud include gratuitous transactions, transactions which differ from fair market conditions and payment of immature debts. Objective preferences include granting or increasing collateral and making in kind payments. Subjective preferences include related party transactions.

The clawback period begins 270 days prior to the *concurso* declaration date or 540 days with respect to related party transactions. The judge may extend such period to an earlier date upon the request of the conciliator, the conservators or any creditor but up to a maximum of three years.

Close out netting is considered as a top priority issue of concern involving derivative transactions. As a safe harbor rule, close out netting of derivative transactions carried out during the clawback period is also allowed.

Re-couponing

Re-couponing is the process of setting the mark to market value of a swap to zero. The process involves the payer paying the early termination amount in cash and the swap being re executed at prevailing market rates.

While market practice has recognized Re-couponing as a sensible means of mitigating counterparty risk, more careful consideration should be given to the actual process in light of the court's avoidance powers, as Re-couponing may result in a *de facto* increase in collateral or the payment of immature obligations and, therefore, avoidable at a subsequent *concurso*.

Multibranch Netting

The issue of multibranch netting appears when a bank party to an over the counter derivative transaction books individual transactions to several branches located in different countries.

The analysis of how to treat the insolvency of such bank or its counterpart (multibranch netting) poses certain levels of complexity depending on the different possible scenarios based on the parties involved. The possible parties include:

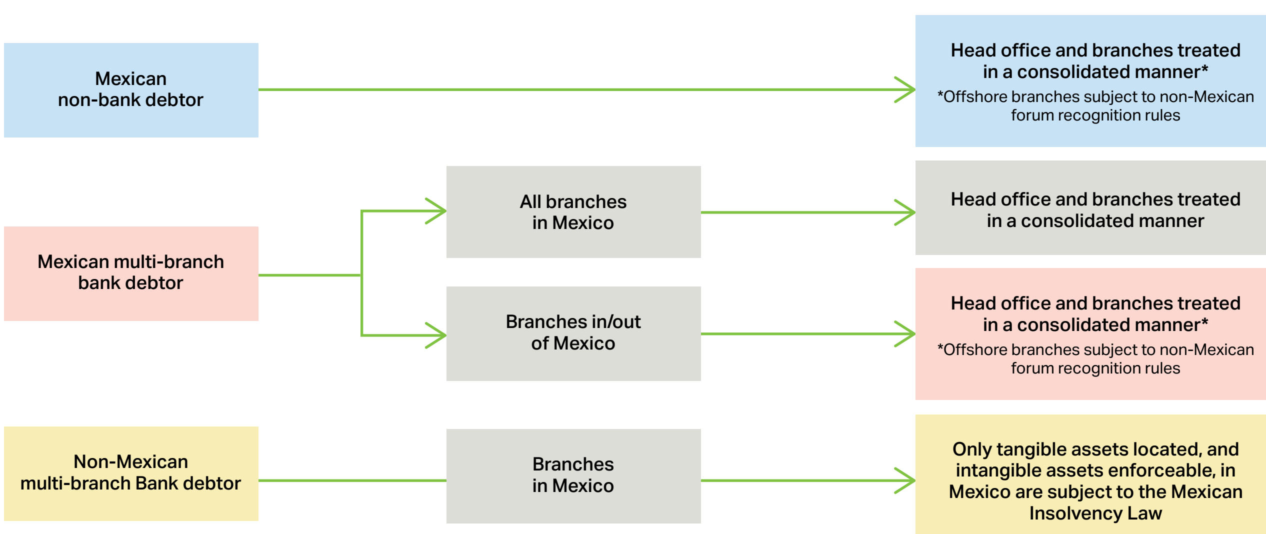
- A Mexican non bank debtor
- A Mexican multibranch bank debtor
- A non Mexican multibranch bank debtor, with one or more branches in Mexico

A Mexican non bank debtor

The Mexican Insolvency Law generally treats the head office and branches of a person or entity as the same body corporate and, therefore, a non debtor multibranch bank counterparty to the debtor would have no impact on the analysis: the non debtor bank's positions would also be treated in a consolidated manner.

The level of comity or recognition of these principles would depend on the laws of the place (outside of Mexico) where a branch of the non debtor bank is located.

Multi-Branch Netting



A Mexican multibranch bank debtor
The insolvency statutes applicable to banks take a consolidated approach to insolvency: it treats a cross border insolvency case and all of its components as part of the same insolvency proceeding.[1] Similar to the prior case, Mexican courts and the bank regulations in charge of overseeing an insolvent bank would recognize the bank and its branches as a single body corporate and all its dealings would be consolidated in the debtor bank's estate.

As in the prior case, the level of comity or recognition of these principles would depend on the laws of the place (outside of Mexico) where a branch is located.

A non Mexican multibranch bank debtor, with one or more branches in Mexico
As an exception to the principle that the head office and branches of a person or entity are treated as the same body corporate, the Mexican branch of a foreign debtor is subject to the Mexican Insolvency Law, but only in connection with tangible assets located, and intangible assets enforceable, in Mexico and with respect to claims held by creditors for operations with those branches.

The natural consequence of this statutory provision requires "ring fencing" the estate. Aside from the fact that, in this case, the Mexican Insolvency Law clearly strays from the consolidated approach and adopts a territorial approach, it requires carrying out an analysis of the estate for which the Mexican Insolvency Law is currently ill equipped to do:

— The location of tangible assets can be relatively straightforward when dealing with realty, but may get more complicated when dealing with chattel: Would a transfer of an asset from the relevant branch to the debtor's headquarters or to another branch be excluded from the estate? Would the transfer be avoided? Would the assets of different branches located in Mexico all be part of the relevant branch's estate?

— The issue is further complicated when dealing with intangible assets: When is an intangible asset enforceable in Mexico? What is the impact of an underlying bank debtor relocating outside Mexico? The Mexican Insolvency Law is silent as to these and other issues pertaining to the location of assets.

— Since a branch is not treated under law as a body corporate separate from the principal headquarters, it is unclear what situations could qualify as "operations with those branches." This issue is even harder to tackle under the Mexican Insolvency Law than it would have been under traditionally territorial statutes, since the nationality or residence of the creditor or the location of their collateral is not relevant to determining the estate of the branch.

— The author knows of no precedent of a main insolvency proceeding involving a branch of a foreign debtor. This lack of precedent and the silence of the Mexican Insolvency Law results in a poor and unsatisfactory framework for dealing with insolvent branches of foreign debtors.

Now, as a practical matter, this issue is moot: since 1994, there have been no foreign bank branches in Mexico. The only case in Mexico's recent history is Citibank's Mexican branch, which it spun off in 1994 to create a wholly owned Mexican subsidiary.

Representatives offices are not branches. While banks may (and many do) establish representative offices in Mexico, these offices are not allowed for booking transactions. This means that derivative transactions may not be booked to a representative office and, therefore, no multibranch analysis is required.

Conclusion

The Mexican Insolvency Law allows for the termination and closing out netting of individual and multiple derivative transactions under the relevant framework agreements, and the application of certain collateral to the payment thereof, upon a party's insolvency. In this sense, the Mexican Insolvency Law is a modern statute that provides a solid framework to mitigate netting risk in the case of insolvency.

However, some insolvency related issues concerning financial derivatives may still require legislative action for the sake of clarity, such as the application of costs and expenses, Re-couponing. Whether to lean on one side or another is a policy issue. Regardless of the stance taken by the lawmaker, precise rules on these issues would add value to the system by bringing clarity to these issues. ■

1. *See*, e.g., American Law Institute. International Statement of Mexican Bankruptcy Law. 2003; p. 107.

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