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Corporate Workouts in Mexico: The Good, the Bad, and the Ugly

Arturo C. Porzecanski

It is now more than ten years that the law governing the Mexican insolvency regime—the *Ley de Concursos Mercantiles* (LCM, best translated as the "Business Reorganization Act" of 2000)—was enacted and has been successfully applied in hundreds of cases of corporate debt workouts. The LCM is widely and rightly lauded as a quantum improvement over its predecessor, the *Ley de Quiebras y Suspensión de Pagos* (the "Bankruptcy and Suspension of Payments Law" of 1943).

Indeed, recent times have brought considerable progress to Mexico in most matters pertaining to corporate law, the strengthening of property rights, and the ease of doing business. The modernization observed was badly needed, considering the long period of turmoil that Mexico underwent starting 100 years ago, when it became engulfed in a protracted nationalist revolution that undermined private property rights and scared away domestic and particularly foreign investment—long after the fighting had ended. The progress is also encouraging, given the antiquated commercial code that had governed business relations in Mexico from colonial times. In appreciation of the difference that progress has made, it is instructive to recall the view of one incisive observer published back in 1922: "While they do stagger out a miserable existence, the corporation and other laws of Mexico are a discredit to this otherwise wonderful country, and all we can hope for, or despair of, is a quick change."[1] Change would eventually come, but not until recently.

Special Note: I have been writing this newsletter for more than 10 years. In the interest of bringing in some new perspectives, I have opened up the newsletter to occasional contributions from scholars who work in the field of international political economy. My hope is that the readers will enjoy these fresh insights.—Sidney Weintraub

The insolvency regime reform adopted eleven years ago was motivated by the widely acknowledged need to deal more effectively with corporate workouts, especially in the aftermath of the 1995 financial crisis in Mexico. It became part of a worldwide phenomenon whereby legislatures in many countries around the world have modernized the content and cross-border provisions of their bankruptcy laws, incorporating local versions of the widely lauded U.S. Chapter 11 reorganization procedure and making it easier to restructure companies with operations in more than one national jurisdiction.

Pre-Reform Legislation

Mexico's previous bankruptcy law had been criticized severely by practitioners for many years. The 1943 *Ley de Quiebras* was very burdensome on judges, overly protective of debtors, and designed to enable an orderly suspension of payments ahead of the eventual

[1] R. B. Gaither, "The Corporation Laws of Mexico," *Virginia Law Review* 9, no. 1 (November 1922): 50.

liquidation of the company in trouble—rather than to facilitate a speedy restructuring of liabilities and of the management and assets of the potentially insolvent corporation. The old law did not prescribe term limits on procedural stages, did not cap the use of litigation by the opposing parties, and allowed debtors to remain under court protection indefinitely, thus motivating debtors to postpone their day of reckoning. It also discouraged creditors from pushing for the liquidation of a corporation in default, because that would only deliver to them the scrap value of the troubled firm.

A good case in point is AHMSA (Altos Hornos de México S.A.), the last large company to file for a suspension of payments under the old law after defaulting on some $1.9 billion in debt. AHMSA is the largest integrated steel producer in Mexico, and for the past twelve years it has been able to continue doing business pretty much as usual, under court protection, despite having failed to settle debts incurred back in the 1990s. Thus, the firm has registered operating profits (e.g., an EBITDA of $368 million in 2010, an amount 39.3 percent higher than that obtained in 2009)—but it has not paid its defaulted creditors.[2]

The New Workout Regime

The 2000 *Ley de Concursos Mercantiles*, on the other hand, incorporated most of the best international practices, and its main objectives have been to preserve and protect the rights of the various local and foreign constituencies typically involved in a Mexican insolvency proceeding, maximizing the value of company assets and their eventual distribution among creditors. The LCM centralized the registry of claims and established a randomized and prompt selection mechanism for examiners, conciliators, and trustees under the responsibility of a new Federal Institute of Bankruptcy Specialists (IFECOM, as it is known by its Spanish acronym). Besides changing the incentive system by fostering corporate restructurings and not just liquidations, the new law imposed restrictions on litigation, dilatory objections, and even appeals. It penalizes delay by automatically triggering a liquidation process after certain time limits have been exceeded.

The LCM is particularly enlightened in its treatment of multinational companies. It promotes cooperation between Mexican and foreign courts; grants local recognition and enforcement of judgments stemming from insolvency proceedings abroad; permits foreign representatives direct access to Mexico's judiciary; affords foreign creditors the right to initiate and participate in Mexican proceedings; and treats foreign and local creditors equally, affording them the same due process.[3]

By now more than 400 cases have been filed under the LCM, involving over 470 corporate debtors and liabilities exceeding the equivalent of more than $60 billion.[4] One rigorous study of numerous bankruptcy cases filed during 1991–2005 found that the introduction of the LCM decreased the average time spent in bankruptcy from 7.8 to 2.3 years; post-reform average recovery rates increased from 19 to 32 cents on the dollar; and violations to the absolute priority rule (that secured creditors should fare better than unsecured creditors) fell from 29 percent to 2 percent.[5]

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[2] See "AHMSA Presents 2010 Financial Results," http://www.ahmsa.com/en/3284/ahmsa-presents-2010-financial-results.

[3] Similar provisions of cross-border significance were enacted in the United States in 2005, when the U.S. Code was amended to provide for a Chapter 15 in order to recognize and facilitate a foreign bankruptcy proceeding, codifying certain forms of relief for foreign representatives consistent with principles of comity.

[4] IFECOM, "Informe Correspondiente al Semestre 1/Jun/2010-15/Nov/2010," http://www.ifecom.cjf.gob.mx/PDF/informes/21.pdf.

[5] Mario Gamboa-Cavazos and Frank Schneider, "Bankruptcy as a Legal Process," Harvard University, draft, June 2007, http://papers.ssrn.com/sol3/papers.cfm?abstract_id=979614&.

Favorable Reform Repercussions

On a global scale, according to an analysis by Standard & Poor's, "Mexico has become a relatively friendly jurisdiction for secured creditors, and it is now one of the friendlier jurisdictions for creditors in Latin America."[6] Therefore, after evaluating the degree of protection for secured creditors, the opportunity granted to them to influence the insolvency process, the certainty of creditor priority, and the time to resolution, this leading credit rating agency has classified Mexico in an intermediate "B" category of insolvency regimes, together with the likes of Brazil, Chile, France, and Spain. (The United States is categorized as the next higher "A2" jurisdiction, together with Germany and Japan, but somewhat less favorable than top "A1" jurisdictions like Australia, Singapore, and the United Kingdom.)[7]

The progress made by Mexico is also captured by the World Bank's "Doing Business" series of annual reports benchmarking the regulations that support or constrain the conduct of business operations around the globe. They include a category for the ease of "closing a business" based on a precise measure of the time, cost, and outcome of the insolvency procedure against a standardized local company. (For example, to make the data comparable across countries, the company has to be 100 percent locally owned with the founder and CEO owning 51 percent of shares; it must operate in the largest business city and own real estate and run a hotel as its major asset; and it owes money to its employees, suppliers, and bank.) As per the 2011 edition of "Doing Business," Mexico ranks a relatively high 23 out of a total of 183 countries for the ease of closing a business there, with Chile ranking as 91st, Brazil trailing in 132st place, and the United States attaining 14th place. (Japan, Singapore, and Canada top the list.) In other categories and with only one exception (its showing in 22nd place under the "obtaining construction permits" criterion), Mexico's comparative performance under the "closing a business" standard is far superior to all the other components of the World Bank's "ease of doing business" rankings.[8]

A number of large Mexican corporations have encountered debt-servicing difficulties in recent years—especially in the wake of the global financial crisis of late 2008–early 2009—and thus provide telling examples of how the LCM is operating in practice. It is a tale of the good, the bad, and the ugly.

The Good

Corporación Durango S.A. (now renamed Bio-Pappel), the largest paper and paper-products producer in Mexico and Latin America, was the first case to be resolved under the new legislation involving a large corporation with major cross-border, overdue liabilities. At first (in 2003 and early 2004), the company engaged in out-of-court negotiations with its creditors to restructure about $1 billion in unsecured debt. The company then filed for formal reorganization in May 2004 and reached an agreement with a majority of its unsecured creditors, with the Mexican court approving the plan in early 2005. (The restructuring was "crammed down" on the remaining unsecured creditors.) The proceeding took a mere nine months.[9]

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[6] Standard & Poor's, "Debt Recovery for Creditors and the Law of Insolvency in Mexico," September 19, 2007, p. 2, http://www.sandprecoveryratings.com/documents/articles/archive/2007/archive_2007-09-19_Debt_Recovery_For_Creditors_And_The_Law_Of_Insolvency_In_Mexico.pdf.

[7] Standard & Poor's, "Update: Jurisdiction-Specific Adjustments to Recovery and Issue Ratings," June 20, 2008, http://www.sandprecoveryratings.com/documents/articles/archive/2008/archive_2008-06-20_Jurisdiction-Specific_Adjustments_To_Recovery_And_Issue_Ratings.pdf.

[8] World Bank, *Doing Business 2011* (Washington, D.C.: World Bank and International Finance Corporation, 2010); see http://www.doingbusiness.org/rankings.

[9] Because the majority of the company's outstanding indebtedness was U.S.-dollar denominated and governed under U.S. law, Durango also filed a case under Section 304 of Title 11 of the U.S. Bankruptcy Code—the

However, in October 2008 Durango again encountered difficulties and defaulted on more than $500 million of notes due in 2017, initiating a second debt restructuring in Mexico through the *Concurso Mercantil* process. Two of the company's affiliates also filed for bankruptcy under Chapter 11 of the Bankruptcy Code in the United States. Durango's bondholders approved a reorganization plan under U.S. law in June of the following year and simultaneously signed an insolvency agreement in Mexico. In sum, this second restructuring was concluded in August of 2009—namely, within ten months—and thus Durango's two pioneer workouts illustrate the admirable change in form, substance, and timing that has taken place in Mexico's insolvency regime.

Several other major corporate workouts were likewise concluded in record time. Iusacell S.A., a wireless cellular provider, filed under the LCM in mid-2006 in the wake of a default on debt issues for approximately $350 million. A debt exchange was approved by 90 percent of its bondholders within weeks, and it received court endorsement in April 2007. In sum, these workouts exemplify what a good corporate insolvency regime is supposed to deliver: speed (after all, "justice delayed is justice denied"), fairness to all the parties involved, and a remedy that is appropriate to the circumstances.

The Bad

Satélites Mexicanos S.A. (Satmex), the main provider of satellite services in Mexico, was hauled by some of its creditors into a Chapter 11 proceeding in the United States in May 2005, following its default on a $250 million bond. Satmex countered by filing for a reorganization in Mexico in mid-2005, and its creditors soon agreed to withdraw their bankruptcy proceedings in the United States and subject themselves to a restructuring under the LCM. Interestingly, Thomas Heather, a partner in White & Case's Mexico City office, was appointed as the mediator at the request of Mexico's Ministry of Communications and Transportation. Satmex reached a comprehensive agreement to restructure its existing indebtedness during the course of 2006. However, the company is yet to deliver a happy ending: skating at the edge of bankruptcy, it has been in protracted talks with its creditors and with potential new investors for the past several years and is currently gathering support for a restructuring and recapitalization plan. Satmex has switched jurisdictions and filed its reorganization plan under Chapter 11 in U.S. Bankruptcy Court, in Delaware. Whatever happens to Satmex, the Mexican *Concurso Mercantil* process cannot be blamed for the company's long-running financial troubles and possible demise.

And the Ugly

Currently, the Mexican insolvency regime is being put to the test by the potentially ugly precedent that Vitro S.A.B. is trying to set. Vitro, a leading glass manufacturer, is one of several major Mexican corporations that found themselves at the losing end of various currency derivatives contracts in late 2008, when in the aftermath of the Lehman Brothers debacle, the Mexican peso unexpectedly took a big hit while the U.S. dollar rallied.

Some of the other companies that lost considerable money at the time include previously troubled retailer Comercial Mexicana (Comerci); multinational cement maker Cemex; the corn flour and tortilla manufacturer Gruma; and Alfa, a conglomerate involved in heavy industry, petrochemicals, electronics, and foods. Comerci defaulted in the wake of a derivatives-related loss of more than $2 billion and has since undergone a major debt restructuring under the aegis of the LCM. Cemex, which lost more than $700 million, had to obtain relief via a comprehensive refinancing

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forerunner of Chapter 15—to protect itself from any creditors commencing legal action in the United States while the company was attempting to reorganize in Mexico.

of its $15 billion in debt obligations to banks and bondholders.

In early 2009, Vitro failed to pay $293 million in derivative contracts as well as interest payments on bonds maturing in 2012, 2013, and 2017, triggering a default on approximately $1.7 billion in debt held by banks and unrelated bondholders around the world. Subsequently, Vitro filed for voluntary bankruptcy in mid-December of last year in the hope of gaining court approval for a restructuring plan that supposedly had the backing of a majority of its creditors. To gain support of a restructuring plan that benefited shareholders by forcing creditors to take steep haircuts (a debt exchange worth around 70 cents on the dollar), Vitro had taken the unusual step of creating $1.9 billion of intra-company loans from subsidiaries, an amount greater than their loans from the company's bona fide creditors. Vitro's subsidiary creditors—the ones that had lent money to the holding company—then voted in support of Vitro's restructuring plan. In effect, the subsidiary creditors voted on their own bankruptcy plan, benefiting Vitro's shareholders at the expense of the company's real creditors, most of whom voted to reject the proposed debt exchange.

This is the first time since the *Ley de Concursos Mercantiles* was enacted eleven years ago that the Mexican courts have been presented with such a situation: a debtor company attempting to defeat its genuine creditors by creating, after its default, massive intra-company liabilities for the sole purpose of rigging the company's restructuring process.

So far, the Mexican judiciary has rightly resisted this strategy, because the letter and intent of the LCM is to handle the financial problems of any company on a consolidated basis—namely, including any and all controlling and controlled entities, as specified in its Article 4-II.[10] Indeed, in the United States or other major jurisdictions, any genuine intra-company liabilities would be offset by their counterpart intra-company assets, and subsidiaries would thus play no role in the consolidated entity's restructuring. In early January of this year, the relevant judge promptly rejected the company's plan because of the intra-company loan vote, and when Vitro appealed, the appeals judge initially refused to take the case. However, after Vitro hired several high-powered lawyers and lobbyists (including former Attorney General Antonio Lozano Gracia and the former central bank president, Guillermo Ortiz) and tried to appeal again, the same judge agreed to hear the appeal. In the meantime, disgruntled creditors have filed lawsuits in New York and Texas—an ominous vote of "no confidence" in what could be the precedent-setting case that stains a rightly lauded, best-practice law that has served Mexico so well and so quickly.

At a time when Mexico is beset by so many other challenges in the sphere of law and order, it would be a shame if progress made in the field of bankruptcy reform was to suffer a setback. If Vitro's liability manipulations are given legal standing, they will have a chilling effect on the access to domestic and foreign financing that Mexican corporations have enjoyed during recent years. The risk premium attached to corporate bond issuance and bank credit extended will rise for all Mexican companies, and only contracts written under New York or other foreign law may become acceptable to domestic and foreign creditors. This is a prospect that Mexico should avoid.

Arturo C. Porzecanski, PhD, is a CSIS senior associate (nonresident) and a professor of international economics and international finance at American University, with the

[10] *Ley de Concursos Mercantiles,* http://www.ifecom.cjf.gob.mx/PDF/LCMyND/leyDeCM-2010.pdf. The law was amended in December 2007.

academic appointment of distinguished economist-in-residence.
E-mail: aporzeca@american.edu

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