

## HEMISPHERE FOCUS

November 14, 2011

**Mexico's Retrogression: Implications of a Bankruptcy Reorganization Gone Wrong**

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An earlier essay ("Corporate Workouts in Mexico: The Good, the Bad, and the Ugly") told of how Mexico had made considerable progress in the past decade-and-a-half in matters pertaining to corporate law, the strengthening of property rights, and the ease of doing business.<sup>1</sup> It highlighted in particular the benefits of a new law governing the Mexican insolvency regime—the *Ley de Concursos Mercantiles* (LCM, best translated as the "Business Reorganization Act" of 2000, as amended in 2007).

It pointed out that the Mexican insolvency regime was being put to the test by the creditor-unfriendly precedent that Vitro S.A.B. was trying to set. Vitro, one of the world's largest producers and distributors of glass products, is one of several major Mexican corporations that found themselves at the losing end of various currency derivative 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.

This essay provides additional background on the Vitro case; updates the troubling developments in that restructuring proceeding so far this year; and discusses the implications of this landmark precedent—not least of which is the impression it is creating, namely, that Mexico is retrogressing, becoming an unpredictable and risky jurisdiction for the adjudication of legitimate claims involving domestic and foreign creditors.

**Background**

Vitro S.A.B., one of Mexico's leading multinational companies, is a holding that conducts substantially all of

<sup>1</sup> See my "Corporate Workouts in Mexico: The Good, the Bad, and the Ugly," *CSIS Issues in International Political Economy*, April 2011.

**Main Points**

- The corporate restructuring of a major Mexican multinational (Vitro), now winding its way through the Mexican courts, is raising serious doubts about the capacity of the country's insolvency regime to deliver an outcome viewed as fair and consistent with prevailing norms and practices in the United States and other reputable jurisdictions.
- The case has the potential to complicate U.S.-Mexico diplomatic relations and to have a chilling effect on the easy access to foreign financing that Mexican corporations have enjoyed during recent years. Cemex, Mexico's flagship multinational corporation, may be particularly vulnerable to adverse fallout from the Vitro case.

its international operations through subsidiaries, including more than a dozen in the United States, and has manufacturing facilities and distribution centers in many countries throughout the Americas and Europe. It has annual net sales approaching \$2 billion, maintains a workforce of about 17,000 mostly concentrated in Mexico, and exports its products to more than 50 countries.

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 \$1.5 billion in debt held by banks and unrelated bondholders around the world. Subsequently, Vitro filed for voluntary bankruptcy in mid-December of 2010 in the hope of gaining court approval for a restructuring plan that supposedly had the backing of a majority of its creditors.

Yet to gain support for a restructuring plan that would spare shareholders and force creditors to take steep haircuts—a debt exchange worth less than 60 cents on the dollar—Vitro had taken the unusual step of creating, post-default, some \$1.9 billion of intra-company loans from subsidiaries. This was an amount greater than their obligations to the company’s bona fide creditors. The company’s intention was to enable these subsidiary creditors—the ones that had lent money to the holding company—to cast votes in support of Vitro’s restructuring plan, thereby overwhelming any opposition from unrelated creditors. Moreover, its affiliates entered into a lockup agreement with the holding company that requires them to vote in favor of a restructuring that would release them from the payment guarantees they had extended to outside creditors.

The issue of intra-company debt had previously been broached in the 2009 restructuring of Corporación Durango S.A.B. de C.V. (now renamed Bio-Pappel), one of Mexico’s largest paper products manufacturers. Durango, like Vitro and several other large Mexican companies, had also encountered debt-servicing difficulties in 2008 and had defaulted on more than \$500 million of notes due in 2017. There were intra-company liabilities between Durango and its subsidiaries, and the bankruptcy court recognized these claims.<sup>2</sup> However, the company and its bondholders came to agreement on a reorganization plan that was finalized in August 2009, and thus Durango’s management did not have to force approval of its restructuring proposal by casting the votes of its subsidiaries. The new obligations that were created (senior guaranteed notes) subordinated all intra-company loans and placed restrictions on the creation of any new intra-company obligations.<sup>3</sup>

The case of Vitro is thus the first time ever—and not just since the *Ley de Concursos Mercantiles* was enacted 11 years ago—that the Mexican courts have been presented with such an odd 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 outcome of its own workout process. It is a maneuver that would be deemed illegal in the United States and other major jurisdictions, where

<sup>2</sup> Standard & Poor’s, “How Did Recovery Ratings on Mexican Corporate Issuers Perform through the Financial Crisis?” October 3, 2011, p. 5.

<sup>3</sup> Fitch Ratings, *Latin America High Yield*, vol. II, November 2, 2010, pp. 32–33.

any intra-company liabilities would be offset by their counterpart intra-company assets, such that subsidiaries play no role in the consolidated entity’s restructuring.

## Recent Developments

As mentioned, Vitro filed for voluntary bankruptcy in mid-December 2010 (in Monterrey’s Federal District Court of the Fourth Judicial Circuit). At the time, its aggregate outstanding third-party consolidated indebtedness was approximately \$1.7 billion, \$1.2 billion of which represented the outstanding principal amount owed on the aforementioned bonds maturing in 2012, 2013, and 2017. Vitro’s aggregate outstanding indebtedness to its direct and indirect subsidiaries (the intra-company debt) was approximately \$1.9 billion as of end-2010.<sup>4</sup>

On January 7, 2011, Vitro’s bankruptcy filing was denied, because the Mexican court found that intra-company claims should not be considered. When Vitro appealed, the Fourth Judicial Circuit Appeals Court judge initially ruled in late January that the decision could not be appealed. This procedural decision was challenged by Vitro, and on April 8 the same judge reversed himself, accepting the company’s filing of a *concurso mercantil voluntario con plan de reestructura previo*—a bankruptcy reorganization plan that is filed voluntarily by a debtor.

Vitro also filed a Chapter 15 petition in the Bankruptcy Court for the Southern District of New York, applying for recognition of the Mexican filing as a “foreign main proceeding” under sections 1515 and 1517 of the U.S. Bankruptcy Code. The purpose was to ensure that the U.S. courts would defer to the Mexican courts, so that Vitro’s bankruptcy reorganization process would take place in only one—its home—jurisdiction. At the request of dissident bondholders, the venue for a decision on this petition was changed from New York to Dallas (part of the Northern District of Texas), where on July 21 a Chapter 15 ruling was issued in favor of Vitro’s Mexico-based proceedings.

Vitro’s *concurso mercantil* process in Mexico then advanced along the expected path. Back in April, the court in Monterrey requested the Federal Institute of Bankruptcy Specialists (IFECOM) to appoint an insolvency professional called a conciliator (*conciliador*),

<sup>4</sup> U.S. Bankruptcy Court, Northern District of Texas, “Memorandum of Opinion on Motion for Preliminary Injunction,” Vitro S.A.B. Plaintiff, June 24, 2011, p. 4.

for the purpose of reviewing the validity and ranking of all claims according to their seniority. He is Javier Navarro-Velasco, a seasoned bankruptcy attorney and a partner in the Monterrey office of Baker & McKenzie.

Last August, a final list of creditors was issued by Conciliator Navarro and was submitted to the relevant court, whereupon a decision was issued granting recognition of rank, amount, and order of those creditors contained in the definitive list. The list recognized the contentious intra-company claims created by Vitro in the wake of its default.

### Latest Developments

The restructuring process has taken an unexpected turn in the last few weeks, however. Navarro found that the company's creditors were sharply divided as to Vitro's December 2010 proposal. Those representing intra-company claims sided with Vitro's management, while the genuine creditors who collectively own more than 60 percent of Vitro's \$1.2 billion of outstanding senior notes and the majority of the third-party claims were opposed. In fact, the latter group put forth a counterproposal to Navarro on October 19 that sought a restructuring not as lopsidedly favorable to Vitro's shareholders.<sup>5</sup>

Faced with this split, the reasonable expectation was that Navarro would seek a negotiated solution most parties could embrace, though a consensus is not required for a reorganization agreement to be valid and binding. Mexican law (the LCM) basically requires that the agreement be approved by the debtor and creditors representing a majority (at least half) of the recognized unsecured debt. Mexican law also allows secured creditors who do not approve of the proposed settlement to continue with their enforcement proceedings, executing on whatever collateral has been pledged to them.

The surprising turn of events was that, on October 31, Navarro handed to the relevant bankruptcy judge, Sandra Elizabeth López, a finalized version of Vitro's restructuring plan that was *less* favorable to all creditors and was particularly harsh toward any dissenting, holdout creditors. This is hardly behavior consistent with the role of a "conciliator"—someone who overcomes distrust or

<sup>5</sup> Ad Hoc Group of Vitro Noteholders, "Ad Hoc Group of Vitro Noteholders Submitted Proposal and Does Not Support the Plan of Reorganization Filed by the Conciliator," *Business Wire*, November 4, 2011.

### Vitro Restructuring Timeline

Feb. 2009	Vitro defaults on its bonds.
Mar. 2009	Vitro begins negotiations with its bondholders.
Dec. 2009	Vitro secretly engages in various intra-company transactions; its subsidiaries go from owing the holding \$1.2 billion to being owed \$1.5 billion.
Oct. 2010	Vitro finally discloses these intra-company transactions.
Nov. 2010	Vitro requests debt forgiveness from its bondholders via a debt exchange, but it is rejected.
Dec. 2010	Vitro files a reorganization plan.
Jan. 2011	The judge rejects the plan because of its dependence on intra-company debt for approval.
Apr. 2011	An Appellate Court reverses the decision and accepts Vitro's plan. A conciliator is appointed.
Aug. 2011	On advice of the conciliator, the list of recognized debts receives court approval; intra-company debtors are included.
Oct. 2011	The conciliator does not host negotiations based on alternative financial scenarios; ignores a creditor counterproposal; and submits a revised plan more punitive for Vitro's creditors.

animosity and attempts to reconcile divergent interests. Rather than acting as an impartial, constructive party in this restructuring process, Conciliator Navarro appears to have sided with Vitro in coming up with an even more debtor-biased financial plan.

According to a press release issued by Vitro, the new plan is "substantially identical" to that filed by the company in December 2010; includes "certain improved economic terms" on new mandatory convertible debentures (MCDs); offers an additional fee to consenting creditors; and incorporates disincentives to dissident creditors "designed to ensure that the restructuring contemplated

by the *Concurso* Plan is consummated and implemented without delay or risk to Vitro or its creditors.”<sup>6</sup> These disincentives include setting up a Creditor Litigation Trust into which interest payments due to nonconsenting creditors will be made and from which all litigation-related expenses will be deducted, as well as imposing time limits after which dissenting creditors forfeit the entirety of their investments.

However, an impartial examination of Navarro’s amended restructuring plan suggests that the “carrots” introduced are not meaningful and that the “sticks” are quite punitive, such that all things considered, his proposal actually appears worse than the company’s previous offer.

For example, according to recently published research by J.P. Morgan’s senior corporate debt analyst Jacob Steinfeld, fewer new bonds and MCDs are now on offer for creditors who participate, and the “sweeteners” mentioned do not deliver much additional value. Thus, for creditors planning to participate, “We value the company’s latest proposal lower than its past proposal.”<sup>7</sup> Regarding the fate of nonconsenting creditors, they are now the object of a blatantly discriminatory deal structure meant to pressure them into surrendering or face losses much more significant than those that consenting creditors will bear. Lamentably for its creditors, “the company can support a much higher debt balance than what is being proposed and could offer a proposal that is worth significantly more.”<sup>8</sup>

### Short-Term Implications

Since the conciliator succeeded in sowing more discord among creditors than existed before he got involved in the case, the immediate consequence of the ongoing legal proceedings in Monterrey will be more litigation—in Mexico, the United States, and perhaps elsewhere.

The conciliator does not appear to have acted in a neutral or constructive manner. Reportedly, he did not obtain or make available the kind of financial information necessary for any meaningful exploration of alternative financial scenarios and thus for a determination of Vitro’s ability to

<sup>6</sup> Vitro Press Release, “Vitro Announces Filing by Conciliador of Concurso Plan in Mexican Court,” October 31, 2011.

<sup>7</sup> Jacob Steinfeld, “Vitro S.A.: New Plan Structure Aimed to Pressure Non-Consenting Creditors,” J.P. Morgan, November 1, 2011, p. 2.

<sup>8</sup> *Ibid.*, p. 3.

pay.<sup>9</sup> He allegedly did not engage in a negotiation process before or after receiving an alternate restructuring proposal.<sup>10</sup> Therefore, Navarro’s actions will surely be challenged in accordance with Mexico’s legal provisions during the coming days and weeks.

Beyond that, ongoing litigation in New York initiated by Wilmington Trust in its capacity as indenture trustee with respect to Vitro’s 2012 and 2017 bonds in default—a combined \$1 billion outstanding—will also take added importance. These securities were guaranteed by numerous Vitro subsidiaries located in the United States and elsewhere. In their respective indentures, each of the Vitro-owned guarantors “expressly acknowledges that this Guaranty is governed by the laws of the State of New York and expressly agrees that any rights and privileges that such Guarantor might otherwise have under the laws of Mexico shall not be applicable.”<sup>11</sup> Vitro’s reorganization plan contemplates the stripping of these subsidiary guarantees such that the bonds may be restructured, but Wilmington argues that these guarantees cannot be affected by the holding’s insolvency proceeding in Mexico. A ruling in this case (on the part of the New York Supreme Court in New York City) should be forthcoming.

### Implications for Issuers and Investors

At a time when Mexico is beset by other serious challenges in the sphere of law and order, it is a pity that the progress that lenders and investors thought the country had made—in corporate governance, creditors’ rights, judicial impartiality, and the ease of doing business—is suffering a setback because of Vitro’s unsettling saga.

At first glance, the trend in successful bond issuance on the part of Mexican companies rated below investment grade does not reveal any Vitro-related reduction in access to the international capital markets. Indeed, despite the debt-servicing difficulties experienced by several leading Mexican companies in 2008–2009,<sup>12</sup> new

<sup>9</sup> Ad Hoc Group of Vitro Noteholders, “Ad Hoc Group of Vitro Noteholders Submitted Proposal.”

<sup>10</sup> *Ibid.*

<sup>11</sup> Supreme Court of the State of New York, County of New York, “Plaintiff’s Memorandum of Law in Support of Its Motion for Partial Summary Judgment,” Wilmington Trust N.A. Plaintiff, September 29, 2011, p. 5.

<sup>12</sup> Seven speculative-grade Mexican corporate issuers rated by Standard & Poor’s defaulted during the 2008–2010 period. Five resolved them within two years and the weighted average

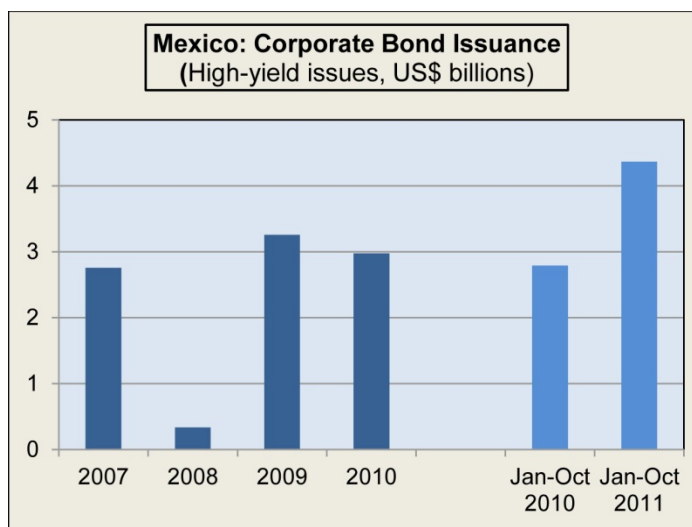
issuance in the U.S. dollar market has bounced back nicely since mid-2009—and 2011 appears set for a banner year. Through end-October, and regardless of all the market turmoil courtesy of Southern Europe’s debt woes, Mexican corporations have managed to raise \$4.4 billion, up sharply from \$2.8 billion, in the first 10 months of 2010.

However, a look behind the overall numbers shows that a great deal of Mexico-related corporate default risk is riding on a single bet—the continued financial viability of Cemex. Granted, it is by far the largest multinational corporation in Latin America, not just Mexico, as measured by the value of its foreign assets and the number of its employees abroad and is one of the largest cement companies in the world, with a presence in more than 50 countries.

Yet Cemex has been skirting a liquidity—and some would say a solvency—crisis for the past three years. In August 2009, the company was fortunate to reach an agreement with 75 bank and private placement bondholders for the refinancing of \$15 billion of debt. Almost half of that amount has since been paid down with the proceeds from asset sales, cost savings, and the placement of new bonds with coupons paying at least 9 percent. Cemex accounted for 38 percent of all Mexican high-yield issuance in the U.S. dollar market during 2009; 17 percent of what Mexican companies raised in 2010; and a whopping 56 percent of new dollar bond issues so far this year—\$2.45 billion.

Given that Cemex’s performance is heavily dependent on the pace of construction activity—and the weak markets of Europe, Mexico, and the United States account for three quarters of its total sales—the company has not recorded a profit for eight quarters in a row, prompting its share price to plummet by nearly two-thirds since November 2009. As of end-September, Cemex remained out of compliance with a year-end, debt-to-EBITDA covenant ceiling under its financing agreement with (mostly bank) creditors. Continued weakness in the Mexican peso, which hurts the company because of its currency mismatches—97 percent of its debt is in currencies other than the Mexican peso—means that Cemex may have to obtain a waiver or reset from its creditors.

recovery rate was 67 percent. The two as yet unresolved cases are Vitro and Industrias Unidas. See Standard & Poor’s, “How Did Recovery Ratings on Mexican Corporate Issuers Perform?” pp. 3–4.



Source: Bloomberg.

One would think that the precedent being set by Vitro would weigh more and more heavily on the minds of bond investors in Cemex and other risky Mexican corporations. After all, Cemex has a similar structure of debt at the holding level backed by guarantees from its foreign subsidiaries—and so do other Mexican companies. It may not be able to support a \$20 billion debt load,<sup>13</sup> as implied by the company’s single-B rating as per Fitch and the recently downgraded assessment from Standard & Poor’s (B- with a Negative Outlook as of November 9). S&P’s downgrade reflected its realization that the company’s financial performance “will remain weak in the coming two years,” such that Cemex “will need to renegotiate the credit conditions of its financing agreement . . . and seek refinancing options for its late-2013 and 2014 debt maturities.”<sup>14</sup>

To see whether the Vitro precedent is starting to be internalized by credit analysts, investors, and rating agencies, last week this author contacted about a dozen of them and asked whether bondholders in particular are aware of the Vitro saga and are starting to hesitate to commit funds to other Mexican companies—especially on an unsecured basis.

<sup>13</sup> Total debt adjusted for off-balance sheet obligations. See Fitch Ratings, “Cemex S.A.B. de C. V. Full Rating Report,” September 14, 2011, p. 22.

<sup>14</sup> Standard & Poor’s Press Release, “Cemex Downgraded to ‘B-’ from ‘B’, Outlook Negative, Off Watch, on Concern for Performance in Depressed Key Markets,” November 9, 2011.

The anecdotal evidence is mixed. Many investors are reportedly aware of the Vitro case, and some of them are asking more credit questions of sell-side and rating-agency analysts than before. The view often expressed is that Vitro may be a special case because of a uniquely investor-unfriendly attitude on the part of its management that will not be seen elsewhere. Others say that they expect Vitro's restructuring plan to be thwarted by the courts on appeal, or even to lead to an eventual amendment in the *Ley de Concursos Mercantiles*—to clarify that the intent of the LCM is to handle the financial problems of any company on a consolidated basis, as per the law's Article 4-II. In this vein, many investors are pleased to see that Vitro's genuine creditors are willing to stand up for their rights and pursue litigation on both sides of the border.

One fund manager quoted in a Bloomberg News story recently stated: "If I'm a CEO of a legitimate Mexican company, I'd be very mad right now at Vitro" because "Vitro's use of intercompany debt may cause other Mexican companies to pay a 'Vitro premium.'"<sup>15</sup>

With regard to Cemex, specifically, many investors are said to perceive it as "too big to fail"—a company that the government would help out in case of emergency. Many also find comfort in knowing that because so many banks, bondholders, and jurisdictions are involved, Cemex may be "too complicated to fail." Bondholders, who are said to feel more secure precisely because banks are deeply involved in Cemex, may have an incentive to refinance the company's obligations and to keep it out of bankruptcy court—especially given the legal uncertainties generated by the Vitro precedent.

As for any notable changes in the language of bond indentures, there is no evidence that the new issuance out of Mexico has included clauses that explicitly subordinate intra-company claims—clauses of the type contained in the bonds that Vitro issued and is now attempting to void. Some point out that even the retailer Grupo Elektra and the broadcaster TV Azteca, both owned by billionaire Ricardo Salinas Pliego—a man with a checkered past who is reportedly viewed with suspicion

<sup>15</sup> The quote is attributed to Robert Rauch, who manages \$2.2 billion of emerging-market assets at Gramercy Advisors LLC. See Jonathan Roeder and Jonathan J. Levin, "JPMorgan Says Sell Defaulted Vitro Debt on Overvalued Offer," *Bloomberg News*, November 8, 2011.

by some investors<sup>16</sup>—were able to sell bonds earlier this year without apparently having to alter the usual boilerplate clauses to address intra-company debt. Only in one case—the refinancing of Iusacell debt this past June—did creditors insert language explicitly subordinating the mobile operator's intra-company debts and banning the voting of any subsidiaries' claims in the event of a future debt restructuring.<sup>17</sup>

The point is also made that investor demand for high-yield issues out of Mexico and other emerging markets, or even out of the United States for that matter, is largely determined not so much by company- or indenture-specific factors but rather by waves of investor optimism and risk appetite—especially these days, when "risk-free" rates are extraordinarily low.

In sum, it may be too early to measure the broader market consequences of Vitro's liability manipulations and of the questions raised by the handling of its *concurso mercantil*. Much probably depends on the final outcome of the litigation taking place in Mexico and the United States. In the meantime, as long as investors persuade themselves that one rotten apple does not contaminate the whole barrel, Mexican corporations may be able to retain the easy access to domestic and foreign financing that they have enjoyed during recent years.

## Conclusion

Current financial-market perceptions notwithstanding, the fact is that Mexico is retrogressing, becoming an unpredictable and risky jurisdiction for the adjudication of legitimate claims involving domestic and international lenders and investors.

This conclusion follows from an analysis of the precedent-setting corporate workout involving a major Mexican multinational (Vitro) now winding its way through the Mexican courts. It raises serious doubts about the capacity of that country's insolvency regime to deliver an outcome viewed as fair and consistent with prevailing

<sup>16</sup> The companies returned to the international bond market for the first time since Chairman Ricardo Salinas settled a fraud suit with the SEC in 2006. See Veronica Navarro Espinosa and Jonathan J. Levin, "Fraud Settlement Sapping TV Azteca Bond Demand," *Bloomberg News*, May 19, 2011.

<sup>17</sup> Grupo Iusacell Celular, S.A. de C.V., "9 percent Senior Secured Notes Due 2017 Indenture," U.S. Securities and Exchange Commission Exhibit T3C, July 5, 2011, Section 3.5, "Intercompany Indebtedness," p. 38.

norms and practices in the United States and other reputable jurisdictions. The case may well have a chilling effect on the easy access to foreign financing that Mexican corporations have enjoyed during recent years. Cemex, Mexico's flagship company, appears particularly vulnerable to adverse fallout from the Vitro case.

There may be diplomatic ramifications as well. Two members of the U.S. Congress, presumably prompted by alarm bells rung by some of their constituents, have recently expressed concern to the Mexican authorities about the implications of the Vitro case. According to a news report, Representatives Patrick Meehan of Pennsylvania and Jared Polis of Colorado wrote to the Mexican ambassador to the United States, warning that Vitro's bankruptcy strategy would "chill cross-border investment" and should not be allowed to set a legal precedent: "Vitro's unorthodox reorganization violated international bankruptcy norms by preserving equity for its own shareholders at the expense of its public creditors, many of whom are U.S.-based."<sup>18</sup>

Evidently, the Vitro case has the potential to complicate even U.S.-Mexico diplomatic relations.

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<sup>18</sup> Heather Perlberg, "Vitro's 'Unorthodox' Debt Plan Spurs U.S. Lawmakers' Complaints," *Bloomberg News*, October 24, 2011.