Paved with Good Intentions: Creditors Face a New Roadblock to Recovery in Mexican Bankruptcies

Timothy S. Springer
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I. INTRODUCTION

THIS Note discusses how a Mexican debtor recently exploited a legislative loophole to block creditors' road to recovery. In December 2010, Vitro, S.A.B. de C.V. (Vitro or the Company) filed a voluntary concurso proceeding—Mexico's equivalent of a Chapter 11 reorganization. Vitro claimed intercompany debts incurred between its parent holding company and controlled subsidiaries as unsecured debts and relied on these claims to overcome objections from third-party bondholders. While more mature bankruptcy codes prevent this strategy, Vitro presented a matter of first impression for Mexico's relatively young code. Moreover, Mexico's civil law system only fueled the procedural chaos.

This Note shows how giving company insiders standing as claimants in Mexican bankruptcies will profoundly affect the flow and cost of capital in Mexico. Part II of this Note discusses how Mexico's bankruptcy code inadvertently allowed Vitro's strategy, and how its civil law system prevented Mexican judges from correcting the oversight. Part III addresses the events leading up to Vitro's bankruptcy and the Company's steps to gain leverage over unsecured creditors. Finally, Part IV outlines why this case sets a dangerous precedent for unsecured creditors and proposes so-

* Timothy S. Springer is a J.D. Candidate at the SMU Dedman School of Law, Class of 2013. He received his B.B.A. in Finance from the Hankamer School of Business at Baylor University.


4. Id.

5. See id.
olutions to counteract unfair advantages for debtors in Mexican bankruptcies.

II. MEXICO'S CIVIL LAW SYSTEM AND INSOLVENCY PROCEDURE

Mexico operates under a civil law system, as compared to the common law systems of the United States and Great Britain. Judges in civil law systems do not interpret, but rather apply the laws as written, collected, and codified by the system's legislative body. As such, judges in "a civil law system can often do nothing on issues where the law is silent." Accordingly, civil law judges emphasize the plain meaning of legal provisions and often cannot deviate from a conventionalist interpretation, even if the judge "can point to principles and goals that suggest that the norm is unjust or imperfect." Unlike judges in a common law system, whose opinions have precedential value, civil law systems do not have the doctrine of stare decisis; rather, civil law judges' decisions bind only the parties to the controversy at hand. By nature of the system, judges rely on legislatures and constitutions to enumerate sufficiently specific provisions to govern novel situations presented to the courts.

Mexico responded to a need for more specific provisions by overhauling its commercial insolvency laws in May 2000. Although this Note is not intended to analyze the specifics of the new law—Ley de Concursos Mercantiles (LCM, best translated as the Business Organization Act of 2000)—some brief discussion facilitates an understanding of Vitro's strategic steps.

In the aftermath of its 1995 currency crisis, Mexico joined a worldwide movement by legislatures to facilitate corporate restructurings and to modernize bankruptcy laws' content and cross-border insolvency provi-
sions.\textsuperscript{15} The United Nations Commission on International Trade Law (UNCITRAL) encouraged many Latin American countries to amend their bankruptcy laws in the first years of the new millennium with its Model Law on Cross-Border Insolvency.\textsuperscript{16} LCM's drafters intended to bolster confidence in Mexican businesses and attract new investors to the country.\textsuperscript{17} Additionally, LCM's appointment of federal, instead of local, judges indicates the drafters' good intentions to eradicate serious problems with corruption.\textsuperscript{18}

LCM requires insolvency proceedings of multiple entities within a single enterprise to be conducted together, unlike its predecessor, which separated holding companies from their controlled subsidiaries.\textsuperscript{19} Mexican legislators attempted to consolidate these entities for equity purposes to prevent "fraud and favoritism."\textsuperscript{20} In fact, when initially denying Vitro's \textit{concurso} plan, the trial court recognized this change and noted "that the legislature contemplated the possibility that related companies that have a relationship of subordination might engage in acts of creditor fraud."\textsuperscript{21} But Mexican legislators still did not harmonize insiders' treatment across related statutes when drafting LCM. Mexican tax laws and regulations requiring public corporations to disclose information consider controlling and controlled companies to be the same economic unit for information disclosure purposes.\textsuperscript{22}

In comparison, the U.S. Bankruptcy Code treats insiders differently in many different situations.\textsuperscript{23} For example, the U.S. Bankruptcy Code removes intercompany debt as unsecured claims by offsetting any genuine intercompany liabilities with the related asset on the balance sheet.\textsuperscript{24} Likewise, at least one class of impaired claims must vote to approve a debtor's reorganization plan without including any acceptance by any...

\textsuperscript{15} Porzecanski, \textit{ supra} note 13, at 1.  
\textsuperscript{17} Martinez, \textit{ supra} note 12, at 75. This goal of attracting investment mirrors UNCI-TRAL's intent. \textit{Id. See also} 11 U.S.C. § 1501(a)(2) (2006) (encouraging greater legal certainty for trade and investment).  
\textsuperscript{18} Martinez, \textit{ supra} note 12, at 76. To this end, Vitro exposes another well-intended, but potentially failed goal of LCM. After originally denying the appeal, the Mexican appellate court reversed itself after several high-powered individuals intervened on Vitro's behalf. Porzecanski, \textit{ supra} note 13, at 5.  
\textsuperscript{19} Ley de Concursos Mercantiles [LCM] [Bankruptcy Law], \textit{as amended}, art. 15, Diario Oficial de la Federación [DO], 27 de Diciembre de 2007 (Mex.).  
\textsuperscript{20} Concurso. Judgment on Commercial Bankruptcy with Preexisting Reorganization Plan, United Mexican States Federal Judiciary District Court Number Two For Civil and Labor Matters in the State of Nuevo León, Commercial Bankruptcy 38/ 2010-VI, Página 49, 67 n.13 (Mex.) (on file with author).  
\textsuperscript{21} Id. at 62.  
\textsuperscript{22} Id. at 65.  
\textsuperscript{23} See 11 U.S.C. § 101(31)(C)(v) (2006) (defining an “insider” as a “person in control of the debtor”); \textit{id. § 547(i) (extending the preference period for insiders from ninety days to one year); id. § 548(a)(1)(B)(ii)(IV) (providing trustee ability to avoid certain transfers to benefit an insider in fraudulent transfer actions).  
\textsuperscript{24} See Govier, \textit{ supra} note 14, at 47.
insider.\textsuperscript{25}

Despite recognizing the Mexican legislature's intention to combine controlled entities, the trial court, as explained in Part III, was likely trying to force a change in the law.\textsuperscript{26} LCM provides no specific counterpart to the doctrine of equitable subordination,\textsuperscript{27} which allows a bankruptcy court to change the payment order of claims as equity requires.\textsuperscript{28} By not dictating a comparable procedure in LCM, Mexican legislators granted insider subsidiaries leave to make claims equally alongside third-party creditors.\textsuperscript{29}

\section{III. VITRO'S DEBTS, DEALINGS, AND DOWNTURN}

\subsection{A. Glass House and Financial Stones}

Vitro began operations in 1909 as a corporation with variable capital under Mexican law.\textsuperscript{30} As one of the largest glass manufacturers in the world, Vitro produces, promotes, and distributes a range of glass products for the wine, beer, cosmetic, pharmaceutical, food and beverage, automotive, and construction industries.\textsuperscript{31} The Company has distribution centers in eleven countries throughout the Americas and Europe with approximately eighty-five percent of the 17,000 workers living in Mexico.\textsuperscript{32} In 2003 and 2007, Vitro raised a total of $1.2 billion through three separate senior unsecured bond indentures (the Old Notes).\textsuperscript{33} Vitro and substantially all of its direct and indirect subsidiaries guaranteed the Old Notes.\textsuperscript{34}

The global financial downturn of 2008 depressed sales and adversely affected demand for Vitro's key industries.\textsuperscript{35} Specifically, the collapse of the automotive and construction markets in the United States crippled two of Vitro's largest customer bases.\textsuperscript{36} Vitro's sales dropped thirty-three percent in 2009.\textsuperscript{37} Additionally, Vitro faced significant margin calls from derivative hedge positions strained by fluctuations in interest rates and international currencies.\textsuperscript{38}

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\textsuperscript{26} Checkler, supra note 3; see infra Part III, note 66 and accompanying text.
\textsuperscript{27} Govier, supra note 14, at 47.
\textsuperscript{28} 11 U.S.C. § 510(c)(1) (2006) ("[T]he court may ... under principles of equitable subordination, subordinate for purposes of distribution all or part of an allowed claim to all or part of another allowed claim or all or part of an allowed interest to all or part of another allowed interest.").
\textsuperscript{29} Govier, supra note 14, at 47.
\textsuperscript{30} Vitro, S.A.B. de C.V. v. ACP Master, Ltd. (Vitro), 455 B.R. 571 (Bankr. N.D. Tex. 2011).
\textsuperscript{31} Press Release, Vitro, S.A.B. de C.V., supra note 1.
\textsuperscript{32} Vitro, 455 B.R. at 574.
\textsuperscript{33} Id.
\textsuperscript{34} Id.
\textsuperscript{35} Black, supra note 2.
\textsuperscript{36} Id.
\textsuperscript{38} Vitro, 455 B.R. at 574.
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The reduced cash flows and sudden margin calls left Vitro unable to meet all of its financial obligations.\textsuperscript{39} As a result, Vitro stopped making scheduled interest payments on the Old Notes.\textsuperscript{40} After Vitro failed to make margin calls on its failed derivative hedges, its counter-parties initiated litigation in the Supreme Court of New York demanding payment of $240.3 million plus interest.\textsuperscript{41} By February 2009, Vitro announced plans to restructure its debts.\textsuperscript{42}

The Supreme Court of New York found Vitro and several of its subsidiaries liable in the margin call lawsuits.\textsuperscript{43} Subsequently, Fintech Investments, Ltd. (Fintech) acquired the derivatives transaction counterparties’ claims against Vitro.\textsuperscript{44} In December 2009, as part of its attempts to restructure, Vitro settled with Fintech by exchanging promissory notes in return for Fintech releasing judgment claims against the Company.\textsuperscript{45} Fintech also agreed to invest $75 million in the Company “to strengthen Vitro’s liquidity.”\textsuperscript{46} This single transaction generated approximately $1.5 billion of intercompany debts between Vitro and its subsidiaries.\textsuperscript{47} Despite the equity infusion, Vitro remained vulnerable to weaknesses in its key industries.\textsuperscript{48}

\section*{B. Vitro's Chaotic Procedural Process}

Vitro began soliciting creditors’ consent in November 2010 for a prepackaged voluntary \textit{concurso} filing.\textsuperscript{49} The company offered bondholders a cash tender or equity exchange with an approximately five percent bonus payment for consent.\textsuperscript{50} A month later, after retiring only $30 million of claims with its 57.5 cent cash tender offer,\textsuperscript{51} the Company extended the acceptance deadline before proceeding with its \textit{concurso} filing.\textsuperscript{52}

Vitro filed its prepackaged petition in Mexico on December 13, 2010,

\begin{itemize}
\item \textsuperscript{39} Id.
\item \textsuperscript{40} Id.
\item \textsuperscript{42} \textit{Vitro}, 455 B.R. at 575.
\item \textsuperscript{43} Id.
\item \textsuperscript{44} Id.
\item \textsuperscript{45} Id.
\item \textsuperscript{47} \textit{Vitro}, 455 B.R. at 574.
\item \textsuperscript{48} Black, \textit{supra} note 2.
\item \textsuperscript{49} \textit{Vitro}, 455 B.R. at 575.
\item \textsuperscript{50} Black, \textit{supra} note 2.
\item \textsuperscript{51} Id.
\item \textsuperscript{52} Press Release, Vitro, S.A.B. de C.V., Vitro Announces the Upcoming Filing of its \textit{Concurso} Plan, the Expiration of its Tender Offer and the Extension of the Expiration Time for its Exchange Offer and Consent Solicitation (Dec. 8, 2010), http://www.vitro.com/vitro_corporativo/docs/ingles/101208i.pdf.
\end{itemize}
despite virtually unanimous rejection by unsecured creditors.\textsuperscript{53} To ensure
the required forty percent of creditors supporting the plan,\textsuperscript{54} Vitro
claimed its substantial intercompany debts were unsecured creditors and
included these claims in the forty percent.\textsuperscript{55} Vitro had approximately
$1.7 billion of aggregate third-party debt outstanding on December 31,
2010.\textsuperscript{56} This amount included $1.2 billion from the Old Notes.\textsuperscript{57} But Vi-
tro also had $2.022 billion of intercompany debts at this time, including
the $1.5 billion stemming from the Fintech transaction.\textsuperscript{58} Creditors im-
mediately objected to Vitro’s insider claims, sparking a heated bout in
which the Company, creditor attorneys, financiers, and members of the
press traded punches.\textsuperscript{59}

Vitro’s financial difficulties and bankruptcy filing produced procedural
chaos as unsecured creditors sought to secure position and rights to sub-
sidiary assets in the United States.\textsuperscript{60} Before Vitro filed for protection in
Mexico, one group of unsecured creditors initiated an involuntary bank-
ruptcy proceeding under Chapter 11 of the U.S. Bankruptcy Code against
fifteen Vitro subsidiaries in the Northern District of Texas.\textsuperscript{61} Other
groups of bondholders filed substantially similar proceedings in the
Southern District of New York on December 2 and 9, 2011.\textsuperscript{62} A day after
filing in Mexico, Vitro filed a petition in the Southern District of New
York and sought to invoke cross-border insolvency protections under
Chapter 15 of the U.S. Bankruptcy Code.\textsuperscript{63} Chapter 15 confers some pro-
tections common to domestic filings to foreign debtors, such as the auto-
matic stay.\textsuperscript{64} Thus, Vitro halted adverse actions against its subsidiaries in
the involuntary proceedings.\textsuperscript{65}

On January 7, 2011, the Fourth District Judge for Civil and Labor Mat-
ters in the Mexican State of Nuevo León rejected Vitro’s attempts to use
insider debts and denied confirmation of the voluntary \textit{concurso} plan.\textsuperscript{66}
Because the decision disqualified Mexico as a viable forum for the re-

\begin{itemize}
\item \textsuperscript{53} Press Release, Vitro, S.A.B. de C.V., \textit{supra} note 1.
\item \textsuperscript{54} LCM, \textit{as amended}, art. 339(11), DO, 12 de Mayo de 2000 (Mex.).
\item \textsuperscript{55} \textit{Black, supra} note 2.
\item \textsuperscript{56} \textit{Vitro}, 455 B.R. at 574.
\item \textsuperscript{57} \textit{Id}.
\item \textsuperscript{58} \textit{Id}.
\item \textsuperscript{59} \textit{Compare Vitro, S.A.B. de C.V., \textit{supra} note} 52 (characterizing claims made by press
about the legality of Vitro’s proposed restructuring as “baseless”) \textit{with Black, \textit{supra} note} 2 (creditors’ attorney suggesting “that a substantial amount of [Vitro’s]
intercompany debt is bogus”).
\item \textsuperscript{60} \textit{Vitro}, 455 B.R. at 575.
\item \textsuperscript{61} \textit{Id}.
\item \textsuperscript{62} \textit{Id}.
\item \textsuperscript{63} \textit{Id} at 576.
\item \textsuperscript{64} 11 U.S.C. § 1520(a)(1) (2006) (applying § 362(1) to stay the commencement or
continuation of judicial proceedings against a debtor within the territorial jurisdic-
tion of the United States).
\item \textsuperscript{65} \textit{See id}.
\item \textsuperscript{66} Concurso. Judgment on Commercial Bankruptcy with Preexisting Reorganization
Plan, United Mexican States Federal Judiciary District Court Number Two For
Civil and Labor Matters in the State of Nuevo León, Commercial Bankruptcy 38/
2010-VI, Página 49, 67 n.13 (Mex.) (on file with author).
\end{itemize}
structuring, Vitro withdrew its Chapter 15 petitions in the United States while it appealed the trial court’s ruling, allowing the involuntary Chapter 11 cases to continue.67 After a ninety-day torrent of positioning, an appellate judge in the Second Unitary Court of the Fourth Circuit in Monterrey reversed the trial court on April 11, 2011 and reinstated the pre-packaged plan.68 As a result, Vitro filed a new petition for Chapter 15 protection in the Southern District of New York.69 In response, the petitioning creditors filed motions to administer the Chapter 11 and 15 cases jointly and to transfer the consolidated case to the Northern District of Texas.70

On August 15, 2011, the Fourth District Court for Civil and Labor Matters in the city of Monterrey affirmed the appellate court’s ruling by announcing the ranking and priority of claims in the Mexican concurso proceedings.71 The ruling established that Vitro’s intercompany claims were equal to other unsecured creditors and therefore Vitro had the right to participate in approving the concurso plan.72

IV. VITRO’S DANGEROUS EXAMPLE AND STEPS TO PREVENT MORE ABUSE

A. EFFECTS ON CURRENT LITIGANTS AND THE MEXICAN BUSINESS COMMUNITY

The Mexican appellate court likely honored its civil law system’s formalism by allowing the intercompany debts to vote as unsecured creditors.73 LCM does not explicitly prohibit this practice. Moreover, this decision likely did not substantially affect Vitro, its subsidiaries, or most of the senior unsecured bondholders.74

Most of the bondholders at the time the Mexican appellate court issued its ruling would profit regardless of the decision.75 These investors had bought the securities at a substantial discount following Vitro’s default in 2009.76 Accordingly, most bondholders were seeking to maximize profits under any recovery scenario.77 Vitro estimated its plan would allow un-

70. Vitro, 455 B.R. at 576.
72. Id.
73. See Comella, supra note 6, at 1972.
74. See Black, supra note 37.
75. Id.
76. Id.
77. Id.
secured creditors to obtain about a sixty-eight percent recovery. Even if Vitro's *concurso* filing was only worth some analysts' estimated sixty cents on the dollar, most bondholders would still realize lucrative recoveries.

Despite these reasons appearing to minimize this precedent, Vitro sends a potentially dangerous signal to other debtors seeking leverage. LCM permits ad hoc committees of unsecured creditors, meeting certain requirements, to form and to force debtors into involuntary bankruptcy proceedings, much like in the United States. Vitro's filing was pre-packaged and voluntary, but now debtors anticipating involuntary bankruptcy filings have a way to circumvent the leverage statutorily granted to the unsecured creditors forcing the involuntary proceedings.

Mexican businesses will suffer if insiders are allowed to force confirmation of *concurso* plans. Recognizing the increased risk of diminished position in restructurings, financial institutions will likely raise risk premiums attached to corporate bond insurance for Mexican companies. The same institutions may even require that other countries' insolvency laws govern contracts for investment in Mexico. An even more drastic result, capital flow into Mexico may decrease sharply as investors seek investments protected by more mature bankruptcy codes.

B. EFFECTS ON RELATED CASES IN THE UNITED STATES AND THE OTHER NAFTA COUNTRIES

Significant economic realities between the NAFTA countries require cooperation to maximize creditor value by simplifying procedural and substantive provisions. Such substantive and procedural differences between the NAFTA countries would violate UNCITRAL's universalism principle. This principle promotes continuity and predictability between different courts in the NAFTA countries. The United States took steps towards harmonizing its bankruptcy procedures with the other NAFTA countries in 2005 by integrating many of UNCITRAL's cross-border insolvency provisions. Under the new provisions of Chapter 15, U.S. courts must cooperate with Mexican courts in cross-border insol-
vency cases where Mexico is the location/forum of the “foreign main proceeding.” But by permitting an action prohibited in the United States, Mexico places U.S. courts in difficult legal waters.

In the present case, U.S. courts hearing proceedings related to Vitro’s subsidiaries have to respect Mexico’s classification of Vitro and its subsidiaries as separate. For example, U.S. bankruptcy judges have discretion to award reasonable attorney’s fees to the alleged debtor after dismissing involuntary petitions. Section 303(i) of the U.S. Bankruptcy Code also allows for punitive damages where the creditor forcing bankruptcy filed in bad faith. Here, a U.S. bankruptcy court for the Northern District of Texas dismissed several involuntary Chapter 11 cases against Vitro subsidiaries following the Mexican Appellate Court reinstating the concurso plan. When considering whether the creditors acted in bad faith by initiating the involuntary proceedings, the court would have to consider the parent company and subsidiaries as separate entities.

U.S. bankruptcy courts have authority to refuse to take an action governed under Chapter 15 of the U.S. Bankruptcy Code that would manifestly contradict public policy. This provision mirrors UNCITRAL Model Law article 6, but the standard of “manifestly contrary” has consistently been narrowly interpreted by courts around the world to mean violating “the most fundamental policies” of the host nation. Additionally, domestic bankruptcy judges face pressures from the same economic realities compelling cooperation in cross-border insolvencies. U.S. courts are thus caught in the somewhat awkward position of becoming complicit in wrongs not quite “bad enough” to overcome a high legal standard.

C. Steps to Correct Oversight and Prevent Future Abuse

Mexico’s civil law system provides two solutions to prevent these unintended consequences. First, the Mexican legislature created LCM and can amend it. The Mexican legislature can bar future insider claims by amending article 15 to include such an explicit provision. Less dramati-

89. 11 U.S.C. § 1525 (2006) (“[T]he court shall cooperate to the maximum extent possible with a foreign court . . .”); see also id. § 1502(4) (2006) (“foreign main proceeding” means a foreign proceeding pending in the country where the debtor has the center of its main interests”).
90. See id. § 1508 (“[T]he court shall . . . promote an application of this chapter that is consistent with the application of similar statutes adopted by foreign jurisdictions.”)
95. Id. § 1506
98. Comella, supra note 6, at 1970.
cally, the legislature could simply acknowledge the uniform treatment of insiders under LCM as equal to that of Mexico's tax laws and regulations for public corporations for information disclosures.99

Mexico's civil law system provides for a second possible solution. Precisely because civil law systems give judges little room for variation, many Latin American countries have created an important tool for interpreting constitutional law: an abstract review of legislation.100 This procedure allows the legislature to empower a judicial body to review a law for "constitutionality on its face without having to wait for a specific controversy to arise."101 Mexico entrusts its Supreme Court with this responsibility.102 The Mexican Supreme Court could review whether LCM's failure to provide creditor protections violates the Mexican Constitution. An abstract review would allow the Mexican Supreme Court to reconstruct a statute in compliance with the Mexican Constitution rather than nullifying the provision altogether.103 But this procedure may be difficult to initiate, as it requires significant support.104

In addition to the two potential civil law solutions, parties may have a simpler private solution. Lenders may begin imposing contract requirements that companies will not vote intercompany debts to approve any potential bankruptcy plans.105 Private contracts allow future parties a simple workaround, but also would require investors to renegotiate existing indentures. Likewise, private law solutions require confidence that Mexican courts will enforce provisions not explicitly supported by statutes. This belief provides the incentive for foreign investment without exorbitant risk premiums.106 With no judicial support for these contractual provisions, investors may not have adequate leverage with borrowers to contract around the insider loophole.

V. CONCLUSION: FIX IT, AND FIX IT SOON

Vitro's slingshot plan may appear to be only a small stone, but the blow through a tiny gap in LCM's armor may indeed prove to be fatal. Mexico must act quickly to quash the signal Vitro sends to other conglomerate debtors considering concurso filings. Otherwise, lenders will raise the cost of capital for Mexican companies enough to stunt the eleven-year

99. See Concurso, Judgment on Commercial Bankruptcy with Preexisting Reorganization Plan, United Mexican States Federal Judiciary District Court Number Two For Civil and Labor Matters in the State of Nuevo León, Commercial Bankruptcy 38/2010-VI, Página 49, 67 n.13 (Mex.) (on file with author).
100. Comella, supra note 6, at 1968.
101. Id.
102. Id. at 1969.
103. See id. at 1972-73.
104. Constitución Política de los Estados Unidos Mexicanos [C.P.], as amended, art. 105, Diario oficial de la Federación DO, 5 de Febrero de 1917. Various government officials can trigger reviews. See Comella, supra note 6, at 1970.
105. Black, supra note 2.
106. See Porzecanski, supra note 13, at 5.
momentum following LCM’s inception.\textsuperscript{107} Without action, Mexico will leave creditors to walk a road to recovery paved with only good intentions.

\textsuperscript{107} Id.; Checkler, \textit{supra} note 3.
Updates