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The Financial Crisis and Implications for U.S.-Mexico Bankruptcies and Restructurings

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It now appears that the worldwide financial crisis will have a significant impact on Mexico. Several challenges are converging on Mexico, among them being a major downturn in the U.S. economy, falling oil prices, reduced demand for Mexican products and services globally and a decrease in remittances from Mexican workers in the U.S. In addition, some Mexican companies made heavy bets against the U.S. dollar, whether by over-indulging in complex derivatives or loading up on dollar-denominated debt or both, and are paying the price now. With both the U.S. and Mexican economies facing severe challenges, companies with operations on both sides of the border will need to take into account two legal systems in determining how to deal with the impact of the downturn on their businesses, operations and financial health. The decisions that management and creditors of entities with businesses spanning the border will have to face are tough in any market, but the drivers and implications of decisions are even more complicated because the laws and practices of two jurisdictions must be taken into account. Should an entity in trouble downsize and close operations or fire employees or both? Should an out-of-court restructuring or workout be pursued? Ought the entity do a "pre-packaged" insolvency proceeding or file for bankruptcy court protection?

This article discusses strategic issues and challenges facing entities with U.S.-Mexico operations, businesses or exposure and their creditors. We note that in this crisis, unlike others in the past, the current Mexican insolvency law may make filing for a proceeding more palatable for both debtors and creditors. So this time around we may see more action in the Mexican courts, which may change the dynamics of negotiations between parties.

Another key element to be taken into account by parties is the current liquidity crisis, in which banks and other financial institutions have their own financial challenges. If market conditions continue, and lenders remain reluctant to lend, even in what might once have been seen as relatively safe circumstances like debtor-in-possession financing, funding for reorganization plans may be hard to come by. This may tip the scales in favor of more liquidations than in previous downturns.

Already two major publicly-listed Mexican corporations – the paper-products manufacturer Corporación Durango, S.A.B. de C.V. ("Durango") and the supermarket and retail chain holding company Controladora Comercial Mexicana, S.A.B. de C.V. ("CCM") – recently filed for bankruptcy protection in Mexico under the Commercial Bankruptcy Law (the Ley de Concursos Mercantiles or "LCM") of Mexico.[1] A number of Mexican companies have disclosed that they incurred enormous obligations under derivatives contracts, some of them similar to those which forced CCM to file for bankruptcy. Just as this article was going to press, CCM announced that, after two unsuccessful attempts to obtain bankruptcy protection under the LCM, it had been persuaded by its creditors to pursue an out-of-court restructuring.[2]

At the same time, a number of U.S. companies have recently filed for reorganization under chapter 11 of the U.S. Bankruptcy Code (the "USBC").[3] Others have disclosed cash flow problems that may lead to their filing for reorganization under chapter 11 or even winding up in liquidation under chapter 7 of the USBC. The distressed companies range from giants General Motors Corporation and Ford Motor Company to the poultry producer Pilgrim's Pride Corporation, which filed under chapter 11 on December 1, 2008.[4]

Many companies facing difficulties in the U.S. and Mexico have operations or subsidiaries, parents or other affiliates in the other country, and thus will have to consider the implications of the laws of the other country as they formulate their strategies. For example, Pilgrim's Pride has extensive operations in Mexico conducted through a Mexican subsidiary. Durango has at least two U.S. subsidiaries that have initiated chapter 11 proceedings. Durango itself brought a parallel proceeding under the relatively new chapter 15 of the USBC. The fact that certain large distressed companies in the U.S. have significant operations in Mexico may mean that their Mexican subsidiaries will have to consider filing for protection under the LCM as well. In some cases, such as that of Home Interiors & Gifts, Inc., which filed under chapter 11 in May 2008, the Mexican subsidiaries may be substantially healthier than the U.S. parent. Filing under the LCM may not be an option for the healthy Mexican subsidiaries, and cash from their operations may be a significant or at least positive element in the restructuring, reorganization or liquidation of the U.S. parent.

These situations present important strategic and tactical issues for debtors as they weigh their options in the face of financial troubles. Creditors of groups with operations and/or affiliates on

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both sides of the border face challenges as well. This article outlines major issues and challenges.

What Proceedings Can or Should be Initiated?

Filing for bankruptcy in any jurisdiction can be a drastic step. Debtors and creditors should normally explore all available options, including an out-of-court workout or restructuring, as well as filing for some type of insolvency proceeding. In a time of crisis, debtors often have an initial instinct to shut down all but necessary communication out of fear, panic, shame or simply because what the next best step is may not be clear. They may think it will be better to wait to communicate until they have a fully formulated plan of action. While it is preferable to have a firm proposal for creditors, waiting to open the dialogue is rarely the best strategy. In some circumstances, sharing financial information with creditors will enable a distressed debtor to negotiate standstill agreements, waivers, tolling agreements or other contractual solutions which will reduce the risk of litigation or attachments of assets which could interfere with the ongoing business operations of the debtor or be a distraction and drain valuable financial and other resources that might better be spent on planning a restructuring, workout or judicial proceeding of reorganization or liquidation. In many cases, the sheer multiplicity of debt obligations may make the process of negotiating such temporary solutions so difficult as to require the appointment of a "chief restructuring officer" to oversee the process, to relieve pressure on the other executives of the company and allow for a more focused and coordinated restructuring process to be carried out.

Some companies may be able to negotiate a "prepackaged" bankruptcy under either the USBC or the LCM[5] or both, in which, in advance of a bankruptcy filing, the debtor and its principal creditors agree upon a restructuring or reorganization plan that is capable of being approved by the court promptly upon commencing the bankruptcy proceeding. Where a negotiated solution cannot be developed for whatever reason, whether because of difficulties in communicating or negotiating with creditors or otherwise, debtors and creditors may be forced to consider the option of a bankruptcy filing.

In instances where there is a concern that a negotiated, out-of-court restructuring or workout may be impossible and/or where there appears to be a high risk of lawsuits, arbitrations, attachments of assets, injunctions or other legal proceedings[6] that will harm the debtor's business, prove distracting, or result in unfavorable asset distribution among creditors, the debtor or its creditors may determine that it is best to seriously consider filing an insolvency proceeding. In the U.S., unless it is clear that liquidation is the only solution, the debtor can file a voluntary petition for a reorganization under chapter 11 of the USBC; and creditors can also file for an involuntary reorganization under chapter 11; and in Mexico, a voluntary or involuntary reorganization proceeding may be commenced under the LCM.[7] Such a filing will have at least two consequences: it will force creditors to organize themselves to negotiate with the debtor, and it will give the debtor the benefit of the automatic stay provisions of the USBC which would prevent lawsuits from proceeding (and prevent creditors from attaching, or foreclosing upon liens on, key assets of the debtor) while the debtor seeks to reorganize under court supervision. Similar protection can be obtained by a Mexican debtor filing under Article 20 of the LCM. It is important to note that in each case the filing by one company in a corporate group does not mean that all of the other companies in the group must also file for protection, and certainly the filing by a U.S. debtor under chapter 11 does not automatically require a filing under the LCM by its Mexican subsidiaries or affiliates, nor does a filing by a Mexican parent under the LCM require a filing by its U.S. subsidiaries under the USBC. In Mexico, each corporate entity must satisfy the requirements for proving insolvency under Article 10 of the LCM; in the U.S., on the other hand, there is no insolvency condition to filing under chapter 11.

In determining whether subsidiaries or affiliates of an entity in financial difficulty are insolvent or should otherwise file for bankruptcy or reorganization, each debtor and its counsel must analyze and evaluate the independent circumstances of each entity to see whether any or all of the subsidiaries or affiliates ought to consider seeking protection. One must take care to include in the mix the potential impact of all contingent liabilities and intercompany transactions, including guarantees of parent, subsidiary or affiliate debt or other instances where comfort has been given by an entity in favor of counterparties or creditors of the entity being analyzed. As a result of such analysis it may be determined that – in order to obtain the benefits of the automatic stay for all members of the corporate group – filings should be made by all or most of them. This will of course be a more complicated proposition when the group has a presence in both the U.S. and Mexico, since an understanding of the impacts of both countries' bankruptcy laws may be required.

A further complication may arise from inter-company obligations which, given the possibility of substantive consolidation in the U.S. but not in Mexico,[8] and the possibility in the U.S. of "equitable subordination" of the liabilities owing to insiders, subsidiaries or affiliates, may mean that third party creditors are more likely in Mexico to be competing with insiders, subsidiaries or affiliates for the assets of a debtor. Decisions with respect to a bankruptcy filing may also be affected by situations in which there are third-party claims against both the parent and its subsidiaries or affiliates; in both the U.S. and Mexico, the creditors of the parent may become subject to the "structural subordination" which results from the creditors of the parent being effectively disadvantaged with respect to creditors of the subsidiaries. If the parent's main assets are its shares in the other companies, its creditors' claims against those assets (in the absence of cross-guarantees by such companies) may prove to be less valuable than the claims of the creditors of the other companies against the operating assets of such companies, as to which the parent, as equity holder, will be subordinated to the creditors of such companies.

Apart from the main remedies debtors have, to obtain automatic-stay protection under chapter 11 and the comparable protection under the LCM, debtors also have the option of bringing a parallel proceeding in the country other than the one in which they were organized. For a Mexican company, that would be a proceeding under chapter 15 of the USBC, and for a U.S. company, it would be a proceeding under Title Twelfth (Título Décimo Segundo) of the LCM. The benefit of such a proceeding to a Mexican company would be to have its Mexican bankruptcy proceeding recognized by a U.S. court and thereby protect its assets in the U.S. from attachment or foreclosure. A similar result could be sought by a U.S. company which had filed under chapter 11 and wished to in effect extend the protection of the automatic stay to its assets located in Mexico by filing under Title Twelfth of the LCM.

In cases where the parent company is insolvent or (in the U.S.) otherwise in need of bankruptcy protection, but its foreign subsidiaries or affiliates do not have a comparable need, it may not be possible to obtain such protection with respect to the foreign companies. In the chapter 11 case initiated a few years ago by Consolidated Freightways, which was converted into a liquidation under chapter 7, its Mexican subsidiaries and affiliates did not enter into proceedings under the LCM; its shares in the Mexican

companies were instead sold to buyers in Mexico. Even if a debtor's subsidiaries or affiliates are entitled to commence a proceeding under the applicable bankruptcy law it may make more sense to sell such subsidiaries or affiliates than to incur the administrative and legal costs involved in attempting to reorganize or liquidate under the bankruptcy law, assuming of course that creditors of the subsidiaries or affiliates can be persuaded to refrain from potentially debilitating legal proceedings.

The remedy of a filing under chapter 15 of the USBC or Title Twelfth of the LCM is an alternative that was not available during previous waves of Mexican restructurings and defaults in the 1990's, although there was the remedy of an ancillary proceeding that could be filed under the old Section 304 of the USBC. Chapter 15, among other differences with Section 304, opens up the possibility of creditors challenging the bankruptcy proceeding initiated in another country. A creditor may argue that the U.S. court should not give recognition under chapter 15 of the foreign bankruptcy proceeding, and if this argument prevails the debtor will be forced to choose between commencing a proceeding under chapter 11 or 7, on the one hand, and remaining subject to lawsuits and attachments in the U.S., on the other. Before a decision on recognition is made, the debtor may wish to obtain a temporary injunction in a U.S. court against any such lawsuits and attachments.

If a Mexican debtor has obligations related to derivatives, where the amounts owed may be more difficult to calculate or understand than under more traditional debt instruments such as loan agreements, promissory notes, commercial paper and bonds, the creditors may wish to initiate a proceeding in the U.S. seeking a court determination or declaratory judgment which would specify the amount of the debtor's obligations or, if not stayed by a pending bankruptcy case, to simply sue in a U.S. court to enforce the derivatives contract. Where the derivative instrument is governed by New York or English law[9], and the creditors are based outside of Mexico and/or are concerned that a Mexican bankruptcy court may have more difficulty determining such amount than would a New York or English court, such creditors might wish to bring an action in a New York or English court to obtain such court's determination as to such amount. This issue is discussed further in the section on derivatives below.

Creditors may have more fundamental concerns with the application of the LCM -- for example, a concern with the method of appointing the auditor, conciliator and trustee (síndico), with the absence of substantive consolidation and equitable subordination concepts or with the lack of experience of the Mexican bankruptcy judges with complex derivatives -- and may wish to persuade the debtor to pursue a negotiated restructuring outside of the bankruptcy court. This may have been part of the motivation of the creditors of CCM which brought suit against the company in the New York courts by reason of defaults under derivatives contracts. By bringing the suit after the initial unsuccessful attempt by CCM to file under the LCM, the creditors brought an element of pressure to bear on the company which may have helped to eventually cause it to agree to negotiate an out-of-court restructuring and at least suspend its efforts to obtain bankruptcy protection.

What Issues Are Likely to Arise With Respect to International Derivatives-Related Obligations?

The derivatives obligations that have already resulted in financial strains on Mexican companies – including not only CCM but also Vitro, Gruma, Cementos Mexicanos (Cemex) and others – appear to be mainly currency-related rather than interest rate swaps, credit default swaps, commodity or equity derivatives or other kinds of complex derivatives; but even within the area of currency derivatives there are various types, e.g. currency swaps, cross-currency rate swaps, foreign exchange transactions and currency options and some may have been long-term contracts and/or with provisions for margin calls, collateral calls or other features designed to protect the creditor party. Whatever the type of derivatives contract which a debtor may have entered into, there are various issues that may be raised in disputes regarding derivatives, including: (i) whether the debtor adequately understood the obligations that it incurred under its derivatives contracts, and whether the extent of such understanding is relevant to determining the validity of its obligations; (ii) which document or documents govern the determination of the amounts of the obligations of the debtor, and what is the applicable method of calculation; and (iii) whether any disputes related to such contracts should be resolved by the Mexican bankruptcy court, a U.S. bankruptcy court or an ordinary civil or commercial court in either Mexico or the U.S.

Were the Obligations Validly Incurred?

The documentation governing derivatives tends to be rather extensive and complex. Virtually all international[10] derivatives obligations will be evidenced by a Master Agreement in a form developed by the International Swap Dealers Association ("ISDA"). However, there are key differences between the form of Master Agreement (Multicurrency – Cross Border) promulgated by ISDA in 1992 (the "1992 ISDA Agreement") and the form of Master Agreement promulgated by ISDA in 2002 (the "2002 ISDA Agreement"); and the Master Agreement will be supplemented by a Schedule for each counterparty, applicable Definitions and a Confirmation for each particular transaction.[11] If such complex ISDA documentation is not translated into Spanish and/or the Mexican debtor has not been adequately informed or advised as to the nature of the obligations it is incurring, it is possible that it will be surprised by the operation of the provisions of the documentation and shocked by the amounts that it winds up owing.

The ISDA documentation contemplates the inclusion of a representation by each party which might be expected to minimize the possibility of disputes arising from such surprises and shocks.[12] The form of Schedule attached to the 2002 ISDA Agreement contains a suggested "Additional Representation" which is worth noting (and is similar to a representation often used in Schedules signed in connection with the I992 ISDA Agreement as well):

"[(i)]***Relationship Between Parties.*** Each party will be deemed to represent to the other party on the date on which it enters into a Transaction that (absent a written agreement between the parties that expressly imposes affirmative obligations to the contrary for that Transaction):

[(1)]***Non-Reliance.*** It is acting for its own account, and it has made its own independent decisions to enter into that Transaction and as to whether that Transaction is appropriate or proper for it based on its own judgment and advice from such advisors as it has deemed necessary. It is not relying on any communication (written or oral) of the other party as investment advice or as a recommendation to enter into that Transaction, it being understood that information and explanations related to the terms and conditions of a Transaction will not be considered investment advice or a recommendation to enter into that Transaction. No communication (written or oral) received from the other party will be deemed to be an assurance or guarantee as to the expected results of that Transaction.

[(2)]***Assessment and Understanding.*** It is capable of assessing the merits of and understanding (on its own behalf or through independent professional advice), and understands and accepts, the terms, conditions and risks of that Transaction.

It is also capable of assuming, and assumes, the risks of that Transaction.

[(3)] ***Status of Parties.*** The other party is not acting as a fiduciary for or adviser to it in respect of that Transaction."

Providers of derivatives products may wish to include such an Additional Representation in a Schedule to help to counter any subsequent claim by the other party to a transaction – particularly a party whose principal officers are not native English speakers, as in the case of most Mexican companies - that it should not be bound by obligations under English language documentation that it did not fully understand.

Although a Mexican debtor may argue, even with respect to derivatives transactions in which such an Additional Representation by such debtor was included, that the debtor did not fully understand the obligations it was incurring and it should not therefore be bound thereby, it seems unlikely that this argument would be accepted by a Mexican court, whether it is a bankruptcy court or a civil or commercial court. In general, under Mexican law debtors are presumed to understand the commercial obligations they incur. Perhaps the greater risk for a creditor under a derivatives contract is that the person who signed the contract did not have sufficient authority to sign it. The question of signing authority is normally less a question of whether the debtor's board of directors approved the contract than it is of whether a power of attorney was issued to the person signing the contract with broad enough general authority to include the contract in question. So it would be important for each institution entering into a derivatives contract with a Mexican debtor to make sure that its counsel examines the relevant power(s) of attorney to ensure that they have the appropriate breadth.

Determination of Amounts Owing

Given the disputes that have already arisen between several Mexican companies and their counterparties over the amounts owing under a number of derivatives contracts – in the case of CCM, it has been reported that the total amount estimated by the company to be owing is approximately US$1 billion less than the total amount estimated by its counterparties[13] -- it may be worth examining in detail the possible approaches that can be used under a Master Agreement to calculate such amounts. First, in order to determine the amount owing under any Master Agreement, one must establish the date of determination and the relevant calculation method. Except when the determination is to be made on a scheduled termination date, the relevant date will be an Early Termination Date resulting from an "Event of Default" or a "Termination Event".

Section 5 of the Master Agreement defines the "Events of Default" (as to which one of the parties will be considered the "Defaulting Party") and the "Termination Events" (as to which neither party is deemed to be a Defaulting Party but one or both of the parties may be an "Affected Party"). If an Event of Default occurs, the "Non-Defaulting Party" may designate an "Early Termination Date"; and if a Termination Event occurs, one or both of the parties may in certain circumstances designate an Early Termination Date. The amount or amounts payable on an Early Termination Date may depend on whether the termination is due to the occurrence of an Event of Default or a Termination Event and which party is the Affected Party.

The list of Events of Default in Section 5(a) includes, among other events, (i) a failure by the Defaulting Party to pay or deliver, (ii) breach or repudiation by the Defaulting Party of the agreement, and (iii) the bankruptcy of the Defaulting Party.[14] The Termination Events listed in Section 5(b), on the other hand, are events generally not under the control of either party, but which may affect either or both of the parties.[15] The description of what constitutes an Event of Default related to bankruptcy is a rather long list which includes the Defaulting Party's or related Credit Support Provider's formal commencement of a bankruptcy or insolvency proceeding by or against the Defaulting Party.[16] Since a related Event of Default is the party's taking "any action in furtherance of, or indicating its consent to, approval of, or acquiescence in, any of the foregoing acts" it appears that the adoption of a Board resolution approving any such commencement or the filing of a petition for bankruptcy (such as the one filed by CCM on October 9, 2008) would be an Event of Default even if time were to elapse between the adoption of the resolution and the filing of the petition or if the bankruptcy court were to reject the petition.

The 2002 ISDA Agreement made some changes in the Events of Default language from that which appeared in the 1992 ISDA Agreement.[17] So it will be important, in any attempt to establish the date of determination of the amount owing, to examine the Master Agreement which was used by the parties[18], to know which Event of Default or Termination Event should be used as the basis for establishing the Early Termination Date and to know whether a grace period is applicable. Also, if an Event of Default occurs and "Automatic Early Termination" was specified in the applicable Schedule, then an Early Termination Date will occur immediately upon the occurrence with respect to the Defaulting Party of its dissolution, general assignment, resolving to wind up or liquidate, seeking or becoming subject to a receiver etc. or anything analogous to such events; and with respect to any formal bankruptcy filing by or against the Defaulting Party, the Early Termination Date would be deemed to occur "as of the time immediately preceding the institution of the relevant proceeding or the presentation of the relevant petition." Such a designation in the Schedule of such Automatic Early Termination would avoid certain 15-day grace periods included in Section 5(a)(vii) with respect to certain of the bankruptcy Events of Default.

Once the Early Termination Date resulting from an Event of Default has been established, the amount payable in respect of such date is to be determined under Section 6(e) of the Master Agreement. Here there has been a significant change in the 2002 agreement from the 1992 agreement, which offered two options: "Market Quotation" and "Loss". Under the 1992 agreement, Section 6(e) provided that if the parties failed to elect a payment measure in Part 1(f) of the Schedule, they were deemed to have elected Market Quotation. Loss could be the primary choice and it was the fallback provision in the event that "a Market Quotation could not be determined or (in the reasonable belief of the party making the determination) would not produce a commercially reasonable result."[19] The 1992 agreement also contemplated two alternative payment methods: the "First Method", which allowed the Non-Defaulting Party to avoid netting of an amount owed to the Defaulting Party; and the "Second Method", which required netting. Under the 2002 ISDA Agreement, the Market Quotation and Loss concepts were replaced by that of a "Close-Out Amount", because some determining parties had experienced difficulty in obtaining quotations from "Reference Market-makers" as required by the definition of Market Quotation in the 1992 ISDA Agreement – and because "even in instances where four quotations could be obtained, in an illiquid market these quotations could be wildly divergent."[20] Although the definition of Close-Out Amount in the 2002 ISDA Agreement is rather complex, it essentially gives the determining party more flexibility to determine the amount payable than did the 1992 agreement, as long as it acts in good faith and uses commercially reasonable procedures.

This summary of some of the differences between the 1992

ISDA Agreement and the 2002 ISDA Agreement illustrates the fact that the claims of parties under derivatives contracts may be determined very differently depending on which ISDA Agreement is applicable, and this may have ramifications for the claims filed in a bankruptcy proceeding involving a Mexican debtor.

The Litigation in New York Against CCM

On November 6, 2008, after CCM's initial unsuccessful attempt to obtain a declaration of bankruptcy in Mexico under the LCM, at least 4 lawsuits were brought against CCM in State Supreme Court, New York County. The plaintiffs are J. Aron & Company (an affiliate of Goldman Sachs), Barclays Bank PLC, JPMorgan Chase Bank, N.A. and, in a combined action, Merrill Lynch Capital Markets AG and Merrill Lynch Capital Services, Inc. ("MLCS"). They are all claims arising from derivatives contracts, and each complaint indicates that the parties submitted to the jurisdiction of the New York courts. Some of the complaints specifically state that the contracts are governed by New York law.

The complaints in these actions were not initially accompanied by a copy of the relevant Master Agreements, Schedules and Confirmations, so it is not possible to know from the complaints which of them arise from 1992 ISDA Agreements and which from 2002 ISDA Agreements, or which involved Additional Representations along the lines of the "Relationship between Parties" representation referred to above. The dates of the related Master Agreements are stated to have ranged from 1999 (in the case of JPMorgan Chase) to 2006 (in the cases of Barclays and MLCS), but it is possible that even as late as 2006 the parties were still using the 1992 ISDA Agreement form (even today many parties still prefer the 1992 form). One complaint refers to a calculation using the Second Method and Market Quotations, which suggests that it involved the 1992 form, but it also refers to a Close Out Amount Notice, which would seem to relate to the 2002 form. This could be an important issue, since as noted above market quotations could be "wildly divergent" at a time of market volatility, and could become a key point of dispute in any claim against CCM.

The language of the complaints suggests that one or more of the four financial institutions used the 1992 agreement form, and one or more used the 2002 agreement form, and thus some appear to be subject to the representations, events of default and amount determination provisions of the 1992 agreement and others are subject to the different provisions of the 2002 form of agreement. The differing provisions may have consequences for the bankruptcy processes involved, and may affect the amounts of the creditors' respective claims and the right of the debtor to challenge the determinations by the creditor. The complaints indicate that the determining parties specified different dates (October 7, 9 and 10) as the Early Termination Date under the relevant contracts. Even though such dates are not very far apart, if there was market volatility during the period in question, a difference of even a day or two could be significant.

By announcing on December 1st that it planned to desist from seeking bankruptcy protection under the LCM, CCM will presumably seek to have the New York lawsuits against it dismissed as well, so that the derivatives contracts at issue can be included in the out-of-court restructuring the company says it intends to pursue. However, the restructuring could become difficult to achieve if there is a significant dispute over the amounts owing under the various derivatives contracts.

At this stage, many of the facts involved in these lawsuits are known only to the parties, and so much of what can be said by outside observers will be merely speculation, at least until more of the facts are disclosed. Nevertheless, it seems clear that the resolution of the issue of the amounts owing will require a detailed examination of the contracts in question, including all of the relevant Schedules and Confirmations.

Other Issues

Article 104 of the LCM states that "Differential contracts, futures contracts and financial derivative transactions that mature after the declaration of bankruptcy" are deemed to mature on the date of the declaration of bankruptcy, which in the case of CCM has still not occurred as of the date this is being written; but it would appear that the effect of determining an Early Termination Date is that the obligations under a Master Agreement mature on such date, so Article 104 should not have to be applied in the case of the four derivative claims cited in the complaints. In any event, Article 104 goes on to define "financial derivative transactions" as those in which the parties are obligated for the payment of money or the compliance with other delivery obligations that refer to goods or a market value underlying such obligations as well as any agreement that pursuant to general rules specifies Mexico's central bank (Banco de México), so the application of Article 104 would be limited to the derivatives obligations which fit such definition. With respect to such obligations, Article 105 of the LCM provides that financial derivatives transactions of the debtor are subject to netting as of the date on which the debtor is declared to be in bankruptcy, which is likely to be a date different from the Early Termination Dates determined under the respective Master Agreement.

There is a question as to whether any Mexican bankruptcy court, or the auditor (visitador) appointed by the court under the LCM to review the assets and liabilities of the debtor, will be prepared to handle any dispute that may arise under the various ISDA Master Agreements to which debtors being reorganized under the LCM may be subject. Given that the agreements are governed by New York law, the creditors at least may prefer that determinations of the amounts owing under the contracts, and whether CCM adequately understood the kinds of obligations they were incurring, be determined by a New York court rather than by the Mexican bankruptcy court or the visitador. If the issue as to any debtor cannot be determined by a non-bankruptcy court because the debtor has successfully initiated a bankruptcy proceeding under the LCM and managed to stay proceedings before a non-bankruptcy court in the U.S. (such as the various lawsuits in New York against CCM) by initiating a chapter 15 proceeding under the USBC, the creditors may attempt to persuade the judge in the chapter 15 proceeding to determine any such issue.

Another issue which may have to be addressed with respect to derivatives contracts in proceedings under the LCM is whether any of the creditors under such contracts will have the status of secured creditors by reason of collateral granted to secure obligations under the contracts. Some of the Schedules may have required the Mexican party to provide "Credit Support" through a pledge of cash or securities, to secure the obligations of such party. To the extent that the collateral so pledged is located in the U.S. and not in Mexico, the Mexican debtor may have an additional reason to commence a chapter 15 proceeding in the U.S. in addition to its proceeding under the LCM, i.e. to prevent the foreclosure in the U.S. of such pledge or to obtain the return of the property foreclosed upon.

What Will be the Impact of Differing Fraudulent-Conveyance and Preference Rules on Cross-Border Bankruptcies?

The legal systems of the U.S. and Mexico address the issue of fraudulent conveyances differently, both within and outside the bankruptcy context. The chapter 11 case initiated in 2005 as to Asarco LLC, whose parent Grupo Mexico, S.A.B. de C.V. ("GMSA"), caused it, in 2003 and prior to the chapter 11 filing, to transfer Asarco's shares in Southern Copper Corporation (formerly

Southern Peru Copper Corporation) ("Southern Copper"), may help to illustrate the differences. Asarco became subject to substantial environmental claims related to its smelters in the U.S., and its creditors claimed that a fraudulent transfer of the Southern Copper shares rendered it unable to meet its environmental liabilities, which at one point were claimed to have amounted to more than US$6 billion. After commencement of the chapter 11 case Asarco, through an independent board of directors appointed by the bankruptcy court, claimed that it had been damaged to the extent of more than US$8 billion by the transfer of the Southern Copper shares.[21]

GMSA may have been surprised by the claims in the chapter 11 case that the transfer was fraudulent, given the different approaches to fraudulent transfers under the laws of Mexico as compared to the U.S. The concept of constructive fraud or even of intentional fraud on creditors is not a concept that has resulted in many successful actions against transferors in Mexico. In part this is attributable to Mexican law, which has always classified fraud as a criminal offense, and the fact that fraud is often extremely difficult to prove in the Mexican courts. It is not uncommon in Mexico for shareholders of companies to transfer assets of the companies to themselves or to third parties without incurring significant risk of prosecution or civil suits. In the U.S. claims of civil fraud are normally easier to pursue than those based on criminal fraud, because of a less stringent standard of proof in civil fraud cases.[22]

The concurrent U.S.-Mexico fraud prosecutions against Ricardo Salinas Pliego indicate the divergent treatment of fraud in the two countries. The U.S. Securities and Exchange Commission claimed in 2003 that Salinas Pliego improperly made a US$109 million profit in 2003 by purchasing debt that TV Azteca phone unit Unefon SA owed to Nortel Networks Corp. for a discounted price, and then receiving repayment from Unefon at full value three months later. The SEC alleged Mexico City-based TV Azteca, whose shares trade, in both Mexico and the U.S., failed to inform shareholders about the transaction.[23] The SEC commenced a civil fraud suit under Sarbanes-Oxley, and a few months later the Mexican authorities initiated a criminal fraud complaint against him under Mexican law. The SEC case was eventually settled when Salinas agreed to disgorge profits and pay a penalty of US$8.5 million.[24] However, the criminal fraud complaint in Mexico was dropped eventually, reportedly due to a failure to develop evidence sufficient to pursue the criminal charge.[25] Given the absence of a concept of civil fraud in Mexico, reliance on criminal fraud charges may be ineffective to enable creditors to recover against Mexican debtors with respect to fraudulent transfers because of the higher standard of proof involved.

The LCM does contain, in articles 112-119, provisions relating to fraudulent transfers, and they are characterized as criminal acts. However, perhaps as a sign of a growing awareness in Mexico of the ineffectiveness of criminal fraud charges in the commercial context, and of the need to encourage Mexican companies in financial distress to consider a bankruptcy filing as a viable approach to resolving their difficulties, the LCM does not contain the concepts of "culpable bankruptcy" and "fraudulent bankruptcy" which were ingrained in the Bankruptcy and Suspension of Payments Law (Ley de Quiebras y Suspensión de Pagos) which was the predecessor of the LCM. Although the LCM permits parties to a proceeding under the law to file criminal complaints against the debtor or any of the creditors, Article 277 of the LCM provides that such complaints must be handled by ordinary criminal courts outside the bankruptcy proceeding under the LCM. This may tend to reduce the risk of such complaints becoming large distractions from the other issues requiring attention in the bankruptcy proceeding, but it does not necessarily increase the appetite in creditors to fix fraudulent transfer complaints against debtors in Mexico.

The rules as to preferential transfers, an offshoot of the fraudulent transfer rules, also differ as between the U.S. and Mexico. Section 547 of the USBC provides that the bankruptcy trustee may avoid (set aside) transfers of the debtor's interest in property: (i) to or for the benefit of a creditor; (ii) for or on account of an antecedent debt owed by the debtor before such transfer was made; (iii) made while the debtor was insolvent; (iv) made - (A) on or within 90 days before the date the petition was filed; or (B) if the creditor was an insider, on or within one year before the date the petition was filed; and (v) that enabled the creditor to receive more than the creditor would have received if - (A) the case were a case under chapter 7 of the Bankruptcy Code; (B) the transfer had not been made; and (C) the creditor received payment of such debt to the extent provided by the provisions of chapter 7.

Under the LCM the "preference period" is 270 days prior to the court's declaration of bankruptcy, rather than the USBC's 90 days prior to the filing of the petition for bankruptcy, and there is no longer period in the LCM for transfers to "insiders" as there is in the USBC. The determination of a preference under Section 547 of the USBC is a kind of "strict liability" determination that does not require a finding of bad faith or fraudulent intent or any distinction being drawn between affiliates and insiders or other third parties (except that the preference period is one year in the case of insiders). On the other hand, the determination of a preference under the LCM signifies a finding that there was fraudulent intent; either there was constructive fraud under Article 117 based on the transfer having been made to an affiliate of the debtor or to an individual who is an officer or director of the debtor (or having a blood or marital relationship therewith); or the transfer falls within one of the types listed in Articles 114-116, such as a payment of an unmatured debt, or a sale by the debtor of assets for prices "notoriously" lower than market prices. With some types of transfers the LCM provides that the transfer will not be treated as preferential if it was not made in bad faith.

These differences could give rise to a claim in a chapter 15 proceeding that a creditor is being disadvantaged in the LCM proceeding in that a transfer that would be treated as fraudulent or preferential under the USBC is not so treated under the LCM, and therefore the creditor should be entitled in the chapter 15 proceeding, pursuant to Section 1506 of the USBC, to relief from the Mexican proceeding because it is "manifestly contrary to the public policy" of the U.S. For example, a creditor might argue that the debtor made a transfer which would be deemed to be preferential under the strict liability test of the USBC but would not necessarily be deemed preferential under the LCM, perhaps because the finding of it being preferential under the LCM would be a finding of criminal fraud, which the Mexican bankruptcy court might be reluctant to determine.

How Are Issues of Procedural and Substantive Consolidation Likely to be Handled in Cross-Border Cases?

In both the U.S. and Mexico it is possible to consolidate cases brought within the respective country against affiliated companies, for procedural purposes, to simplify the administration of the cases. In the U.S. this can be done pursuant to Rule 1015 of the Federal Rules of Bankruptcy Procedure, and in Mexico under Article 15 of the LCM. In the U.S. it is also possible, through application of the bankruptcy court's general equity powers under Section 105 of the USBC, to achieve a "substantive" consolidation of cases affecting affiliated companies, in which the assets and liabilities of all of the members of the corporate group are combined and inter-company liabilities are netted out, so long as the party or parties seeking

such consolidation can demonstrate that it will not only simplify the administration of the case but also not be to the significant detriment of any of the creditors.[26]

In Mexico, substantive consolidation is extremely difficult to achieve, and as a result it is often possible for inter-company liabilities to be treated as on par with third party liabilities. Article 15 of the LCM says that the bankruptcy proceedings of two or more debtors shall not be consolidated, except as provided therein, and that proceedings of affiliated companies may be consolidated but shall be conducted separately. It appears that Mexican bankruptcy judges have generally interpreted this to mean that the assets and liabilities of the affiliated companies cannot be combined.

With inter-company liabilities being capable of ranking equally with third party claims, third-party creditors may be disadvantaged by having to compete with the claims of affiliates, but this may be offset to the extent they have obtained guarantees from the affiliates prior to the commencement of the LCM proceeding. However, the risk of being disadvantaged is illustrated by the recent filing under the LCM by Durango, in which intercompany claims against Durango will apparently allow its affiliates to present claims for about US$862 million against Durango and thereby control the voting by creditors on any reorganization plan.[27] There could be an argument by the creditors in the Chapter 15 proceeding against recognition of the Mexican proceeding, on the ground that the absence of substantive consolidation under the LCM is fundamentally unfair to third-party creditors. It is not clear whether such an argument will be convincing to the Bankruptcy Court in the Southern District of New York.

What Are the Likely Dynamics of Cross-Border Proceedings?

Any bankruptcy proceeding involving affiliated companies on both sides of the U.S.-Mexico border will require some consideration of the bankruptcy laws of both countries, as well as the management issues that arise from the effects of such laws. Such issues include (i) conflicting deadlines and goals of the proceedings that can be commenced in each country, (ii) the possibility of inconsistent results leading to conflicting outcomes, (iii) differing treatment of secured creditors, and (iv) possibly differing degrees of willingness by the courts in the respective countries to cooperate with the courts on the other side of the border.

To the extent that a debtor is at risk of claims being filed against it, and/or liens enforced against its assets, in both countries, it will need to consider following up on any filing under its home country's law with a parallel filing under chapter 15 of the USBC or Title Twelfth of the LCM, as the case may be. If it does not do so, or there is a delay in its home country's courts accepting its bankruptcy petition, there is a risk – as in the case of CCM – that it will have to deal with distracting legal proceedings in the other country while trying to pursue its bankruptcy filing in its home country. As noted above, the difficulties encountered by CCM in obtaining bankruptcy protection in Mexico, and the existence of the lawsuits filed against it in New York, may have been factors in causing it to drop the attempt to file under the LCM in the likely expectation that an arrangement with its creditors could be negotiated outside of court which would lead to the New York actions being withdrawn. In the meantime, it will have to deal with the possibility of other suits being filed by creditors that lack confidence in the outcome of the out-of-court negotiations.

Even if a Mexican debtor does obtain protection under the LCM and is in a position to commence a chapter 15 proceeding, it may have to fend off challenges in such proceeding contesting the legitimacy of the LCM proceeding. This is what has occurred in the case of Durango, where the creditors claim that they will not be fairly treated in the Mexican proceeding and that therefore the Mexican proceeding should not be recognized as a "foreign main proceeding". If the shoe is on the other foot, and the debtor is based in the U.S. but seeks recognition in Mexico of its chapter 11 proceeding as a foreign main proceeding under Articles 292 et seq. of the LCM, it may face similar claims.

The LCM provides for specific time deadlines that may force the debtor and its creditors to act promptly to avoid impairment of their respective positions. In some cases the deadlines have been thwarted by an inability to resolve labor claims or intransigent secured creditors, such as in the case of Bufete Industrial, which commenced its bankruptcy proceeding under the LCM in 2002; the case is still pending. After the court-appointed visitador audits the financial position of the debtor, if the court declares the debtor to be in bankruptcy, the judgment will instruct the Federal Institute of Bankruptcy Experts (the Instituto Federal de Especialistas de Concursos Mercantiles or "IFECOM") to name a conciliator to work with the debtor and its creditors to develop a reorganization plan.

If the debtor has significant secured creditors, in the U.S. such creditors may be forced under the USBC to accept a reorganization plan which eliminates their secured position, as long as they receive "adequate protection" in exchange, essentially by the secured creditor being compensated for any default and the payment terms for the secured claim being reinstated as they existed prior to the bankruptcy filing; this allows for some flexibility in achieving a reorganization which is for the overall benefit of the creditors. However, this ability to "cram down" a plan over the objections of the secured creditors is not permitted in Mexico under the LCM. In this respect the LCM under Article 217 et seq. adopts a rule that may be more rigid than the so-called "absolute priority rule" as provided in section 1129 of the USBC, although in practice creditors of companies subject to a proceeding under the LCM have sometimes felt the rule is not always applied faithfully, at least in the reorganization context.[28]

If a U.S. debtor in a chapter 11 proceeding has made payments to a Mexican party that are then challenged in the chapter 11 context, any attempt to set such transfers aside as preferential under Section 347 of the USBC will require service of process to be made on the Mexican defendant in the preference action. In order to make any eventual judgment against the Mexican party to be enforceable against it in the Mexican courts, such service must comply with Mexican due process requirements, which normally cannot be satisfied through service by mail. Personal service will ordinarily require the complaint to be served through letters rogatory issued by the U.S. bankruptcy court to a Mexican court having jurisdiction over the defendant, requesting the assistance of the Mexican court in effecting the service. This is likely to be much more time-consuming than service by mail.

One case that has been concluded in parallel proceedings indicates that, even where a Mexican debtor is able to thwart an involuntary chapter 11 proceeding against it in the U.S., and the debtor is able to conclude its proceeding under the LCM, it may see an advantage in commencing a chapter 11 proceeding after all. Satélites Mexicanos, S.A. de C.V. ("SatMex"), initially filed in June 2005 under the LCM, succeeded in having an involuntary chapter 11 proceeding withdrawn and then commenced an ancillary proceeding under the old Section 304 of the USBC. By July 2006 it concluded its case under the LCM and then, in order to ensure acceptance by its foreign creditors of the reorganization plan it had negotiated under the LCM and minimize lawsuits against it by them after it emerged from the LCM, it negotiated a prepackaged bankruptcy proceeding under chapter 11 as well which was

commenced in August 2006. The reorganization plan was approved by the U.S. court in October 2006 and the final combined closing occurred at the end of November of that year.[29]

Conclusion

Cross-border restructurings involving Mexico and the U.S. can, when they involve bankruptcy proceedings on either or both sides of the border, raise complicated issues involving the bankruptcy laws of the two countries. Adding to the usual difficulties, costs and burdens of a bankruptcy case in either country is the additional layer of complexity resulting from the cross-border issues, some of which are discussed above. Where there are complex derivatives contracts involved, the complexity is likely to be even greater. Such complexity should give pause to any debtor or creditor considering the commencement of bankruptcy proceedings in which there are assets, subsidiaries or operations in both countries, and much of the complexity can be avoided by a cooperative approach by the debtor and creditors to negotiating an out-of-court restructuring. Nevertheless, the advantage to the debtor of obtaining the protection of the automatic stay and other potential benefits to the debtor or the creditors of commencing a bankruptcy proceeding may mean that dealing with such complexity will become unavoidable.

1. Published in the Diario Oficial de la Federación on May 12, 2000. Amendments to the LCM were published in the Diario Oficial on December 17, 2007.
2. See "Comercial Mexicana to succumb to pressure from creditors and shun Mexican bankruptcy protection – report", Debtwire, December 1, 2008.
3. 11 U.S.C. § 101 et seq.
4. Pilgrim's Pride files for Chapter 11, Wall Street Journal news alert, December 1, 2008.
5. Perhaps the most significant amendment to the LCM enacted in December 2007 was the inclusion in the law of specific provisions in Articles 339-342 for a Prior Restructuring Plan (Plan de Reestructura Previo) comparable to a prepackaged bankruptcy under chapter 11.
6. The proceedings may arise due to defaults under loan agreements, promissory notes, commercial paper, bond transactions or derivative instruments, class action lawsuits (such as those brought against Pilgrim's Pride prior to its chapter 11 filing) or other types of claims.
7. Other possible reasons for a debtor wanting to commence a bankruptcy proceeding may be: (i) an excessive amount of debt, which may be incapable of being restructured except through bankruptcy, (ii) operational problems, (iii) a need to dispose of assets or cancel liabilities in a way that would be prohibited under existing debt agreements, and (iv) an inability to pay debts as they become due. Certain types of regulated entities, such as banks, are not subject to reorganization under chapter 11 of the USBC, and financial institutions are subject to a special chapter of the LCM (Articles 245-261 of the law).
8. See discussion below on substantive consolidation.
9. Under the ISDA Master Agreement, which would normally be the basic document governing the derivatives transaction, the choices are either New York or English governing law and jurisdiction.
10. Derivatives obligations of Mexican companies owing to Mexican creditors, including those traded on the Mexican derivatives market, may be subject to non-ISDA documentation, which this section does not address.
11. Currency swaps are often subject to the 2000 ISDA Definitions, which are subject to an Annex which is updated electronically from time to time on ISDA's website. Foreign exchange transactions and currency options are also usually subject to ISDA's 1998 FX and Currency Options Definitions. There will also be a Schedule and Confirmations agreed to by the parties, containing specific information describing the amounts and other particulars of the transaction. Under each Master Agreement form there are prescribed forms of Schedules and Confirmations. Each Confirmation should be separately dated and describe the specific amounts involved and other particular characteristics of the transaction, in each case subject to the overall rules established by the Master Agreement and Schedule initially signed by the parties (although the parties may agree from time to time to amend the relevant Schedule). So the analysis of a party's obligations with respect to a particular derivative "product" will begin with an examination of the applicable Master Agreement, Definitions, Schedule and Confirmations.
12. Each Master Agreement form contains basic representations in Section 3 thereof, and each Schedule may have additional representations of the parties, including specific tax representations arising from the applicable tax laws affecting the parties, and other "Additional Representations" which the parties may wish to include.
13. Comercial Mexicana offers creditors USD 450m in cash, Debtwire, December 8, 2008.
14. Other Events of Default listed in Section 5(a) are (a) a default by a "Credit Support Provider" of the Defaulting Party, (b) a misrepresentation by the Defaulting Party, (c) default under a "Specified Transaction" or any related credit support arrangement, (d) a "Cross-Default" specified in the applicable schedule as applying to the Defaulting Party, and (e) the merger or consolidation by the Defaulting Party or its Credit Support Provider or its transfer of all or substantially of the assets of either thereof to another entity which does not assume their obligations under the agreement, or the benefits of any Credit Support Document fail to extend to the derivatives obligations under the Agreement.
15. Termination Events under Section 5(b) are: (i) illegality, (ii) force majeure events, (iii) tax events, (iv) tax events upon merger, (v) "Credit Events" upon merger, and (vi) any Additional Termination Events the parties may agree to include in the Schedule.
16. Other bankruptcy-related events related to a party or its Credit Support Provider are: (1) dissolution, (2) insolvency, (3) a general assignment for the benefit of creditors ("general assignment"), (4) adoption by it of a resolution for its winding-up, official management or liquidation, (5) seeking or becoming subject to an administrator, receiver or the like, (6) having a secured party take possession, attach or levy all or substantially all of its assets, (7) causing or becoming subject to "any event with respect to which, under the applicable laws of any jurisdiction, has an analogous effect" or (8) taking "any action in furtherance of, or indicating its consent to, approval of, or acquiescence in, any of the foregoing acts".
17. For example, the later Master Agreement form includes as an Event of Default a general repudiation by the Defaulting Party of its obligations under the contract whereas the earlier form is limited to repudiations of Specified Transactions. The later form also changed the treatment of cross-defaults. With respect to bankruptcy, the 2002 ISDA Agreement provides for a 15-day grace period (rather than a 30-day grace period) within which a debtor might seek to prevent the occurrence of an Event of Default by having an involuntary proceeding dismissed or stayed. Also, the 2002 agreement provides that a bankruptcy proceeding initiated by a "principal regulator, supervisor or similar official" will be treated as an immediate Event of Default without any grace period, which is a change from the 1992 agreement.
18. It should be noted that after the adoption of the 2002 form its use was not mandatory, and the 1992 form continued to be used in many transactions.
19. User's Guide to the ISDA 2002 Master Agreement, 2003 Edition, Part I.G.5 (p. 24).
20. Id.
21. Emily Chasan and Mica Rosenberg, "Asarco seeks billions from Grupo Mexico in dispute", Reuters report, September 3, 2008.
22. In criminal fraud cases in the U.S., the standard is "beyond a reasonable doubt", while in civil fraud cases the standard is the less stringent "clear or convincing evidence" or "a preponderance of the evidence". See Jackson v Virginia, 443 US 307, 61 L Ed 2d 560, 99 S Ct 2781(1979).
23. U.S. Securities and Exchange Commission, Litigation Release No. 19022 / January 4, 2005..
24. SEC News Digest, September 15, 2006.
25. Reported in the Mexico City newspaper Reforma, September 10, 2006.
26. Some limitations on the concept were enunciated in Official Representatives of the Bondholders and Trade Creditors of Debtors Owens Corning v. Credit Suisse First Boston, 126 S. Ct. 1910 (2006).
27. Corporacion Durango intercompany debt weighs in – report, Debtwire, December 3, 2008.
28. See Robert L Rauch, The Mexican Concurso Mercantil Process from an International Investor's Perspective, presentation at LatinFinance/ Institutional Investor conference on Corporate Restructuring & Distressed Investing in Post-Crisis Latin America, February 8, 2007.
29. Satmex Restructuring Illustrates Benefits of Cooperation Under Insolvency Laws of Mexico and the United States, White & Case Insolvency Notes, December 2006.