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ARTICLE

Cross-Border Bankruptcy Reform in NAFTA Jurisdictions: Has Seizing Control of Troubled, Closely-Held Corporations Gotten Easier?

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Introduction

The past 15 years have witnessed unprecedented development in global insolvency reform. On nearly every continent, legislatures have revised the substantive content and the cross-border provisions of their bankruptcy laws. Do these reforms – specifically, the cross-border provisions of many new statutes – help trustees and other court-appointed representatives seize control of previously difficult-to-access closely-held or family-controlled 'offshore' enterprises or assets?

Two rather recent cases, in Mexico and in the US respectively, highlight and illustrate this issue in NAFTA jurisdictions.[1] This article briefly reviews those cases in the context of Mexican and US cross-border and substantive bankruptcy law, then suggests some implications arising from them.

The issue

Mexican businesses are typically family-owned and run. This is consistent with the business environment of most Latin American countries, where many of the region's largest companies are controlled by a few prominent families. In the US, 'close control' likewise remains the perceived predominate means by which midsized and smaller corporations are held.[2]

Such family control often extends to 'offshore' interests (e.g., to firms incorporated or doing business outside the controlling family's host jurisdiction). Until recently, creditors of family members[3] could obtain control of such interests only through unwieldy means – or not at all. However, cross-border provisions of both the Mexican *Ley de Concursos Mercantiles* (LCM) and the US Bankruptcy Code (US Code) offer trustees and court-appointed representatives (and, by extension, creditors) improved mechanisms for divesting such individuals of control of their holdings when things go wrong.

The law

Mexico's LCM

Mexico's present bankruptcy scheme has been in force since 2000. The LCM includes a host of changes to Mexico's prior law – including modernised domestic provisions, incorporation of virtually all of the UNCITRAL Model Law provisions on cross-border cases, a quasi-judicial administrative agency for the oversight

Notes

* The author wishes to thank Lic. Eduardo Martinez Rodriguez of EDUARDO MARTINEZ, ABOGADOS S.C., Mexico, D.F., a member of the International Insolvency Institute, for his very helpful comments in preparing this article. The views and opinions expressed here (and any errors or omissions) are the author's own. For questions or comments regarding this article, contact mgood@southbaylawfirm.com or eaemartinez@emabogados.com.mx.

1 Similar issues may arise in jurisdictions with cross-border provisions similar to those of Mexican and US law – each of which closely track the UNCITRAL Model Law. For a comprehensive collection of the cross-border provisions of jurisdictions worldwide, see *Cross-border Insolvency: A Guide to Recognition and Enforcement* (INSOL 2008), available at <www.insol.org/crossBorder.htm> (last accessed 31 January 2008).

2 Private or 'closely-held' corporations are informally and consistently estimated by researchers to comprise a large majority of US firms. See, e.g., V. Nagar, K. Petroni, D. Wolfenz, 'Governance Problems in Close Corporations', at <http://pages.stern.nyu.edu/~dwolfenz/CC.pdf> (last accessed 31 January 2008) at 1 ('Out of almost 4.7 million corporations that filed taxes in 1997, only 8,000 corporations were publicly listed in the NYSE, Nasdaq, and Amex combined'); J.H. Astrachan and M.C. Shanker, 'Family Businesses' Contribution to the U.S. Economy: A Closer Look', (2003) *Family Business Review*, Vol. XVI, No. 3, <www.ffi.org/pdf/otnContributionUSEconomy2003.pdf> (last accessed 31 January 2008) at p. 216 (estimating that firms in which family members control strategic direction and participate in the company in some fashion comprise approximately 89% of all US firms).

3 Individual corporate principals are often subject to creditor action regarding the corporation's debt. For example, Felipe, Jacobo, and José Maria Xacur brothers (whose bankruptcy cases are discussed below) were *avalistas* (*viz.* co-makers of obligations) on approximately USD 300 million in notes obtained for the benefit of companies they controlled. In the US, it is likewise not uncommon for the principal shareholders to personally guarantee corporate debt. Such guarantees frequently contain so-called 'marshaling provisions' waiving the creditor's requirement to pursue the primary obligor before seeking recovery from the guarantor-principal.

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of cases, and expanded powers and jurisdiction for bankruptcy judges and officers of the estate.[4]

Under Mexican law, any natural or legal person engaged in trading, commerce or any lawful business activities and whose debts have been incurred for commercial or business purposes[5] may be declared a debtor – voluntarily[6] or involuntarily (by its creditors or by the pubic prosecutor of its domicile *Minsterio Publico*).[7] Under either scenario, the commencement of a case is analogous to that of an involuntary proceeding under the US Code: upon the filing of a proper petition,[8] the presiding court will admit the petition and, thereafter, direct the appointment of an examiner to ascertain the debtor's insolvency.[9] Within approximately 35 days of the examiner's appointment,[10] the court will issue a judgment granting or denying a *concurso* (analogous to an order for relief). Thereafter, the debtor has between 185 and 365 days to negotiate with its creditors over the terms of an acceptable plan of this reorganisation. During this 'conciliation' stage, the debtor administers its affairs under the supervisor of an appointed 'conciliator' – an individual vested with authority to oversee operations and financial affairs, issue reports and, in extreme cases, directly administer the debtor's estate.

If the debtor cannot successfully negotiate an acceptable plan within the one-year conciliation period, if the conciliator seeks liquidation at an earlier point, or if the debtor seeks liquidation directly rather than a reorganisation, the court may enter a judgment of bankruptcy. At this point, a receiver is appointed and a liquidation of the debtor's assets proceeds[11] in a manner similar to that under Chapter 7 of the US Code.

The US Code

The US Code has been in effect since 1978. Despite significant revisions in 1984, 1994, and 2005, the basic statutory scheme applicable to domestic insolvency proceedings has not changed for 30 years. Business and individual debtors may seek reorganisation voluntarily through Chapters 11 and 13;[12] 'straight liquidation' (effected by a trustee pursuant to statute) is available through Chapter 7. Creditors may also seek recourse through an 'involuntary' petition for relief under Chapter 7 or 11.

In a reorganisation under Chapter 11, the debtor may remain in possession subject to less court supervision than that imposed under Mexican law, but has only 18 months or less[13] in which to file a confirmable plan of reorganisation. Thereafter, any creditor may file and seek confirmation of a reorganisation plan. The same time limits apply to any trustee appointed in the debtor's case.

In an involuntary filing, the petition may be – and often is – contested.[14] If, over the debtor's objection, an order for relief is granted, a trustee will be appointed automatically (in a case under Chapter 7) or upon noticed motion and an appropriate evidentiary showing of fraud, mismanagement, or other facts and circumstances demonstrating that appointment of a trustee is in the 'best interests' of creditors.[15] In a Chapter 11 case, the trustee is typically appointed by the Office of the US Trustee after consultation with creditors. In a Chapter 7 case, the trustee is typically appointed from a standing 'panel' of trustees extant in the debtor's judicial district; however, the US Code sets forth provisions for a creditors' election of a trustee if the designated 'panel' trustee is not to the creditors' liking.[16]

Notes

4 Several very general but useful summaries of the LCM are available to the English reader. *See, e.g.*, J. Fernandez-MacEvoy, 'Mexico's New Insolvency Act Increasing Fairness and Efficiency in the Administration of Domestic and Cross-Border Cases (Part I)', [19 AUG 2000] *Am. Bankr. Inst. J.* 16; R. Phelan, C. Beckham, Jr., 'Cross-Border Insolvency with Mexico' (materials prepared for Second Annual International Insolvency Conference (2002)), at <www.iiiglobal.org/country/mexico/Cross_Border_Insolvency_with_Mexico.pdf> (last accessed 31 January 2008).

5 LCM Article 4 (incorporating by reference the Code of Commerce).

6 LCM Article 20

7 LCM Article 21.

8 LCM Articles 20, 22, 23.

9 LCM Article 29.

10 LCM Articles 40 and 42. Interim relief is available pursuant to LCM Article 37.

11 LCM Articles 197-216.

12 Because, as a practical matter, Chapter 13 cases typically involve the reorganisation of much less debts and assets than those resolved under Chapter 11, the focus of this article's summary of reorganisation under the US Code is on Chapter 11.

13 Section 1121 of the US Code, revised in 2005 under BAPCPA, provides the debtor with 120 days of 'exclusivity', during which only the debtor may file a plan of reorganisation. This 'exclusivity' period may be extended for a period of only 18 months from the date the order for relief is entered, but not beyond. *See* 11 U.S.C. § 1121(d)(2)(A) ('The 120-day [exclusivity] period ... may not be extended beyond a date that is 18 months after the date of the order for relief under this chapter').

14 Alternatively, the debtor may elect to consent to the petition and remain in control of its assets as a 'debtor-in-possession' under Chapter 11 or, if the petition was for relief under Chapter 7, simply 'convert' the case to the one under Chapter 11. *See* 11 U.S.C. § 706(a).

15 11 U.S.C. § 1104(a).

16 *See* 11 U.S.C. § 702. These same procedures are incorporated by reference – and, therefore, likewise applicable in Chapter 11 cases – pursuant to 11 U.S.C. § 1104(b).

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Cross-border provisions: Mexico and the US

Both Mexican and American provisions for cross-border bankruptcies have evolved considerably in recent years:

LCM

One of the primary features of the LCM is its adoption – virtually *in toto* – of the UNCITRAL Model Law of cross-border insolvencies. Specifically, Title XII of the LCM (i) promotes comity and cooperation between the Mexican courts and foreign courts;[17] (ii) authorises local recognition and enforcement of judgments issued in connection with foreign insolvency proceedings;[18] (iii) creates a 'world-wide estate' that should be administered and distributed as a global unit;[19] (iv) grants foreign representatives direct access to the Mexican courts;[20] (v) enables foreign creditors and parties in interest to initiate or participate in a Mexican bankruptcy case;[21] (vi) affords due process to all creditors, wherever located, concerning any relief requested in the case;[22] (vii) treats all similarly situated creditors, local and foreign, equally;[23] and (viii) preserves and maximises the going-concern value of the troubled business while a global solution is negotiated and implemented.[24]

Mexico holds the honour of leading the world in adopting UNCITRAL's provisions – it was among the very first to do so. As discussed very briefly below, Mexico's judiciary has upheld these provisions in the face of Constitutional challenge.

US Code – Chapter 15

In the US, similar cross-border provisions were enacted with the 2005 amendments to the US Code. Specifically, Congress provided an entirely new Chapter – Chapter 15 – in order to implement many of UNCITRAL's provisions. Chapter 15 generally tracks the Model Law's provisions[25] and replaces the US Code's former Section 304 – itself the first codified procedure in the US by which a foreign bankruptcy representative could obtain recognition or facilitation for a foreign proceeding.[26]

Chapter 15 is fundamentally procedural in nature. It formalises and streamlines the 'recognition' process, and further controls access to US Courts: foreign bankruptcy representatives must first seek recognition from American bankruptcy courts before pursuing substantive relief in other US forums.[27] However, the Chapter also codifies certain relief for foreign representatives. For example, the bankruptcy court may, in its discretion and upon request of the foreign representative, entrust the administration and/or distribution of the debtor's assets located within the US to a foreign representative.[28] The representative may, consistent with principles of comity, also seek removal of US-based litigation to the federal bankruptcy court or seek dismissal of the case altogether in favor of adjudication before the foreign bankruptcy tribunal.

Seizing corporate control using new cross-border law – two examples

The legislative framework discussed above suggests that domestic insolvency reform, combined with growing

Notes

17 LCM Article 278.
18 LCM chapter II of title XII
19 LCM Article 4.
20 LCM Article 289.
21 LCM Article 290.
22 LCM Article 290.
23 LCM Article 291.
24 LCM Article 299.
25 Some modifications are designed to conform the Model Law with existing US law. *See In re Iida* 377 B.R. 243, 256 (Bankr. 9th Cir. 2007) (hereinafter, '*Iida*').
26 *Iida* 377 B.R. at 254 (citations omitted) ('Congress enacted former § 304 as part of the Bankruptcy Reform Act of 1978 ... It was an innovation. Prior to the enactment of § 304, United States bankruptcy law did not provide specific procedures by which a foreign bankruptcy trustee could obtain relief in the United States to facilitate the foreign bankruptcy proceeding.').
27 *Iida*, 377 B.R. at 256-57, 258 ('The primacy of the bankruptcy court's authority over whether ancillary assistance will be granted to a foreign representative is reenforced by authorization for the bankruptcy court to issue any appropriate order necessary to prevent the foreign representative from obtaining comity or cooperation in another court in the United States if recognition is denied. 11 U.S.C. § 1509(d)').
28 11 USC 1521(a) and (b). The primary requirement for such relief is that the interests of creditors are sufficiently protected. *Iida* 377 B.R. at 258 and n.24 (citing *In re SPhinX*, 351 B.R. 103, 112-13 (Bankr. S.D.N.Y. 2006)) ('Under § 1521(a), the court may, at the request of the foreign representative, entrust administration or realization of the debtor's assets located within the United States to such foreign representative where necessary to effectuate the purpose of chapter 15 and to protect the debtor's and creditors' interests. Under § 1521(b), the court may, at the request of the foreign representative, entrust distribution of the debtor's assets located within the United States to such foreign representative, so long as the interests of creditors are sufficiently protected. Thus, both subsections of § 1521 require that the court consider the interests of creditors when making its determination. Notably, these statutes direct the court to consider the interests of all creditors, not just the interests of United States creditors.').

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uniformity and enforcement in the recognition of cross-border cases, has eased the ability of court-appointed representatives to seize control of closely-held businesses and other assets located 'off-shore'. Two recent examples illustrate this trend.

Mr. Smith goes to Mexico: Xacur[29]

The Mexican LCM's cross-border provisions were put to the test almost immediately after their enactment when creditors of Felipe, Jacobo, and José Maria Xacur filed involuntary petitions under Chapter 7 of the US Code in Houston, Texas. The Xacur brothers were *avalistas* (co-makers) on loans to their family's Mexican corporations (the *Xacur* companies) of approximately USD 300 million. The filings were precipitated by the Xacur brothers' relocation from Mexico to Houston, and by the *Xacur* Companies' commencement of a *suspension de pagos* proceeding under Mexico's prior law.

Following a hotly contested hearing on the viability of the involuntary proceedings, US Bankruptcy Judge Karen Brown entered orders for relief with respect to all three Xacur brothers.[30] W. Steven Smith was appointed Chapter 7 trustee and – consistent with the US Code's provisions – charged with marshalling and liquidating the Xacur brothers' assets. That estate included 99.9% of the capital stock of two Mexican holding companies, which in turn held 99.9% of ten operating Mexican subsidiaries (all of which had been previously placed into *suspension de pagos* proceedings).

In January 2001 – less than seven months after the LCM's passage – Mr. Smith filed a petition in Mexico City's Federal District Court seeking recognition of the Xacurs' US cases. Once again the proceeding was hotly contested – and required resolution of a broad array of defences, including lack of jurisdiction, viability of the LCM (in light of the pre-existing *suspension de pagos* proceedings), qualification of the Xacur brothers as 'merchants' under the LCM, and defences arising under inter-American treaties in force as between the US and Mexico. Over these and other objections, the Mexican District Court entered an order in December 2002 recognising and enforcing the American Chapter 7 proceedings, and affording Mr. Smith cooperation in prosecuting the Xacur brothers' cases.[31]

The District Court's 2002 order was not the end of the matter. The Xacur brothers pursued review of this decision through the Mexican appellate system, finally reaching the Mexican Supreme Court of Justice in 2005 with the contention that the LCM was unconstitutional. The Supreme Court disagreed, ruling unanimously in November of that year that the LCM's cross-border provisions do not violate the Mexican Federal Constitution.

The *Xacur* decision is an important one: It validates the Mexican legislature's efforts to reform the country's insolvency system, and further provides to creditors and other parties in interest a critical tool – and growing confidence – in doing business in Mexico.

Mr. Kitihara goes to Hawaii: Iida

A very recent decision issued by the United States' Ninth Circuit Bankruptcy Appellate Panel illustrates application of a similar technique within the US. Though the 'main case' was Japanese, the result could be identical in the case of a court-appointed Mexican receiver or conciliator. In 2004, Katsumi Iida – a Japanese national – was adjudicated a bankrupt under Article 126 of the Bankruptcy Law of Japan. Junichi Kitihara was appointed trustee of Mr. Iida's bankruptcy estate under the relevant provisions of Japanese law.

Mr. Iida and his son, Masaaki Iida, were officers and directors of a group of Hawaiian corporations which, themselves, held substantial ownership interests in limited partnerships that owned and operated the Kahala Mandarin Oriental Resort and another Hawaiian luxury hotel.

Acting pursuant to his authority as trustee in the Japanese case – and pursuant to both Mr. Iida's shareholder's rights and the Hawaiian corporations' bylaws – Mr. Kitihara assumed control of the US corporate entities and removed the Iidas as directors, then replaced the corporations' officers. Thereafter, Mr. Kitihara effected a sale of the Kahala Mandarin resort. The Japanese bankruptcy court approved the sale.

At first acquiescent to the change of corporate control and to the sale, the Iidas subsequently opposed Mr. Kitihara's actions and sought redress through the Hawaii court system. In Hawaii Superior Court, the Iidas contested the validity of Mr. Kitihara's assumption of control of their corporations and sought to restrain his distribution of the Kahala Mandarin sale proceeds.

Notes

29 The *Xacur* cases, and their procedural history before the Mexican courts, are summarised in materials prepared by Mexican counsel for the Chapter 7 Trustee appointed in these cases. *See* D.U. Oscos Coria, 'THE XACUR CASE: The Mexican Experience', available at <www.insol.org/emailer/january2006_downloads/the_xacur_case.doc> (last accessed 31 January 2008).

30 These proceedings did not end in the bankruptcy court – instead, the Xacur brothers appealed Judge Brown's rulings to the US District Court and, from there, to the US Fifth Circuit Court of Appeals. Their petition for a *writ of certiorari* from the US Supreme Court was denied.

31 An English-language copy of the Mexico City District Court's recognition order is available online at <www.iiiglobal.org/country/mexico/Xacur_Banamex_Ruling_English.pdf> (last accessed 31 January 2008).

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Mr. Kitihara's response to the Iidas' law suit illustrates well the tactical flexibility afforded foreign representatives under US cross-border provisions. After obtaining a second order from the Japanese bankruptcy court approving his prior actions, Mr. Kithara then (i) sought recognition under Chapter 15 of the Japanese proceeding;[32] (ii) commenced an ancillary proceeding before the US Bankruptcy Court in Hawaii;[33] (iii) removed the Iidas' Hawaii law suit to the Bankruptcy Court;[34] and (iv) further sought dismissal of the law suit with prejudice.[35] The bankruptcy court granted Mr. Kitihara's request. The Ninth Circuit Bankruptcy Appellate Panel affirmed, noting that nothing in the US Code or in Hawaii law required Mr. Kitihara to obtain further court approval before assuming control of the Iidas' corporations and liquidating assets.[36]

Iida is significant because it highlights, and reemphasises, Chapter 15's streamlined efficiency in cross-border proceedings: foreign representatives may, upon recognition: (i) remove pending litigation from the US forum of origin; (ii) seek assistance from US courts where necessary; and (iii) administer US-based assets. In fact, the *Iida* decision goes further in concluding and reemphasising that formal recognition was not necessary for Mr. Kitihara to administer the debtor's assets where that administration was not disputed and judicial assistance was not required. It is noteworthy that, in this case, the assets in question had *already* been administered *before* judicial assistance from US courts became necessary. Mr. Kitihara's pursuit of assistance under Chapter 15 was for the purpose of addressing the debtor's *ex post facto* contest to this administration.

Conclusion

Together, *Xacur* and *Iida* highlight trustees' and court representatives' improved and growing ability to divest the principals of closely-held corporations in NAFTA jurisdictions of corporate control, where (as in *Xacur*) the debtor holds a voting majority of stock or where (as in *Iida*) the corporation's bylaws or state corporations law would permit the principal to replace and reorganise the directorship and management of a closely-held corporation.

With improved cross-border bankruptcy provisions and the ability to select from courts in multiple jurisdictions from which to initiate bankruptcies against corporate principals, trustees (and creditors) may now have improved tactical options in their efforts to seize and administer significant assets of troubled, closely-held companies.

Notes

32 *See* 11 USC §§1515, 1517. The Iida's opposition to Mr. Kitihara's request for recognition was overruled. *Iida*, 337 B.R. at 250-251.
33 11 U.S.C. 1504. *Iida*, 337 B.R. at 251.
34 *Iida*, 337 B.R. at 251.
35 *Ibid.* at 252.
36 *Ibid.* at 263 ('The bankruptcy court correctly determined that nothing in the Bankruptcy Code or in Hawaii state law required the Foreign Representative to obtain any further order from a court within the United States recognizing his authority as trustee before he could proceed to exercise and act upon any rights, titles or interests of the Japanese bankruptcy estate, including his right as a shareholder of the Hawaii Corporations').

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