

International Corporate Rescue



Published by:

Chase Cambria Company (Publishing) Ltd
4 Winifred Close
Barnet, Arkley
Hertfordshire EN5 3LR
United Kingdom

Annual Subscriptions:

Subscription prices 2009 (6 issues)

Print or electronic access:

EUR 695.00 / USD 845.00 / GBP 495.00

VAT will be charged on online subscriptions.

For 'electronic and print' prices or prices for single issues, please contact our sales department at:
+ 44 (0) 207 014 3061 / +44 (0) 7977 003627 or sales@chasecambria.com

International Corporate Rescue is published bimonthly.

ISSN: 1572-4638

© 2009 Chase Cambria Company (Publishing) Ltd

All rights reserved. No part of this publication may be reproduced, stored in a retrieval system, or transmitted in any form or by any means, mechanical, photocopying, recording or otherwise, without prior permission of the publishers.

Permission to photocopy must be obtained from the copyright owner. Please apply to:

E-mail: permissions@chasecambria.com

Website: www.chasecambria.com

The information and opinions provided on the contents of the journal was prepared by the author/s and not necessarily represent those of the members of the Editorial Board or of Chase Cambria Company (Publishing) Ltd. Any error or omission is exclusively attributable to the author/s. The content provided is for general purposes only and should neither be considered legal, financial and/or economic advice or opinion nor an offer to sell, or a solicitation of an offer to buy the securities or instruments mentioned or described herein. Neither the Editorial Board nor Chase Cambria Company (Publishing) Ltd are responsible for investment decisions made on the basis of any such published information. The Editorial Board and Chase Cambria Company (Publishing) Ltd specifically disclaims any liability as to information contained in the journal.

Hold 'Em? Or Fold 'Em? Labour Claims, Secured Claims, Tax Liabilities and Their Potential Impact on the Outcome of Mexican *Concurso* Proceedings

Ernesto A. Linares, Principal, DKL Consultores, SC, Mexico City, Mexico, **Lic. Eduardo Martinez Rodriguez**, Partner, Jáuregui, Navarrete y Nader, SC, Mexico City, Mexico and **Michael D. Good**, Managing Principal, South Bay Law Firm, Torrance, California, USA¹

I. Introduction

Commercial insolvency is – if nothing else – a protracted series of battles and bargains amongst the debtor, its creditors, and other stakeholders (i.e., principals, employees, regulatory agencies, investors, etc.). The objective of this extended contest is to extract the most potential value (or minimise the prospective loss) from the insolvency process – sometimes in collaboration with other participants, but just as often at others' expense. The 'rules' of the contest are derived from the substantive law of those jurisdictions in which the debtor does business, and from the unwritten laws of the market.

In Mexico, as in many other Latin American countries, the substantive legal 'rules' affecting insolvency proceedings have undergone extensive change in recent years. In 2000, the Mexican legislature enacted a completely re-written *Ley de Concursos Mercantiles* (Law of Commercial Reorganisation) ('LCM'), designed to eliminate many of the perceived problems with prior Mexican insolvency law. Likewise, the *Código de Comercio* (Commercial Code) and the *Ley General de Títulos y Operaciones de Crédito* (Credit Transactions Law) underwent considerable amendment in 2000 and 2003, with the objective of enhancing creditors' rights and, from a lender's perspective, increasing the attractiveness of secured lending. Yet despite these changes, old ideas and customs – and old legislation – remain, and must be incorporated into the rapidly changing legal fabric of Mexican commerce.

Against this backdrop, how do debtors and their creditors resolve the potential disputes that commonly attend commercial insolvency in Mexico? To fully address this question would require a discussion well beyond the scope of the present article; however, the

following very brief overview outlines some of the issues that arise when the Mexican debtor bargains with three of its most prominent Mexican creditor constituencies: labour, secured lenders, and taxing authorities.

2. Background: Mexican creditors' rights under non-insolvency law

2.1. Labour claims

The Mexican Constitution and the Mexican Federal Labour Law² are the result of the Mexican post-revolution (PRI) governments. They reflect a paternalistic attitude toward, and protection for, workers and labour unions. Indeed, the country's labour laws are perceived by some Mexican practitioners to be so strong as to create a potential barrier to increased foreign investment in Mexico.

These protections appear to have survived recent insolvency reform. Articles 65, 66, 67 and 68 of the LCM, for example, all recognise certain protections and priority for labour-related claims. The second paragraph of Article 65 recognises two general types of labour claims: (i) those derived from Article 123, section A XXIII of the Mexican Constitution; and (ii) other labour debts. The rights of labour claims under the LCM are – as they are outside of insolvency proceedings – heavily protected.

In addition to labour claims, the remedies available to organised labour must be reckoned with. Unions have the right to enforce a strike or 'work stoppage' until differences between the parties are resolved. As will be discussed below, such rights can be used with great effect in connection with Mexican insolvency proceedings.

Notes

- 1 The views and opinions expressed here (and any errors or omissions) are the authors' own. For questions or comments regarding this article, contact mgood@southbaylawfirm.com, or elinares@dkl.com.mx, or edmartinez@jnn.com.mx.
- 2 *Ley Federal del Trabajo*.

2.2. Secured claims

Unlike the labour laws, the law of secured credit has evolved considerably in recent years. Relatively recent amendments to the *Ley General de Títulos y Operaciones de Crédito* ('LTOC') provide that a *Prenda sin Tránsito de Posesión* (Pledge Without Transfer) – i.e., a pledge of personal property to secure a debt without transfer of possession of the collateral to the creditor – creates a chattel mortgage and gives the creditor a right of first preference against the collateral so long as the corresponding debt remains unpaid. This represents a change from the prior law, which required the creditor's physical possession, or the possession by a third party, of the collateral as a prerequisite to a valid pledge.³ These amendments also have expanded the categories of collateral to which such non-possessory pledges apply.⁴

Other amendments to the Credit Transactions Law create a *Fideicomiso en Garantía* (Guaranty Trust) – i.e., an express statutory authority for the use of trust agreements to create security interests in real property and personal property. Specifically, the law designates an array of institutions and entities that are authorised to act as trustees for trusts created for the purpose of guaranteeing the payment of debt to the creditor named as beneficiary of a trust.⁵ The rights of creditor-beneficiaries and the duties of debtor-trustors also have been clarified: For example, the law now provides that the trustor is fully liable for risk of loss and deterioration of the collateral that is subject to the security interest. If the value of the collateral decreases to less than the amount of the debt, the beneficiary can demand that the trustor provide additional collateral. If the trustor fails to comply with this demand, the debt becomes due immediately, and the beneficiary can instruct the trustee to commence nonjudicial foreclosure proceedings against the collateral.

Consistent with these reforms, certain provisions of the new LCM generally strengthen an apparent trend toward improved protections for secured creditors.

2.3. Tax claims

As in the US, Mexican tax legislation is updated annually in order to address current economic circumstances and to eliminate potential abuses. In this regard, legislators

frequently consult the Mexican business, legal, and tax professional communities. In recent years such consultations also have included input from IFECOM specialists, and – in order to integrate the country's tax and insolvency schemes – have incorporated such specialists' comments and experiences regarding tax claims in *concurso* proceedings.

Upon enactment of the LCM, the Mexican Federal Tax Code was modified to reflect the new law. As described below, present tax legislation provides possible benefits for debtors in the case of an approved *concurso* agreement and further provides for certain tax deferrals during the conciliatory stage.

3. Labour claims in insolvency proceedings

As noted, the LCM recognises two general species of labour claims: (i) those who have preference above all credits in the *concurso* (i.e., 'preferred labour' claims);⁶ and, (ii) other labour claims whose preference rating is similar to tax claims.⁷

'Preferred labour' claimants have significant leverage, unique to any class of creditors: at any time during the *concurso*, such claimants may seize assets from the debtor and eventually sell them to the best bidder. By contrast, other labour claims have no such rights; instead, their claims – like general unsecured claims – are converted into UDIs,⁸ which do not accrue interest and are unaffected by foreign exchange rate fluctuations.

In bankruptcy liquidation proceedings, 'preferred labour' claims have priority over any other category of creditors' claims – and, therefore, remain in a dominant position at virtually every point in a Mexican insolvency proceeding. Other labour claims are less protected.

4. Secured creditors' claims in insolvency proceedings

4.1. Debtors' protection

During the conciliatory stage of a *concurso* proceeding, secured creditors are prevented from proceeding against their collateral by virtue of a stay imposed with respect to the debtor's assets.⁹ Once the conciliatory stage is terminated and the debtor placed in bankruptcy,

Notes

3 LTOC at Art. 346.

4 LTOC at Art. 353.

5 LTOC at Art. 395. Such entities include insurance and bonding companies, stock brokerages, limited object financial organisations, and general warehouses for deposit.

6 Based on Art. 123 section A XXIII of the Mexican Constitution, and in LCM Art. 224 I.

7 LCM Art. 221. Such claims include wage claims over two years old. Other claims involve union contract termination claims.

8 *Unidades de Inversión*. UDIs were created 1995 in order to have a measure that reflects inflation. LCM Art. 89.

9 LCM Art. 65. However, this stay does *not* apply to labour claimants.

secured creditors can sell assets to the highest bidders, with prior notification to the appointed *sindico* (who has the right to oppose such a sale).¹⁰

4.2. Financing the debtor

Where the debtor has liquidity problems and requires financing, Article 75 allows an appointed *conciliador* to arrange for new credit. This credits effectively “primes” secured debt, but remains subordinate to labour claims.¹¹

4.3. Concurso treatment

In the US, secured creditors remain subject to, and may be treated under, the provisions of a confirmed plan. In essence, a plan may be confirmed over the objection of a secured creditor provided that such creditor is afforded either the present value, or ‘indubitable equivalent,’ of its secured claim under the plan. By contrast, secured creditors in Mexico may not be affected by a *concurso* plan under the LCM unless they consent.¹² Thus, the debtor’s ability to deal with secured creditors – and the proportion of secured debt on the distressed firm’s balance sheet – will be an important consideration in gauging the ultimate relief available to a firm weighing reorganisation under the US Code or the LCM.

4.4. Priority in liquidation

Wages for the last two working years, prior to the date of the declaration of insolvency, and employees’ claims for labour indemnifications, have priority over any other category of creditors’ claims. Thereafter, expenses incurred in the administration of the debtor’s assets should be paid first. Then, secured creditors must be paid with the proceeds from the sale of mortgaged or pledged assets. If the value of such assets is insufficient to cover the debt, secured creditors will be considered

as unsecured for the balance due. Common unsecured creditors of commercial transactions collect *pro rata* from the outstanding balance.

5. Tax claims in insolvency proceedings

5.1. Debtors’ protection

Unlike ‘preferred labour’ claimants, holders of tax claims do not have the right to seize the debtor’s assets or sell them during the conciliatory stage.¹³ However, tax claims continue to accrue, with interest as prescribed under the Federal Tax Code – usually at rates exceeding market interest.¹⁴

5.2. Concurso treatment

As with insolvency proceedings in the US, Mexican *concurso* proceedings offer certain tax advantages to debtors properly situated.

One of the primary attractions of the *concurso* is the Federal Tax Code’s Article 146-B, which affords two alternative types of tax claim reductions with the implementation of the approved *concurso* agreement. The first applies when tax claims are less than 60% of all recognised claims in the *concurso* proceeding. In this particular situation, tax claims are commonly¹⁵ treated identically to the claims of general unsecured creditors: Tax claims share a *pro rata* distribution identical to that of other, general unsecured creditors, based on the face value of their claims.¹⁶

The second, alternative treatment applies when tax claims exceed 60% of all recognised claims. Here, only the accrued inflation-indexed increases, interest and penalties assessed by the Mexican SAT are subject to *pro rata* distribution with general unsecured claims. The face value of such tax claims must be paid in full.¹⁷ Likewise, if the tax claims result from employees’ or other third parties’ tax withholdings, no reductions apply. Moreover, the debtor may be subject to criminal

Notes

10 LCM Arts 213 and 214.

11 LCM Art. 224 II.

12 Why would secured creditors consent? In a liquidation scenario, secured creditors are paid with the proceeds of the collateral. In the event the collateral’s value exceeds the secured creditor’s claim, the excess value must be remitted to the *sindico* for distribution to general unsecured creditors. Where the collateral’s value is less than the secured creditor’s claim, the secured creditor holds an unsecured claim for the balance due. The prospect of sharing in the *pro rata* distribution to general unsecured creditors is viewed as one of the primary motivations for a secured creditor’s agreement to a *concurso* plan.

13 See *Código Fiscal de la Federación* (Federal Tax Code) at Arts 144, 146-B.

14 LCM Art. 69. The *Código Fiscal de la Federación* (CFF) provides at Art. 21 that each tax claim is adjusted for inflation and accrues interest as determined by Mexico’s *Servicio de Administración Tributaria* (SAT) (an agency analogous to the US Internal Revenue Service). Penalties also accrue where the SAT already has notified the debtor of the existence of a tax claim. CFF at Art. 81.

15 Such treatment is dependent upon the approval of Mexican taxing authorities. Practical experience suggests that such treatment is often approved.

16 To qualify for this treatment of tax claims, the *pro rata* treatment must exclude all ‘related party’ claims. CFF at Art. 146-B.

17 CFF Art. 146-B.

prosecution with respect to tax claims arising from employees' or third parties' withholdings.

In addition to potential reductions in tax liabilities, interim tax relief is available as well. *Concurso* debtors can obtain a deferral of the IETU (business flat tax) for up to three years. This deferral applies from the date of the initial *concurso* ruling until the date of the *concurso* agreement is in effect, or bankruptcy is declared.¹⁸

5.3. Priority in liquidation

Upon the declaration of bankruptcy liquidation, the Mexican SAT or any other tax authority can proceed to sell the debtor's assets in which the taxing authority holds or obtains a lien, subject to the *sindico's* (trustee's) prevention if the *sindico* believes he can obtain greater value for such assets through the LCM's liquidation procedures.¹⁹ Typically, Mexican taxing authorities do not wish to sell such assets. Consequently, such assets are typically liquidated by the *sindico* under the provisions of the LCM.²⁰

6. Anticipating insolvency: practical planning considerations

6.1. Labour claims

As their priority suggests, 'preferred labour' claims require the debtor's and the *conciliador's* close attention. In particular, the ability of such claimants to seize and sell the debtor's assets positions them to extract concessions that would be unavailable to similar claims in the US. Indeed, there have been cases in which such 'preferred labour' claims consumed substantially all of the proceeds from the sale of the debtor's assets.

Until recently, the position of 'preferred labour' claims has been further strengthened by the economic realities of Mexican insolvency law: the liquidity requirements imposed by the LCM as a prerequisite for commencing a *concurso* proceeding virtually guarantee the existence of such claims, and in potentially large amounts. Further, the right of Mexican unions to strike is well-recognised. This right is not affected by proceedings commenced under the LCM, and it has been the experience of some *conciliadores* that threatened or actual labour strikes can adversely affect reorganisation efforts during a *concurso*.

Conversely, the Mexican Federal Labour Law recognises a *concurso* proceeding as a legitimate means of terminating a union contract;²¹ moreover, such contractual claims receive liquidation treatment inferior to 'preferred labour' claims. In bargaining over proposed union concessions, therefore, both the debtor and the union must weigh relative costs and benefits: Will a threatened immediate 'work stoppage' be effective if a contractual dispute cannot be resolved? Or will a threatened immediate liquidation leave unionised labour in worse position than if it had acquiesced to the debtor's proposals?

At least two factors may alter this dynamic. First, the rapid integration, in NAFTA jurisdictions, of technology into business processes and the resulting increases in individual labour productivity permit Mexican businesses to do what their US counterparts have been doing: replace labour with technology, modestly increase individual wages, and dramatically reduce overall labour 'headcount' – thereby reducing aggregate labour costs and the threat of 'preferred labour' claims arising from unpaid wages.

Second, very recent amendments to the LCM permit the debtor and its creditors (including labour claimants) to commence a '*Concurso Mercantil con Plan de Reestructura Previo*' ('Reorganisation with Prior Plan of Restructuring')²² – effectively, a 'pre-packaged' reorganisation. The parties' ability to bargain in advance of a liquidity crisis permits labour to save jobs and wages, and the debtor to minimise 'preferred labour' claims at the point of entry into *concurso* proceedings. In the meantime, debtors and appointed *especialistas* (either *conciliadores* or *síndicos*) should prioritise the negotiation of liquidation terms for union contracts in advance of a unilateral 'work stoppage.'

6.2. Secured claims

The differing treatment of secured creditors in the US and Mexico presents an interesting dynamic for cross-border insolvency planning. Unlike their prospective treatment in the US, secured creditors cannot be 'crammed down' in Mexico, and have the ability to 'opt out' of *concurso* proceedings should they so choose. In this sense, secured creditors would appear to have a far *better* bargaining position in Mexico than in the US. However, this bargaining position is tempered by the existence of 'preferred labour' claims – which, as

Notes

18 IETU Law at Article Supplementary 21.

19 LCM Arts 213 and 214.

20 LCM Arts 229, 230 and 232.

21 *Ley Federal del Trabajo* Art. 434 V.

22 LCM Art. 339.

noted, may have competing rights against the same assets as those collateralising the creditors' debt. For this reason, financial institutions with secured claims do not usually demand involuntary *concurso*s; instead, the preferred method of recourse for such claimants is to proceed directly against the collateral.

Likewise, in bankruptcy liquidation (which, under Mexican law, automatically occurs in the event a *concurso* plan cannot be reached), the debtor's estate will be distributed differently in Mexico than in the US – i.e., secured creditors in Mexico are subordinate to 'preferred labour' claims, whereas in the US they are not. Consequently, secured creditors will fare *worse* in Mexican bankruptcy liquidation than they would in the US.

This relative treatment of secured and 'preferred labour' debt, combined with a secured creditor's ability to share in residual distributions from the debtor's bankruptcy estate to the extent that such creditor's collateral is insufficient to satisfy the claim, in fact provides incentive for secured creditors to reach agreement with the debtor and the *conciliador* over the terms of a *concurso* plan once a *concurso* proceeding is commenced. Alternatively, secured creditors may negotiate with labour interests in order to secure their positions and mitigate the potential detriment of impending 'preferred labour' claims.

6.3. Tax claims

As suggested by the discussion above, *concurso* proceedings offer the prospect of tax relief for certain debtors. Such debtors may be able to obtain an effective reduction of tax liabilities – or at least, a reduction of accruing increases, interest, and penalties – through an approved *concurso* plan, as well as interim relief during the pendency of the *concurso* proceeding.

7. Conclusion

The foregoing considerations are by no means the entire 'sum and substance' of Mexican insolvency planning. It is perhaps stating the obvious to note that each insolvency provides its own unique mix of potential opportunities for the vigilant and pitfalls for the unwary. Nevertheless, it is the authors' hope that readers will glean some of the more common, critical considerations and 'deal points' that must be resolved in order to successfully navigate the rapidly changing currents of Mexican insolvency practice.

International Corporate Rescue

International Corporate Rescue addresses the most relevant issues in the topical area of insolvency and corporate rescue law and practice. The journal encompasses within its scope banking and financial services, company and insolvency law from an international perspective. It is broad enough to cover industry perspectives, yet specialized enough to provide in-depth analysis to practitioners facing these issues on a day-to-day basis. The coverage and analysis published in the journal is truly international and reaches the key jurisdictions where there is corporate rescue activity within core regions of North and South America, UK, Europe Austral Asia and Asia.

Alongside its regular features – Editorial, The US Corner, Economists' Outlook and Case Review section – each issue of *International Corporate Rescue* brings superbly authoritative articles on the most pertinent international business issues written by the leading experts in the field.

International Corporate Rescue has been relied on by practitioners and lawyers throughout the world and is designed to help:

- Better understanding of the practical implications of insolvency and business failure – and the risk of operating in certain markets.
- Keeping the reader up to date with relevant developments in international business and trade, legislation, regulation and litigation.
- Identify and assess potential problems and avoid costly mistakes.

Editor-in-Chief: Mark Fennessy, Orrick, Herrington & Sutcliffe, London

John Armour, Oxford University, Oxford; Stephen Ball, London; Samantha Bewick, KPMG, London; Geoff Carton-Kelly, Baker Tilly, London; Sandie Corbett, Walkers, British Virgin Islands; Stephen Cork, Smith & Williamson, London; Ronald DeKoven, 3-4 South Square, London; Simon Davies, The Blackstone Group, London; David Dhanoo, Qatar Financial Centre Regulatory Authority, Qatar; Hon. Robert D. Drain, United States Bankruptcy Court, Southern District of New York; Nigel Feetham, Hassans, Gibraltar; Stephen Harris, Ernst & Young, London; Matthew Kersey, Henry Davis York, Sydney; Ben Larkin, Berwin Leighton Paisner, London; Guy Locke, Walkers, Cayman Islands; Professor John Lowry, UCL, London; Lee Manning, Deloitte, London; David Marks, 3-4 South Square, London; Riz Mokal, 3-4 South Square, London; Lyndon Norley, Kirkland & Ellis, London; Rodrigo Olivares-Caminal, University of Warwick, Coventry; Wayne Porritt, Bank of America, Tokyo; Susan Prevezer Q.C., Quinn Emanuel Urquhart Oliver & Hedges LLP, London; Sandy Purcell, Houlihan Lokey Howard & Zukin, London; Dr. Arad Reisberg, UCL, London; Peter Saville, Kroll, London; Daniel Schwarzmann, PricewaterhouseCoopers, London; Sandy Shandro, UCL, London; Richard Snowden Q.C., Erskine Chambers, London; Dr. Shinjiro Takagi, The Industrial Revitalisation Corporation, Japan; Lloyd Tamlyn, 3-4 South Square, London; Stephen Taylor, Alix Partners, London; William Trower Q.C., 3-4 South Square, London; Mahesh Uttamchandani, The World Bank, Washington, DC; Robert van Galen, NautaDutilh, Amsterdam; Miguel Virgós, Uría & Menéndez, Madrid; Professor Sarah Worthington, London School of Economics, London.

For more information about *International Corporate Rescue*, please visit www.chasecambria.com