

## **THE MUNICIPAL INSOLVENCY PROCEDURE IN MEXICO AS A NECESSITY**

In recent years, several municipalities in Mexico have experienced a recurring problem of lack of liquidity and insolvency to meet their obligations, with this problem having various origins, ranging from political, social and economic causes. However, there is an upward trend in the majority of these, which is repeated from municipality to municipality, and that is the increase in the cost of servicing the long-term debt due to the lack of payment of the same in view of the scarcity of funds on the part of the municipality. The lack of resources in question is exacerbated by the way in which the collection of the long-term debt is carried out, which given the lack of payment by the municipalities and previously accrued interest on arrears, they are executed through a trust mechanism to which a portion (and in some cases the entirety) of resources coming from the federal government, called federal contributions, which make up a majority of the income of municipalities in Mexico, which are automatically allocated so that the trustee makes the payment directly to the financial institutions without having to go through the municipality itself. As the municipalities cannot use on said funds, they have to cover their current expenses (provision of public services, payroll, suppliers, etc.) using existing funds, either residuals of prior federal contributions or other sources, which in many occasions are not even sufficient to cover said expenses. This situation adds to the increase of long term debt, a labyrinthine situation that drowns the financial stability of the municipalities, contributes to stagnation, and subjects creditors to decades of debt which affects all creditors as well as the main purpose of the municipality, which is to provide public services to its inhabitants. The purpose of this article is to analyze the situation mentioned above, as well as to propose a solution to a problem of public interest through the creation of an insolvency procedure aimed at stabilizing the financial situation of the Mexican municipalities. This is feasible by virtue of the institutions contained in this mechanism, which is not provided for in the Mexican legislation in force, but which has been contemplated and used in other parts of the world with varying results.

## **I. THE STATUS OF THE MEXICAN MUNICIPALITY**

### **1. The legal framework of the municipality in Mexico.**

Mexico has three levels of government, municipal, state and federal, each with its own set of exclusive powers and others shared with the various levels of government. The municipal unit, is the basis of the territorial organization in Mexico, as well as of its political and administrative organization. The main purposes of the municipality are the provision of public services and the urban management of the territory under its responsibility within the scope of its authority.

The legal framework that the municipality is subject to provides it with legal personhood, capacity and property as any other person under ordinary law, however, it also endows it with authority, giving it the opportunity to exercise acts of authority with respect to the governed (person under public law). The municipality exercises such authority through a collegiate body called the Municipal Council, which is made up of a municipal president and a certain number of administrators and aldermen fixed by the local legislature. The Municipal Council voices the will of the municipality and exercises the legal acts that fall under its authority through decisions reached by its members by majority vote in the sessions designated for such purposes.

#### **A. Legal framework of the municipality's estate.**

A municipality can enter into legal acts like any other person of private law, so in principle, the municipality's estate is composed of rights and obligations that any individual can incorporate into its estate, however, given its nature as an authority, it has the legitimacy to incorporate certain rights and obligations that are exclusive to persons invested with this nature. Therefore, the contents of the estate of the municipality are composed of (a) assets; (b) rights and obligations created on

the basis of its scope of authority; and (c) rights and obligations created on a coordination level.

a. Municipal property.

Taking into account the nature and purposes of the municipality, it is necessary that it has a differentiated regime from that of private law persons with respect to its property, with the purpose of protecting certain property that is intended for the provision of public services or that represents an important role for the population living in the municipality. Therefore, Mexican law provides for two different regimes for municipal property:<sup>1</sup>

i. Public property: property whose regime is provided for real property where public services are provided by the municipality; areas that are intended for the enjoyment of the general public; as well as property which is important to the municipality and its population such as monuments and cultural sites. Their essential nature is that they cannot be sold by the Municipal Council (inalienable); they cannot be acquired through the passage of time by a different person (imprescriptible); and they cannot be attached by a different authority in order to be applied to the payment of overdue obligations (unattachable).

ii. Private property: Property owned by the municipality that does not fulfill any of the functions of public property or which have been successfully disincorporated from the public property regime. Its essential features are as follows: they can be disposed of by the Municipal Council without limitations

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<sup>1</sup> The rules governing the internal regime of the municipality are issued by the State to which the municipality belongs, so their regulation may vary from State to State, however, they all maintain more or less uniform provisions, which will be described further on.

(alienable); they cannot be acquired through the passage of time by a different person (imprescriptible) and cannot be attached.<sup>2</sup>

b. Obligations and rights created as a result of its authority.

i. Obligations and rights created by virtue of the administrative acts that the municipality can carry out within its scope of authority: The administrative activity of the municipality is carried out with the aim of fulfilling the general interest through various means, such as the police; through interventions aimed at regulating and promoting the activity of individuals; through the public services it provides to meet collective needs and through the direct regulation of economic and cultural life and welfare. These functions are carried out by carrying out various legal acts of authority that create obligations and rights that are part of the property of the municipality. Among these acts that create obligations and rights which can be quantified in monetary terms are those that can be as varied as the situation merits, we can find in general all those contracts of administrative nature; concessions; orders; expropriation; penalties; among others.

ii. Income of a fiscal or tax nature: the municipality has the capacity to collect revenue from its subjects through its authoritative relationship with them. Among these is the opportunity to obtain income through an activity that is levied by the municipality in the form of a tax<sup>3</sup>; the collection of payment for

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<sup>2</sup> Some States allow said assets to be subject to attachment for the payment of certain obligations, for example the State of Baja California allows such property to be attachable for the payment of labor obligations; but the State of Mexico allows only private property to be attachable for the payment of obligations of any nature.

<sup>3</sup> The capacity of the municipality to impose taxes is quite limited, since most of the activities are taxed by the Federal and State governments based on collaboration agreements where they are given the exclusive right to collect such tax in order to

the provision of a public service (fees); the collection of payment from those who benefit from a particular improvement made by the municipality (special contributions); the collection of payment for the exploitation of municipal property (revenue); the collection of fines and administrative sanctions (income).

Within this category are also the so-called "federal contributions". Federal contributions are funds assigned by the federal government to the several States and through them to the municipalities and administrative subdivisions of Mexico City, due to their adherence to the National System of Fiscal Coordination; through them they are compensated for the resources that they no longer receive and that are reserved for the Federation, as they suspend the collection of taxes that they previously collected. The federal contributions are the main source of income received by the municipalities, since in many cases they represent more than fifty percent of the total income they receive per year. In addition, it is the only regular source of freely available income for municipalities, so the amount of such contributions is a fairly reliable indicator of the resources available to the municipality to meet its obligations.

iii. Obligations created by virtue of their employment status:

ia. Obligations arising directly from the employment relationship that exists between public servants and the municipality.

ib. The obligations of the municipality with respect to the social security payments of its employees.

c. Obligations and rights created in a coordination context.

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avoid double taxation. The most typical example of a municipality is one that exclusively receives taxes levied on transfers of real estate.

These obligations and right refer to those where the municipality does not use its authority to generate such rights, but rather when it binds itself and acquires rights like any other individual. Therefore, the obligations created pursuant to this basis are governed by the applicable legislation of ordinary law, such as the Civil Codes of each state and of the Federation. Therefore, these types of obligations are created when the authority of the municipality does not participate to generate the legal consequences described above.

## **B. The Public Treasury.**

The municipal public treasury is a way to group together the liquid income of the municipality that forms part of its assets for the existence and functioning of the municipality. Inside the municipal treasury, we can find income that is the product of obligations of varying nature, so that the municipal treasury, a financial concept that aims to implement, year after year, the municipality's income collected through a an income law<sup>4</sup> through the budget of expenditures issued by the municipality itself, which contains all the spending that will be incurred in the various items throughout the year, not being able to allocate any money to any item that is not included in the budget.

The municipal treasury is composed of: (a) ordinary or freely disposable income; (b) extraordinary income; and (c) public debt.

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<sup>4</sup> A draft law on municipal income is proposed every year by the relevant municipality to the corresponding State Congress, so that the proposal can be passed as a law through a legislative process, since municipalities do not have a formal legislative body. This is due to the fact that in Mexico tax rates are only coercive if they are contained in a law.

a. Ordinary income or freely disposable income: Funds that are not intended for a specific purpose and can be freely applied to any item by the municipality, comprising taxes, fees, special contributions, proceeds, profits, as well as federal contributions.

b. Extraordinary Income: All income that is not anticipated in detail in the income budget given its randomness and contingencies. Within this heading, subsidies and credits are mainly included, as well as any other income received by the municipality that does not fall under any of the ordinary items.

c. Public Debt: Defined as any financing arranged by the municipality. It is generally divided into: (i) short-term public debt and (ii) long-term public debt.

i. Short-term Public Debt: Debt which is taken out for a term equal to or less than one year, which must be paid in full no later than three months before the end of the corresponding administration's term, and no new short-term obligations may be taken out during these last three months. Likewise, they are characterized by not being guaranteed and being registered in the Sole Public Registry of Obligations and Financing of the Ministry of Finance and Public Credit.

ii. Long-term Public Debt: Refers to public debt contracted for a term of more than one year and intended for productive public investment, as well as for refinancing and restructuring. Such loans can and generally are guaranteed by federal contributions and must be registered in the same way in the Sole Public Registry of Obligations and Financing of the Ministry of Finance and Public Credit.

The Law of Financial Discipline of the Federal Entities and Municipalities, which is the legal body which regulates the federal contributions that will serve as a guarantee to the municipalities, allows committing up to 100% (one

hundred percent) of the federal contributions of the municipality. This makes clear that municipalities must prioritize payment of such financing even over those amounts necessary to pay for the constitutional services they must provide, taking into account that federal participations in several cases are the main income of municipalities in Mexico.

## **2. The financial situation of the municipalities in Mexico.**

Taking into account the legal regime described above and to which the municipalities in Mexico are subject from a financial perspective, it is necessary to study the financial situation of several municipalities, as well as the main cause of their problems, in order to propose a solution in accordance with their needs.<sup>5</sup>

In 2018, the municipality of Ensenada, Baja California, was considered by the Ministry of Finance and Public Credit as the only municipality with a high level of debt among the 655 municipalities analyzed by said Ministry. Likewise, 63 were classified with a debt level that was under observation. In order to carry out the study, two municipalities will be analyzed for each of the regions that make up the geography of Mexico: north; center; lowlands<sup>6</sup>; and the south.

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<sup>5</sup> The information presented below was obtained from the records kept by the Ministry of Finance and Public Credit, which make up the alert system that measures the level of indebtedness of public entities, specifically municipalities, as well as the debt registry of this same agency. The financial information is obtained directly from the municipalities themselves.

[https://www.disciplinafinanciera.hacienda.gob.mx/es/DISCIPLINA\\_FINANCIERA//Municipios\\_2018](https://www.disciplinafinanciera.hacienda.gob.mx/es/DISCIPLINA_FINANCIERA//Municipios_2018)

<sup>6</sup> This region includes the States of Michoacán and Colima.



## A. Northern Mexico

### a. Ensenada

The public debt and obligations payable by the municipality of Ensenada, Baja California<sup>7</sup>, according to the Ministry of Finance and Public Credit for 2017, 2018 and 2019 until September, and taking into account the Public Debt and Obligations payable by the municipality in relation to the total freely disposable income received by the municipality in each of those years; the public debt service in proportion to the aforementioned income; and the total income of the municipality and the liabilities payable by the municipality contracted at terms of less than one year (short-term debt), represented:

	<b>Public debt and obligations payable through freely disposable income</b>	<b>Debt service and liabilities payable through freely disposable income</b>	<b>Short-term liabilities, providers and third-party vendors through freely disposable income</b>
<b>2017</b>	66% (under observation)	7% (under observation)	29% (high)
<b>2018</b>	62% (under observation)	10% (high)	30% (high)
<b>2019 (Until September)</b>	49.5% (sustainable)	11% (high)	0.9% (sustainable)

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<sup>7</sup> This category includes the balance of loans payable; securities issuances; debt in which the public entity provides guarantees through its own source of payment; obligations derived from Public-Private Partnerships (accounting only for the investment part); and any other obligation that involves scheduled financial payments.

According to this table, we can see that the real financial problem of the municipality is the cost of long-term financing at its expense. According to the Ministry of Finance and Public Credit, the municipality of Ensenada, Baja California only has a long-term financing. A loan hired with Banco Bansi, S.A. de C.V., I.B.M. on February 4, 2015 in the amount of \$665,156,105.00 pesos payable over twenty years and with the purpose of refinancing the public debt of said municipality, as well as for productive public investment and guaranteed with 60% (sixty percent) of the federal contributions to which the municipality is entitled.

During the first quarter of 2017, Banco Bansi, S.A. de C.V. I.B.M. was owed \$663,309,176.00 pesos with respect to the principal amount of the aforementioned loan, while at the end of that year, \$646,315,381.00 pesos was owed, so from the second quarter to the fourth quarter of 2017, \$16,993,795.00 pesos was paid into the principal. During this same period, the following amounts were paid for services arising from the credit with Bansi: interest in the amount of \$46,498,343 pesos; commissions in the amount of \$4,043,905.00 pesos and expenses arising from the credit in the amount of \$3,601,115 pesos. In comparison, at the end of 2018, the amount of \$622,582,671 pesos was owed, so during that year, the amount of \$23,732,710 pesos was paid into the principal. Regarding expenses related to the loan, interest was paid in the amount of \$58,796,546 pesos; commissions in the amount of \$9,725,365 pesos; and for expenses in the amount of \$517,010 pesos.

The high cost of the credit in such years is clearly noticeable. In 2017, only \$16,993,795.00 pesos were applied to the principal while \$54,143,363 pesos were paid as debt service; in 2018, only \$23,732,710 pesos were applied to the principal, while \$69,038,921 pesos were paid as debt service. Taking these comparisons into account, the financial problem is obvious.

As of September 2019, as shown in the table above, according to the alert system of the Ministry of Finance and Public Credit, the public debt and obligations of the municipality of Ensenada, Baja California were 49%.5% (forty-nine point five

percent) of the total freely disposable income received by the municipality during the year up to that month. Nonetheless, the resulting amount was classified as sustainable debt; public debt service represented 11% (eleven percent) of the aforementioned income, which was classified as high level of indebtedness; and finally, the ratio between the municipality's total income and its obligations and short-term liabilities (payable in less than one year) was surprisingly found to be 0.9% (zero point nine percent). The drastic reduction of this last item is evident, where the municipality went from high levels of indebtedness in its short-term debt and ended up with an almost zero debt.

However, the radical change can be explained if we observe the financial transactions of the municipality during 2019. In the first two quarters of that year, the municipality of Ensenada made two large payments on account of the credit in question that were applied to the principal of the debt and that together added up to \$27,092,703 pesos; while with respect to debt service payments the following payments were made: interest payments, in the amount of \$32,831,312 pesos; fees in the amount of \$7,174,918 pesos; and expenses related to the loan in the amount of \$432,311 pesos. These were the only payments made during the year, and as of July 2019 no payments were applied toward the loan and the State Government decided not to disburse the federal contribution into to the trust designated for the payment of said credit in the amount of 60% (sixty percent) used to guarantee payment of the loan. Evidently, the payments made by the municipality in the first two quarters are even greater than the payments of the principal made both in 2017 and 2018, likewise, the payment made on account of debt service is significantly less than that made in the four quarters of said years. Therefore, it is evident that the amounts allocated to pay the debt service of the remaining public debt and that were not applied toward the principal were used to pay the short term debt of the municipality through an illegal default where even the state government participated by not paying the federal contributions directly to the payment trust, even though this activity is grave, it allowed lowering the level of indebtedness of the municipality with respect to its short term debt.

b. Hermosillo, Sonora

Hermosillo, Sonora has the same problem as the municipality of Ensenada, Baja California, where the cost of financial services on its loans are generally detrimental to its finances. Of the nine loans contracted by the, seven were guaranteed with federal contributions in the same terms previously discussed and negotiated with private banks. According to the Ministry of Finance and Public Credit, the following information shows the financial status of the municipality, where at first glance we can see that the cost of long-term public debt servicing increases year after year:

	<b>Public debt and obligations payable through freely disposable income</b>	<b>Debt service and liabilities payable through freely disposable income</b>	<b>Short-term liabilities, providers and third-party vendors through freely disposable income</b>
<b>2017</b>	93.8% (under observation)	8.3% (under observation)	17.05% (under observation)
<b>2018</b>	78.8% (under observation)	9.6% (under observation)	13% (under observation)
<b>2019 (up to September)</b>	80.1% (under observation)	10.4% (high)	12.4% (sustainable)

Notwithstanding the above, and despite the fact that the aforementioned relationship is not apparent, the unpaid balance with respect to its short-term debt also increases year after year. In theory these are the amounts must be paid in full at the end of each year; however, the municipality has outstanding balances since most of its funds are used to pay the interest on the long-term debt, which can be seen in the following table:

	<b>Amounts allocated to pay long-term public debt</b>	<b>Amounts allocated to pay the principal of the long-term debt</b>	<b>Amounts allocated to the payment of long-term debt service</b>	<b>Total Short-Term Public Debt</b>
<b>2017</b>	\$191,546,377 pesos	\$36,835,652 pesos	\$154,710,725 pesos	\$710,835,930.5 pesos
<b>2018</b>	\$264,788,213.5 pesos	\$50,614,714.51 pesos	\$214,173,499 pesos	\$730,430,632.2 pesos
<b>2019 (up to July)</b>	\$132,595,286.6 pesos	\$24,105,450.24 pesos	\$108,489,836.3 pesos	\$654,808,326.2 pesos

### **C. Central Mexico.**

#### **a. Capulhuac, State of Mexico**

With respect to the municipality of Capulhuac, State of Mexico, the Ministry of Finance and Public Credit reports the following results:

	<b>Public debt and obligations payable through freely disposable income</b>	<b>Debt service and liabilities payable through freely disposable income</b>	<b>Short-term liabilities, providers and third-party vendors through freely disposable income</b>
<b>2017</b>	16.1% (sustainable)	1.0% (sustainable)	36.8% (high)
<b>2018</b>	20.9% (sustainable)	2.8% (sustainable)	56.2% (high)
<b>2019 (up to September)</b>	21.6% (sustainable)	3.4% (sustainable)	42.6% (high)

The problem with this municipality is completely different from that of the municipalities of Hermosillo and Ensenada previously described, since the instability of its finances is not a product of the cost of long-term debt, but of short-term debt, a situation that is completely reversed. As is evident, the short-term debt, as well as its respective interest, remain very low in relation to the growth of the short-term debt. The payment of the short-term debt increases year by year as it leaves unpaid balances that should have been made that same year, thus increasing the long-term debt as the municipality prefers to make payments toward the most pressing debt:

	<b>Amounts allocated to pay long-term public debt</b>	<b>Amounts allocated to pay the principal of the long-term debt</b>	<b>Amounts allocated to the payment of long-term debt service</b>	<b>Total Short-Term Public Debt</b>
<b>2017</b>	\$1,208,921.9 pesos	\$561,303.90 pesos	\$647,618 pesos	\$59,663,202.33 pesos
<b>2018</b>	\$2,391,387.4 pesos	\$615,507.32 pesos	\$1,775,880.08 pesos	\$70,679,746.36 pesos
<b>2019 (up to July)</b>	\$1,525,605 pesos	\$628,303.31 pesos	\$897,302.57 pesos	\$69,886,134.63 pesos

b. Sultepec, Estado de México

In Sultepec, State of Mexico, the Ministry of Finance and Public Credit has reported the following results:

	<b>Public debt and obligations payable through freely disposable income</b>	<b>Debt service and liabilities payable through freely disposable income</b>	<b>Short-term liabilities, providers and third-party vendors through freely disposable income</b>
<b>2017</b>	47.2% (sustainable)	9.3% (under observation)	-27.6% (sustainable)
<b>2018</b>	45.6% (sustainable)	10.2% (high)	-50.8% (sustainable)
<b>2019 (up to September)</b>	41.8% (sustainable)	10.2% (high)	-57.5% (sustainable)

Although, the records obtained by the Ministry of Finance and Public Credit during these three years show that the municipality has a sustainable short-term debt performance, this is a mistake in the database since it records the percentages in question as negative. Thus, as shown in the following data, this municipality has a problem similar to the municipality of Capulhuac previously analyzed in terms of its short-term debt, with similar unpaid balances at the end of each year:

	<b>Amounts allocated to pay long-term public debt</b>	<b>Amounts allocated to pay the principal of the long-term debt</b>	<b>Amounts allocated to the payment of long-term debt service</b>	<b>Total Short-Term Public Debt</b>
<b>2017</b>	\$12,715,927.76 pesos	\$1,442,603.05 pesos	\$11,273,324.71 pesos	\$58,013,089.55 pesos
<b>2018</b>	\$13,881,598.43 pesos	\$2,456,557.79 pesos	\$11,425,040.64 pesos	\$62,227,943.91 pesos
<b>2019 (up to July)</b>	\$7,595,802.87 pesos	\$1,343,881.79 pesos	\$6,251,921.08 pesos	\$61,716,415.58 pesos

However, we can see that not only is short-term debt a problem for this municipality, but that it also presents a similar problem to the northern municipalities

analyzed above, since, year after year, a very small amount is paid on account of the long-term principal and a stratospheric amount on account of the debt service. It is not surprising that they only have a long-term debt, guaranteed with federal contributions and entered into with private banks.

#### **D. Mexican Lowlands.**

##### **a. Villa de Álvarez, Colima**

In Villa de Álvarez, Colima, the Ministry of Finance and Public Credit has reported the following results:

	<b>Public debt and obligations payable through freely disposable income</b>	<b>Debt service and liabilities payable through freely disposable income</b>	<b>Short-term liabilities, providers and third-party vendors through freely disposable income</b>
<b>2017</b>	18.4% (sustainable)	3.2% (sustainable)	26.1% (high)
<b>2018</b>	14.9% (sustainable)	2.9% (sustainable)	58.6% (high)
<b>2019 (up to September)</b>	14.1% (sustainable)	3.5% (sustainable)	-3.6% (sustainable)

It could be understood that there was a reorganization in the short-term debt of the municipality in 2019, however it turns out to be a wrong information, because the balance of the short-term debt reported by the Ministry until mid 2019, continued to report the same amount due in 2018:



	<b>Amounts allocated to pay long-term public debt</b>	<b>Amounts allocated to pay the principal of the long-term debt</b>	<b>Amounts allocated to the payment of long-term debt service</b>	<b>Total Short-Term Public Debt</b>
<b>2017</b>	\$9,372,263.52 pesos	\$4,207,277.74 pesos	\$5,164,985.78 pesos	\$139,266,344.3 pesos
<b>2018</b>	\$9,443,714.12 pesos	\$4,214,591.77 pesos	\$5,229,122.35 pesos	\$279,848,892.3 pesos
<b>2019 (up to July)</b>	\$3,858,159.31 pesos	\$2,173,171.49 pesos	\$1,684,987.82 pesos	\$279,848,892.3 pesos

Similarly, we can notice that the financial problem of the municipality is not the long-term debt, because although the interest paid is higher than the principal, it is not as disproportionate as the other cases analyzed above. The real problem of this municipality, just as in the municipalities of Sultepec and Capulhuac, is the very high balance that the short-term debt left behind year after year, which becomes unpayable after several years.

b. Tonalá, Jalisco

In Tonalá, Jalisco, the Ministry of Finance and Public Credit has reported the following results:

	<b>Public debt and obligations payable through freely disposable income</b>	<b>Debt service and liabilities payable through freely disposable income</b>	<b>Short-term liabilities, providers and third-party vendors through freely disposable income</b>
<b>2017</b>	104.6% (under observation)	12.9% (high)	-0.7% (sustainable)
<b>2018</b>	95.1% (under observation)	16.3% (high)	-1.4% (sustainable)

<b>2019 (up to September)</b>	97% (under observation)	17.6% (high)	6.3% (sustainable)
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At first glance, the table above shows that the municipality's problems are related to its long-term debt. Tonalá municipality had two long term loans in 2017, one with public banks guaranteed with federal contributions and the other with private banks equally guaranteed with federal contributions but much more expensive than the first. Later, in 2018, it arranged a separate loan with a public-private partnership for the purpose of making productive public investment.

The financial status of the municipality can be seen in the following table:

	<b>Amounts allocated to pay long-term public debt</b>	<b>Amounts allocated to pay the principal of the long-term debt</b>	<b>Amounts allocated to the payment of long-term debt service</b>	<b>Total Short-Term Public Debt</b>
<b>2017</b>	\$115,563,698.3 pesos	\$29,310,273.25 pesos	\$86,253,425.05 pesos	\$3,152,265.5 pesos
<b>2018</b>	\$153,025,725.8 pesos	\$51,766,721 pesos	\$101,259,004.8 pesos	\$13,552,068 pesos
<b>2019 (up to July)</b>	\$78,374,297.93 pesos	\$38,986,689 pesos	\$39,387,608.93 pesos	\$203,111,800.4 pesos

The municipality pays increasingly higher amounts for long-term debt, both for the service and the principal, and its problem is identical to that of the northern municipalities examined above.

## **E. Southern Mexico.**

### **a. Othón P. Blanco, Quintana Roo**

In Othón P. Blanco, Quintana Roo, the Ministry of Finance and Public Credit has reported the following results:

	<b>Public debt and obligations payable through freely disposable income</b>	<b>Debt service and liabilities payable through freely disposable income</b>	<b>Short-term liabilities, providers and third-party vendors through freely disposable income</b>
<b>2017</b>	77.8% (under observation)	8.6% (under observation)	9.4% (sustainable)
<b>2018</b>	72.3% (under observation)	9.2% (under observation)	6.8% (sustainable)
<b>2019 (up to September)</b>	73.9% (under observation)	10% (under observation)	-7.9% (sustainable)

The ratio of both long-term and short-term debt, according to the data provided, is as follows:

	<b>Amounts allocated to pay long-term public debt</b>	<b>Amounts allocated to pay the principal of the long-term debt</b>	<b>Amounts allocated to the payment of long-term debt service</b>	<b>Total Short-Term Public Debt</b>
<b>2017</b>	\$47,767,369.38 pesos	\$13,724,563.86 pesos	\$34,042,805.52 pesos	\$145,281,095.6 pesos
<b>2018</b>	\$53,646,582.61 pesos	\$11,655,459.36 pesos	\$41,991,123.25 pesos	\$132,641,745.5 pesos
<b>2019 (up to July)</b>	\$28,911,202.72 pesos	\$8,280,121.6 pesos	\$20,631,081.12 pesos	\$94,829,938.45 pesos

The table above reveals that the financial situation of the municipality of Othón P. Blanco is very similar to that of the northern municipalities, where there are

extremely expensive loans in comparison to the amounts paid toward the principal. These credits were initially arranged with private banks and guaranteed with federal contributions, but in 2018 the long term debt of the municipality was refinanced in order to transfer it to a state bank and with the benefits that this entails; it was also used to pay part of the short term debt, which can be seen for mid 2019, however, the long term debt shows the same behavior as in previous years.

b. Cozumel, Quintana Roo

Lastly, in Cozumel, Quintana Roo, the Ministry of Finance and Public Credit has reported the following results:

	<b>Public debt and obligations payable through freely disposable income</b>	<b>Debt service and liabilities payable through freely disposable income</b>	<b>Short-term liabilities, providers and third-party vendors through freely disposable income</b>
<b>2017</b>	93.1% (under observation)	10.7% (high)	14.8% (sustainable)
<b>2018</b>	87.2% (under observation)	11% (high)	9.8% (sustainable)
<b>2019 (up to September)</b>	79.2% (under observation)	9.3% (under observation)	-0.2% (sustainable)

The ratio of both long-term and short-term debt, according to the data provided, is as follows:

	<b>Amounts allocated to pay long-term public debt</b>	<b>Amounts allocated to pay the principal of the long-term debt</b>	<b>Amounts allocated to the payment of long-term debt service</b>	<b>Total Short-Term Public Debt</b>
<b>2017</b>	\$48,827,379 pesos	\$3,317,877 pesos	\$45,509,502 pesos	\$171,054,961 pesos
<b>2018</b>	\$54,958,923.96 pesos	\$3,329,576.57 pesos	\$51,629,347.39 pesos	\$182,014,493.9 pesos
<b>2019 (up to July)</b>	\$23,405,878.09 pesos	\$336,610.54 pesos	\$23,069,267.55 pesos	\$160,927,906.1 pesos

The situation in Cozumel is exactly the same as that in Othón P. Blanco. In 2018, the municipality took out a loan to refinance its public debt, which was transferred from private to public institutions. Likewise, the municipality used part of this loan to pay short-term debt that had been accruing, as can be seen in mid 2019; however, as before, the problem of long-term public debt still remains.

## **F. Conclusion**

Out of the eight municipalities with financial problems analyzed, four have a problem related exclusively to their long-term debt; two to their short-term debt and another two that have a particularly worrisome problem in both types of debt.<sup>8</sup>

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<sup>8</sup> The municipality of Ensenada is one of the entities with a problem with both long and short-term debt, because although the problem of its short-term debt was solved by directing the funds intended to pay the long-term debt in collusion with the state government, which also did not pay the guarantees of the loan, the default incurred is considered illegal and very probably, since it is a temporary solution, the problem will return as a result of the default interest that the municipality will have to pay due to the default in question.

Of the municipalities that have a problem with their long term public debt, all of them have situations that are repeated from municipality to municipality, namely: (i) all loans were initially contracted with private banks; (ii) all loans are guaranteed with federal contributions; (iii) the amounts paid for debt service are stratospheric in relation to the amounts paid on the principal; and (iv) the privileged payment of the long-term public debt affects the payment of the short-term public debt, making it a matter of time before it becomes a financial problem involving both items.

With regard to the short-term debt, its characteristic is that it accumulates year by year and reaches a point where it becomes unpayable for the municipality. Similarly, the preference of paying the short term public debt can be detrimental to the payment of the long term debt, however, since it does not have any payment guarantees, the municipality simply stops paying the short-term debt without there being an impact as important as the lack of payment of the long-term debt, which is guaranteed with federal contributions, and where the payment becomes forced because it is paid directly by the government of the State to which the municipality belongs; contrary to the above and as studied in previous sections, the assets of the municipality in most States are unseizable and therefore the creditors do not have an immediate means for the payment of short-term loan.

## **II. THE MUNICIPAL INSOLVENCY PROCEDURE IN OTHER JURISDICTIONS**

The municipal insolvency procedure, although not new in the world, since it has been used in countries such as the United States, Hungary and Colombia, has not been proposed in Mexico, this chapter intends to review how this figure is applied in various parts of the world to compare how this figure has been used according to the specific needs of each jurisdiction.

### **1. Colombia**

The insolvency procedure to restructure subnational debt is provided for in Law 550 of 1999 and applies to the territorial entities of that country, which are, according to article 286 of the Political Constitution of Colombia, departments, districts, municipalities and indigenous territories.

#### **A. Procedure.**

The authority in charge of processing the restructuring agreements is not the judicial branch, but the Ministry of Finance and Public Credit, an administrative authority. However, this is so because of a historical context, since at the time this legislation was enacted, the Colombian judicial system was quite weak as a result of several factors, including the politicization of the judicial system, the appearance and interference of drug trafficking, cartels and guerrillas.

During this restructuring procedure, the Ministry of Finance and Public Credit acts as a judge and appoints the promoter of the restructuring agreement, who is responsible for ensuring that an agreement is reached between the municipality and the creditors to restructure the municipality's debt. According to Article 6 of said legislation, the territorial entity is entitled to file for the initiation of the restructuring

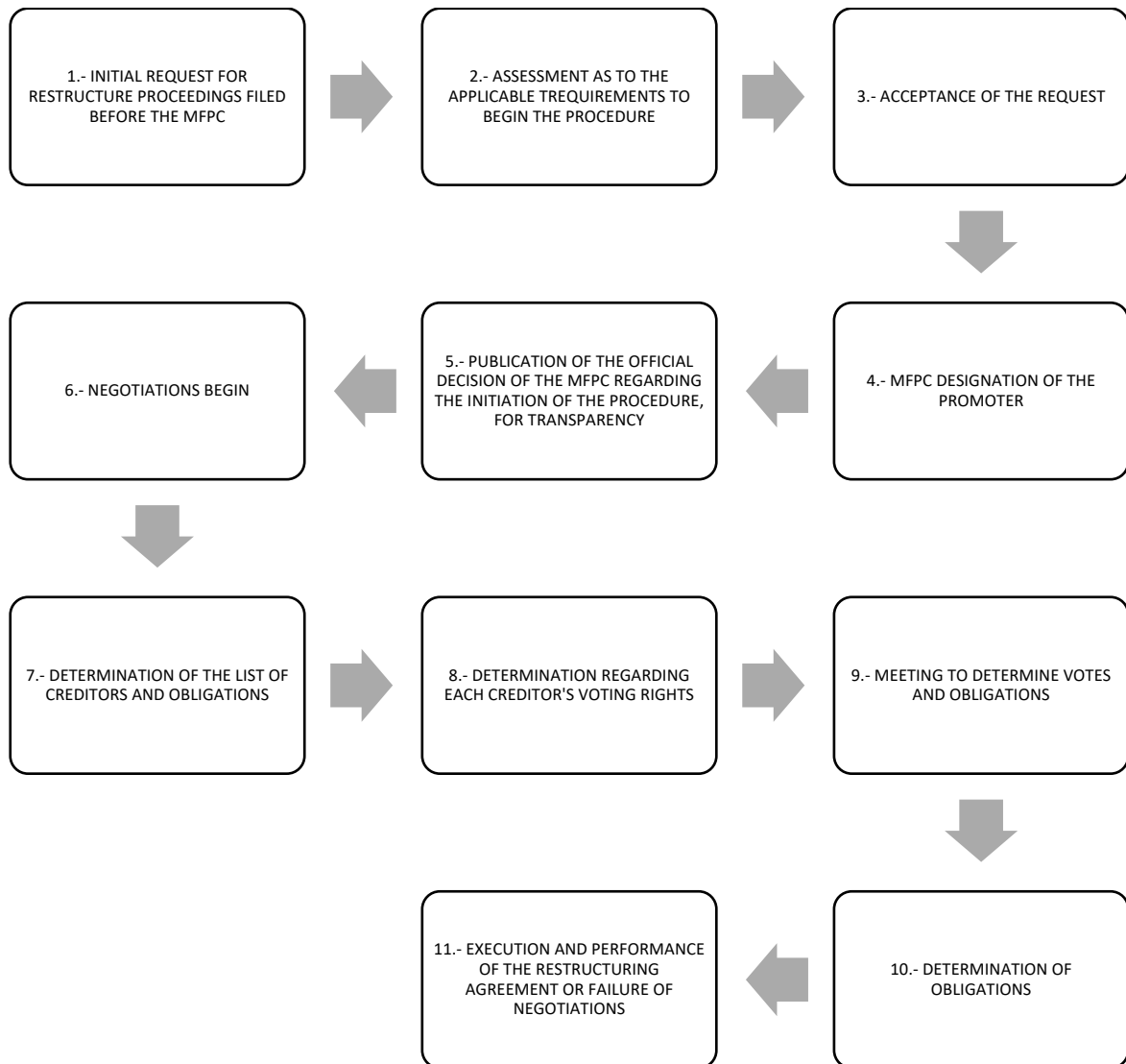
agreements; as are one or more creditors; or directly by the Ministry of Finance and Public Credit itself, where the following requirements must be met in order to initiate the procedure:

a.- Default of over 90 days of two or more commercial obligations payable by the entity, or the existence of two or more commercial judicial proceedings seeking to recover past due commercial payments.

b.- That the cumulative value of the aforementioned obligations represents at least five percent of the current liabilities of the territorial entity.

The restructuring procedure to be followed, in summary, is as follows:





## B. Effects of initiating negotiations

Pursuant to Article 13 of the relevant legislation, the negotiation begins at the moment the notice of the restructuring procedures is made public, which has the following effects:

- a.- Ban against the initiation of commercial enforcement proceedings against the entity

b.- Ban against commercial attachments against the entity.

c.- Suspension of ongoing commercial enforcement proceedings and attachments initiated prior to negotiations.

d.- Suspension of the statute of limitations for commercial recovery proceedings.

e.- Suspension of lapse periods in respect of commercial claims against the territorial entity

f.- Resumption of public services if suspended.

g.- Prohibition against making offsets, payments, settlements, reconciliations or compromises of any kind of obligations against the territorial entity, or on carrying out operations not necessary to avoid interruptions in the provision of public services

### **C. Classes of creditors**

There are four different classes of creditors in restructuring processes for territorial entities, as follows:

a.- Workers and retirees.

b.- Public entities and social security institutions

c.- Financial institutions and other private entities

d.- External creditors

The external creditors, which are those who belong to any of the five classes of creditors provided for in Title XL of Book Four of the Colombian Civil Code, according to the nature of the municipalities, which are:

a. First class obligations, described in Article 2496 of the Colombian Civil Code: Legal expenses incurred in the general interest of the creditors.

b.- Second class obligations, described in Article 2497 of the Colombian Civil Code, which contains the following:

i. The carrier or transport operator in relation to the property of the debtor in his possession or in that of his agents or employs, up to the amount due for carriage, expenses and damages; provided that such effects belong to the debtor.

ii. A lienholder in relation to movable property.

c.- Third class obligations, described in article 2499 of the Colombian Civil Code, which only includes mortgage obligations.

d.- Fourth class obligations, described in Article 2502 of the Colombian Civil Code, which contains the following:

i. Tax obligations against collectors, administrators and auctioneers of income and tax assets.

ii. Obligations against charitable or educational publicly financed establishments, and those of townships against collectors, administrators and auctioneers of their goods and income.

iii. Obligations against raw material or input suppliers necessary to produce or process goods or for the provision of services.

e.- Fifth class obligations described in Article 2509 of the Colombian Civil Code are all which that are not described in the preceding paragraphs.

#### **D. Restructuring agreement, effects and compliance**

##### a. Parties to the restructuring agreements

According to Article 58 of the relevant legislation, the parties to the restructuring agreement are the territorial entity and the external creditors in terms of Title XL of Book Four of the Colombian Civil Code and those which were listed above, however this phrase only implied that anyone who has a certain and uncontested credit in their favor would be a party.

##### b. Determining the number of votes that correspond to each creditor

Article 22 of the legislation in question states that:

i. Each creditor is only entitled to the number of votes equivalent only to the principal of the credit in its favor.

ii. The calculation for past due obligations is updated in proportion to the monthly consumer price index between the period starting on the due date of the obligation and the cut-off date of the list of obligations.

iii. Workers are given preferential treatment since the entirety of their credit is taken into account to count the votes that concern them, without any discounts for interest, fines or penalties

iv. The voting rights of pensioners is calculated by taking into account all of the past-due pension payments, taking into account twenty-five percent of the actuarial calculation

v. In the case of leasing agreements, past due unpaid rent is taken into account.

vi. Determination of obligations

The claims are determined by the promoter according to article 25 of the relevant legislation, who takes into account the list of creditors presented by the territorial entity together with its application, as well as with the other elements of the trial. These decisions must meet the following requirements:

- i. Creditors.
- ii. Status of the obligation.
- iii. Amount.
- iv. Conditions of each obligation.

c. Execution of the restructuring agreements

The restructuring agreement is concluded when the following situations converge, in accordance with Article 29:

- i. An absolute majority (fifty-one per cent) of the vote of external creditors, consisting of at least three classes of creditors; if there are only three classes of creditors in the proceedings, this majority may consist of only two classes of creditors.

ii. In the event a single creditor or group of creditors belonging to the same business organization holds an absolute majority of such votes, a concurrent vote from creditors of any class that is equal to or greater than twenty-five percent of the eligible votes shall be required.

iii. The approval of the territorial entity.

e. Minimums of the restructuring agreement

According to article 56, paragraph 14 of the Law, specifically, the provisions of article 33 of the Law must be followed:

i. Rules for the establishment and operation of a Supervisory Committee in which external creditors are represented, and where the promoter will be a member, with the right to speak but not to vote.

ii. Rules that must be observed by the territorial entity in its financial and administrative planning and performance, in order to give priority to pension, labor, social security, and tax obligations arising during the agreement.

iii. Differentiation of the entity's contributions to the National Pension Fund of Territorial Entities.

iv. Conditions and terms under which credits are to be paid.

v. Priority of payments.

vi. Rules for the interpretation of the agreement.

vii. The rules that the territorial entity must observe in its financial and administrative planning and execution, in order to promptly address pension,

labor, social security and tax credits that arise during the performance of the agreement.

viii. The regulation of default events, the manner in which they are to be remedied and the consequences thereof.

ix. The regulation related to the authorizations given by the Supervisory Committee that allow the Territorial Entity to enter into agreements contracts that that relate to assets linked to the department or that refer to the delivery, transfer or limitation of property over assets, such as trusts, supplies, sales with repurchase agreements, pledges and mortgages

x. The requirement that the territorial entity provide the Supervisory Committee, during the term of the restructuring agreement, with all reasonable information for the proper monitoring of the agreement with minimum requirements regarding quality, sufficiency and timeliness.

xi. Arrangement of special temporary labor conditions, if any.

xii. Payments in kind, if any.

xii. A commitment to bring the territorial entity's accounting and disclosure practices at the territorial level in line with applicable legal standards, if necessary, within a period not exceeding six months.

f. Effects of the failure to reach an agreement

In the event that the restructuring agreement is not concluded within the four-month period mentioned above, the effect is simply to return matters to their initial state, as the territorial entities are not susceptible to liquidation due to their nature and also cannot initiate a new procedure under Article 11 of Law 550 of 1999.

g. Effects of the restructuring agreement

The restructuring agreement, pursuant to Article 34, shall be binding on the territorial entity; its creditors; persons who have not taken part in the negotiation and even those who have not agreed to it, and shall have the following effects:

i. The obligation of the territorial entity to subject the disposal of any of the entity's assets to prior authorization to be issued by the Supervisory Committee.

ii. Release of existing precautionary measures.

iii. Termination of ongoing commercial enforcement proceedings initiated by creditors against the territorial entity.

iv. Suspension, for the duration of the agreement, of the enforceability of liens, collateral and trusts.

v. A reduction requested by the territorial entity or by any creditor, of the amount of coverage of any security or trust interest previously granted.

vi. After the restructuring agreement, no new loan agreements may be entered into without the prior authorization of the Ministry of Finance and Public Credit.

vii. The conclusion and fulfillment of such an agreement is a priority regional investment project.



## **E. Economic effects of restructuring agreements**

At present a total of one hundred and eleven territorial entities in Colombia have been subject to this procedure, of which one hundred and seven restructuring agreements have been concluded. Only three of these agreements have not been fulfilled; thirty-four are in the process of being fulfilled, and seventy-five have been fulfilled, either in advance or in a timely and legal manner.

In view of the foregoing information, we can conclude that the procedure mentioned above has been successful in meeting its purpose in most of the cases in which it was used, on the other hand, this procedure entails numerous economic advantages for the parties involved, the main ones being as follows:

- a. It encourages the improvement of the quality of accounting and budgetary information of the territorial entities.
- b. It is a provisional mechanism that is enabled in order to achieve an end, based on established requirements.
- c. Payment settlements encompass all creditors.
- d. Reduces transaction costs associated with judicial litigation of creditors' claims.
- e. During the execution of the agreement, the priorities of current expenditure are determined.
- f. Liability agreements can eventually become channels for strengthening social investment, as resources are no longer committed to the fulfilment of private obligations.

g. The implementation of a liability settlement provides for measures both in income and in expenses.

h. A liability restructuring agreement allows the creditor to reduce the uncertainty associated with the timing, amount and manner of payment of its obligations.

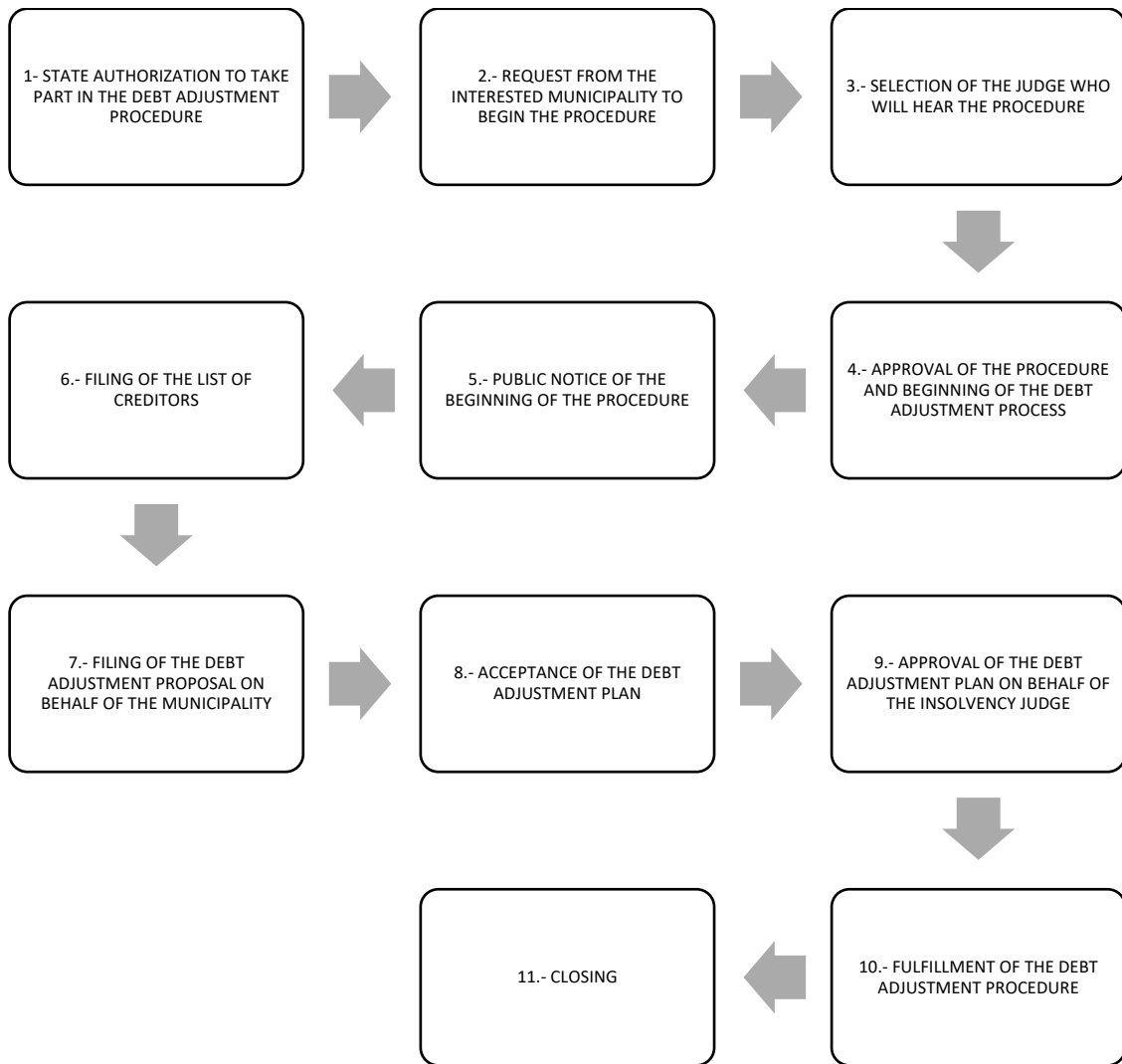
i. Promotes monitoring of the resources of financial institutions through the establishment of a supervisory committee.

## **2. United States of America**

The municipality's debt adjustment procedure is provided for in Chapter 9 of Title Eleven of the U.S. Code. The title in question is also called the U.S. Bankruptcy Code. The procedure can only be initiated by municipalities, the latter being a political subdivision, a public agency or an instrumentality of the State.

### **A. Procedure**

In general terms, the debt adjustment procedure under Chapter 9 of the Bankruptcy Code is as follows:



## B. Requirements to be a Chapter 9 debtor

In order for a municipality to be eligible for Chapter 9 of the Bankruptcy Code, it must meet the following requirements

§109. Who Can Be Debtor

...

(c) An entity may be a debtor under Chapter 9 of this title only if such entity

(1) is a municipality;

(2) is specifically authorized, in its capacity as a municipality or by name, to be a debtor under such chapter by State law, or by a governmental officer or organization empowered by State law to authorize such entity to be a debtor under such chapter

(3) is insolvent;

(4) desires to effect a plan to adjust such debts; and

(5) (A) Has obtained the consent of its creditors who have at least a majority of the amount of the claims of each class that the entity intends to affect under the plan in the case of that chapter;

(B) has negotiated in good faith with creditors and has failed to obtain the agreement of creditors holding at least a majority in amount of the claims of each class that such entity intends to impair under a plan in a case under such chapter;

(C) Is unable to negotiate with its creditors because negotiation is impractical; or

(D) reasonably believes that a creditor may attempt to obtain a transfer that is avoidable under section 547 of this title.

#### a. What is meant by municipality

The concept of "municipality" is defined in Section 101 of the U.S. Bankruptcy Code which states:

#### §101. Definitions

...

(40) The term "Municipality" means political subdivision or public agency or instrumentality of a State.

...

The legislation in question does not specify what is to be understood by a political subdivision, public agency or instrumentality of the State, and therefore the courts have taken on the task of interpreting it:<sup>9</sup>

i. Firstly, the political subdivision is interpreted as follows: "Section 81(7) defines political subdivision as "any county or parish or any city, town, village,

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<sup>9</sup> Orange County, 183 B.R. 594 (Bankr. C.D. Ca. 1995).

neighborhood, settlement or other municipality..." The common denominator that binds these units is the ability to exercise various sovereign powers such as taxation, eminent domain and the power to enforce laws".

ii. The term "public agency," §81 (6) describes public agencies as "incorporated authorities, commissions, or similar public agencies organized for the purpose of constructing, maintaining, and operating revenue-producing enterprises."

iii. Finally, an instrumentality of the State refers to "Sections 81 (1) - (5) describes several types of instrumentalities including different types of local improvement districts such as school districts... or port districts..."

b. Authorization from the State to be a debtor pursuant to Chapter 9 of the Bankruptcy Code

An authorization from the State of which the municipality is located is required to be a debtor under Chapter 9 of the Bankruptcy Code; however, each State is free to regulate whether or not municipalities within its territory have the opportunity to take part in such proceedings. Therefore, all municipalities must prove to the bankruptcy judge that they have been authorized by the State to which they belong to participate in an insolvency proceeding, either by referring to the legislation that authorizes it or by proving the administrative or political act that authorizes the municipality to participate in the proceeding.

c. Insolvency of the municipality

Another essential requirement for a municipality to undergo insolvency proceedings is that it be insolvent. Municipal insolvency is defined under the relevant law as:

§101. Definitions

...

(32) The term "insolvent" means -

- (C) with reference to a municipality, financial condition such that the municipality is
  - (i) generally not paying its debts as they become due unless such debts are the subject of a bona fide dispute; or
  - (ii) unable to pay its debts as they become due.

d. Willingness to implement a debt adjustment plan

This is interpreted as the requirement for the municipality to signal to the court its interest in pursuing an insolvency proceeding in order to arrive at a restructuring plan, and not just to gain time to avoid paying off creditors.

e. Prove the relationship with creditors

This is the last requirement under Section 109(c) of the Bankruptcy Code and is as follows:

i. It has obtained the consent of its creditors who have at least a majority of the amount of the claims of each class that the entity intends to have affected under the plan under that Chapter;

ii. It has negotiated in good faith with its creditors and has failed to obtain the consent of creditors who have at least a majority of the claims of each class that the entity intends to affect under the plan under said Chapter;

iii. It is unable to negotiate with its creditors because negotiation is impractical;  
or

iv. reasonably believes that a creditor may attempt to secure an avoidable transfer under section 547 of this title.

In general, all fractions are limited to the need for the municipality to demonstrate good faith in its negotiation with creditors, which does not have to be reciprocal.

**C. Request for insolvency and appointment of the bankruptcy judge before whom the proceedings will be conducted**

a. Request for insolvency and appointment of the bankruptcy judge before whom the proceedings will be conducted

The application to begin the procedure can only be completed by the municipality and must contain the requirements listed above and will be filed before the Federal Courts with residence in the State to which the municipality belongs. Unlike the other chapters, where an insolvency request is immediately forwarded to an insolvency judge, the Chapter 9 request is sent to the judge in charge of the Circuit Court of Appeals in order to appoint the insolvency judge before whom the procedure will be conducted.

b. Effects of filling out the application to initiate the insolvency procedure.

The main effect of filing for insolvency is the automatic suspension (automatic stay) of the following categories:

i.- The commencement or continuation of any judicial, administrative or other action or proceeding against the debtor that was or could have been commenced prior to the commencement of the restructuring proceedings.

ii.- Any enforcement proceedings against the debtor or against its property by any court order obtained prior to the commencement of the proceedings.

iii.- Any act to obtain possession of the debtor's property; or the proceeds of the debtor's property; or to obtain control over the ownership of the debtor's property

iv.- Any act to create, perfect or strengthen any encumbrance against the debtor's property.

v.- Any action to collect, calculate, or recover a right against the debtor that has arisen prior to the insolvency procedure.

vi.- The set-off of any debts that have arisen prior to the insolvency procedure.

vii.- Of any tax procedure.

viii.- The commencement or continuation of any administrative or judicial proceeding or other action against any officer or resident of the debtor that is intended to enforce any claim against the debtor.

ix.- The reinforcement of any liens which have arisen from taxes or their calculation owed by the debtor.

c. Publications in newspapers with a wide circulation

Notice of commencement of a Chapter 9 proceedings, dismissal and the relief order must be published pursuant to Section 923 of the Bankruptcy Code once a week for three consecutive weeks in the newspaper of largest circulation in the district where the proceeding has been filed, and if the court deems it necessary, in a separate newspaper of general circulation among the vendors and bond holders of the municipality.



#### **D. List of creditors and acknowledgement of credits**

The list of creditors must be submitted by the debtor within a reasonable period of time set by the court. This list must contain the creditors known to the municipality, which will be recognized as such, except those that appear as disputed, contingent or pending credits as provided in Article 925 of the Bankruptcy Code.

However, as provided in Rule 3003, the list submitted by the debtor is presumed to be valid and creditors who are not included in the list or who are included in the list as disputed, contingent or pending credits within a reasonable period of time at the discretion of the court. The credit recognition procedure is carried out within the insolvency proceedings, and once the creditor is notified and heard, the bankruptcy judge determines the amount of the credit in dollars at the time of filing the insolvency request, as provided in Article 502 of the Bankruptcy Code, and in accordance with the general guidelines of all insolvency procedures, specifically as provided in Chapter Eleven of the Bankruptcy Law and described in Chapter One of this document.

#### **E. Debt adjustment plan**

The debtor is the only party entitled to submit the debt adjustment plan. This plan must be submitted within the time set at the prudent discretion of the court, as provided in Article 941 of the Bankruptcy Code.

Pursuant to Article 901 of the Bankruptcy Code, the debt adjustment plan must contain the provisions of Article 1123 (a) (1), (a) (2), (a) (3), (a) (4), (a) (5), (b) and (d), namely:

§1123. Content of the plan

(a) Notwithstanding any other applicable non-bankruptcy law, the plan shall-

- (1) designate, subject to section 1122 of this title, classes of claims, other than claims of a kind specified in section 507(a)(2), 507(a)(3), or 507(a)(8) of this title, and classes of interests;
- (2) specify any class of claims or interests that is not impaired under the plan;
- (3) specify the treatment of any class of claims or interests that is impaired under the plan;
- (4) provide the same treatment for each claim or interest of a particular class, unless the holder of a particular claim or interest agrees to a less favorable treatment of such particular claim or interest;
- (5) provide adequate means for the plan's implementation, such as-
  - (A) retention by the debtor of all or any part of the property of the estate;
  - (B) transfer of all or any part of the property of the estate to one or more entities, whether organized before or after the confirmation of such plan;
  - (C) merger or consolidation of the debtor with one or more persons;
  - (D) sale of all or any part of the property of the estate, either subject to or free of any lien, or the distribution of all or any part of the property of the estate among those having an interest in such property of the estate;
  - (E) satisfaction or modification of any lien;
  - (F) cancellation or modification of any indenture or similar instrument;
  - (G) curing or waiving of any default;
  - (H) extension of a maturity date or a change in an interest rate or other term of outstanding securities;
  - (I) amendment of the debtor's charter; or
  - (J) issuance of securities of the debtor, or of any entity referred to in subparagraph (B) or (C) of this paragraph, for cash, for property, for existing securities, or in exchange for claims or interests, or for any other appropriate purpose;

...

- (b) Subject to subsection (a) of this section, a plan may-
  - (1) impair or leave unimpaired any class of claims, secured or unsecured, or of interests;
  - (2) subject to section 365 of this title, provide for the assumption, rejection, or assignment of any executory contract or unexpired lease of the debtor not previously rejected under such section;
  - (3) provide for -
    - (A) the settlement or adjustment of any claim or interest belonging to the debtor or to the estate; or
    - (B) the retention and enforcement by the debtor, by the trustee, or by a representative of the estate appointed for such purpose, of any such claim or interest;
  - (4) provide for the sale of all or substantially all of the property of the estate, and the distribution of the proceeds of such sale among holders of claims or interests;
  - (5) modify the rights of holders of secured claims, other than a claim secured only by a security interest in real property that is the debtor's principal residence, or of holders of unsecured claims, or leave unaffected the rights of holders of any class of claims; and
  - (6) include any other appropriate provision not inconsistent with the applicable provisions of this title.

...

- (d) Notwithstanding subsection (a) of this section and sections 506(b), 1129(a)(7), and 1129(b) of this title, if it is proposed in a plan to cure a default the amount necessary to cure the default shall be determined in accordance with the underlying agreement and applicable nonbankruptcy law.

The voting system for such a plan is governed by the provisions of Chapter 11 of the Bankruptcy Law.

#### **F. Economic effects of the municipality's debt adjustment procedure**

The aforementioned debt restructuring procedure is strongly criticized by the US bankruptcy doctrine. Criticisms made by Yale University Professor Omer Kimhi and University of Utah Professor Laura Napoli Coordes allow us to understand the obscurity of this law and the urgent need for its reform. These problems are apparent from the statistics provided, from 1937 to June 2018 only 680 cases have been brought under this chapter, of which only 70% have resulted in a restructuring plan.<sup>10</sup> The problems identified by the professors are the following:

- a.- The lack of a root cause solution to the problem of municipal insolvency. In a few years, most of these municipalities will become insolvent again, for Chapter Nine only helps the municipality reduce its debt levels, but not to eliminate the cause of the economic deterioration.
- b.- The obscurity of the law, which fails to establish uniform terms for each type of entity that use Chapter Nine, since the same terms apply to a city as to a school, whose needs are polar opposites.
- c.- The lack of clarity in the priority that each class of creditors should have.
- d.- The mistake on behalf of the legislator in equating the benefits entailed by Chapter Eleven concerning large enterprises to municipalities. A private enterprise needs time to produce, taking into account that goods applied to the productive capacity are more valuable than the goods themselves, while

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<sup>10</sup> <https://muninetguide.com/municipal-bankruptcy-statistics/>

the municipality does not operate as a market entity but rather as a political and social entity, which are incompatible with the ends of private enterprise.

e.- The lack of public policies in parallel with the restructuring procedure provided for in Chapter Nine of the Bankruptcy Law.

### **3. Hungary**

In March 1996, the Hungarian Parliament passed the Local Government Debt Restructuring Law (Law XXV), which, as its name suggests, applies only to local governments according to section 2 of the law, which refers to section 3 of the Self-Government Act, which states that only municipalities and counties exercise self-government.

#### **A. Procedure**

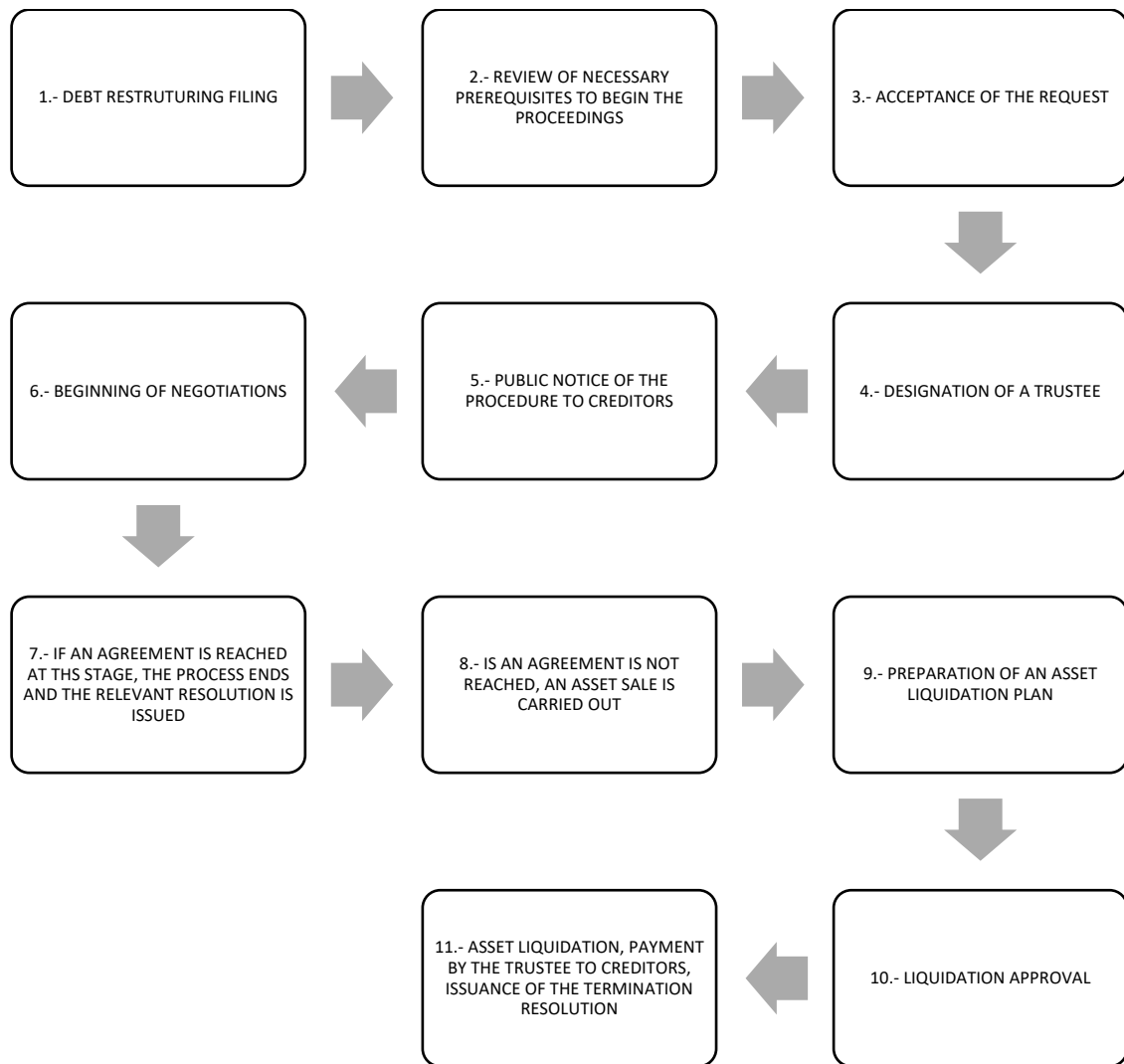
The Hungarian procedure is conducted before a judicial authority and can be brought by either the local government or its creditors in the following cases:

- a. If the local government fails to pay or dispute an obligation within sixty days of its due date, an invoice sent by a creditor; a payment order or a claim.
- b. Failure to make payment of an outstanding debt after sixty days from its due date.
- c. Failure to comply with a payment obligation as set out in a final and enforceable court decision.

d. Failure to comply with a payment obligation under a previously executed debt restructuring agreement.

e. Failure to pay its debt to other local governments, including failure to pay under an established partnership, within sixty days following a direct request for payment from the municipality.

The general debt restructuring procedure for local governments is summarized as follows:



## **B. The initiation of debt restructuring and its effects**

Although it is true that the procedure begins with the application filed with the competent court, the debt restructuring as such begins on the date on which the final decision of the judge on the favorable qualification of the application to initiate the debt restructuring procedure is published in the court bulletin, leading to:

a. Claims against the local government, can only be heard within the debt restructuring procedure, however, those initiated before the debt restructuring procedure will be heard by the judge who first heard the case, which does not exempt the creditor from informing the judge who hears the debt restructuring procedure of the terms of its outstanding claim.

b. The anticipated maturity of the local authority's obligations.

c. Set-off applies only in respect of claims which were made prior to such publication.

d. A 60-day period for creditors to submit their claims begins to elapse, and after 15 days following the above-mentioned term, the financial supervisor must inform the creditors whether their claims are accepted.

e. Prohibition of the foreclosure of local government assets.

f. Prohibition against local government from making decisions that would compromise its assets without prior judicial authorization.

g. A prohibition on the acquisition of property.

h. A prohibition on making advance payments.

i. A thirty-day period begins for the Mayor of the local government to send the Financial Supervisor: (i) a report on the local methods of supply and financing of the local government; (ii) an inventory of assets and annual accounts of the local government as of the day before the beginning of the debt restructuring, justified and with the indication of the assets that can be used to fulfill outstanding obligations; (iii) the draft regulation on the crisis budget; (iv) a detailed summary of ongoing judicial and administrative procedures, as well as ongoing enforcement procedures; (v) contracts related to the assets of the local government within one year before the start of the debt restructuring procedure and obligations undertaken; (vi) detailed information on business associations with local government participation; (vii) detailed information on local government institutions, their economic situation, debts and claims; (viii) other documents that are necessary for the performance of the task of the financial supervisor.

j. The appointment of the financial supervisor, who has the powers of a trustee in the Mexican bankruptcy proceedings.

k. The beginning of an eight-day term for the formation of the Debt Restructuring Committee, which is composed of the mayor, the notary, the chairman of the finance committee, and a local government representative.

l. The beginning of the most important term within the procedure, which is the one-hundred-and-eighty-day term that the debt restructuring committee is given to prepare the debt restructuring program and the settlement proposal.

### **C. The crisis budget regulations**

The local government must present crisis budget regulations within thirty days of the start of the debt restructuring, which must be done by the local government's notary, who is a type of administrative authority within the local government.

The draft crisis budget regulations should contain the following items:

- a. The necessary operational expenses of the local government.
  
- b. The use of funds registered with the local government, which are not its property but are under its management, such as funds earmarked for specific items where the central government provides support, but which require the assistance of the local government for their implementation.

The draft crisis budget will be discussed within eight days by the debt restructuring committee, which will need its approval and will then be sent to parliament for final approval. The local government must administer its assets as agreed until a settlement is reached with its creditors or the assets are distributed by the court. If parliament does not accept the plan, the court shall proceed directly to the distribution of the assets.

### **D. The debt restructuring negotiation**

- a. Proposal for the reorganization and liquidation plan

Once the crisis budget has been approved, the Debt Restructuring Committee will proceed to prepare the reorganization and liquidation plan, which will have to comply with the provisions of Section 20 of the aforementioned legislation, which provides that:



Section 20. (1) If the representative body has adopted the crisis budget regulation, the debt restructuring committee shall prepare a reorganization program and a liquidation proposal.

(2) In addition to a detailed description of the economic situation of the local government, the reorganization program shall include a proposal for the use of liquidated assets, by debt and various planning measures (e.g. loans) related to debt restructuring, and shall identify the revenues that the local government can receive in such manner..

(3) In the settlement proposal, the debt restructuring committee will classify the creditors' claims, the original maturity of the receivables or other settlement accounts as local government creditors, and may propose a differentiated settlement for different groups, with proper justification.

(4) The debt restructuring committee shall take into account a creditor with a disputed claim, if the claim enforcement process is ongoing, in preparing the settlement proposal in accordance with the creditor's stated claim.

If the debt restructuring committee does not prepare both the reorganization program and the liquidation proposal within 180 days, the financial supervisor will notify the creditors, who may prepare the liquidation plan to be proposed to the debt restructuring committee within 30 days. If accepted, it will be considered as a settlement proposal.

#### b. Negotiation of the reorganization program

Both the reorganization program and the liquidation proposal are sent to the financial supervisor, who will call a hearing for the adoption of the reorganization program, which must be notified to all creditors eight days before the hearing is held. During the hearing referred to above, if half plus one of the creditors agree with the proposal, that program will be binding upon all creditors who did not agree with the proposal and to those who did not participate in the hearing but were duly notified of the hearing.

#### c. Content of the restructuring agreement

The restructuring agreement must contain the following:

Section 24. The agreement shall be in writing and shall include:

(a) The proposed settlement, the manner of its implementation and the monitoring measures by creditors;

(b) The manner in which creditors will be repaid;

(c) Any changes to payment schedules, waivers or assumption of claims by creditors, and anything that the local government and creditors deem necessary to restore or maintain the solvency of the local government;

(d) The participation of the local government representatives and the creditors who accept the agreement.

Section 25. (1) The agreement shall be signed by the mayor, the notary, the creditors or their legal representatives or agents, and shall be approved by the financial supervisor.

...

If the settlement meets the formalities established by law, the court shall approve the settlement, declare the procedure completed and order the publication of the settlement in the court bulletin.

#### c. Failure to fulfill the restructuring agreement

In the event that the local government fails to comply with the restructuring agreement, the creditor can initiate debt restructuring proceedings again, in which it can demand payment of its original claim, as set out in section 27 of the aforementioned Law.

### **E. Distribution of assets by the Court**

a. Cases in which the distribution of assets by the Court is justified:

i. If the debt restructuring committee is dissolved because it is no longer operational or because it has never convened.

ii. If the Parliament does not accept the crisis budget regulation proposed by the debt restructuring committee.

iii. In the event the debt restructuring committee does not carry out the proposal for the restructuring agreement and if the creditors do not intend to draft the liquidation proposal.

iv. If the debt restructuring proposal is not accepted by the court.

v. If no settlement is reached within 240 days from the date of the start of the debt restructuring proceeding.

b. Commencement of the distribution of assets by the Court

The municipality must comply with the provisions of the crisis budget regulation throughout the period until the liquidation is completed. If this does not exist, it must be prepared by the financial supervisor.

In order to proceed with the liquidation of the municipality's assets, the financial supervisor must submit a duly justified report within 30 days, which must:

i. Determine the methods to provide local government services.

ii. Determine what local government assets and subsidies received from the central budget are necessary for the fulfillment of local government obligations.

iii. Define the scope of negotiable assets within the debt.

This report must be sent to the municipal government as well as to each and every one of the creditors, who may submit their comments within fifteen days. If there are any comments, a hearing will be convened in which the commentator and the financial supervisor may participate. Once the hearing has been carried out, the financial supervisor has a period of eight days to present the final report, which must be approved by the court.

c. Liquidation of municipal government assets

Once the report submitted by the financial supervisor has been definitely approved, the financial supervisor shall proceed as set out in Section 30 of that legislation, which is as follows:

i. Within thirty days, classify the creditors' claims according to the following priority:

1. Salary of ordinary staff, including severance payments upon termination of a public service or public employment relationship.
2. Secured obligations, up to the amount of the guarantee, provided that the guarantee was created six months before the start of the debt restructuring procedure.
3. Obligations arising from the receivables resulting from interest rate subsidies granted to the State under a prior debt restructuring procedure, repayment of assistance to beneficiaries and recipients and any reimbursable budget support.
4. Social debts receivable in the form of social security obligations and contributions.

5. Credits that have not been previously specified.
6. Interest receivable, as well as outstanding payments, contributions and fines collected during the debt restructuring period.
7. Liquidation of municipal assets within sixty days at the highest attainable market price. In doing so, it must respect cultural heritage and state property laws.
8. During the following thirty days, the distribution of the liquidated assets will be proposed, as well as the fulfillment of the obligations with the adjudication of the non-liquidated assets to the creditors according to the priority established in the law, which must be sent to the municipality, the creditors and the court.

d. Termination of the asset distribution by the Court

Once the distribution project has been submitted and approved, the financial supervisor will proceed with its implementation. Once this is done, the judge relieves the financial supervisor of his duties, declares the termination of the procedure and publishes such resolution in the court's bulletin.

## **F. Economic effects of restructuring agreements**

Despite the legislative progress that this legislation represented, in practice it has not been widely used by municipalities. Between 1996 and 2010, only thirty-eight debt restructuring procedures have been filed, of which eighteen had reached a restructuring agreement, eleven had ended in liquidation of the municipality, six were undergoing the procedure in the year in which the study was conducted, one

was initiating the liquidation procedure, one was under appeal and one lacked any public information on the subject.

However, the following benefits can also be observed from the judicial implementation of such a procedure:

- a. The procedure is transparent and explicit.
- b. The risk of the financial bailout was reduced.
- c. Essential services are provided during the proceedings.
- d. There is a real cooperation between the financial supervisor, the municipality, the court and the creditors in the process of debt restructuring.
- e. A setting was provided for municipalities to participate in order to start a new debt-free period and promote the financial advancement of the entity.

### **III. PROPOSAL OF A MEXICAN MUNICIPAL INSOLVENCY PROCEDURE**

#### **1. Approach to the principles and aims of the municipal insolvency procedure**

##### **A. Overview of the financial problem of the Mexican municipality**

In order to propose an effective model, we must take into account the two debt scenarios faced by the Mexican municipality, which were analyzed in the first part of this article: (i) excessive indebtedness as a result of the payment of the debt service due to long-term loans; and (ii) excessive indebtedness as a result of the accumulation of short-term debt due to the lack of payment of the same.

Both scenarios have completely different effects:

In the first scenario, the cost of servicing the public debt in the long term is a time bomb, since (i) at first, treasury cannot apply payments to other items and concentrate most of the funds to the payment of the public debt service, where we do not lose sight of the fact that these payments are obligatory, since as they are guaranteed with federal participations, the resources are deposited directly in the trusts as a guarantee for the payment of the loans. This, in the long run, stagnates the municipality to the detriment of its population and diminishes the quality of the public services it should provide. (ii) Secondly, the ever-increasing concentration of funds to service the long term public debt causes the municipality to cease to comply with its short term obligations, which is the case of most of the suppliers and service providers and which do not have a guaranteed obligation as is the case for creditors of long term public debt. This becomes a systemic fault that affects all those involved in a legal relationship with the municipality, where the only beneficiaries are the owners of the bank to the detriment of all other creditors, the municipality and its inhabitants, thus benefiting from a financial captivity to which the municipalities are made subject to during many years.

The second scenario is less serious than the first, since despite the fact that there are a wide range of creditors who cannot be paid due to the municipality's lack of resources, since they do not have guarantees for their payment or a legal mechanism to enforce their rights, creditors only have the option of waiting for the municipality to pay voluntarily, which, although done to their detriment, does not stifle the municipality's finances in an aggressive manner as illustrated in the first scenario. In the municipalities analyzed, the lack of payment of this item only causes its accumulation without generating a systemic problem and which can be remedied by engaging in a long term loan that can encompass other obligations as was the case of the municipalities of Cozumel and Othón P. Blanco, which belong to the state of Quintana Roo. Although they had to refinance their long-term public debt in order to contract a long-term public credit due to the high cost of the long-term public debt service contracted with the private bank, they made use of such resources to successfully pay a part of their short-term public debt.

## **B. Nature of the Mexican municipality for the purposes of the municipal insolvency procedure**

The municipality is a complex entity with the capacity to have rights and obligations; that its purpose is not to produce as is the case for private enterprises, but rather that its purpose is to carry out public services entrusted by the legislation for the benefit of its inhabitants; that it has its own assets; and that it also periodically receives income from the federal and state governments that is generally greater than the income earned by the municipality itself, even though in most cases this income is committed to payment of the public debt. It is on this basis that the possible solution to the financial problems of the municipality should be assessed.

Also, it is necessary to take into account the serious error in which various legislations incur in trying to equate the problems of the municipality with the problems that afflict businesses, as provided for in Chapter 9 of the Bankruptcy Law



of the United States of America mentioned above, which provides solutions that are not in line with reality or that only temporarily resolve the problem, so that a simple suspension in the payment of debts is not in all cases sufficient to provide a solution to the financial problems that municipalities face; the above seeking the benefit of both the debtor and his creditors and the inhabitants of the municipality itself.

### **C. Purposes of the municipal insolvency procedure**

Accordingly, the purposes of the proposed procedure, which must be established as a matter of public interest, are as follows:

The financial recovery of the municipality and the rehabilitation of the municipality's public finances, as well as avoiding that the municipality's general failure to meet its payment obligations put at risk the provision of public services recognized at the constitutional level as essential to its inhabitants; the viability and economic continuity of the business of its creditors; and the strengthening of the economy at the municipal, local and federal levels.

A settlement agreement between the municipality in debt and its creditors will be sought at all times, provided that such an agreement does not significantly exacerbate the financial situation of the municipality.

## **2. Procedural framework for the municipal insolvency procedure**

We clarify that for the purposes of the proposed procedure, the framework contained in the Mexican Bankruptcy Law is used as a starting point, from which several changes and new institutions are proposed to adapt to the particular needs of the municipality's situation. Therefore, this procedure will have a pre-bankruptcy stage where the financial situation of the municipality will be determined from an

accounting standpoint; and a bankruptcy stage that will be comprised of three sub-stages: an obligatory stage for the recognition, priority and classification of credits and two non-sequential stages for the conciliation and liquidation of assets of the insolvent municipality, respectively.

## **A. Right of recourse in the municipal insolvency procedure and procedural requirements**

### **a. Right to request the insolvency proceedings**

The right to file for insolvency proceedings corresponds primarily to the debtor through a petition, which the institution exercises in order to release itself from its obligations; and, on the other, such right is available as a to the various entities that seek the municipal bankruptcy and that are also entitled to do so. Therefore, the right of to seek this procedure corresponds to the following entities:

i. Municipality: This right applies to the municipality in order to enjoy the benefits of the procedure and to improve its finances.

ii. Creditors: We propose that a single creditor may initiate insolvency proceedings; however, they will have to demonstrate that the requirements of the municipal bankruptcy proceeding that will be developed later have been met and that the procedure is based on the general failure of the municipality to comply with its obligations in order to be consistent with the nature of the proceeding, which is to achieve the participation of all of the debtor's creditors to said proceeding, which is not possible if only one creditor is affected by the debtor's insolvency, since in the given case, said creditor could individually execute the debtor's assets without the need to fight over the priority, validity and that its claim that will be paid against several debtors.

iii. Local legislatures: The power to request a commercial insolvency is also given to these bodies because the local legislature is empowered to inspect the financial status of the municipalities under its purview and only when both the review procedure and the audits to verify the financial status of the municipality have been carried out and either the illiquidity or the insolvency of the municipality is noted, the above so that it does not become a tool of submission by the several States with respect to the municipalities in their respective territories.

iv. The Federal government through the Superior Auditing Office of the Federation: For the same reasons set forth in the preceding paragraph, we propose that said authority be granted the authority to request a municipal insolvency in cases of misappropriation of federal funds destined for a specific purpose and whose investigation has been unfavorable to the municipality and that the relevant audits reveal municipal insolvency or illiquidity. The same applies to cases in which the municipality has not complied with the rules on financial discipline and federal expenditure and the investigation into the matter has proved to be justified and has revealed that the municipality in question may be insolvent or not be in a position to pay its outstanding obligations.

v. The Public Prosecutor's Office: In the same case as in Article 21 of the Commercial Insolvency Law, that is to say, in case j a judge notices the illiquidity or insolvency of the municipality and notifies the Public Prosecutor's Office so that it can make the appropriate filings.

Likewise, it is necessary to consider that, in the event the municipal insolvency is requested by the municipality itself, it is necessary to create certain conditions to withdraw the request so that it is not used as a means of political control. This is because, as a general rule, the municipal government lasts three years in office, and it would lend itself to political games with a subsequent mandate in the event that

such a competition is requested at the end of the term in office. Consequently, a judicial opinion that resolves that the process withdrawal does not cause damage to any of the parties in order to make the withdrawal of the bankruptcy action appropriate.

b. Procedural requirements

In the case of an application for a municipal insolvency procedure, the municipality must accompany its application with the following:

a. The audited financial statements of the municipality from the inauguration of the current administration until the date of the filing of the municipal insolvency procedure; as well as the financial statements for the entire term of the preceding administration until the installation of the current administration.

b. A statement that details the reasons and causes that led him the municipality to its current state of insolvency

c. A list of your creditors and debtors that includes their names and addresses, the due date of each of their credits of each of them, the order of payment priority which the municipality believes each should be assigned, the particular characteristics of such credits, as well as their guarantees.

d. An inventory of the municipality' real estate, which should specify which properties that in the public domain and which are in the private domain; movable property; securities; and rights of any other kind.

e. A list of the pending proceedings to which the municipality is a party, which should specify the parties to each proceeding, the identification information of

each proceeding, type, status and before the authority before which each proceeding is being heard.

f. The necessary administrative acts that evidence the municipality's intent to initiate the insolvency procedure.

g. Proposal of a preliminary settlement to repay its creditors, except if such a procedure has the insolvency of the municipality as its objective. In this case, it must encumber private property sufficient to mitigate the insolvency of the municipality or indicate the actions aimed to disincorporate public property to be used for this purpose and, if necessary, a preliminary agreement of creditors where the remainder of the debt is agreed upon.

h. Action plan of the municipality for the continuation of the public services under its purview.

These requirements must be met following the declaration of the municipal insolvency proceedings in the event the process is not initiated by the municipality.

In addition, in order not to further aggravate the insolvency or illiquidity of the municipality, we propose that the following precautionary measures are decreed ex officio upon admission of the request for municipal bankruptcy. These can be expanded by the judge, at the request of the party or a comptroller:

a. Prohibition on making seizures on the accounts of the municipality or on enforcing payment using the funds within them for the payment of its obligations.

b. Prohibition against the transfer of the proceeds of the federal contributions directly to the payment trusts, which would channel the amounts directly to the municipality for use in its ordinary operations.

c. Re-establishment of public services if these had been suspended, with the added benefit that any expenses incurred as a result will be consolidated as super-priority debts, this benefit must be implemented at all times under the supervision of the judge until the declaration of the completion of the insolvency proceedings

d. Prohibition on any activities that are not necessary to avoid paralysis of the provision of public services, and a respective obligation to consult the court to verify whether any such acts are indeed necessary.

e. Prohibition against compensation and payments of any kind in respect of the municipality's obligations.

In the proceedings were initiated by anyone other than the municipality, such measures must be issued at the request of the interested party and must be decreed by the court at its discretion, we would into account the purposes of this law in order to prevent malicious claims from having an effect on the ordinary operation of the municipality.

## **B. Determination of the financial situation of the municipality**

As mentioned above, it is necessary to provide the bankruptcy judge with information concerning the financial situation of the municipality, since, as noted above, the situations are different when there are problems with the long-term public debt and with the short-term public debt. In order to achieve this, it is necessary for the judge to be supported by a specialized adviser on the subject, so it is advisable to preserve the figure of the insolvency comptroller. However, in order to achieve its purpose, the comptroller should not be provided by the Federal Institute of Specialists in Commercial Insolvency, which is the Mexican institution responsible

for providing such specialists, due to their business focus which is completely incompatible with the nature of the municipality.

Given the above, we proposed that such specialist be provided by the Ministry of Finance and Public Credit, because although the Supreme Auditing Office is responsible for reviewing the various entities in all orders of government in cases of misappropriation of funds in the federal government itself and for non-compliance with financial discipline rules, as discussed in the previous chapter. Since the Supreme Auditing Office has the right to file for a municipal insolvency, it would be consolidating itself as a judge and jury by being entrusted with preparing the report that consolidates the beginning of the municipal insolvency procedure. By virtue of the above, a separate government is introduced, namely, the Ministry of Finance and Public Credit, since it is accustomed to working with the accounting systems of the various government entities in the country.

Likewise, we propose a second assessment criteria to determine whether the municipality is in insolvent or illiquid, where we propose the following parameters for its determination:

a. Illiquidity: This situation is easier to determine objectively than insolvency as it is not necessary to account for all the municipality's assets and liabilities. We propose to maintain the approach proposed by the legislator in the Bankruptcy Law, which is in the event that the municipality fails to meet its payment obligations to two or more different creditors and also:

i. That the out of the obligation owed by the municipality, those which are at least thirty days past due must account for at least thirty-five percent of all the outstanding obligations against the municipality on the date on which the request for the municipal insolvency procedure was filed.

and

ii. That the municipality does not have sufficient liquid assets to pay at least eighty percent of its obligations in its municipal treasury at the time such obligations become payable due, as of the date of submission of the request for municipal insolvency.

b. Insolvency: As has been deeply studied in the insolvency doctrine, the difficulty of determining whether a person is insolvent, meaning that the sum of their debts is greater than the assets in a short period of time, made it necessary to resort to objective assumptions such as the debtor's failure to pay its obligations in order to presumptively determine its insolvency. We therefore agree with this position, acknowledging the complexity and fruitlessness of this task; therefore, the following situations which presume the insolvency of the Municipality are proposed:

When the illiquidity of the municipality is proven, and:

a. The municipality is ordered to pay its overdue obligations amounting to thirty-five percent or more of all the municipality's obligations on the date on which the respective judgments become final and the municipality has not made voluntary payment thereof or has not provided for payment thereof in the following expense budget for the subsequent period or made payment during the validity of the subsequent expense budget

b. that the municipal insolvency proceedings be brought by a third party and that the municipality fails to contest or agrees with such measure.

c. The municipality requests the court to initiate the insolvency proceedings having the insolvency as a presupposition.



### **C. Declaration of municipal insolvency and its effects**

Once the comptroller has issued its opinion and the parties have presented their respective arguments, the judge must issue the municipal insolvency ruling. If the municipal insolvency ruling is accepted, the court must specify the financial situation of the municipality and its causes, such as long-term public debt, short-term public debt or both; the declaration of illiquidity or insolvency of the municipality; and it will also have the following essential requirements and effects:

- a. The instruction to the Ministry of Finance and Public Credit to appoint a comptroller or trustee, as applicable.
- b. The declaration of the opening of the stage of acknowledgement, classification and priority of claims.
- c. An order to the municipality to provide the comptroller or trustee with its books, records and other documents in its possession. As well as necessary funds to cover the expenses and publications of the municipal insolvency.
- d. An order to the municipality to produce all documents that are required for the proceedings together with the request for the municipal insolvency.
- e. An order for the municipality to publish the decision of the municipal insolvency in its municipal gazette, as well as in the Official Gazette of the Federation and in one of the newspapers with the largest circulation in the State to which the municipality belongs.

f. In case that the municipal insolvency was requested by the municipality, the decision should ratify any precautionary measures decreed in the admission decree, as well as order any additional measures to preserve the purpose of the law, whether or not requested by the municipality, the comptroller or necessary in the court's opinion.

In the event that the insolvency was requested by a third party, the court order shall include any measure that would be issued in the event that the municipal insolvency proceeding had been requested by the municipality itself, as well as any other measure deemed necessary to preserve of the purpose of the law, whether or not requested by the municipality, the comptroller or necessary in the court's opinion.

g. The setting of a retroactive date, which shall be understood as two hundred and seventy calendar days immediately prior to the date of the municipal bankruptcy judgment, which may be extended with no fixed time limit in order to render ineffective those acts that have been carried out as creditor fraud.

h. The opportunity for the corresponding separation actions to be exercised, unless the assets whose separation is sought are providing a constitutional public service and the underlying agreement is also in effect.

i. The early maturity of all debts owed by the municipality with the exception of such obligations as are indispensable for the provision of public services, as well as the employment obligations of the municipality.

j. The suspension of the accrual of interest on municipal loans and the conversion of its loans to UDIs (inflation-referenced currency reference), in respect of secured loans, we propose maintaining the same rule as in the Commercial Insolvency Law.

k. The possibility for the comptroller or trustee, as appropriate, to submit the legality of any contract entered into by the municipality for review before the insolvency court, with the participation of any third parties to the process, which will be heard as an ancillary proceeding.

l. The order for a mandatory review of the legality of every long-term loan entered into by the municipality, each of which will be heard through ancillary proceedings. Once each procedure has been completed, the contract will either be confirmed or annulled, and in the latter case the court will be responsible for reporting any potential illegal actions of the officials in charge of obtaining the credit to the competent authorities.

m. Each and every pending procedure both before and after the municipal insolvency decision, in which either the payment or the validity of the claims payable by the municipality shall be reassigned to the relevant insolvency court to be decided in accordance with the Commercial Insolvency Law. The above measure is included due to the failure of the reassignment provision in current Commercial Insolvency Law, since nothing is more detrimental to the finances of a debtor than having to litigate each claims to which it is party across several States, since travel and attorney's costs are incurred, which were unnecessary when the reassignment provision was in force.

n.- The obligation of the municipality and the comptroller or trustee, as appropriate, to present a plan for the operation of the municipality, which shall detail how the provision of constitutional public services will continue, as well as any modifications + to the current expenditure budget, which will be made available to the creditors while judicial approval is sought.

#### **D. Acknowledgment, classification and priority of credits**

We propose the creation of an independent phase that contemplates hearing the creditors to request acknowledgment of their claims, preparation of credit lists by the comptroller or trustee and the judicial decision as to acknowledgment, classification and priority of credits, since it is absurd that insolvency proceedings, begin with credit negotiations and the term to reach an insolvency settlement without any of the parties having legal certainty with respect to the credits that may vote upon the insolvency agreement. It is therefore proposed that this stage be subdivided as follows:

We propose that creditors use the same process for the recognition of credits as established by the Commercial Insolvency Law, that is, within twenty calendar days following the date of publication of the municipal insolvency ruling in the Official Gazette, as well as the terms to object to the provisional list of credits and to file an appeal. However, the comptroller trustee will have the obligation to file the provisional and final list of credits and the judge to issue the Judgment of Acknowledgment, Classification and Priority of Credits as provided for in the Commercial Insolvency Law.

In light of the above, we propose making two distinctions regarding the credits payable by the municipality: (i) credits that will be given a super-preference are those credits payable from the bulk of the assets pursuant to the Commercial Insolvency Law and that will be paid before all other credits; and (ii) any others, and would be classified as follows

a. Super-preferred credits:

i. Credits arising from unpaid salaries resulting from labor relations with the municipality.

ii.- Debts related to the pension system to which the municipality belongs.

iii.- Debts incurred as a result of the reinstatement of public services recognized as essential at a constitutional level, resulting from the admission of the application for insolvency proceedings or from the insolvency ruling in case the insolvency proceedings were requested by a third party, which have been suspended by the municipality prior to any of the two situations mentioned above.

iv.- Those incurred during the liquidation of the municipality's assets arising from the security, administration and conservation services related to the assets being sold.

v.- Expenses incurred by judicial or extrajudicial proceedings in the benefit of the municipality's finances

b.- However, credits not listed above will have the following order of priority:

i.- Secured creditors or creditors secured by federal contributions.

ii.- Labor claims other than super-preferential claims as mentioned above.

iii.- Tax obligations.

iv.- Credits with special privileges.

v.- Ordinary creditors, which are those who are not included within the cases mentioned above.

vi.- Subordinated creditors, which are those who have agreed to be deemed as such and those which have been incurred by the municipality having either a friendship, family or business relationship with any of the members of the municipal leadership in office at the time the debt was incurred

In addition, the Judgment of Acknowledgement, Classification and Priority of Credits will expressly announce the opening of the settlement stage in the case where the declaration of municipal bankruptcy is based on the illiquidity of the municipality, in the event that it is based on insolvency, it will order the opening of the stage of liquidation of the municipality's assets. In addition, in the event that the financial situation is caused by the repayment of short-term public debt, an official letter will be sent to the various public banking institutions in order to seek adequate financing to convert short-term public debt into long-term public debt with an acceptable financial cost and always monitored by the conciliator and the court; private banks may also participate in such financing.

#### **E. Settlement stage**

We propose that the settlement should last 180 calendar days, counted from the date on which the publication of the order that decrees the finality of the Judgment of Acknowledgement, Classification and Priority of Credits takes effect, which may be extended under the same terms as in ordinary insolvency proceedings. Further, it is necessary for the comptroller to report on a monthly basis during the entire settlement term the measures taken to reach a settlement between the municipality and its creditors, with a focus on the latter so that the work entrusted can be effectively carried out.

We believe that the proposal of the insolvency settlement, its vote, adoption and implementation should be carried out in the following manner:

##### **a.- Proposal of the insolvency settlement**

A proposal for the insolvency settlement will be made by the conciliator or by the municipality, in the latter case by providing the comptroller with an opportunity to

make a statement on its feasibility, so that it can be made available to the creditors who may or may not adhere to the proposal. The bankruptcy settlement must provide for the payment of all the claims against the municipality, as well as the provision of deductions and waivers or any other arrangements by which payment to creditors can be made. However, payment must be arranged through classes which must be paid for under the same terms and conditions:

i.- Super-preferred creditors: Will be composed by the creditors that comprise this classification with the exception of creditors with claims arising from an employment or social security relationship with the municipality.

ii.- Preferred Creditors: Shall include secured creditors; those secured with federal contributions and those with special privileges.

iii.- Common and subordinated creditors: As the name suggests, this will include such creditors.

The insolvency settlement will also provide for the payment of creditors who have an employment claim of any kind, a pension claim or a tax claim, which cannot be changed and must be paid in full. In addition, a reserve will be set aside for those creditors who, at the time of execution of the insolvency settlement, do not have the right to vote because they have not been included in the Judgment on Acknowledgement, Classification and Priority of Credits, but whose recognition is pending validation in appeal.

#### b.- Vote on the insolvency settlement

The vote in favor of the insolvency settlement will be cast taking into account the classes proposed above, and therefore the approval of at least 50% of the creditors with voting rights in each of the classes indicated in the previous section will be required.

However, we propose that the judge should have cram down power over dissenting creditors. In the event that the judge finds that the 50% required for the approval of the bankruptcy agreement is not met, he will no longer take into account the vote of those dissenting creditors in the event that:

i.- All classes have undergone a reduction equal to or greater than that provided for in the case of the cram down contemplated for the dissenting class.

ii.- All classes have been subject to a moratorium equal to or greater than that provided for in the case of the cram down contemplated for the dissident class.

iii.- The dissenting class has not had its special guarantees or privileges removed or diminished.

Once the above has been ascertained, the court will approve the settlement agreement after verifying it to ensure that it meets the formal requirements laid down in the legislation and which are proposed to be the same as those in the Commercial Insolvency Law, taking into account the different nature of the municipality.

c.- Implementation of the insolvency settlement

It is proposed that the court should have all the powers at its disposal to compel the municipality to comply with the insolvency settlement, so that its functions will not cease until the settlement has been fully discharged, with the parties having the power to resort to the court in order to report event of non-compliance.

Pursuant to the above, if the terms of the insolvency settlement are not complied with, any person who is a party to or has an interest in the insolvency settlement may



request its forced execution. Both the affected party and the municipality, on a bilateral basis, may modify the terms established in the bankruptcy agreement, with the limitation that no benefits can be established other than those corresponding to the class to which the affected creditor belongs, unless there is absolute absence of justified opposition from the creditors with voting rights.

## **F. Municipal asset liquidation stage**

This stage is proposed only as an exception and as an extreme solution in the following cases:

- a. The request made by the municipality to initiate municipal insolvency proceedings on the basis of its insolvency.
  
- b. When the municipal bankruptcy is requested by a third party on the basis municipal insolvency and the municipality agrees or does not contest such assertion.
  
- c. When any of the conditions referred to in the corresponding article are met that lead to the presumption of the municipality's insolvency.
  
- d. In the event that the settlement term and any extensions thereto have elapsed without an insolvency settlement having been reached.
  
- e. In the event of non-compliance with the insolvency settlement, where the municipality's failure to comply is insurmountable in the opinion of the comptroller and the court.

We propose that this stage should follow the following guidelines:

a.- Judicial Order Regarding Liquidation of Municipal Assets

The purpose of this order is to declare that state, with the following effects:

i.- An order to the Ministry of Finance and Public Credit to appoint a liquidator or to designate the acting comptroller as such, in case he has not received such designation in the declaration of the municipal insolvency proceeding

ii.- A decree that the order be published in the Federal Official Gazette as well as in a newspaper with high circulation in the State of the municipality.

iii.- A decree for the municipality to publish said order in its municipal gazette.

iv.- An order that the liquidator take possession of each and every private domain property belonging to the municipality.

v.- An order that the liquidator perform a valuation of each and every private domain asset belonging to the municipality.

vi.- The order that the liquidator sell of each private domain property of the municipality.

vii.- Designation of the retroactive date on which any assets transferred by the municipality to the public domain regime to avoid being liquidated in the insolvency procedure should revert to private domain and could be up to a year prior to the commencement of insolvency proceedings.

viii.- An order to the liquidator that within sixty days after the liquidator takes possession of the Municipality's private property, to issue a report that shall contain:

- 1.- The state of the municipality's accounting.
- 2.- An inventory of the municipality's assets.
- 3.- A balance sheet of the municipality's finances at the date the report was issued.
- 4.- The trustee's declaration establishing whether the sale of the private domain assets owned by the municipality to this date are sufficient to cover the entire debt or, if not, the extent to which it is possible to pay such debt with proceeds from the liquidation of assets.
- 5.- The declaration of the liquidator determining whether there are public domain assets that can be disincorporated for the payment of debts in the event that liquidation of private domain assets do not suffice.

a.- Liquidation of municipal assets

We propose that the liquidation of the assets be made through public auction in the same terms established in the Commercial Insolvency Law or through some platform for such purposes, such as the Service for the Administration and Liquidation of Assets in order to make the liquidation more efficient. The purpose is for the liquidator to have sufficient powers to dispose of the property as quickly as possible, and always recover the amount determined in the valuation, which can only be less in the event of a subsequent auction.

c.- Shortage of assets to offset the municipality's insolvency

In the event that the opinion rendered by the liquidator finds that the sale of the municipality's private property is insufficient to relieve the municipality's

insolvency, or that all the municipality's private property has been liquidated without the debt being discharged, we propose that the judge, taking into account the aforementioned opinion, order the municipality to disincorporate the public property that is not being used to carry out a public service.

#### d.- Payment of Creditors

Once the above has been performed and funds have been collected from the disposal of the aforementioned assets, each class will be paid in accordance with the Judgement of Acknowledgement, Classification and Priority of Credits, and the amounts of the super-preferred creditors and those who did not have the right to vote in the insolvency settlement will not be affected.

#### i.- Payment to super-preferred creditors

In the event that there are insufficient funds to pay the super-preferred creditors with the proceeds of the liquidation of both the private and public property disincorporated for such purpose, we propose that the liquidator make use of the creditors' guarantees for the payment of the claims of super-preferred creditors as provided in the bankruptcy stage in the Commercial Insolvency Law, specifically Articles 226 and 227. In case of creditors secured by real guarantees, we propose proceeding in accordance with the Commercial Insolvency Law, although it is rare for municipalities to grant real guarantees to satisfy past due obligations, therefore, we propose expanding the scope of these powers by using guaranteed federal contributions to pay said creditors, which would be carried out as follows:

1.- In accordance with the Judgement of Acknowledgement, Classification and Priority of Credits, the liquidator will determine the number of debts guaranteed using federal contributions; the amount of each debt, the percentage of federal contributions that are subject to the payment of each debt on a yearly basis, as well as the number of years that such encumbrance

on federal contributions will last, in order to provide for payment in accordance with the aforementioned Judgment.

2.- To distribute the amount due for the super-preferred claims on a pro-rata basis among all debts on federal contributions until the total payment of such obligations have been fulfilled.

3.- Circulate the payment plan amongst creditors whose payment is guaranteed with federal contributions, to allow them to make any comments and objections deemed necessary.

4.- Once the last step is concluded, the court will decide whether to authorize the proposed payment plan. If not authorized, the court will instruct the liquidator to prepare a new payment plan.

5.- When approved, the court will order all local and federal authorities involved to comply with the terms of the payment plan.

ii.- Payment to remaining creditors

As for the remaining claims, they will be paid as follows:

1.- Privileged creditors should foreclose on their guarantees, and creditors secured by federal contributions shall continue to receive the guaranteed funds on a yearly basis in accordance with the Judgement of Acknowledgement, Classification and Priority of Credits, except where there are no funds available after payment of the super-preferred creditors as described above.

2.- In case of ordinary or subordinated debt, the full remaining amount shall be divided and paid in accordance with the insolvency ratio.

Once the proceeds obtained from the sale of the privately owned assets have been exhausted or in the event that the guarantees have been applied for the payment of super-preferential credits, both the liquidator and the court will call upon the creditors and the municipality to enter into a settlement agreement, whereby they will have an additional, non-extendable period of 180 calendar days to reach an agreement under the same terms as those established in the settlement stage, as explained above. In the event that a settlement agreement is not reached, the court may compel the municipality, if such a possibility exists and if feasible, to allocate the payment of its federal contributions up to the maximum percentage that can be allocated by a municipality under applicable law to the payment of the remaining claims. The ultimate case would be to provide creditors the opportunity to individually retain their rights and actions against the municipality for the remaining balance in accordance with the Judgment of Acknowledgement, Classification and Priority of Credits.

#### **H. Termination of the municipal insolvency procedure**

The court, through a declaration, must order the termination of the insolvency procedure, only in the following cases:

- a.- When a settlement has been reached and has been fully complied with.
- b.- When all the creditors of the insolvency proceedings have been paid in full.
- c.- When creditors have been given the opportunity to individually retain their rights and actions for the remaining balance against the municipality in accordance with the Judgment of Acknowledgement, Classification and Priority of Credits.

### 3. Conclusions

We believe that the proposed mechanism is sufficient to provide a solution to the root of the Mexican municipality's financial problem as described above; pre-eminence is given to the position of the municipality where its finances are affected by the cost of long-term debt as this is a problem that escalates into a systemic situation. This is not the case with the issue of short-term debt, where there is only the possibility of obtaining a relevant long-term credit to cover it, as this is the proper solution to the problem in the settlement stage of the municipal insolvency procedure. Firstly, we had to identify the purposes of a bankruptcy procedure, which led us to conclude that the most important issue is to rehabilitate the municipality's finances to guarantee the continuity of the public services which the constitution assigns to the municipality, and secondly the viability of the creditors' finances, which is why in relation to these two issues, the proposed procedure focuses the former, rather than the latter.

However, a number of adjustments are needed to the Mexican Constitution to make this insolvency procedure possible, but in general terms, the Mexican legal system has the structure and institutions necessary to propose an insolvency proceeding of this nature, which, due to the permitted length and scope of this work, would be impossible to cover in full.

In order to design the above procedure, the Mexican legal framework and the main bankruptcy trends around the world were taken into account, which are evident in:

**A.-** The voting mechanism in the insolvency settlement contained in the Commercial Insolvency Law for the proposed procedure, which was based on Chapter Eleven of the Bankruptcy Law, since it is much simpler than the one contained in the Commercial Insolvency Law. Further, the legal institutions originating in United States bankruptcy law are not entirely foreign to our legal

system, since it is widely known that Mexican insolvency law borrows heavily from United States legal proceedings.

**B.-** Adoption of the “municipal asset liquidation” is based on the Hungarian restructuring model and aimed to liquidate the municipality’s assets in order to mitigate its insolvency status in case an insolvency settlement is not reached; included due to the United States law professors’ opinion as to the inefficacy of the procedure in Chapter 9 of the Bankruptcy Law since it is mere a debt restructuring mechanism. Therefore, we opted to include the asset liquidation mechanism, but only as a possibility which leads to a possible solution to the problem referred to before, since the legal body used as a basis to create the proposed procedure is based on the insolvency proceeding contemplated in the Commercial Insolvency Law, but which is not exclusive to said legislation, since this institution has been under development in our legal system for centuries and is similar to the asset liquidation stage within the ordinary commercial insolvency procedure used to pay outstanding debt.

Nevertheless, it was determined that the most important of all the credits to be paid by the municipality are those related to the provision of services under its purview, since the provision of such services is the fundamental task of a municipality, and therefore the rules concerning payment of creditors need to focus and prioritize this task. Firstly, these claims were included in a super preferred class, as were those arising from the municipality's labor and pension obligations.

Secondly, the other claims were established on the basis of a graduation that took into account mainly the guarantees granted by the municipality for their payment, as well as their importance in the Mexican legal system, so the main focus was on those claims secured by federal contributions, as this is the most commonly used method to guarantee public debt acquired by the municipality. Although such loan is in the interest of the national credit, it must be paid after payment in full of the



debt that has been elevated to the category of super-preferred due to its importance for the population of the municipality, as well as its constitutional status.

On the other hand, the proposed procedure was designed to achieve an understanding between the creditors and the municipality, avoiding the need for either side be left without legal recourse, which is why so much time is invested in negotiations between parties aimed to achieve proper payment of the municipality's outstanding claims without sacrificing its finances in the process, where the option of last resort is to lease creditors' claims pending for collection at a later time, all while taking into consideration the debt issues which were discussed at the beginning of this work.

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