

Brief Summary of the *Concurso Mercantil* Proceeding

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General Aspects

The Law of Insolvency Proceedings (*Ley de Concursos Mercantiles*) (hereafter the “Law”) is a federal law in effect in Mexico since May 2000. It is only applied to individuals and companies that ordinarily carry out business activities (*comerciantes*), including business corporations. It is the only law regulating insolvency proceedings for business corporations in Mexico.

The Law regulates only one proceeding, which is court-driven and requires the participation of independent professionals appointed by the Federal Institute of Experts in Business Insolvency (*Instituto Federal de Especialistas de Concursos Mercantiles*) (hereafter the “Institute”). The Institute forms part of the judicial branch of the government and was created to support the judges on the administrative matters dealing with insolvency cases.

The proceeding has three 3 (three) stages. The first stage lasts on average 3 (three) months and is addressed to determine if the debtor should be declared insolvent. The second stage should last no longer than one (1) year and is addressed to reach a reorganization of the debtor, and the third stage is bankruptcy, if stage 2 (two) is not successful in reorganizing the debtor.

Stage one is not optional. Stage two must be followed unless the debtor requests the court to skip the reorganization stage to go directly to bankruptcy.

The First Stage or “Pre-Stage” of the Proceeding

The first stage is also known as the “pre-stage” of the proceeding. It starts with the filing of the insolvency claim and terminates with a judgment, which may either declare the debtor insolvent and subject to the proceeding (*en concurso mercantil*), or may resolve that the debtor does not meet the requirements to be declared insolvent under the Law, in which case, the proceeding would be terminated.

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The insolvency claim may be filed by the debtor, by a creditor or by the attorney general. If filed by the debtor, it is an insolvency request. The debtor requests the court to be declared insolvent and attaches to the filing copies of his financial statements, a preliminary list of his creditors, debts and assets. Upon receipt of the filing, the court requests the Institute to appoint an independent professional called “visitor” (*visitador*) to verify the debtor meets the financial test required by the Law to be declared insolvent.

Under the Law, the following financial test must be met to be declared insolvent (in *concurso mercantil*):

- (1) To have overdue obligations to 2 (two) or more different creditors, and
- (2) To have had 35% (thirty five percent) or more of its obligations overdue for at least 30 (thirty) days, or
- (3) Lack of liquidity² to repay at least 80% (eighty percent) of its obligations due on the date on which the insolvency petition is filed.

The audit to be performed by the visitor is made within the premises of the debtor. The visitor should have access to the financial and accounting information of the debtor, and may request access to verify the existence and conditions of the debtor’s assets. The visit finishes with the report the visitor files with the court informing if the debtor meets the financial test required to be declared in *concurso mercantil*. If the debtor meets the financial test, the court must issue a judgment declaring the debtor in *concurso mercantil* and opening the second stage of the proceeding. If the debtor does not meet the financial test, the court must issue a judgment providing that the debtor is not insolvent and closing the proceeding.

The first stage of the proceeding lasts approximately 3 (three) months if the debtor files the claim. If a creditor or the attorney general does, it may take longer. During the first years of application of the Law, the first stage of the proceeding could last in certain cases up to 1 year or longer if the filing was made by the creditor or the attorney general because the debtor would appeal all the resolutions and file an “amparo” claim³ and request a stay on the proceeding, which

² The term “liquidity” is used only for purposes of this paper. Instead, the Law provides a list of the assets which the debtor must have in an amount at least equal to 80% of its due obligations. Such list basically refers to cash, investments, deposits and securities available in no longer than a 90-day period.

³ The “amparo” claim is a remedy that can be filed before the federal courts and may grant a “stay” on the actions performed against the person filing the remedy. It may be filed for different reasons, but the main one is to protect the claimant from a breach of its rights granted by the Constitution.

was usually granted. However, the Supreme Court has issued a legal precedent⁴ providing that a stay must not be granted under “amparo” suits against the visit taking place in the pre-stage of the proceeding; which has reduced the period of time required for the debtor to be declared in *concurso mercantil* upon a filing by a creditor. According to the last report rendered by the Chairman of the Institute on June 21, 2005, currently the average time to elapse between the filing of an insolvency claim and the issuance of the judgment that declares the debtor in *concurso mercantil* is of 177 business days.

During this stage of the proceeding, no special measures take place, unless any of the parties requests the court to order special measures, which are usually granted. For instance, a creditor or the debtor may request the court to order a stay immediately after the filing on the grounds that there are strong possibilities that a creditor segregates assets from the debtor. In such case, the court will usually order the measures requested within the following couple of days.

The Reorganization Stage of the Proceeding

The reorganization stage of the proceeding begins with the judgment declaring the debtor in *concurso mercantil*. Upon the issuance of such judgment:

(1) A stay on all enforcement proceedings on assets of the debtor takes place, including proceedings in favor of secured creditors, but only excluding enforcement proceedings to collect wages and indemnities in favor of the debtor’s employees;

(2) The debtor must suspend the payment of obligations acquired before the judgment, not deemed necessary for the ordinary course of business of the company;

(3) Except for secured debts up to the value of their collateral, all other debts cease to accrue interest;

(4) The amount of each debt is frozen and, if denominated in a foreign currency, is exchanged to Pesos and then to UDIS⁵;

(5) A “look back” period is set, starting on the date of the judgment and going back 270 (two hundred and seventy) days, during which, transactions made to prefer a creditor can be void;

⁴ Novena Epoca. Instancia: Primera Sala. Fuente: Semanario Judicial de la Federación y su Gaceta Tomo: XXI, Enero de 2005 Tesis: 1a./J. 69/2004 Página: 379 Materia: Civil Jurisprudencia.

⁵ UDIS is a monetary unit which value is indexed to inflation in Mexico.

(6) The court requests the Institute the appointment of an insolvency professional called “conciliator” to be in charge of the reorganization stage.

During the reorganization stage, the debtor remains in the management of the company, with the surveillance of the conciliator. Notwithstanding the foregoing, the conciliator is entitled to request the court the removal of the debtor from the management of the company if he believes it is convenient to protect the estate.

The conciliator has 2 (two) main roles (in addition to the surveillance of the debtor’s management): to carry out the proceeding for the acknowledgement and classification of the claims and to negotiate with the parties a restructuring agreement. The conciliator must complete both tasks in no longer than 365 (three hundred and sixty five) calendar days. The Law provides for an initial term of 185 (one hundred and eighty five) days, which may be extended for 2 (two) periods of 90 (ninety) days each at the request of the parties. Therefore, if on the day the relevant term expires, no restructuring agreement executed by the parties has been filed with the court, the judge must declare the debtor bankrupt.

The compulsory term for the reorganization period is the result of the experience had with the old Mexican insolvency law. Under the old law, debtors would request the court an order to suspend their payments, which the court would usually grant. However, the suspension of payments had no term, so it could take many years, and in many cases, more than a decade, for the creditors to get a judgment to declare the debtor bankrupt. As a result, to avoid the foregoing, the Law provides for a non-flexible compulsory term of one-year, which has proved to be insufficient for large cases.

For the acknowledgement and classification of the debts, the conciliator must notify each creditor of the insolvency judgment and review the acknowledgement requests filed by the creditors. In the performance of his task, the conciliator must verify that each claim is legal and binding, and must rank the claims in accordance with the priorities provided by the Law. The conciliator prepares a list with the names of the creditors, amount of the claim and priority. The list may be challenged by the debtor and the creditors. The final list is approved by the court in a judgment called the “Judgment of Acknowledgement of Claims”, which becomes the basis for the voting proceeding during the restructuring agreement or the payment to creditors in bankruptcy.

As to the terms of the reorganization, the Law is open, it does not impose restrictions or limitations, except for the term to reach an agreement and the percentage of debt acknowledged in the proceeding required for its approval.

The reorganization process under the Law has been criticized for not regulating specifically Debtor-in-Possession Financing. The Law does not prohibit it, however, the lack of its regulation makes it difficult to work in practice, as the Law provides no assurance that a creditor granting DIP financing will be granted priority over existing debt. The creditor would have to negotiate it with the other parties and need the approval of the court, which would delay very much the process. The concept of “critical vendor” is theoretically incorporated in the Law since the debtor must not suspend payments deemed necessary for its ordinary course of business. The Law entitles the conciliator to determine which payments are “deemed necessary” without needing the prior approval of the court. The court must only be informed within the next 24 hours of the payments made. To date, very few creditors have been “deemed necessary” which when combined with the absence of DIP financing, has resulted in it being difficult to continue to operate a business while in Concurso. As a result, a majority of the large successful restructurings have been holding companies.

For the reorganization agreement to be valid and binding, the Law provides a formula. Basically, it requires that the agreement be approved by the debtor and either (i) unsecured creditors representing a majority⁶ of the debt acknowledged to all unsecured creditors in the proceeding, or (ii) by creditors representing a majority of the debt acknowledged to all unsecured creditors plus the debt acknowledged to the secured creditor that approved the agreement.

However, it should be noted that the restructuring agreement can be vetoed, and therefore, not become effective (i) if creditors holding over 50% (fifty percent) of the claims oppose to the plan approved by greater than 50% (fifty percent) of the debt, or (ii) if one or more unsecured creditors holding together at least 50% (fifty percent) of the debt acknowledged to unsecured creditors oppose to the restructuring plan.

Also, it is worth mentioning that the Law treats inter-company creditors the same way as any other creditor. Consequently, inter-company creditors vote *pari passu* with all other creditors and receive equal treatment unless the inter-company creditors agree to less favorable terms voluntarily.

A validly approved agreement binds all unsecured creditors. The consent of the debtor is always required, therefore, no exceptions are allowed. Secured creditors which did not approve the agreement are not bound by it and may continue with the enforcement proceedings of their collateral, unless the agreement provides their full payment within the following 30 (thirty) business days.

Bankruptcy

⁶ For these purposes, a “majority” means more than 50% (fifty percent).

The judgment declaring the debtor bankrupt terminates the reorganization stage, starts the last stage of the proceeding called bankruptcy, and replaces the conciliator with a liquidating trustee. The court requests the Institute in the judgment to appoint a liquidating trustee to be in charge of the bankruptcy process. If the conciliator is also registered with the Institute to perform as liquidating trustee, the conciliator will usually be confirmed as liquidating trustee.

The liquidating trustee has the main role to sell the assets of the estate to pay off the creditors in the order and manner set forth in the Judgment of Acknowledgement of Claims.

Under the Law, bankruptcy does not have a term. The liquidating trustee must provide the court a status report every 2 (two) months. Liquidation continues until no assets are left. If the liquidating trustee runs out of assets before he has finished paying off the creditors, the bankruptcy proceeding may be temporarily closed until the debtor receives more assets. Creditors keep their right to request the continuation of the bankruptcy proceeding every time the debtor receives new assets until their claims are extinguished by the statute of limitations.

The opening of the bankruptcy stage and the appointment of the liquidating trustee has the following effects:

(1) Removes the debtor from the management of the company and suspends the ability of the debtor to perform legal acts on behalf of the company, therefore, any legal acts performed by the debtor after bankruptcy are declared invalid;

(2) The administration of the debtor's assets is turned over to the liquidating trustee, who may elect to continue or discontinue the debtor's business pending final liquidation, and has full authority to manage the business and dispose of the debtor's assets;

(3) Third parties having possession of the debtors' assets are ordered to deliver such assets to the liquidating trustee and to make payments only to the liquidating trustee. Payments made to the debtor cause double payment obligations.

The Law provides the following rankings and priorities to pay off the creditors' claims in bankruptcy:

(1) Debts for wages and indemnities in favor of employees accruing during the 2 years prior to the judgment declaring the debtor in *concurso mercantil* have first priority;

(2) Expenses incurred in the management, preservation, custody and sale of the pool of assets; after such expenses are paid, expenses incurred in the litigation of assets of the estate, if any, and after such expenses are paid, the fees of the independent professionals appointed by the Institute;

(3) Secured creditors, on the understanding that secured creditors must only contribute to the expenses mentioned in paragraph (2) above to the extent such expenses were incurred strictly in connection with their collateral. Secured creditors must not contribute to the payment of the independent professionals appointed by the Institute.

(4) Labor debts other than those described on number 1 above and debts in favor of tax authorities;

(5) Creditors with special privileges, other than secured creditors;

(6) Unsecured creditors.

In the event the assets of the estate, other than collateral in favor of secured creditors, are not sufficient to pay the labor debts listed in number 1 above, the liquidating trustee is entitled to use the proceeds of sale of the collateral in favor of secured creditors to pay the debts listed in number 1 above, passing over to secured creditors only the remaining proceeds.