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The Mexican Financial Reform on Bankruptcy Matters

On November 26, 2013, the Mexican Congress approved significant amendments to thirty four laws regulating financial matters and issued the new *Ley para Regular las Agrupaciones Financieras* (Law Regulating Financial Groups) in a single decree of amendments that includes the so called financial reform (the "**Financial Reform**"). The Financial Reform was signed into law by President Enrique Peña Nieto on January 9, 2014 and is expected to be published in the *Diario Oficial de la Federación* (Official Gazette of the Federation) on January 13, 2014 at the latest. The Financial Reform will become effective the day following its publication on such Official Gazette.

The Financial Reform intends to comply with certain commitments agreed to in the *Pacto por México*, entered into by the President of the United Mexican States ("Mexico") and the presidents of the main political parties. The stated purpose is to transform the banking sector and credit into leverage for the development of Mexican families and companies, as well as to extend the benefits of an economy formed by competitive markets, with special emphasis, among others, in the financial services sector. In such regards, the amendments proposed in the Financial Reform mainly seek to (i) favor the increase of credit by development and commercial banks, (ii) encourage competition among the participants of the financial sector, and (iii) strengthen the Mexican financial system.

In connection with bankruptcy matters, the Financial Reform provides for amendments to the *Ley de Concursos Mercantiles* (Bankruptcy Law; the "**Bankruptcy Law**"), which main purpose is to expedite the *concurso mercantil* proceeding and to deal with certain issues that in practice have resulted in the vulnerability of the rights of the creditors and the debtor.

The most relevant proposals that intend to expedite the *concurso mercantil* proceeding are, among other, (i) prohibiting the judge to extend the periods set forth in the Bankruptcy Law, (ii) the consolidation of *concurso mercantil* proceedings of companies that are part of the same corporate group, which concept now includes companies that have the ability to make decisions with respect to another company, regardless of the share holdings, (iii) the ability of a debtor to request the *concurso mercantil* prior to being generally in default with respect to its payment obligations, when such situation is expected to occur inevitably within the following 90 days, (iv) the possibility to request the *concurso mercantil* directly in the stage of bankruptcy, (v) permitting common representatives to file credit recognition claims on behalf of a group of creditors and the addition of certain rules for the subscription of the debt restructuring agreement in the case of collective credits, (vi) allowing for the use of standardized forms to request or demand the *concurso mercantil*, (vii) the ability to file petitions and other communications electronically, and (viii) the transparency in the process is emphasized.

The Financial Reform sets forth certain measures that intend to strengthen the protections of the creditors' and/or debtor's interests, in order to avoid abuses that diminish the bankrupt estate. For such purposes, the Financial Reform allows debtors to obtain dip financing for maintaining the ongoing business of the company and the necessary liquidity during the

concurso, which will be considered privileged for purposes of the preference of the payment thereof.

Regarding abuses with respect to inter-creditor schemes of companies that are generally in default with respect to their payment obligations, the Financial Reform expressly recognizes subordinated creditors, including inter-company creditors in accordance with certain rules, and establishes that such inter-company creditors will not be allowed to vote for the approval of the debt restructuring agreement when such inter-company creditors represent 25% or more of the total amount of recognized credits, unless such creditors consent to the agreement adopted by the rest of the recognized creditors. Likewise, the retroactivity period applicable for the review of fraudulent conveyances is broadened only with respect to transactions entered into with inter-company creditors.

The Financial Reform also clarifies that the netting or the application of assets provided as collateral of derivative contracts, repo and securities lending transactions is allowed when such agreements provide that the ownership of such collateral has been transferred to the creditor.

The Financial Reform provides for additional guidelines to the rules contained in the Bankruptcy Law for the sale of the debtor's asset in order to protect to bankrupt estate. For example, the Bankruptcy Law (i) clarifies that the sale of securities will be made in accordance with such law and that the provisions of the *Ley del Mercado de Valores* (Securities Market Law; the "Securities Law") regarding the offering of securities will not be applicable; (ii) establishes that a secured creditor that is claiming the separation of its collateral from the bankrupt estate must grant security in case that its claim does not proceed; (iii) establishes that the procedures for the sale of assets may be entrusted to specialized third parties if the recovery value of the assets would be greater or it would be more profitable considering the costs and benefits; and (iv) defines the rules applicable for the valuation of assets that are necessary for the operation of the company in the ordinary course of business and that are granted as collateral, in the event the *síndico* (receiver or bankruptcy trustee) prevents the separate foreclosure of such collateral if it considers it would be beneficial for the bankrupt estate.

With respect to the *concurso mercantil* proceeding with pre-pack plan, the Bankruptcy Law permits the appointment of a *conciliador* (conciliator) that is not registered with the *Instituto Federal de Especialistas de Concursos Mercantiles* (Federal Institute of Bankruptcy Specialists), by the agreement of the debtor and creditors representing at least the majority of the total amount of debt. Likewise, the percentage required for filing a petition for *concurso mercantil* with pre-pack plan will increase to creditors representing at least a majority of the total amount of debt.

In order to avoid abuses against the bankrupt debtor, the amendments to the Bankruptcy Law provide for the creation of a system to award responsibility to the debtor's management and relevant employees for damages caused to the debtor if (i) acting with a conflict of interest; (ii) favoring one or more shareholders and causing damages to other shareholders; (iii) obtaining economic benefits for itself or for others; (iv) knowingly making, providing, disseminating, publishing or ordering false information; (v) ordering or causing the accounting registries, related documentation or conditions in a contract to be altered, modified or destroyed; (vi) failing to register transactions or causing false information to be registered, or causing nonexistent transactions or expenses to be registered or real transactions or expenses are exaggerated or

otherwise carrying out any act or transaction that is illegal or prohibited by law causing a damage to the bankrupt debtor and obtaining an economic benefit, directly or indirectly; and (vii) in general carrying out any willful or illegal act or acting with bad faith pursuant to the Bankruptcy Law or other laws. Although the Bankruptcy Law replicates the business judgment rule contained in the Securities Law applicable to the members of the board of *sociedades anónimas bursátiles* (publicly traded companies) and allows such members of the board and relevant employees of the bankrupt debtor to obtain insurance, guaranty or bonds to cover the amount of the indemnification for losses and damages caused, except for willful misconduct, acts of bad faith or illegal, it is important to mention that the Bankruptcy Law expressly prohibits any agreement, or provisions in the by-laws with respect to any type of considerations, benefits or exemptions that limit, release, substitute or redeem the liabilities of such members of the board and relevant employees of the bankrupt debtor.

Finally, due to the complexity of the banking business, the Financial Reform creates a specific legal framework for the court liquidation of banking institutions in the *Ley de Instituciones de Crédito* (Credit Institutions Law; the "**Credit Institutions Law**"); therefore, banking institutions shall be excluded from the Bankruptcy Law. The most relevant provisions in such respect are summarized below.

Under the reform to the Credit Institutions Law, the extinction of capital of a banking institution, meaning that its assets are not enough to cover its debts, is a cause to revoke the banking institution´s authorization to organize and operate as such. In addition, it will lead to the commencement of the liquidation procedure of the banking institution. The *Comisión Nacional Bancaria y de Valores* (National Banking and Securities Commission; the "CNBV") is the agency authorized to verify the extinction of the capital of a banking institution and revoke the corresponding authorization. The CNBV must inform the *Instituto para la Protección del Ahorro Bancario* (Institute for the Protection of Bank Savings; the "IPAB") about the extinction of the capital of a banking institution, and the IPAB may request a federal judge to declare the court liquidation of the institution. The IPAB will also act as receiver under the liquidation procedure and will carry out the creditor´s identification process.

Unlike the Bankruptcy Law, the banking liquidation procedure does not foresee a conciliation period prior to liquidation. Once the federal judge issues a sentence declaring the court liquidation, the IPAB may collect the debts of the banking institution, transfer its assets, pay or transfer its debts, liquidate the shareholders and carry out any other acts necessary to conclude the liquidation.

The IPAB will carry out the creditors' identification process. The IPAB must also comply with the following preference for the payment of the banking institution´s debts: first, secured creditors; second, labor obligations; third, debts with a special privilege provided by statute; fourth, credits from deposits and loans received or accepted by the banking institution and thereafter, payments shall be made in the preference provided in article 241 of the Credit Institutions Law, noting that the last debts to be paid are subordinated preferred and non-preferred obligations.

As of the date when the liquidation procedure of the banking institution begins, all term obligations shall become due and payable; unsecured peso denominated obligations and loans in

UDIS will cease to cause interests, unsecured obligations denominated in foreign currency will convert to pesos and will cease to cause interests; secured obligations will remain in their original currency and will only cause ordinary interest up to the amount of their guarantee; it will be deemed that the condition of obligations subject to a condition precedent never took place, it will be deemed that the condition of obligations subject to a condition subsequent took place and the parties shall return the assets exchanged while the obligation was in effect, in addition, the mechanisms to acquire funds shall be cancelled.

The reform provides that derivative, repo and securities lending transactions entered into by the banking institution will remain in effect for a period of 2 business days as of the date when the revocation of the authorization to organize and operate as a banking institution is published. After such 2 business day period, these transactions shall become due and payable as agreed by the parties or as provide by the Credit Institutions Law, and shall be netted and paid. If the banking institution in liquidation is both debtor and creditor in respect to the same counterparty, all the transactions entered into with such counterparty will be netted.

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