INSOL INTERNATIONAL

TREATMENT OF SECURED CLAIMS IN INSOLVENCY AND PRE-INSOLVENCY PROCEEDINGS II

INSOL INTERNATIONAL

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PRESIDENT'S INTRODUCTION

Banks and other lending institutions will extend credit provided they can obtain effective security in the event of default. This results in the lender being assured that it has the right to recover its debt in a quick and efficient manner.

When a borrower defaults under a loan agreement, the lender is usually unaware of the extent of the debtor's financial difficulties. There is always a risk that the debtor may be unable to repay other creditors in addition to the lender and be forced into insolvent liquidation proceedings.

Unsecured creditors usually receive very little or nothing through the rateable distribution process employed in such proceedings. However, in most jurisdictions secured creditors stand outside the insolvency proceedings and the credit instruments would give the lender the ability to enforce its rights without utilizing the courts. A secured creditor also has the right to pursue recovery as an unsecured creditor for any balance of the debt which the security does not satisfy.

In June 2007 INSOL published the first edition of this book. The subject matter continues to be of interest and relevance to practitioners and, as a result, the INSOL Technical Research Committee decided that a second edition of this book should be published. INSOL International is delighted to present this new and updated 20 chapter book which includes seven new country chapters (namely, Brazil, BVI, Cayman Islands, Hong Kong, Mexico, Nigeria and Singapore) and 13 updated and revised chapters of previously included countries. The chapters cover a wide range of key issues that practitioners would find useful, including the types of security rights that are available, the enforcement of such rights, circumstances when the granting of secured rights may be challenged and declared void, and the impact of reorganisation of a company on secured creditors, to name but a few.

The project was led by Evan C Hollander of Orrick, Herrington & Sutcliffe LLP, New York. Evan was also involved in the publication of the 1st edition of this book and we are very grateful for his guidance, interest, and ongoing commitment to publish this book to a very high standard. Evan had a great team working on this project and we are indebted to all of them for committing their time to the editing and review process. We would also like to thank the contributors for taking the time to write / update these chapters, despite their busy schedules.

Julie Hertzberg
President
INSOL International

FOREWORD

Consistent with INSOL's mission statement to "facilitate the exchange of information and ideas", the Technical Research Committee first produced in 2007 a comparative study of the treatment of secured claims in pre-insolvency and insolvency proceedings. The template utilized in the prior edition of this guide, developed with the assistance of my predecessor Andrew DeNatale Of Counsel and Head of the Special Situations Lending Group at Stroock & Stroock & Lavan, provided a handy, accessible and well-organized reference tool outlining the issues impacting the enforcement of secured claims in the twelve jurisdictions covered in that edition. Thus, that template has been incorporated with slight modification into this new edition covering the laws in 20 jurisdictions.

The treatment of secured claims is a matter that insolvency practitioners address in virtually every case in every jurisdiction. This new volume clearly illustrates the advantages and limitations of secured status in in pre-insolvency and insolvency proceedings in each of the 20 jurisdictions covered. As more corporations have extended their presence across borders, it has become critical for practitioners and investors to understand the nuances of the treatment of secured claims in multiple locations. It is the Committee's hope that this study will enable practitioners to navigate the complexities that arise in multinational restructurings, and to provide investors with a handy guide for sound practical information regarding the risks and rewards of secured investments in different countries.

The project would not have been possible without the help and support of others. The initial acknowledgement must go to the Technical Research Committee for developing the concept and format of the project, and to my predecessor who oversaw the production of the prior edition of this volume. I also extend my thanks to the contributors, each of whom submitted excellent material for the jurisdictions covered by the project. Finally, I would like to extend my sincere gratitude to my colleagues, Scott Morrison, Vincent Yiu and Nicholas Sabatino for assisting in the editing of the chapters in this volume and Emmanuel Fua, Peter Amend and Monica Perrigino, who assisted in drafting the materials on the United States.

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CONTENTS

MEXICO

1. Briefly summarise the types of security rights available and indicate, in each case:

- ***What are the common forms of security rights taken in respect of movable or personal property, including the taking of a pledge, lien, retention of title, fixed or floating charge?***
- ***What are the common forms of security rights taken in respect of immovable or real property, including the taking of a mortgage, lien or privilege?***
- ***Is the security interest granted by law, contract or both?***

Under Mexican law the most common forms of security rights taken in respect of movable or personal property are the commercial pledge and the non-possessory pledge, which are governed by federal law. The most common form of security taken in respect of immovable or real property is the mortgage, which is governed by law of each state of the Mexican Republic. Along with the security rights mentioned above, there is the industrial mortgage which can be created over movable and immovable property, and the security trust which can include both, immovable and movable property.

1.1 Movable property

1.1.1 Commercial pledge

The pledgor creates a security interest over tangible movable property. Generally, the pledged assets are delivered to the pledgee or a third party, acting as a depositary, who retains possession of the pledged assets until the secured obligations are fulfilled.

The commercial pledge is granted through the execution of an agreement between the pledgor and the pledgee and the delivery of the pledged assets to the pledgee or the depositary. There might be additional requirements depending on the type of assets, for example, negotiable instruments or stock certificates must be duly endorsed "in pledge" in favour of the pledgee before the registration of the pledge in the corresponding registry, such as the shares' registry book, and their delivery to the pledgee. In order to be enforceable against third parties the pledge must be registered in the corresponding public record office.

1.1.2 Non-possessory pledge

The non-possessory pledge is granted through the execution of an agreement between the pledgor and the pledgee, in which a security interest is created over tangible movable property, but contrary to the commercial pledge, the pledgor remains in possession of the pledged assets and can use and sell such assets in the ordinary course of business, subject to certain rules. If the amount pledged is greater than a specified threshold (currently, approximately USD$85,000)[1] the pledge must be ratified by a public notary. In order to be enforceable against third parties the pledge must be registered in the corresponding public record office.

1.2 Immovable property

1.2.1 Mortgage

The mortgage creates a security interest over immovable property in order to secure the obligations of a debtor to a creditor. It is governed by the law of each state of the Mexican Republic. The mortgage is

[1] 250,000 Mexican investment units (unidades de inversión (UDIs)) as of 10 February 2020.

granted by means of an agreement which is executed through a public deed issued by a notary public and, in order to be enforceable against third parties, it must comply with public notice requirements by way of registration in the corresponding public record offices.

A mortgage is also utilised to secure an interest in certain types of movable property, such as a ship or other type of vessel, for which registration of a maritime mortgage in the National Maritime Public Registry is required.

1.3 Movable / immovable property

1.3.1 Industrial mortgage

The industrial mortgage extends to all assets, operational cash and receivables of an industrial or commercial unit, thus creating a security interest over movable and immovable property. It is granted by means of an agreement which is executed through a public deed issued by a notary public. It must be registered in the corresponding public registry to be enforceable against third parties.

When talking about industrial mortgages, it is important to mention the working capital loan (*crédito de habilitación y avío*) and the fixed asset loan (*crédito refaccionario*). A working capital loan is extended by a bank for the purchase of raw materials and supplies, or for the payment of wages and direct expenses which are essential for the operation of the business of the debtor. A working capital loan is secured by the raw materials and supplies that were purchased with the loan and by the inventory resulting from the processing of the supplies and raw materials. A fixed asset loan is extended by a bank for the purpose of financing the purchase of equipment and machinery or for the construction of buildings needed for the debtor's business. A fixed asset loan is secured by the buildings or equipment that are acquired with the proceeds of the loan and additionally by any inventory that includes the new equipment and machinery located in the buildings.

The facilities described in this section are not commonly used because it is more practical to guarantee the debtors' obligations through a security trust or a non- possessory pledge, since both of these security rights contemplate extrajudicial enforcement methods, as further explained in section 2.

1.3.2 Security trust

Through this structure, the debtor transfers title of the secured assets, which can be movable and / or immovable property, to a trustee, to be held in trust to the benefit of the lender, who is the first beneficiary. The trust must be documented in a notarial instrument, if immovable property is incorporated to the trust or if movable property is transmitted to the trust which exceeds the amount provided by law (approximately USD $85,000).[2]

The security trust is considered a bankruptcy remote vehicle. When the assets enter into the trust they are transferred to the patrimony of the trust, thus isolating and protecting the assets and minimising the risk in bankruptcy. The foregoing, in principle, means that the assets are not considered to be part of the estate of the debtor in a bankruptcy proceeding.

2. How are security rights enforced? Is a court process or out-of-court procedure required or are both methods available? What are the practical difficulties experienced when security is enforced?

[2] 250,000 Mexican investment units (unidades de inversión (UDIs)) as of 10 February 2020.

2.1 Enforcement of security rights

In most instances, the collateral structures mentioned above are foreclosed by means of a judicial procedure.

However, regarding the non-possessory pledge and the security trust, there is a legal exception in which they can be foreclosed through an extrajudicial foreclosure procedure. This procedure is available subject to the terms agreed in the corresponding agreement and only if there are no disputes among the parties respecting:

- the enforceability of the security obligations;
- the amounts claimed; and
- the delivery of the possession of such assets.

The procedure will commence with the formal request to the debtor for the possession of the assets by the trustee or creditor, as applicable. Such notification must be made through a notary public. Once the assets are delivered to the creditor or trustee, as applicable, the sale of the assets will proceed, subject to the procedure established by the Commercial Code. In the event there is no agreement between the parties, they must request the foreclosure of the assets through a judicial procedure.

In the case of the security trust, the parties may also agree to the way in which the trustee can proceed to dispose of the assets subject to certain requirements provided by law, including the notification to the debtor, who will have a right to respond and object to the foreclosure.

2.2 Practical difficulties

Among the practical difficulties experienced when the security is enforced is the time and cost of the judicial procedure, which as in many other jurisdictions, tends to be lengthy and costly. This is due to lawyers' fees and possible delays resulting from various available legal challenges that can be made by the debtor, including the right to challenge any court decision by bringing a constitutional proceeding called *amparo*, questioning the constitutionality of the decision.

The delays are not exclusive to the judicial procedures. Even when the creditor or trustee can request the possession of assets in extrajudicial procedures, by means of a notification made by a public notary, there can be significant delays resulting from difficulties in locating and notifying the debtor.

The lack of registration may also represent a practical issue when enforcing a security, since as stated above, the registration in the corresponding public record office make the security interests enforceable against third parties; registration also determines the priority of the claims over the assets.

3. Are pre-insolvency proceedings available? If so, describe the types of pre-insolvency proceedings that are available, including:

- ***Who can initiate the proceeding?***
- ***What are the criteria used for opening the proceeding?***
- ***Who are the main actors: court, administrator, liquidator, trustee, receiver, controller, representative of creditors, state representatives etc.?***

- ***Does the debtor's management remain in control of the business during the proceeding?***
- ***May contracts and secured and unsecured debts be adjusted in the proceeding without affected creditor consent?***
- ***What is the level of creditor consent that is required to effectuate a restructuring?***
- ***Is shareholder consent required in order to effectuate a restructuring?***

Mexican insolvency law (*Ley de Concursos Mercantiles*, LCM) provides for a single insolvency proceeding known as *concurso mercantil*. This procedure consists of two main stages: i) the conciliation stage (a pre-insolvency stage); and ii) the bankruptcy stage (an insolvency stage).

3.1 *Concurso mercantil*

In accordance with the LCM, the following persons can file an insolvency proceeding:

- the debtor;
- any creditor;
- the district attorney (*ministerio público*);
- a judge; and
- tax authorities in their capacity as creditors.

An insolvency proceeding may be commenced if the debtor has not complied with its obligations with two or more different creditors, and the following conditions are met:

i) a debtor has defaulted on its payments to two or more different creditors of obligations that represent at least 35% of all the debtor's obligations and that have been due for more than 30 days; and / or

ii) the debtor does not have sufficient assets to pay at least 80% of its obligations due on the date of the filing of the claim.

The petition to initiate the proceeding may be filed by the debtor itself if either of the conditions referred to in i) and ii) above are met. The petition may also be filed by any creditor or by the district attorney when both conditions in i) and ii) above are met.

According to the LCM, eligibility for bankruptcy according to the specified conditions is presumed when, among others: i) the debtor does not have sufficient assets to attach after a default; ii) the debtor is in default with two or more of its creditors; or iii) the judge determines that the debtor is fraudulently conveying its assets to avoid the payment of obligations. This presumption is subject to rebuttal in certain cases.

3.1.1 Commencement of the concurso mercantil

A *concurso mercantile /* insolvency proceeding is commenced by the filing of a petition by the debtor or the filing of a claim by one or more creditors before the Federal District Judge with jurisdiction for the location where the debtor is domiciled.

The petition must request, among other things:

- an insolvency declaration; and
- that the proceeding move to the conciliation stage (which is a period for the debtor to attempt to agree on a restructuring with its creditors) or directly to the bankruptcy stage (in which a receiver is appointed to liquidate the debtor, which may be effected by selling the business as a going concern) without first going through a conciliation stage.

Title One, Chapter IV of the LCM governs the process for determining whether the insolvency conditions are satisfied. Once a petition or claim is filed, the judge controlling the insolvency proceeding will instruct the Federal Institute of Business Reorganisation Specialists (*Instituto Federal de Especialistas en Concursos Mercantiles*) (IFECOM) to designate a visitor (*visitador*) within five days.[3] The purpose of the visit is to inspect the debtor's financial situation in order to provide information for the judge to determine if the requirements for the initiation of the proceeding and a declaration of insolvency are satisfied. It is worth noting that, in the case of a claim submitted by the creditors, the visit will take place after the debtor replies to the claim.

The visitor appointed by IFECOM, which is typically an independent accountant, reviews the books and records of the debtor and reports to the judge. Within 15 calendar days of the visit, the visitor will issue and deliver to the judge a report regarding the debtor's financial situation. The judge will give five calendar days to the debtor (in case of a petition) or the creditors (in case of a claim) to challenge the visitor's report. Five calendar days after the previous term, the judge will determine if the applicable insolvency condition(s) are satisfied and will issue an order declaring the debtor's insolvency, the retroactivity date (the date to which the effects of the insolvency proceeding will be applied retroactively) and instruct the notification of the debtor, the IFECOM, the visitor, the creditors (whose addresses are known), the district attorney (if applicable), and the union's representative or the Labour Defence Attorney (*Procurador de la Defense del Trabajo*).

The proceeding will then move to the conciliation stage, unless the petitioner expressly requests that the proceeding moves directly to the bankruptcy stage. If the petitioner requests that the proceeding moves directly to the bankruptcy stage, and the judge so authorises, a receiver (*sindico*) will be appointed by IFECOM. Otherwise, if the proceeding moves to the conciliation stage, a conciliator (*conciliador*) will be appointed by IFECOM.

3.1.2 Claim process and priorities

Within five calendar days of his / her designation, the conciliator will request the registration of the judgment in the corresponding public record offices and will publish an excerpt of the judgment in the Federal Official Gazette (*Diario Oficial de la Federación*) and in one of the highest circulation newspapers in the locality where the proceeding are being commenced. Within 30 days of the publication of the judgment, the conciliator is required to submit to the judge a provisional list of claims using the information derived from the debtor, the data included in the conciliator's report, and filed proofs of claims.

Creditors must file proofs of claim against the debtor at one of the following stages of the proceeding: i) within 20 days after the date of the publication of the insolvency order; ii) within five days after the

[3] IFECOM is the federal administrative arm of the Mexican insolvency process and has specialists in business administration, financial, legal and accounting advice.

filing of a provisional list of creditors; or iii) within nine days of issuance of the order recognising and ranking the claims (after this term no credit recognition can be requested).

Proofs of claim must contain, among other information, a description of any collateral, as well as a description of the claim generally, stating whether the claim is entitled to preferential or priority status. After a five-day objection period, the judge sends copies of all objections to the conciliator, who then prepares the proposed final list of claims for submission to the judge. After the judge has made a determination regarding the proposed list and priorities, the judge issues an order of recognition and ranking of claims.

In cases where the insolvency proceeding goes directly to the bankruptcy stage, the powers and duties granted to the conciliator will be exercised by the receiver.

3.1.3 Conciliation (reorganisation)

Unless the petitioner has requested that the proceeding goes directly to the bankruptcy stage (without going through conciliation), once the debtor is declared insolvent, the conciliation stage begins and the IFECOM appoints a conciliator to conduct a conciliation process between creditors and the debtor aimed at developing a restructuring plan.

The LCM provides for a period of 185 calendar days for the reorganisation stage overseen by the conciliator. However, two 90-day extensions can be granted (for a maximum of 365 days). If no conciliation and reorganisation agreement is agreed upon within such period, the bankruptcy stage will begin.

During the conciliation stage, the debtor's management may remain in control of the business, with authority to continue to conduct the ordinary operations of the company, including paying any essential expenses. The conciliator may, however, request the removal of the debtor's management, in which case, the conciliator would assume the authority for the debtor's day-to-day operations. Even if the debtor's management remains in control, the conciliator has the obligation to monitor the debtor's books and records and transactions carried out by the debtor, with a goal of preserving the business enterprise as a going concern. The debtor requires the conciliator's consent to dispose of assets outside the ordinary course of business. Therefore, transactions such as entering into or termination of material contracts, including new financing arrangements and the assumption, granting or substitution of guarantees or security interests, and the transfer of material assets would require the conciliator's approval.

The restructuring agreement may be signed by all recognised creditors without the need for those creditors to hold a meeting to vote in favour of the agreement. In order for the agreement to be effective, it has to be signed by the insolvent entity or person and the creditors who represent more than 50% of the amount of unsecured and subordinated recognised liabilities and more than 50% of the amount of secured or privileged liabilities. As the insolvent entity must sign the agreement, it is understood that shareholder consent is required, and the quorum needed for such approval will depend on the debtor's by-laws and the laws applicable to such entity.

If the required majorities are achieved, the restructuring agreement will be binding on all recognised unsecured creditors, so long as it contains certain provisions that protect their interests, such as provisions requiring inflation-indexing of the debt, payment of all amounts that were due between the date of the judge's order declaring insolvency and the date of the agreement, and payment of all amounts that become payable after the date of the agreement.

In addition, the LCM imposes certain limitations on and conditions for certain changes affecting unsecured recognised creditors who do not sign the agreement. By way of example:

- payment deferrals may have a maximum duration only equal to or lower than the deferral applicable to creditors who did sign the agreement and who represent at least 30% of the total recognised amount due of the same class of liabilities;
- reductions of principal or interest must be in the same or lower amounts as reductions affecting recognised creditors who did sign the agreement, and who represent at least 30% of the same class of liabilities; and
- a combination of a payment deferral and a reduction must be on the same terms as are applicable to at least 30% of the amount of liabilities held by creditors who did sign the agreement.

With respect to secured creditors who did not sign the restructuring agreement, they may initiate or continue with the foreclosure of their collateral, unless the agreement provides for the payment of their claims up to the value of their collateral.

Once the restructuring agreement is signed by the debtor and the required majorities of creditors, the conciliator files it with the judge. The judge then submits it to the recognised creditors. The recognised creditors then have five days to present any objections with respect to the authenticity of their consent, or a veto of the agreement. In this regard, under the LCM, the agreement may be vetoed by the ordinary recognised creditors that:

- have not signed the agreement;
- the full payment of their credits are not established in the agreement; and
- their recognised credits jointly represent more than 50% of the total amount of the credits recognised to said creditors.

If the agreement is vetoed then the insolvency proceeding will pass to the bankruptcy stage, which is further explained in section 4.

Once the agreement has been sanctioned by the judge, the insolvency proceeding (*concurso mercantil*) is concluded.

4. Are insolvency proceedings available? If so, describe the types of insolvency proceedings that are available, including:

- ***Who can initiate the proceeding?***
- ***What are the criteria used for opening the proceeding?***
- ***Who are the main actors: court, administrator, liquidator, trustee, receiver, controller, representative of creditors, state representatives etc.?***
- ***Does the debtor's management remain in control of the business during the proceeding?***
- ***May contracts and secured and unsecured debts be adjusted in the proceeding without affected creditor consent?***

- ***What is the level of creditor consent that is required to effectuate a restructuring?***

- ***Is shareholder consent required in order to effectuate a restructuring?***

4.1 Bankruptcy stage

For the initiation of the insolvency proceeding, its main actors and the specific requirements and conditions of the restructuring agreement, see section 3.

Under Title Six of the LCM, if the debtor and the creditors are not able to agree to a restructuring plan within the specified time period, or if the debtor or creditor requests that the proceeding move directly to the bankruptcy stage and the judge so authorises, a bankruptcy proceeding (*quiebra*) is declared and, within the following five calendar days, a receiver (*síndico*) (who can be the conciliator or other person) is appointed by the IFECOM. Once this liquidation process begins, the legal capacity of the debtor to manage its business is suspended. The *síndico* assumes control of the debtor and begins the process of selling assets (as a general rule, such sale will be made through a public auction) and paying the recognised creditors. The *síndico* can, however, decide to transitionally continue operations of the bankrupt company during the bankruptcy stage.

In cases where the business is sold as a going concern, so that the debtor's contracts would be assigned to the acquirer as part of the sale, the counterparties to the contracts would have the right to reject the assignment of their respective contracts. This right must be exercised within 10 business days after the receiver provides notice of the proposed assignment. A counterparty that does not respond within 10 business days will be deemed to have consented to the assignment of its contract.

The *síndico* must file bimonthly reports to the judge on the status of the process, including the remaining assets and the identification of the creditors that have not yet been paid. Only when all the recognised creditors have been paid will the proceedings be terminated.

5. Could the granting of a security right or interest to a specific creditor be voided or be deemed a preferential treatment prejudicing the rights of the debtor or third parties? What are the grounds upon which the security right or interest can be challenged?

In order to protect creditors from fraudulent transactions, the LCM provides that transactions which are not in the ordinary course of business and which occur during a "retroactive period" will be ineffective. Transactions potentially subject to invalidation include gratuitous transactions, transactions at excessively low or high prices relative to the market value, transactions with related parties, payments of obligations not yet payable, remittance of debts, and the granting of new security interests or guarantees.

The LCM establishes a "retroactive period" of at least 270 days. This period is doubled for creditors who are "related parties", such as:

- holding companies or individuals who jointly or severally hold 50% or more of the corporate capital of the debtor;

- companies that are controlled by the debtor;

- directors and officers of the debtor or of the controlling or controlled companies of the debtor; and

- companies that share the same directors or officers.

The retroactive period can also be extended, for a maximum of three years, if requested by the conciliator, the receiver or by creditors, so long as the request is filed before the date the judge issues its order concerning recognition and priority of credits.

As explained above, certain transactions with related parties, such as officers and directors of the debtor, may be considered fraudulent as against creditors. Under the LCM, any person, including directors and officers, that might have acquired assets from the debtor in a transaction that is considered fraudulent will be responsible for the damages and losses that the debtor's estate may suffer if the assets in question have been lost or transferred to a *bona fide* third party. Claims against an officer or director in this respect may be brought by one-fifth of the recognised creditors or recognised creditors representing jointly at least 20% of all recognised credits or by the representative of the creditors (*interventor*).

Any creditor or group of creditors representing 10% or more of the value of the credits owed by the debtor set forth in the provisional list of credits has the right to request the judge to appoint an intervener in the proceeding. The intervener can represent the interests of creditors and be assigned the responsibility of overseeing actions of the conciliator, the receiver and the debtor (regarding the operation of its business).

6. Is enforcement of security rights treated differently in each type of proceeding?

6.1 Conciliation stage

From the moment the judge pronounces the sentence declaring the commercial insolvency of the debtor, no seizure or enforcement order can be executed against the assets and rights of the debtor, except for those that are carried out to ensure the payment of accrued salaries and severance payment to workers for the two years prior to the declaration of the insolvency.

The secured recognised creditors that had not participated in the restructuring agreement will be able to initiate or continue the enforcement of their security interests in the collateral securing their credits, unless the agreement contemplates the payment of their credits up to the value of their collateral and the creation of an ordinary credit for the amount exceeding the value of the collateral.

6.2 Bankruptcy stage

In the bankruptcy stage, the enforcement of security rights is not stayed, and the secured creditors may initiate or continue an enforcement proceeding. However, they must notify the receiver, who may participate in the proceeding to protect the interests of the estate.

During the first 30 calendar days, the receiver can prevent the separate enforcement of security rights over the assets:

- that are related to the ordinary course of the business; and

- that the receiver considers would benefit the estate to sell with other assets.

In order to prevent such enforcement, the receiver must make a valuation of the assets pursuant to the LCM and pay the secured creditor within the following three calendar days of the sale of such assets.

In principle, Mexican law does not contemplate accelerated procedures for secured creditors under the *concurso mercantil*. However, it is worth noting that, if certain assets were transferred into a separate trust agreement (which, as explained above, is a bankruptcy remote vehicle, in favour of a certain creditor), then such assets, in principle, can be separated from the debtor's estate, and the beneficiary thereunder might then follow a special procedure to enforce its claim, which will depend on the nature and specific characteristics of the trust.

7. What are the relative priorities in distributions among creditors and shareholders of the debtor during a pre-insolvency or insolvency proceeding?

According to the LCM, there are two types of creditors, insolvency creditors (*acreedores concursales*) and creditors against the estate (*acreedores contra la masa*).

7.1 Creditors against the estate

Credits against the estate have priority over insolvency creditors, and, according to the LCM, the proceeds obtained from the sale of the assets will be used to pay the credits in the following order:

- labour credits (accrued salaries in the two years[4] prior to the insolvency declaration (*declaración de concurso*);
- credits regarding the administration of the estate (acquired by the debtor with the authorisation of the conciliator or by the receiver);
- credits for the security, repair, conservation and administration of the assets of the estate and those acquired to maintain the ordinary operations of the company; and
- credits regarding costs and expenses derived from judicial and extrajudicial proceedings for the benefit of the estate.

7.2 Insolvency creditors

After credits against the estate are paid, the following order is implemented to pay the insolvency creditors:

- singularly privileged creditors – those whose expenses derive from burial or illness that has caused the death of the debtor, if applicable;
- secured creditors which, according to the LCM, are the creditors whose credits are secured by a pledge or a mortgage duly constituted;
- unsecured labour (different to those described above) and tax creditors;
- privileged creditors under Mexican commercial laws, for having a special privilege under such legislations or having a retention right (for example, creditors that are entitled to retain an asset until payment is made);

[4] The Supreme Court has established that the term of two years is unconstitutional since it violates the guarantee of equality before the law. It has determined that the term that should be applicable is a one-year period in accordance with the Mexican Constitution; however, this determination is not yet binding. See Tesis Aislada 1a VIII/2012 (9A), Semanario Judicial de la Federación y su Gaceta, Novena Época, Libro VI, Marzo de 2012, Tomo 1, p. 271.

- ordinary creditors – those who are not part of any of the classifications above; and
- subordinated creditors – those who had agreed to the subordination of their credit, or are related parties of the insolvent entity and are unsecured.

Notwithstanding the foregoing, claims of secured creditors would be paid up to the amount of the respective collateral, after the following claims are paid:

- labour claims for salaries and severance for the two calendar years preceding the insolvency declaration;
- litigation expenses related to the defence or recovery of secured assets; and
- expenses necessary for the reparation, conservation and disposition of the secured assets.

Shareholders are not treated in the proceeding and, thus, may not recover prior to creditors being paid in full.

8. How can secured creditors protect their interests in collateral during a pre-insolvency or insolvency proceeding?

In order to ensure that they are considered among the recognised creditors, secured creditors need to file a proof of claim (as established in section 3).

It is also important to register the security rights in the corresponding public record offices, since such registrations will be used to determine the priority of the creditors in respect of specific collateral, and the registration makes the security rights of a creditor enforceable against third parties.

9. Can the rights of a creditor against a non-debtor guarantor be affected in a proceeding of the primary obligor?

No, unless it is expressly consented by the affected recognised creditor.

10. What happens to secured creditors who have not complied with all the required processes for protecting their secured rights?

If the creditors do not register their security rights in the corresponding public record offices, their rights will not be enforceable against third parties. Furthermore, according to the LCM, the priority of the secured creditor will be determined according to the date of registration.

As established above, creditors must file proofs of claim against the debtor at one of the following stages of the proceeding:

- within 20 days after the date of the publication of the insolvency order;
- within five days after the filing of a provisional list of creditors; or
- within nine days of issuance of the order recognising and ranking the claims (after this term no credit recognition can be requested).

If the creditors do not submit their proof of claims and they are not listed in the conciliator list or in the order recognising and ranking the claims, they will be precluded from requesting the recognition of their credit.

11. During a pre-insolvency or insolvency proceeding, is the secured party permitted to foreclose or take other enforcement actions against the collateral? Does this stay apply to all claims against the debtor?

As established above (see section 6), after the sentence declaring the commercial insolvency of the debtor is issued, no seizure or enforcement order can be executed against the assets and rights of the debtor for the entire conciliation stage, except for those that are carried out to ensure the payment to workers of accrued salaries and severance for the two years prior to the declaration of the insolvency. After the execution of the restructuring agreement, the secured recognised creditors that had not participated in such agreement will be able to initiate or continue the enforcement of their guarantees, unless the agreement contemplates the payment of their credits or the payment of the value of their guarantees and the constitution of a credit for the amount exceeding the value of the guarantee.

In the bankruptcy stage, the enforcement of security rights is not stayed; however, the enforcement is subject to certain restrictions, including the receiver's power to challenge the enforcement.

12. Can collateral in which a secured party has an interest be used by the debtor or sold during a case without the consent of the secured party? If collateral may be sold without the secured party's consent, may it be sold "free and clear" of the liens of the secured party?

Are there specific rules regarding the debtor's use of "cash collateral" as opposed to other types of collateral?

In a bankruptcy scenario, all assets should be transferred free and clear of claims and liabilities. In a restructuring agreement, it will depend on the terms of the agreement.

In principle, the creditor's consent is needed to sell collateral over which he / she has a security interest. However, as established below (see section15), the security rights of a creditor can be affected in the following scenarios:

- by the execution of the restructuring agreement, as long as the conditions explained in section15 are met;
- in the event that a labour resolution establishes the foreclosure of a collateral of a secured creditor which cannot be replaced by a surety agreement, the collateral can be foreclosed, and the conciliator will have to register the amount of the execution of the collateral as a credit against the estate in favour of the secured creditor, and, in cases where the amount resulting from the foreclosure of the collateral is less than the credit, the difference will be considered as an ordinary credit; and
- the receiver can prevent the enforcement of a security by establishing the convenience of selling the guarantees with other assets, as long as the receiver pays the value of the collateral to the secured creditor and, in cases where the value of the collateral is lower than the credit, registers the difference as an ordinary credit.

Regarding cash collateral, in accordance with Mexican commercial law, the creation of cash collateral transfers the property of the cash to the creditor, unless otherwise agreed. In the cases in which the

parties have agreed the transfer of ownership of the cash, when there is a default of the guaranteed obligations, the creditor can keep the cash, up to the amount due without the need of an enforcement proceeding or judicial resolution. In cases where the cash collateral exceeds the amount due, the debtor is entitled to preserve its rights to any amount of cash collateral exceeding the amount of the secured obligation. In the event that the cash collateral is less than the amount due, the secured creditor preserves its rights against the creditor for the difference.[5]

13. During the course of a pre-insolvency and insolvency proceeding, can additional liens on a secured creditor's collateral be granted to a third party in violation of the contractual arrangements between the debtor and the secured creditor?

As a general rule, the entity during the insolvency proceeding must continue to comply with its obligations under existing agreements; thus, it should not violate its contractual arrangements. An exception to this rule is if the conciliator opposes the performance of such obligations in order to protect of the estate.

14. What distribution will a secured creditor receive if a company is reorganised?

As a general rule, the restructuring agreement must ensure the payment of the credit to the secured creditor, unless otherwise consented by such creditor. In the event the secured creditor does not participate in the restructuring agreement, the creditor will be able to take enforcement actions against the collateral, unless the agreement sets forth the payment of:

- the credit; or
- the guarantee and the constitution of an ordinary credit for the amount exceeding the value of the guarantee.

It is worth noting that the payment of the credit to the secured creditors will be subject to the order established in section 7.

15. Will the rights of a secured creditor over assets of a debtor remain intact subsequent to the reorganisation of the company?

No. It will depend on the specific restructuring agreement. Notwithstanding the foregoing, the law sets forth certain protections to the secured creditors that do not sign the agreement, including their right to take enforcement actions against the collateral, if the agreement does not: i) establish the payment of the credit owed to the creditor pursuant to the provisions of the LCM; or ii) include the payment of the guarantee and the constitution of an ordinary credit for the amount exceeding the value of the guarantee.

16. What rights does a secured creditor have if its secured claim is over-secured? What happens if a secured claim is under-secured?

In a case where the claim is over-secured, the secured creditor will have a right over the amount owed for the secured obligations, and the debtor will be entitled to preserve its rights to any amount exceeding the amount of the secured obligations. In a case where the claim is under-secured,

[5] General Law on Securities and Credit Operations (Ley General de Títulos y Operaciones de Crédito), Article 336.

the secured creditor will have a right over the collateral, and the amount still owed to the creditor will constitute an ordinary credit against the estate.

17. Will a court give full force and effect to a foreign restructuring of contractual arrangements that are governed by local law? If so, what requirements will need to be met for the court to do so?

The LCM provides that foreign restructuring or insolvency proceedings may be recognised by a Mexican tribunal, provided that the following requirements are met:

- the proceeding is a foreign collective proceeding (judicial or administrative), carried out by means of a law regulating the insolvency, bankruptcy or reorganisation of entities and in which the assets and business of such entities are controlled or surveilled by a foreign tribunal for their restructuring or liquidation;
- the request is submitted by a person or corporate body duly appointed in a foreign proceeding to act as a representative of the foreign proceeding or to manage the restructuring or liquidation of the assets or business of the entity;
- the request is submitted before the competent tribunal; and
- the request must meet certain requirements provided by the LCM, such as the submission of the foreign tribunal's resolution which started the foreign proceeding, a certificate issued by the foreign tribunal confirming the existence of the foreign proceeding etc.

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