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DIP Financing Regulation in the Commercial Bankruptcy Law of Mexico

By Francisco Javier Garibay Güémez*

The purpose of this article is to analyze, from a legal perspective, the obstacles that can be faced by those who intend to grant financing to Mexican companies facing a commercial bankruptcy process, considering current legislation.

Access to sources of financing is a fundamental tool for companies to optimize their operations, innovate, and develop to their greatest potential, generating jobs and channeling resources towards productive investments that promote economic development for the benefit of society. However, in Mexico, only a small percentage of companies have access to credit for development, which can help explain why from the 200 thousand companies that are created every year in Mexico, almost half of them close within their first year, and nearly 30 percent by their second.[1]

> The deficient operation of credit markets represents one of the most important obstacles for economic growth. Indeed, only 43% of companies have reported using credit from financial intermediaries. This factor is concerning, even when comparing Mexico's situation *vis-à-vis* the rest of Latin America, as only 29% of the registered companies with 100 employees or less have any sort of bank financing, while the average in Latin America is 45%, and there is a similar lag for companies with more than 100 employees.[2]

Lack of liquidity for companies not only considerably limits their development, but it also leads them to default on their payment obligations. This situation, if it becomes generalized, puts them in a condition that may trigger cause to initiate a commercial reorganization proceeding. The need to have access to sources of financing is enhanced in the case of companies that

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[1] COMISIÓN NACIONAL BANCARIA Y DE VALORES, *Encuesta Nacional de Competitividad, Fuentes de Financiamiento y Uso de Servicios Financieros de las Empresas,* [en línea] 18 de agosto de 2018, *available at* https://www.cnbv.gob.mx/Prensa/Estudios/Reporte%20de%20la%20ENAFIN.pdf.

[2] MEJAN, Luis Manuel, *Las reestructuras empresariales y el concurso mercantil,* en Perspectiva Jurídica, Universidad Panamericana Campus Guadalajara, [en línea] 15 de agosto de 2018, *available at* http://www.edkpublicaciones.com/up/index.php/indice-7/las-reestructuras-empresariales-y-el-concurso-mercantil.

undertake a commercial reorganization process, as without adequate cash flow, they are incapable of reorganization and to be able to successfully come out of it.

Considering the foregoing, and in response to the recommendations of international organizations,[3] one of the main purposes of the 2014 amendment to the Commercial Bankruptcy Law (*Ley de Concursos Mercantiles*—"Bankruptcy Law")[4] consisted of generating conditions that facilitate access to companies nearing a commercial reorganization, or already in it, to sources of financing that allow them to obtain the liquidity they require during the commercial reorganization process, and thus successfully conduct their debt restructuring plan.

The approved amendments to the Bankruptcy Law within the framework of the 2014 financial reform include the express possibility that the financially distressed company may obtain loans during the processing of its commercial reorganization, or prior to the declaration of commercial reorganization (a concept known in common law as DIP financing[5]), which must be indispensable to maintain the operation of the company, and the required liquidity during the commercial reorganization process ("DIP Financing"). The intent with this is not only to grant legal certainty to financially distressed companies and to lenders that wish to provide this type of "emergency loans," but to

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[3] Such as the United Nations Commission for International Trade Law (UNCITRAL), the World Bank and the International Monetary Fund.

[4] Published on January 10, 2014, in the Federal Official Gazette (*Diario Oficial de la Federación*).

[5] *Debtor in Possession Finance* o *DIP Finance*, is a term used in common law to refer to financing granted to a company that has initiated the procedure regulated in Chapter 11 of the US Federal Bankruptcy Code, which works on the basis that the credit granted by the lender granting such financing has seniority with respect to its payment, vis-à-vis the other debts of the company. "Under Section 364 of the Bankruptcy Code, lenders or investors who provide a Chapter 11 debtor with post-petition debt financing receive a priority claim that ranks ahead of the firm's prepetition unsecured debt. DIP lenders are therefore among the first to be repaid under the plan of reorganization. If the DIP loan is unsecured, it will be treated as a super-priority administrative claim. If the firm cannot attract financing on this basis, it can grant DIP lenders security in its assets (either a lien on unencumbered assets or a junior lien on assets that already secure some debt). The firm can even grant DIP lenders a security interest that is senior to existing secured debt (known as "priming"), although the bankruptcy judge will only permit this if the collateral of the creditors who are being primed is "adequately protected." Currently, most DIP financing is provided on a secured basis, although priming of existing secured debt is less common." GILSON, Stuart G. *Creating Value through Corporate Restructuring: Case studies in bankruptcy, buyouts, and breakups,* John Wiley & Sons, Inc., Hoboken, New Jersey, 2010, pp. 27–28.

generate conditions that allow them to preserve the value of the company, seeking its survival.

However, in spite of the progressive stance that the inclusion of this new regulation in the Bankruptcy Law represents, authorizing companies to obtain DIP Financing (even from the time of filing for commercial reorganization), we consider that, from a legal standpoint, there are still several obstacles in the Bankruptcy Law that make such a possibility unfeasible and even unmanageable for companies.

REQUIREMENTS FOR THE DESIGN OF AN EFFECTIVE DIP FINANCING REGULATION

Both the Legislative Guide on the Insolvency Regime adopted by the United Nations Commission on International Trade Law ("UNCITRAL"), and various reports issued by the World Bank and the International Monetary Fund, point to the existence of three essential elements for the design of an effective DIP Financing regulation, namely: (i) the determination of the incentives that may be offered to DIP Lenders; (ii) the establishment of a regulatory framework for the authorization of these operations that allows for the assessment of the different interests that may be affected by this type of financing and incentivizes DIP Lenders to arrange them, when they contribute to the generation of value; and (iii) consideration of the possible sources of DIP Financing, taking into account their limited nature.[6]

With respect to the determination of incentives as the crucial first element in the design of an effective DIP financing regime, it has to do with priorities or guarantees that provide DIP Lenders with a reasonable degree of legal certainty regarding the possibility to recover the funds of the loan granted to the company in reorganization. These priorities or guarantees usually consist of (i) the possible concession to DIP Financing of a "super-priority status," which would place them in an eventual bankruptcy scenario, in a preferential position not only against ordinary creditors but also in relation to all or some of the claims against the bankruptcy estate, only losing its preferential ranking with respect to secured creditors; and (ii) the granting of an absolute priority to the DIP Lenders, not only over ordinary creditors and creditors against the bankruptcy estate, but also against secured creditors, through what has been

[6] RODRÍGUEZ ÁLVAREZ, José Antonio, *La Financiación Postconcursal*, en "La ley concursal y su aplicación," Fundación de Estudios Financieros, Papeles de la Fundación, No. 33, p. 126.

called "privileged lien."[7]

The second of the critical elements in the design of an effective DIP financing regime refers to the need of establishing an effective regulatory framework that determines the conditions under which DIP Financing can be authorized, always seeking to incentivize the different stakeholders in the bankruptcy process to find a solution that maximizes the value of the debtor's assets, while allowing the balancing of different interests involved.[8]

Finally, the third of these elements refers to access to sources of DIP Financing, which in Mexico are reduced to the commercial or financial creditors of the financially distressed company, and only rarely to third parties who have no previous relationship with such company, and who saw the possibility of obtaining extraordinary returns to their investment.[9]

The current regulation of DIP Financing in the Bankruptcy Law is not effective, because, as explained hereinafter, it does not comply with the aforementioned elements.

PROBLEMS REGARDING DIP FINANCING CURRENT REGULATION IN MEXICO

Prior to being declared bankrupt, a company may request to the judge for its authorization to immediately obtain loans that are indispensable to maintain the ordinary operation of the company, in addition to the liquidity required during the processing of the commercial reorganization.[10] This petition may only be made from the date when the company filed for commercial reorganization declaration, or once such filing is admitted for processing. For the processing of DIP Financing, the judge may authorize the granting of appropriate collateral, if the company so requests it. Once the company has

[7] In jurisdictions where it is possible to grant DIP Financing the status of a privileged lien, such lien is only authorized with reluctance and as a last resort, and is usually subject to conditions such as the notification to the secured creditors affected and the concession to them of the opportunity to be heard and defeated in court, as well as the obligation of the bankrupt company to prove that it is not in a position to obtain the necessary financing without that priority. In addition, various mechanisms are established to ensure the protection of secured creditors against any decline in the economic value of the assets that were given as collateral. The International Monetary Fund has warned about the risks that this privilege entails, insofar as it can affect the value of collateral and have an undesirable impact on credit markets. *Ibidem*, pp. 126–127.

[8] *Ibidem*, pp. 127–128.

[9] *Ibidem*, p. 128.

[10] Art. 37 of the Bankruptcy Law.

filed its petition and given the urgency and need of the DIP Financing, the judge, upon prior opinion from the inspector (*visitador*), will issue a resolution with respect to the authorization of such funding, and issue the guidelines under which the authorization of such financing, and its ordinary repayment during the commercial reorganization, will be authorized.

Furthermore, once the commercial reorganization has been declared and, therefore, the conciliation stage has been initiated, the conciliator will have the authority to decide, upon prior opinion from the auditors (if any), on whether DIP Financing must be obtained. If the conciliator authorizes the company to obtain such financing, it must define the guidelines under which it will be authorized, including providing collateral, if this were requested from the company by its eventual lenders ("DIP Lenders").[11]

The main reason why a financially distressed company would be forced to request DIP Financing is down to the need to maintain a minimum level of liquidity to help it finance its operations during the commercial reorganization process (satisfying their immediate working capital requirements). This would need to be in such a way that it may continue operating and paying the wages of its employees and vendors, office rent, premiums for the insurance it has purchased, attorneys and other outside counsel fees and, in general, continue with its production process in a regular and orderly fashion, to be able, to the extent possible, to restore the trust of clients, vendors, employees and creditors.

A lack of liquidity for companies usually leads them to default on their payment obligations and places them in situations that can trigger the circumstances set forth in Articles 9 and 10 of the Bankruptcy Law, to initiate the commercial reorganization process. In a nutshell, the circumstances consist of *de facto* situations faced by a company that has failed to generally comply with its payment obligations to two or more different creditors, and in such cases, one or both of the following occurs:

i. The obligations that are at least 30 days past due, represent 35 percent or more of all obligations of the company as of the date on which the complaint or petition for commercial reorganization is filed; and/or

ii. The company does not have liquid assets to comply with at least 80 percenr of its past due obligations as of the filing date of the complaint or petition for commercial reorganization.

Therefore, if a company entered into a commercial reorganization process (whether at its own request or as required by any creditor or the Public

[11] Art. 75 of the Bankruptcy Law.

Prosecutor's Office (*Ministerio Público*))[12] as a result of its relative insolvency or lack of liquidity, it is evident that to come out of such process through a satisfactory negotiation with its creditors, it is of vital importance that it has a minimum amount of liquidity to allow it to continue operating and being able to reorganize and restructure its debt in such a way as to guarantee its survival and enable it to come out of the commercial reorganization procedure favorably.

However, the situation faced by the financially distressed company is frequently a disincentive for DIP Lenders for granting it loans, due to the significant risk that this represents. Therefore, to allow DIP Lenders to have greater confidence in deciding to assume such risk, Article 224 of the Bankruptcy Law establishes a ranking intended to incentivize DIP Lenders to give them the certainty that their loans will be repaid with priority.

> **Article 224.** The following are credits against the Bankruptcy Estate and must be paid in the specified order, and prior to any of those referenced in Article 217 of the Law:
>
> **I.** Those referenced in Article 123, Section A, Subsection XXIII of the constitution, and its regulatory provisions;
>
> **II.** Those obtained for the company to manage the Bankruptcy Estate with authorization from the conciliator or receiver or, as applicable, the indispensable credits to maintain the ordinary operation of the company and the liquidity required during the processing of the commercial reorganization. In this last circumstance, all payment privileges and priorities in case of granting such loans in contravention of what the judge has resolved or what the conciliator has authorized, will be lost, in addition to the event of a resolution through a final judgment setting forth that the credits were granted through creditor fraud and to the detriment of the Bankruptcy Estate;
>
> **III.** Those obtained to pay for the ordinary expenses for the security of the property comprising the Bankruptcy Estate, to repair, preserve and manage these, and
>
> **IV.** Those resulting from judicial or extrajudicial proceedings for the benefit of the Bankruptcy Estate.

[12] Pursuant to Article 9 of the Bankruptcy Law, when it is the financially distressed company that files for commercial bankruptcy, it suffices for it to fall under one of the circumstances mentioned in Article 10. To the contrary, when it is a creditor or the Public Prosecutor's Office that demands the declaration of bankruptcy to the company, it is necessary for the company to fall under both circumstances provided in such Article.

As we can see from the Article transcribed above, there is an exception to the classification of credits set forth in Article 217 of the Bankruptcy Law, mentioning that those called “credits against the bankruptcy estate” must be paid prior to the credits of the following types of creditors:

(i) creditors with a special priority;

(ii) creditors with a security interest;

(iii) creditors with special privileges;

(iv) ordinary creditors; and

(v) subordinated creditors.

However, further on we find one of the main inconsistencies of the Bankruptcy Law; since, on the one hand, Article 224 sets forth the aforementioned exception, mentioning that the credits listed therein must be paid “prior *to any* of those referenced in Article 217 of this Law” (which include creditors with a security interest) while, on the other hand, Article 225 sets forth that faced with creditors with a security interest or with a special priority, the priority referenced in Article 224 may not be enforced, but rather only the following have priority: (i) labor creditors, considering the wages of the year prior to the declaration of commercial reorganization of the company;[13] (ii) the expenses of

[13] Although Article 225 of the Bankruptcy Law still mentions two years, it is important to mention that the first chamber of the Supreme Court of Justice of the Nation (*Supreme Corte de Justicia de la Nación*) has determined that “Articles 224, Section I and 225, Section I of the Commercial Bankruptcy Law, by expanding without an objective and reasonable justification the term of one year provided by the Federal Constitution to two years as workers’ priority in commercial bankruptcy, violate the fundamental right of equality before the law to the detriment of the other creditors,” therefore, “such Articles of the Commercial Bankruptcy Law are unconstitutional to the extent that they refer to the excess time of two years, but not with respect to the ranking, and the priority ranking for one year of the credits created in favor of workers, since this circumstance is precisely what the Constitution provides in Article 123, Section A, Subsection XXIII. “See precedent 1a. VIII/2012 (9a.), which is published in the Federal Judicial Weekly Gazette, Tenth Period Book VI, Volume 1, March 2012, page 271, titled: “COMMERCIAL BANKRUPTCY. ARTICLES 224, SECTION I AND 225, SECTION I OF THE LAW ON THE SUBJECT MATTER, BY ESTABLISHING CREDIT PRIORITY IN FAVOR OF WORKERS FOR THE TERM OF TWO YEARS, VIOLATE THE FUNDAMENTAL RIGHT OF EQUALITY BEFORE THE LAW.” Although such precedent is from 2012 and the amendment to the Bankruptcy Law is from 2014, here we have a clear example of the lack of legislative technique, given that even though our legislators did reflect the change in Article 224, eliminating the part that stated “increasing the wages corresponding to the years prior to the declaration of commercial bankruptcy of the company,” considering the aforementioned precedent, they forgot to make the amendment in all other Articles of the Bankruptcy Law that refer to such two years, for which reason Articles 65, 67 and 225 still mention the same “two years.”

litigation filed for the defense or recovery of the property subject to collateral or those that have such priority; and (iii) the expenses required to repair, preserve and dispose of these. Considering the foregoing, the priority that the Bankruptcy Law grants DIP Lenders may not be enough to entice them to grant financing to companies undergoing a reorganization process or, otherwise, their risk analysis may be such that it causes the economic conditions under which such funding is offered to be too burdensome for the company undergoing commercial reorganization.

We consider that the current regulations on DIP Financing set forth in the Bankruptcy Law are insufficient to generate incentives that entice them to grant financing under adequate economic conditions to companies undergoing commercial reorganization, since it does not grant DIP Lenders sufficient certainty with respect to the priority level of their credits, and it does not eliminate the obstacles that still exist in our law, which make it inviable for these to be recovered by such creditors, increasing their risk position *vis-à-vis* other creditors.

A clear example of the inconsistency of the Bankruptcy Law regarding the incentives to grant DIP Financing consists in the lack of logical correspondence between the provisions of Article 43, Sections VIII and IX, therefore, with respect to the treatment of these credits.

> **Article 43.** The commercial reorganization declaration ruling will contain: . . .
>
> **VIII.** The order to the company to suspend the payment of the debts acquired prior to the date on which the effects of the commercial reorganization ruling start; unless these are indispensable for the ordinary operation of the company, including any indispensable credit to maintain the ordinary operation of the company and the liquidity required during the processing of the commercial reorganization, with respect to which the judge must be informed within seventy-two hours after these have been incurred;
>
> **IX.** The order to suspend, during the conciliation stage, all orders for seizure or enforcement against the property and rights of the company, with the exceptions provided in Article 65; . . . .

From a systematic interpretation of both Sections, we can see that DIP Financing is not subject to the suspension of payments set forth in Article 43, Section VIII. Therefore, the company (debtor) may not cease to pay the DIP Lenders the debts acquired under the relevant loan. However, Section IX does not exclude DIP Financing from the stay of execution; therefore, DIP Lenders may not seize or enforce property during the conciliation stage if the financially

distressed company defaults on the loan agreement. Thus, the conciliation stage becomes a stage where the DIP Lenders may not coercively demand compliance with their loan agreement as they only have a legitimate legal expectation that the financially distressed company will voluntarily comply with its payment obligations pursuant to it. According to the pandectists, during the conciliation stage, there is only the legal duty by the financially distressed company to comply with its obligations assumed under the loan agreement (*Schuld*), but there is no right for the DIP Lenders to demand compliance coercively (*Haftung*).[14]

DIP FINANCING RANKING

It is essential that the liquidation of the bankruptcy estate be made in an orderly fashion to satisfy the rights of the creditors of the company in case of bankruptcy. For maintaining such order, our legislature chose to classify the priority level of the credits that correspond to each of the lenders, establishing specific priorities attributable to a particular type of creditors over others, to satisfying their credits with respect to the bankruptcy estate starting once the judge issues the reorganization ruling.[15]

This way, the Bankruptcy Law discriminates against creditors when taking into consideration the particular characteristics of their credits, which in no way entails a violation of the concept of equality, as a human right established in

[14] *See* ROBLES FARÍAS, Diego, *Teoría general de las obligaciones,* Oxford, México, 2011, pp. 70–76.

[15] "Insolvency Law was born almost one millennium ago in business corporations. It arose from the need for state law to guarantee the prevalence of the *par conditio creditorum* principle, to put it against the prevalent *prior in tempore potior in jure* principle. Its purpose is to prevent the person that acts first against a debtor from taking it all and only leaving the remaining balance for subsequent creditors. The post-medieval corporation established the parity principle. From then on, *par conditio creditorum* became one of the great pillars of Bankruptcy Law, by allowing all creditors to be treated as equals, in such a way as to allow them to receive their payment on a *pro rata* and equitable basis. However, due to different political circumstances imposed by legislators, in all bankruptcy legislation in the world, senior credits have started to appear that have made the parity principle ineffective, to give way to several priorities. In these cases, senior creditors will always receive their payment before the rest of the creditors, resulting in the majority of these not being collected. It is for this reason that the Argentinian professor Ariel Dasso states that in all forums before which he appears, that *par conditio* has died" PEÑA BRISEÑO, Víctor Manuel, *La subordinación de créditos en el Derecho Concursal Comparado. El caso mexicano,* en Perspectiva Jurídica, Universidad Panamericana Campus Guadalajara, [online] August 17, 2018, *available at* http://www.edkpublicaciones.com/up/index.php/ediciones/la-subordinacion-de-creditos-en-el-derecho-concursal-comparado-el-caso-mexicano (translated by this article's author).

Article 1 of our Constitution, since, as the Supreme Court of Justice has determined, the principle of equality under the law does not necessarily entail that all persons may always and under any circumstance be in conditions of absolute equality, but rather, to the contrary, such principle refers to equality before the law, which translates into the right of citizens to receive the same treatment as those that are in a similar *de facto* situation. The foregoing means that not all inequality is in violation of fundamental rights, but rather only when it produces a distinction between objective and *de facto* equal situations, without there being a reasonable and likewise objective justification, in such a way that for equal *de facto* situations, similar legal situations must apply.[16] This way, the concept of equality is inspired by the principle of equity, which consists in giving equal treatment to equals, and unequal treatment to unequals, which situation is manifested in the Statements of Purpose of the Bankruptcy Law, by establishing that equity is not reached by giving equal treatment to different creditors (because their credits are not equal), but rather recognizing their differences and, above all, preventing fraud and favoritism.[17]

The creditors that have the priority referenced by Professor Peña include, first, workers, who pursuant to Articles 224 and 225 of the Bankruptcy Law will collect their wages accrued in the past year, and the indemnity that corresponds to them, before all other creditors. Like the aforementioned labor credits, DIP Financing is considered "credits against the bankruptcy estate," therefore, they shall be paid prior to the other creditors, except for workers and creditors with a security interest or with a special priority. However, we consider that this exception is an error. DIP Financing must receive a similar treatment to that which is granted to those mentioned in the three Sections of Article 225, or even better treatment.

The current system of priorities set forth in the Constitution and in our Bankruptcy Law contains certain flaws, including the super-priority that such regulations grant labor credits. DIP Financing should have a priority status with respect to such credits, for practical reasons; it is important to remember that this type of financing directly benefits the financially distressed company and its property, increasing the returns of all other creditors and their expectations to

[16] *See* case law titled: TAX CRIMES. ARTICLE 101 OF THE FEDERAL TAX CODE SETS FORTH ALL CASES WHERE THE REPLACEMENT AND COMMUTATION OF SANCTIONS OR ANY OTHER BENEFIT TO THOSE SENTENCED FOR SUCH CRIMES ARE NOT APPLICABLE, AND THE REQUIREMENTS THAT MUST BE SATISFIED IN THOSE THAT MAY BE GRANTED, IS NOT A VIOLATION TO THE PRINCIPLE OF EQUALITY BEFORE THE LAW.

[17] *See* the statement of purpose of the Bankruptcy Law.

see the collection of their credits satisfied. DIP Financing may serve the financially distressed company to be able to continue with the ordinary operation of the business, which necessarily entails paying the wages and other benefits of its employees, and thus keep their jobs.[18] It is therefore ineffective—and a disincentive for potential DIP Lenders—to pay the employees before paying the lenders that made it possible to comply with the emerging labor obligations.

JUDICIAL AUTHORIZATION TO OBTAIN DIP FINANCING

Dr. Arellano García defines interim measures as all "judicial decisions pursuant to which measures are adopted to prevent damages or danger, in the cases, with the procedure, and with the legally established requirements."[19] Thus, the nature of injunctions (also called interim measures)[20] consists in being interim, ancillary, and summary judicial[21] provisions, issued in the event of the existence of a right, and seeking to facilitate the enforcement of the ruling, if such right is recognized.

The logic behind these measures is, therefore, to guarantee the survival of a right, whose holder believes may suffer some impairment, so that, given the danger in delay, it becomes necessary to provisionally replace the lack of a final

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[18] However, we consider that for DIP Financing to be able to have such senior status, the guidelines under which they are approved to be obtained must contain an obligation of the bankrupt company to use such funds to pay wages and other benefits of workers (to the extent they are indispensable to continue with the ordinary operation of the business). We must remember that such financing is granted for the purpose of keeping the company alive, therefore, preventing collective labor disputes is indispensable for such purpose.

[19] ARELLANO GARCÍA, Carlos, *Práctica Forense Mercantil,* Editorial Porrúa, México, 2013, p. 319.

[20] In precedent 415/2012, the Supreme Court of Justice of the Nation seems to create a distinction between interim measures and injunctions, implying that the former is a general category and the second is the specific application. However, our highest court used such distinction for arguing that applying to the general category (interim measures) a rule corresponding to the special category (commercial injunctions) would result in an argumentative fallacy, and thus we can conclude that when an interim measure is requested for maintaining a status quo, the Federal Code of Civil Procedure (*Código Federal de Procedimientos Civiles*), which provides as interim measures those called attachment measures, set forth in its Articles 384 to 388, is applicable by extension.

[21] While we understand that there are some interim measures that are issued by authorities other than judicial authorities, such as administrative authorities (e.g., the conciliation and arbitration boards), or even by arbitration panels in a commercial arbitration context; in the context of a commercial reorganization, these measures can only be judicially authorized.

resolution, granting a provisional resolution aimed at ensuring the subsequent effectiveness of the final resolution.

Considering the foregoing, it is important to question whether the authorization by the judge to obtain DIP Financing constitutes an interim measure or not. For such purpose, it is convenient to analyze both the nature and the effects of the authorization and determine whether it is indeed possible to affirm that such authorization constitutes an injunction (or interim measure).

As mentioned above, for the purpose of facilitating access to DIP Financing for the company, and to reduce the damages that may be inexorably caused to it by the simple passage of time, the Bankruptcy Law contemplates, in its Article 37, the possibility that from the moment when the request for commercial reorganization is filed, or once it has been admitted for processing, the company may request the judge for its authorization to obtain DIP Financing. For this, the Bankruptcy Law sets forth that the judge may, considering the *urgency and need* for such financing, and for the purpose of *maintaining the ordinary operations* of the company and the liquidity required during the processing of the commercial reorganization, upon prior opinion from the inspector, authorize the company to obtain DIP Financing.

Three things from the previous paragraph should be highlighted. The first of these consists on the location of the provision in question, which refers to the interim measures that the judge may issue at any stage of the commercial reorganization process. The second is that, to decide with respect to the convenience of authorizing the DIP Financing, the judge must consider the urgency and need to receive it. Lastly, the third lies in the purpose sought by authorizing the company to obtain DIP Financing, which is to maintain the ordinary operations of the company, and liquidity during the processing of the commercial reorganization.

If we see the three issues mentioned above, it would seem that these perfectly fit the characteristics and the nature of interim measures, since they (i) are authorized judicially, (ii) are granted considering urgency and need (danger in delay or *periculum in mora*); and (iii) have a preservation purpose, since they are intended to preserve the company, in accordance with the purpose of the Bankruptcy Law set forth in its first Article (*fumus boni iuris*).

However, from a review of Article 37 mentioned above, we can see that the legislature did not wish to include the authorization to obtain DIP Financing within the list of interim measures. Additionally, certain issues may call into question that indeed it is a measure of such kind. It is important to remember that such authorization is not always granted judicially, but rather it may be granted by the conciliator (upon prior opinion from the auditors) in terms of Article 75. Additionally, if we consider the effects generated with such measure,

it would seem that these, even though they are intended to preserve the company, do not preserve a legal *de facto* situation, but rather they produce a right that translates into the authorization to enter into an agreement with a third party, which should have ultimate substantive effects, granting certainty to such third party that intends to grant the relevant financing.

Encompassing such authorization to enter into DIP Financing within the list of interim measures would entail to give such authorization an interim nature, which could generate uncertainty for eventual DIP Lenders with respect to the ultimate nature of such authorization and, therefore, with respect to the validity of their loan agreement.

In turn, we consider that beyond the theoretical discussion with respect to the nature of the judicial authorization, another of the shortcomings of the Bankruptcy Law is that it does not provide for and does not regulate what will happen with the loan granted by the DIP Lenders, if the judge decides that the company does not fall under any of the circumstances for commercial reorganization to apply. It is important to remember that the company may petition the judge for its authorization to obtain DIP Financing from the time when it files for commercial reorganization, which must be granted or denied by the judge immediately, considering the aforementioned urgency and need. Now, let's imagine that, after a judge grants the relevant authorization, the company enters into the loan agreement and borrows the funds therefrom, the judge finally determines that the company was not under any of the circumstances for commercial reorganization to be admissible, as provided in Article 10 of the Bankruptcy Law.[22] What then would be the legal status of the DIP Lenders that lent funds to the company? Evidently, one possibility for facing the foregoing would be to argue that they have the authority to accelerate the loan agreement, since the deciding reason that led them to enter into it was in the presumption that the company would be declared in commercial reorganization, and the fact that its credit would have priority given its classification as a credit against the bankruptcy estate, with all the benefits that this entails. They could also have provided such circumstance as a cause for acceleration of the loan agreement. However, the judicial pronouncement that the DIP Lenders and the company would have to follow to terminate the agreement is expensive. The fact of accelerating the loan agreement and obtaining a ruling compelling the company to return to the DIP Lenders the funds resulting therefrom would not resolve the problem, since it could place the company in the circumstances for commercial reorganization, in the

[22] Provided that the company was not able to file for commercial reorganization with prior restructuring plan.

understanding that this would entail that, this time, the credit of the DIP Lenders would be deemed an ordinary credit.[23]

We consider that the Bankruptcy Law should provide greater legal certainty to the DIP Lenders, establishing that if it is determined that the company is not under any of the circumstances to initiate the conciliation stage, the DIP Financing granted by third parties acting in good faith would preserve their status as credits against the bankruptcy estate in case of a subsequent commercial reorganization. We expect that a measure of this kind could generate greater certainty for DIP Lenders that wish to grant loans to companies that are going through financial hardship.

The fact that the Bankruptcy Law is silent on the matter may have an effect contrary to that which the legislature sought, since the eventual DIP Lenders would choose to grant DIP Financing until the companies are officially in the conciliation stage, and once the conciliator has given its authorization to grant such loans.

An alternative to reduce the aforementioned risk would be to file for commercial reorganization with a prior restructuring plan. One of the great advantages that this possibility entails is the fact that it would allow the company to file for and obtain the declaration of commercial reorganization immediately, without the need to appoint an inspector to determine whether effectively the company incurred any of the circumstances provided in Article 10 of the Bankruptcy Law.[24] However, it is important to remember that to use this alternative, the filing for commercial reorganization with prior restructuring plan must comply with all the requirements set forth in Articles 20 and 339 of the Bankruptcy Law, which include the need for such filing and the composition proposal to be signed by creditors that represent, at least, the simple majority of all of the obligations owed by the company, which in many cases may be hard to achieve.[25]

We consider that limiting the possibility of receiving DIP Financing upon filing for commercial reorganization for companies that do not have the possibility to file such petition with a prior restructuring plan is contrary to the purpose of the Bankruptcy Law, since when a company is going through

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[23] Or in the best case scenario, with a security interest, if the granting thereof were authorized by the judge.

[24] In addition to using this option, the company may request and obtain from the judge the injunctions set forth in Article 37 of the Bankruptcy Law.

[25] Another alternative would be filing for commercial bankruptcy on an imminent basis, pursuant to the provisions of Article 20 Bis of the Bankruptcy Law.

financial hardship, time is of the essence. In Mexico, the actions of the authorities are naturally slow. Waiting for companies that face illiquidity to obtain consent from the majority of their creditors, or to be in the conciliation stage, may take a long time, to the detriment of the company, its creditors, and society as a whole.

Additionally, the time for the inspector to be appointed by the Federal Institute of Commercial Bankruptcy Specialists (*Instituto Federal de Especialistas de Concursos Mercantiles*) to accept its commission, inform the judge of the name of its assistants, start its duties, review the financial and accounting condition of the company, and interview its senior management, executive and management team, and its outside financial, accounting and legal advisors, to finally issue a pronouncement with respect to the request to obtain DIP Financing, only prolongs the agony.

To make the authorization of DIP Financing more efficient, the Bankruptcy Law should provide mechanisms through which legal certainty is increased both for DIP Lenders and companies that are going through troubling financial situations, which cannot file for commercial reorganization with a prior restructuring plan.

CONVERSION OF DEBT TO EQUITY AS A FORM OF PAYMENT TO DIP LENDERS

The incentives that could encourage DIP Lenders to grant financing to companies going through a commercial reorganization process include, for example, the high level of influence that they may eventually obtain and exercise over these. The level of influence frequently depends on the amount of the DIP Financing, and the mechanisms established in the loan agreements. Such mechanisms may be contingent upon the right of DIP Lenders to designate a certain number of members of the board of directors of the financially distressed company, perform audits, access confidential information and, in general, establish certain affirmative and negative covenants for the company, which grant the DIP Lenders a level of influence that allows them to control the behavior of the company to a certain extent.

One of the circumstances where such influence usually materializes is during the negotiation of the compositions with the recognized creditors in reorganization. Indeed, in several jurisdictions (such as in the United States)[26] it is common for

[26] In the United States, for example, there are investment funds dedicated to bailing out and acquiring undervalued companies, to then reorganize them and sell them as a fully viable and solvent company. These include funds such as Cerberus, Fintech Advisory, Oaktree, Apollo,

DIP Lenders to leverage their position as senior creditors for influencing the recognized creditors in the negotiations of composition in reorganization. If after analyzing the financial situation of the company, DIP Lenders determine that it has potential, it is possible that they agree with the company on a conversion of debt to equity mechanism as form of payment, provided that its financial hardship is due to poor management, which may be easily reverted by the DIP Lenders as soon as the company comes out of the commercial reorganization.

Thus, one of the advantages that DIP Lenders enjoy with respect to the recognized creditors consists in that, by not being strictly considered commercial reorganization creditors,[27] their credit is not subject to the same rules that apply for the recognized creditors resulting from the credit recognition, classification and priority ruling, in such a way that a particular agreement for conversion of debt to equity by the DIP Lenders with the shareholders of the financially distressed company would not be subject to being declared void pursuant to Article 154 of the Bankruptcy Law. We must remember that the ruling declaring commercial reorganization is not only the procedural and legal basis of the commercial reorganization, but also a watershed with respect to the obligations assumed by the company, since all of the obligations prior to the declaration of commercial reorganization (except for the DIP Financing authorized by the judge in terms of Article 37 of the Bankruptcy Law) are subject to commercial reorganization rules, and are therefore the subject matter of a composition in reorganization, or are paid with the commercial bankruptcy payment, while all obligations acquired after the declaration of commercial reorganization (such as the DIP Financing) are not subject to such rules, and may therefore be paid during the conciliation stage by the company.

We consider that this conversion benefit is important for DIP Lenders, especially if we consider recent cases such as those of the construction companies Homex[28] and ICA,[29] which in a certain way have cast serious doubts

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Angelo Gordon, Silver Point, Appaloosa, and Strategic Value Partners.

[27] We say that DIP Lenders are not commercial bankruptcy credits, strictly speaking, since (i) by considering their credit to be a "credit against the bankruptcy estate," it may not be modified by the commercial composition in bankruptcy, which may only agree its payment; and (ii) in case of bankruptcy, they have the super-priority set forth in Article 224 of the Bankruptcy Law.

[28] On June 13, 2014, Desarrolladora Homex, S.A.B. de C.V. (jointly with some of its subsidiaries) was declared in commercial bankruptcy with prior restructuring plan, which ended through a ruling dated July 3, 2015, and through which the First District Court in the State of Sinaloa approved, as a final ruling not subject to appeal, the composition executed with the majority of its recognized creditors. In such composition, it was resolved, among other things, to

regarding the conversion of debt to equity as an efficient mechanism to grant legal certainty to recognized creditors, if there are ordinary creditors that do not execute the composition in reorganization approving such conversion. This is due to the Bankruptcy Law setting forth in its Articles 158 and 159 the rules that provide the way to determine and pay the credits corresponding to such ordinary creditors, which do not include the conversion of debt to equity.

Pursuant to Article 158, for a composition in reorganization to be considered executed by all common recognized creditors, it is essential for such composition to set forth the *payment* of their credits, in the three types provided in such Article. In turn, Article 159 sets forth that the composition in reorganization may only provide for all common recognized creditors that do not execute it: (i) a *stay*, with conversion of ordinary interest, with a maximum term equal to the shortest term agreed to by the common recognized creditors that have executed the composition; (ii) a release of the principal balance and accrued unpaid interest, equal to the lesser amount agreed to by the common recognized creditors that have executed the composition, or (iii) a *combination of relief and stay*, provided the terms are identical to those accepted by at least 30 percent of the amount recognized for the common recognized creditors that executed the composition.

Thus, considering the provisions of Article 2012 of the Federal Civil Code (*Código Civil Federal*), which sets forth that a creditor *may not be compelled* to receive something other than what is due, even when it may be of a higher value, the validity of a composition in reorganization that provides a conversion of debt to equity as payment to the ordinary creditors that did not execute it may be questionable, since one may argue that such composition would be illegal, given that it contradicts both the Bankruptcy Law and the Federal Civil Code, *more so*, considering that the latter provides in its Article 2062 that only the delivery of the thing or amount due may be understood as payment or

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convert unsecured loans into the reorganized capital of the company, and to issue stock options for unsecured creditors. For more information, see the information filed as a relevant event by the issuer to the Mexican Stock Exchange (*Bolsa Mexicana de Valores*) at http://www.bmv.com.mx.

[29] On September 3, 2017 Empresas ICA, S.A.B. de C.V. (jointly with some of its subsidiaries) was declared in commercial bankruptcy with prior restructuring plan, which ended through a ruling dated March 1, 2018, through which the Twelfth District Court on Civil Matters in Mexico City issued the rulings approving the composition executed with most of its recognized creditors. In such composition it was resolved, among other things, to convert the debt to equity as payment to the ordinary creditors. For more information, see the information filed as a relevant event by the issuer to the Mexican Stock Exchange (*Bolsa Mexicana de Valores*) at http://www.bmv.com.mx.

performance with delivery of the thing or amount due, which does not occur when providing any amount or thing.

Although we understand the commercial reorganization system, specifically with respect to the *iuris et de iure* presumption of presumptive signature[30] and the cramdown for holdout creditors[31] constitutes an exception regime to the *res inter alios acta* principle of civil law, and according to which contracts only produce obligations for the parties that execute it; we consider that it is questionable that such exception to the *res inter alios acta* principle suffice to consider as "payment" what is really a payment in kind, since it does not abide by the rules (*numerus clausus*) provided in Article 159 of the Bankruptcy Law, since, considering that it is an exception rule, it may not be applied by analogy or compelling logic.[32]

In the words of Dr. Diego Robles, "payment or performance with the obligation must be understood as the exact, precise execution at the place agreed or mentioned by law of the claim due, in such a way that the link between the creditor and the debtor is broken or extinguished."[33] This way, we are of the opinion that if a composition in reorganization were to establish as "payment" to the recognized creditors giving shares comprising the capital stock of the financially distressed company, this would not be a payment, strictly speaking, but rather this would be a payment in kind as a substitute form of compliance, which, to be valid (and therefore extinctive, releasing and satisfactory) would require, without exceptions, the agreement of the parties or, in other words, acceptance by all of the ordinary creditors since, as mentioned above, the exception to the *res inter alios acta* principle set forth in Article 149 of the Bankruptcy Law does not cover this case of payment in kind.

We consider that a composition in reorganization establishing giving shares, as a result of a conversion of debt to equity, as "payment" to the ordinary creditors that do not execute it, should not be approved by the judge. We must remember that Article 164 of the Bankruptcy Law sets forth that to issue the resolution approving a composition in reorganization, the judge must verify that the composition proposal satisfies all the requirements provided in Title V of the Bankruptcy Law and that it does not contravene public order provisions.

This way, we can assert that one of the advantages of the conversion of the

[30] Art.158 of the Bankruptcy Law.

[31] Art.159 of the Bankruptcy Law.

[32] *See* Article 11 of the Federal Civil Code, pursuant to which "laws that establish exceptions to the general rules are not applicable to any case that is not expressly specified in such laws."

[33] ROBLES FARÍAS, Diego, *Teoría general de las obligaciones,* Oxford, México, 2011, p. 399.

credit resulting from DIP Financing (which may be resolved at any time), is the fact that, since it does not form part of the composition in reorganization, it would be immune to the consequences of the challenges filed by the recognized creditors that do not execute the composition resolving the conversion of the credits of the recognized creditors, and which, in addition to the fundamental reasons mentioned above, and given that these result from a strict interpretation of an exception (such as Article 159 of the Bankruptcy Law), these also have an important constitutional protection that must be mentioned. Indeed, considering the "*pro personae*" or "*pro homine*" principle set forth in Article 1 of the Constitution, and considering the human right of liberty of association set forth in Article 9 thereof,[34] the recognized creditors that do not execute the composition agreeing to a conversion of debt to equity as "payment," may argue that the judicial approval of such composition would constitute a negative effect on their human right of liberty of association, since it would be equivalent to forcing them to associate with the other creditors (whether as members or shareholders of the company).[35]

Although one may argue that the approval of a composition with such characteristics by the judge would not necessarily entail an imposition on the ordinary creditors that did not execute the obligation to become members or shareholders of the financially distressed company, since such creditors may simply refuse to receive such shares as payment, it is true that this would entail placing them between a rock and a hard place, given that they would have to decide between waiving a right and violating a human right, which we consider to be completely absurd. Additionally, the case may arise that the particular characteristics of the creditors generate some type of legal impossibility to materialize such conversion of debt to equity, as may be the case of foreign creditors that pursuant to the Foreign Investment Law are subject to any restriction on becoming members or shareholders of companies engaging in certain types of activities (or may only be so for up to a specific percentage interest) or, with respect to creditors that are regulated entities, whose bylaws do not allow them to be shareholders of the financially distressed company due to certain legal restrictions.

Although the undeniable lack of legal certainty generated for the recognized

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[34] And in Articles 20 of the Universal Declaration of Human Rights, 21 of the International Covenant on Civil and Political Rights, 8 of the International Covenant on Economic, Social and Cultural Rights, and 15 and 16 of the American Convention on Human Rights.

[35] *See* the case law titled: CHAMBERS OF COMMERCE AND INDUSTRY, MANDATORY AFFILIATION. ARTICLE 5 OF THE LAW ON THE SUBJECT MATTER VIOLATES THE LIBERTY OF ASSOCIATION ESTABLISHED BY ARTICLE 9 OF THE CONSTITUTION.

creditors revolving around the aforementioned discussion may be resolved through deliberation by our highest court, where the need to preserve companies as sources of employment, would be weighted above the unrestricted protection of liberty of association, we highlight the advantage for DIP Lenders of not being deemed commercial reorganization creditors, while we consider that it is urgent to amend the Bankruptcy Law, for clearly and convincingly establishing the possibility to agree on the conversion of debt to equity as a form of payment to the recognized creditors.

BENEFITS AND OBSTACLES FOR CREDIT INSTITUTIONS THAT INTEND TO GRANT DIP FINANCING

Banking regulations demand that all credit institutions contribute a specific percentage of their profits to create preventive reserves, which have the purpose of minimizing the risk that granting loans entails, faced with the possibility of default by their clients.

This way, pursuant to Article 111 of the General provisions applicable to credit institutions (commonly known as the Sole Bank Circular Letter—*Circular Única de Bancos* ("CUB")),[36] credit institutions must classify, create and record, on a quarterly basis in their accounting records, the preventive reserves for each of the loans that they have in their commercial loan portfolio, adjusting to the methodology and the request for information outlined in the CUB. To achieve the foregoing, these institutions must make calculations contemplating ratios regarding the probability of default, the severity of the loss and the exposure to default.

One of the advantages that granting DIP Financing entails for credit institutions that decide to grant these type of loans consists in that the CUB grants special treatment to determine the severity of the loss concerning loans granted to companies that have been declared in commercial reorganization with prior restructuring plan.[37] The benefit consists of allowing them to use more favorable variables at the time of calculating the amount of funds to be

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[36] *See* general provisions applicable to Credit Institutions, published in the Federal Official Gazette, dated December 2, 2005, amended through resolutions published in the aforementioned Official Gazette on March 3 and 28, September 15, December 6 and 8, 2006, January 12, March 23, April 26, November 5, 2007, March 10, August 22, September 19, October 14, December 4, 2008, April 27, May 28, June 11, August 12, October 16, November 9, December 1 and 24, 2009, January 27, February 10, April 9 and 15, May 17, June 28, July 29, August 19, September 9 and 28, October 25, November 26 and December 20, 2010, January 24 and 27, March 4 and April 21, 2011, respectively.

[37] It is important to mention that such preferential rules would apply until a composition is

contributed to creating the preventive reserves mentioned above. Such benefit is even higher when the credit has been secured.[38]

We consider that if the DIP Financing granted adjusts to the aforementioned rules (and the guidelines established by the judge or conciliator), it is evident that they do not incur the crime set forth in Article 12 of the Credit Institutions Law (*Ley de Instituciones de Crédito* ("LIC")). We must remember that such Article sets forth a prison sentence for directors, officers, employees or those that directly participate in granting loans to natural or legal persons whose state of insolvency is known, provided it is foreseeable when performing the transaction, that such persons lack financial capacity to pay or be liable for the amount of the evidenced amounts, thus producing property damages or losses to the credit institution. The sentence in question varies depending on the amount of the transaction, and the property damages or losses caused to the credit institution, which may range from two to 15 years in prison.

The reason why we consider that granting DIP Financing could not fit the aforementioned crime is that, in principle, it would not be granted to companies in a state of insolvency,[39] but rather to companies that suffer a lack of liquidity.

> In the law, insolvency is understood to be the conditions of the assets vis-à-vis liabilities, when the former does not suffice to pay for the latter [. . .] ceasing payments does not always entail insolvency, since it may exist without the latter existing [. . .] a company may cease its payments not because its assets do not fully cover its liabilities, but rather because, due to certain circumstances, which are quite frequent nowadays, it lacks cash to do so. Lacking cash is not the same as being insolvent.[40]

Furthermore, these types of credits are grounded in the Bankruptcy Law, which allows and even promotes credit institutions to grant them, while at the same time it demands that it be previously approved by the judge or the conciliator, under specific guidelines that necessarily the financially distressed company must comply with. However, to provide greater legal certainty to

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adopted between the bankrupt company and the recognized creditors, or a resolution is issued declaring the bankruptcy of the company.

[38] *See* Article 114 of the CUB.

[39] Pursuant to Article 2166 of the Federal Civil Code, there is insolvency when the sum of the property and credits of the debtor, estimated at their fair value, does not equal the amount of their debts. Bad faith, in this case, consists of knowledge of such deficit.

[40] PALLARES, Eduardo, *Tratado de las Quiebras,* Editorial Porrúa, México, 1937, pp. 58 y 59.

potential DIP Lenders, we consider that Article 112 of the LIC should be amended to clearly and decisively exclude the commitment of a crime, for the credits granted under Articles 37 and 75 of the Bankruptcy Law.

Lastly, we consider that another obstacle to DIP Financing by banks is set forth in Article 65 of the LIC, pursuant to which, to grant loans, credit institutions must estimate the viability that borrowers or counterparties will repay these, using for such purpose an analysis based on quantitative and qualitative information, which enables them to establish their creditworthiness and repayment capacity within the term provided for the loan. The foregoing must be followed without affecting the consideration of the monetary value of the collateral offered.

Indeed, it would be practically impossible for a company about to enter into commercial reorganization, or already in it, to provide qualitative and quantitative information that enables financial institutions to determine that it has creditworthiness when it is precisely the generalized default in the payment of its obligations that led it to such situation. Likewise, it would be somewhat complicated for such a company to demonstrate that it has repayment capacity within a specific term when it requires the funds from the DIP Financing to be able to satisfy its immediate working capital requirements, not to mention the multiple obstacles that financial institutions may face when trying to collect their credit during the conciliation stage.

CONCLUSIONS

The 2014 amendment to the Bankruptcy Law undoubtedly represents progress in adopting innovative mechanisms that promote loans being granted to companies going through a commercial reorganization process, seeking to secure their preservation for the benefit of society. However, certain obstacles merit attention from legislators, to grant greater legal certainty to the eventual creditors of financially distressed companies, to the company itself, and to its other creditors.

Considering the foregoing, we need an amendment that generates greater confidence and promotes granting DIP Financing loans. We consider that the main obstacles that currently inhibit these types of loans from being granted to financially distressed companies are fundamentally the lack of incentives offered to DIP Lenders to grant this type of financing, the defects in the regulation related to the request for judicial authorization to obtain DIP Financing, and the existence of legal restrictions that hinder the access of financially distressed companies to DIP Financing from a bank.

The first of these obstacles is evidenced by the lack of certainty regarding the

ranking that will be granted to DIP Lenders within the commercial reorganization process. The second obstacle lies in the incapacity for DIP Lenders to seize property during the conciliation stage in case of default of the loan agreement by the financially distressed company, and the lack of mechanisms that allow for such loans to be granted promptly and expeditiously to companies that are not able to file for commercial reorganization with a prior restructuring plan. Finally, the third of the obstacles lies in the requirements established by the LIC so that financial institutions can be in a position to grant DIP Financing to financially distressed companies.

Although the uncertainty generated by the areas where the Bankruptcy Law is silent may be dissipated through exercises of interpretation by the Federal Judicial Branch, the truth is that the imperative need to preserve companies should be sufficient reason for the referenced amendment to be implemented, which would have as its purpose to incentivize, promote and facilitate granting DIP Financing to companies going through commercial reorganization, which would ultimately translate into ensuring that such companies have the liquidity to allow them to guarantee their viability and survival, for the benefit of the company, its workers, its creditors and society as a whole.

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