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Distressed M&A Transactions in Mexico

By Francisco Javier Garibay Güémez and Maria Antonia Alevras*

This article analyzes the complex and emerging Mexican regulation governing the acquisition of distressed businesses. In some sections, it engages in a comparative analysis with Spanish bankruptcy law for purposes of analyzing the challenges that the acquirer would face, before or during the different stages of the bankruptcy process under Mexican law.

Article One of the Mexican Bankruptcy Law (*Ley de Concursos Mercantiles*, "Bankruptcy Law") cites the tension between the public interest in preserving bankrupt companies and the public interest in protecting the creditors of companies in general default of their payment obligations. Given the significant social and economic burdens associated with these conflicting interests, distressed mergers and acquisitions ("M&A") transactions may offer creative solutions that traditional debt restructuring is unable to deliver. Specifically, distressed M&A transactions may present an efficient solution that is attractive to both the company and its creditors because it preserves the business and saves jobs while also seeking to maximize creditor recovery. Despite the merits of a distressed M&A strategy, the Bankruptcy Law offers no clear rules concerning the different methods and mechanisms for disposing of assets of a company that is undergoing a bankruptcy process aside from the overriding principles of the preservation of a going concern (in the reorganization stage) and value maximization (in the liquidation stage).

This article seeks to analyze the complex and emerging Mexican regulation governing the acquisition of distressed businesses. In some sections, the article discusses the problems that the acquirer would face under Mexican law, before or during the different stages of the bankruptcy process, through a comparative analysis with Spanish bankruptcy law. Countries such as the United States (with the sales procedure provided in Section 363 of the U.S. Bankruptcy Code) and the United Kingdom (and its pre-pack administration rules) provide guidance to establish clear rules regarding the sale of business assets to maximize creditor realization in a bankruptcy scenario. However, as Spain and Mexico are both

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civil law jurisdictions, Spanish law better navigates the interplay between the bankruptcy regime and other complementary civil law regulations.

While in Mexico a business is generally acquired through either the purchase of the shares of the company that owns such business or the purchase of the assets that make up the business, a share purchase is rarely a viable alternative for a distressed company because the buyer would directly acquire all of the assets and liabilities of the company in question (whether known or unknown) and not only those that are of its interest.

Additionally, the sale of the shares of the bankrupt company is not an alternative that offers solutions in an insolvency situation since the shareholder and not the company would receive the proceeds of the sale. Therefore, it is unlikely that a sale of the bankrupt company's shares would help to meet the goal of rescuing the bankrupt company. Accordingly, this article only analyzes the second of these alternatives: namely, the sale of assets.

The sale of assets of a company going through financial hardship can take place in four different time frames:

(i) In the vicinity of insolvency;

(ii) During the reorganization stage;

(iii) During the execution of the reorganization plan; and

(iv) During the liquidation stage.

This article analyzes each of these stages and explain both the advantages and disadvantages of disposing of the bankrupt company's assets under the Mexican legal framework.

DISPOSING OF ASSETS IN THE VICINITY OF INSOLVENCY

Avoidance Powers Rules

There is no *de facto* prohibition on the sale of distressed assets owned by a business close to insolvency under the Bankruptcy Law. However, the main risk that any acquirer of such assets would face is the related asset purchase agreement being considered a fraudulent transaction and, therefore, being set aside (i.e., ineffective *vis-à-vis* the bankruptcy estate). Bankruptcy Law on fraudulent conveyance is focused on overturning past transactions to which the insolvent debtor was a party or which involved the debtor's assets whose consummation is found to be prejudicial to the debtor (i.e., a reduction to the net value of its property).

The retroactive period is the period that begins 270 days prior to the bankruptcy declaration. Such a period may be extended to an earlier date by the judge, at the request of the conciliator (*conciliador*), the receiver (*síndico*), the conservators (*interventores*) or any creditor, provided that:

(i) The facts invoked by the abovementioned persons fall within any of the circumstances set forth in Articles 114 to 117 of the Bankruptcy Law (providing the relevant documentation);

(ii) The requested extension date does not exceed three years prior to the bankruptcy declaration; and

(iii) The request is filed before the issuance of the debt recognition, priority, and ranking ruling.[1]

Some types of transactions carried out prior to the bankruptcy declaration can be set aside. The transactions subject to avoidance can be grouped in four categories:

(i) Per se fraudulent transactions;

(ii) Cases of constructive fraud;

(iii) Objective preferences; and

(iv) Subjective preferences.[2]

Per se fraudulent transactions are those that a company carries out before the bankruptcy declaration, intentionally defrauding creditors if the third party that participated in the transaction had prior knowledge of such fraud. Pursuant to Article 113 of the Bankruptcy Law, all *per se* fraudulent transactions are avoidable, regardless of the time when they were carried out. On the other hand, the other types of transactions subject to avoidance (cases of constructive fraud, objective preferences, and subjective preferences) are avoidable only if they are carried out within the retroactive period.

The Bankruptcy Law sets forth a series of *iuris et de iure* and *iuris tantum* presumptions regarding which types of transactions are carried out as creditor fraud if they were carried out following the retroactivity date. Pursuant to Article 114 of the Bankruptcy Law, the following are conclusively presumed to be fraudulent (without admitting evidence to the contrary):

(i) Gratuitous transactions;

(ii) Transactions under which the debtor pays consideration of a sub-

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[1] *See* precedent VI.1o.C.133 C, which is published in the Federal Weekly Judicial Gazette, Ninth Period, Volume XXX, October 2009, page 1507, titled: "BANKRUPTCY. REQUIREMENTS TO DECLARE THE INCIDENTAL PROCEEDING OF AMENDMENT TO THE RETROACTION DATE ADMISSIBLE."

[2] Sepulveda, Eugenio, et. al. *Mexican Legal Framework of Business Insolvency*. White & Case, 2011, p. 43.

stantially higher value, or receives consideration of a substantially lower value than that of its counterparty;

(iii) Transactions in which conditions or terms significantly differ from then-prevailing market conditions or trade usage or practices;

(iv) Any debt remission made by the debtor;

(v) Any payment of un-matured obligations; and

(vi) The discount of debtor's payables by the same debtor.

These circumstances of presumptively fraudulent transactions, where no evidence to the contrary is admitted, constitute a limited list of transactions subject to being voided since the article in question does not provide a section that causes us to assume the existence of other acts that are analogous to those mentioned above.

Furthermore, Article 115 of the Bankruptcy Law sets forth certain *iuris tantum* presumptions with respect to fraudulent transactions carried out following the retroactive date, which are based on granting objective preferences to certain creditors with respect to others. Thus, under the article in question, the following are presumptively fraudulent transactions: (i) granting of collateral or additional collateral if not initially contemplated in the transaction documents, and (ii) payments-in-kind if such method of payment was not originally agreed to in the transaction documents. Likewise, Articles 116 and 117 of the Bankruptcy Law set forth other *iuris tantum* presumptions concerning fraudulent transactions, which, unlike Article 115, are based on granting subjective preferences to related parties of the debtor. Article 116 lists the presumptive fraudulent acts if the bankrupt company is an individual debtor, while Article 117 lists the fraudulent acts concerning an entity debtor.[3]

[3] Pursuant to Article 116 of the Bankruptcy Law, related parties of an individual debtor include (i) his or her spouse, concubine, blood relatives up to the fourth degree, in-law relatives up to the second degree, and adopted relatives, and (ii) legal entities in which the debtor or any of the persons mentioned in (i) is the manager or director, or directly or indirectly, together or alone, hold rights that enable them to exercise the vote with respect to more than 50 percent of the capital stock, or have decision-making powers at the shareholders' meetings, are entitled to appoint a majority of the directors or are otherwise entitled to make fundamental decisions for such entities. Additionally, pursuant to Article 117 of the Bankruptcy Law, related parties of an entity debtor include (i) the manager, directors or relevant employees of the debtor or of its related parties; (ii) the spouse, concubine, blood relatives up to the fourth degree, in-law relatives up to the second degree, and adopted relatives of a manager or director; (iii) individuals who directly or indirectly, together or alone, hold rights that enable them to exercise the vote with respect to more than 50 percent of the capital stock of the bankrupt company or of its related parties or that have decision-making powers at its shareholders' meetings, are entitled to appoint a majority of its directors or are otherwise entitled to make fundamental decisions for such entity;

The three aforementioned articles set forth presumptions that admit evidence to the contrary, therefore, it will correspond to (i) the bankruptcy specialists or of any interested party, to provide evidence regarding the facts related to the circumstances in question, and (ii) the third party with which the bankrupt company entered into an agreement during the retroactivity period, to prove its good faith, to be able to disprove the *iuris tantum* presumption of creditor fraud.

Actio Pauliana

In addition to the authority granted to Mexican bankruptcy judges to set aside fraudulent transactions under the Bankruptcy Law, civil judges have an authority to set aside transactions based upon a definition of civil law insolvency focused on a debtor's balance sheet (i.e., the sum of the debtors' property and collection rights, estimated at their fair value, are less than the sum of its debts).

> In the law, insolvency is understood as the status of assets *vis-à-vis* liabilities, when the former is insufficient to pay the latter . . . ceasing payments does not always entail insolvency, since it may occur without the latter occurring . . . a company may cease its payments not because its assets are insufficient to pay its liabilities, but rather because, due to certain circumstances, which are quite frequent nowadays, it lacks the cash to do so. Lacking cash is not the same as being insolvent.[4]

Accordingly, as the civil standard differs, a debtor may be insolvent under civil law, regardless of whether it may also be declared in bankruptcy under the Bankruptcy Law.

Civil law courts have authority to nullify transactions carried out by the debtor to the detriment of its creditors under the following claims:

(i) Creditor fraud claim (*actio pauliana*);

(ii) Nullity claim due to simulation (*acción de nulidad por simulación*); and

(iii) Subrogation claim (*acción oblicua*).

Of these three types of claims, only the first one is relevant for the case of disposing of assets of a distressed company. According to the provisions of Article 2163 of the Mexican Federal Civil Code, for a transaction to be deemed

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(iv) entities sharing managers, directors or principal officers; and (v) entities that control, are controlled by or are under common control of the debtor.

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

to detriment the creditor and rendered unenforceable, it must render the debtor insolvent. Therefore, not all acts that are detrimental to creditors will be deemed to give rise to creditor fraud for purposes of the *actio pauliana*, but rather only those that produce (or increase)[5] the insolvency of the debtor.

Additionally, unlike the Bankruptcy Law, for the *actio pauliana* to be admissible, the following conditions must be met:

(i) The debtor must have entered into or performed an actual (not simulated) transaction;

(ii) Such voidable transaction shall cause or increase the debtor's insolvency;

(iii) The rights on which the plaintiff's claim is based must precede in time the voidable transaction; and

(iv) Both the debtor and its counterparty acted in bad faith.[6]

Furthermore, pursuant to Article 2175 of the Federal Civil Code (*Código Civil Federal*), the transaction would only be void *vis-à-vis* the creditor plaintiff for an amount up to the amount of its credit.

Regime Applicable to Executory Agreements

Mexican legislators consulted the United Nations Commission on International Trade Law's ("UNCITRAL") legislative guide on insolvency law in determining the treatment to be given to agreements entered into by a bankrupt company prior to the declaration of bankruptcy, both in light of the special law that governs each of the specific agreements, and the different factors that may justify interrupting their enforcement. The UNCITRAL legislative guide specifically provides that, to achieve the objectives of maximizing the value of the estate and reducing liabilities, it is fundamental that the bankrupt company be able to (i) preserve all agreements that are beneficial to it, and (ii) set aside all agreements that are burdensome to it (i.e., those where the ongoing cost of performance exceeds the benefit to be derived from the agreement).

According to the Bankruptcy Law, as a general principle, the declaration of bankruptcy does not affect the enforceability of an executory agreement, unless the conciliator sets it aside on the grounds that it is in the best interest of the

[5] *See* precedent I.9o.C.58, which is published in the Federal Official Weekly Gazette. Ninth Period, Volume IX, May 1999, page 985, titled: "CREDITOR FRAUD ACTION. NOT ONLY INSOLVENCY MAKES IT ADMISSIBLE, BUT ALSO THE AGGRAVATION OF THE ALREADY EXISTING INSOLVENCY."

[6] Bad faith consists of the knowledge of insolvency.

estate.[7] Any party to an executory agreement with the debtor shall be entitled to request that the conciliator determine whether he will allow or set aside the agreement. If the conciliator allows the agreement to continue, the debtor must perform or guarantee performance thereunder. If the conciliator sets aside the agreement or does not provide an answer within 20 business days, the debtor's counterparty may thereafter, declare the early termination of the agreement by giving notice thereof to the conciliator.[8] The 20-day term balances, on the one hand, the conciliator's need to complete a thorough analysis of any agreements pending enforcement with the need for the debtor's counterparties to receive a definitive response from the conciliator.

The authors consider that the 20-day silent accession rule must provide an exception in cases where there is an ongoing distressed M&A strategy and there are bidders subject to a process to acquire the assets of the business as a going concern. If the 20-day term proves too short to allow the conciliator to objectively evaluate his decision with respect to a particular contract and there is an ongoing distressed M&A effort, the debtor counterparty should not be permitted to terminate it and potentially render the business less attractive to potential bidders because it is left without an agreement that may potentially be critical to operating as a going concern.

Additionally, the Bankruptcy Law denies the effectiveness of the so-called *ipso facto* or automatic termination clauses as a result of the filing of a petition or demand for, or the declaration of bankruptcy, making them inapplicable to the bankrupt company if it were determined that its application would worsen the financial condition of the debtor.[9] While disallowing *ipso facto* or automatic termination clauses goes against the general principles of Mexican contract law and may increase transaction costs due to the negotiation of alternative contractual protections, it is undoubtedly crucial to a successful bankruptcy proceeding. The Bankruptcy Law does not recognize claims by creditors adversely affected by the ineffectiveness of their contractual *ipso facto* protections for demonstrated damages or losses resulting from the continued contractual performance after a bankruptcy declaration.

DISPOSING OF ASSETS DURING THE REORGANIZATION STAGE

General Provisions

As a general rule, during the reorganization stage, the debtor remains in

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[7] Arts. 86, 92 of the Bankruptcy Law.

[8] Art. 92 of the Bankruptcy Law.

[9] Art. 87 of the Bankruptcy Law.

possession of its enterprise and under the control of prior management, unless the conciliator requests that the court exercise the exceptional remedy of removal.[10] Therefore, in the case of a corporation (*sociedad anónima*), its board of directors (or its sole director) would continue performing their duties. However, the board may only execute transactions in the ordinary course of business.[11] The conciliator, upon a prior opinion from the conservators (*interventores*), must oversee and authorize the disposal of the assets of the company that are not linked to the ordinary course of its business (i.e., real property, machinery, intellectual property, contractual relationships—including with employees—debts, etc.). For this, the conciliator in the reorganization stage must consult and apply, *mutatis mutandis*, the disposal procedures and other general rules set forth in Articles 197, 198, 205 and 210 of the Bankruptcy Law, which govern the disposal of assets by the receiver in the liquidation stage.

This framework requires that the conciliator, similar to the receiver selling assets as a going concern during the liquidation stage, endeavor to authorize asset dispositions as a going concern that maximize sale proceeds and minimize collection times.[12] The conciliator's authority to approve the disposal of all (or substantially all) of the assets that comprise the business is another important consideration. The framework crafted by Mexican legislators stipulates that the assets of a bankrupt company must be sold during the liquidation stage, preferably pursuant to dispositions that preserve the business as a going concern. However, the Mexican Legislature also provided for the possibility of the conciliator to authorize a sale of the enterprise as a going concern during the reorganization stage. Articles 75 and 197 of the Bankruptcy Law specifically

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[10] Arts. 74 and 81 of the Bankruptcy Law.

[11] Although the LCM does not give us clear guidance as to what constitutes a transaction carried out in the ordinary course of business, the actions that may be understood as such are those that: (i) are consistent in nature, scope and magnitude with the past practices of the debtor and are taken in the ordinary course of the normal, day-to-day operations of such debtor; (ii) do not require authorization by the board of directors or shareholders of such debtor (or by any person or group of persons exercising similar authority) and does not require any other separate or special authorization of any nature; and (iii) are similar in nature, scope and magnitude to actions customarily taken, without any separate or special authorization, in the ordinary course of the normal, day-to-day operations of other persons that are in the same line of business as the debtor.

[12] Furthermore, the procedures and general terms under which the disposition of assets is carried out, must address the business characteristics of the transactions, current sound financial practices, the places where the property to be disposed is located, and the time and general and specific conditions under which the transaction is carried out, even considering a reduction, as applicable, of the transaction costs.

provide that the conciliator is obligated to follow the guidelines set forth in Article 197 which requires an analysis of whether a sale that preserves the business as a going concern maximizes recovery value (as compared to a sale of individual or specific assets).

If the sale is consummated during the reorganization stage, the recognized creditor's plan will stipulate debt haircuts and/or term extensions as well as the rules for distributing net sale proceeds. On the other hand, if no agreement among the recognized creditors is reached prior to the expiry of the reorganization stage, the judge will issue a liquidation judgment, after which time any distribution of net sale proceeds shall be made following the priority established in the Bankruptcy Law.

The conciliator's approval of a value-maximizing enterprise sale during the reorganization phase in lieu of the specifically designated liquidation phase is not only consistent with the Bankruptcy Law's concern for preserving bankrupt companies and limiting their negative systemic impact, but also benefits these companies by occurring earlier in their respective distressed life cycles. Specifically, an earlier sale should minimize the disruptive impact of a bankruptcy on a company, likely resulting in:

(i) Lower cost to the bankrupt company;

(ii) A greater likelihood that the company will survive the bankruptcy;

(iii) Less devaluation or depreciation of enterprise components;

(iv) A higher collection rate for creditors; and

(v) Less work force disruption.

From a practical perspective, a faster sale of a distressed company should minimize the risk that a bidder will lose interest due to a prolonged M & A process while maximizing distressed asset value, which is directly tied to the impact of the bankruptcy process on the company over time.

Notwithstanding the foregoing, the Mexican Legislature has not developed a comprehensive Bankruptcy Law that offers the necessary tools for Mexican courts to facilitate the efficient sale of business assets in the reorganization stage. A telling example of the need for legislative attention to this area is the fact that Article 380 of the General Law of Negotiable Instruments and Credit Transactions *(Ley General de Títulos y Operaciones de Crédito*, "LGTOC") criminalizes the sale of assets granted as collateral under a non-possessory pledge during the reorganization stage while Article 214 of the Bankruptcy Law contains an exception to criminal liability in the liquidation stage. The Mexican Legislature should urgently set its mind to establishing a uniform set of exceptions for the reorganization and liquidation stages under the Bankruptcy

Law that facilitate value-maximizing dispositions of distressed assets. The discussion that follows examines, by means of comparison with the Spanish bankruptcy law (*Ley Concursal Española*), several areas where the Bankruptcy Law governing distressed M & A sales should be improved: namely, the contractual assignment of agreements affecting the continuity of the business' operations and exceptions relating to labor, tax and social security debts in the context of sales during the reorganization phase.

Article 2051 of the Federal Civil Code (*Código Civil Federal*) requires payee consent for any contractual assignment. While Article 211 of the Bankruptcy Law provides a deficient exception mechanism for sales during the liquidation stage involving counterparty notification and a ten business day time frame for deemed contractual acceptance or rejection giving rise to an early termination right, there is no such exception available during the reorganization stage to permit the bankrupt company to avoid the burdensome and impractical procedure of requesting consent from multiple counterparties prior to any sale. The practical effect of this deficiency is that, depending upon the significance of the contract in question, a single counterparty's failure to consent to an assignment could jeopardize an asset sale, a reality that translates into transactional risk and depresses the asset value, contrary to the public interest that the Bankruptcy Law seeks to protect.

In contrast to the Mexican case, the Spanish Legislature understood that, in order to facilitate efficient sales during bankruptcy and preserve bankrupt companies, the bankruptcy process must establish exception rules to the general civil law principles requiring payee consent for any contractual assignment. Article 146 bis of the Spanish bankruptcy law eliminates the requirement for payee consent to a contractual assignment relating to the enterprise sale of a bankrupt company subject to certain conditions.[13] This exception is broadly

[13] Article 146 bis of the Spanish Bankruptcy Law. Special provisions on the transfer of productive units. (1) In case of a transfer of productive units, the rights and obligations derived from the agreements assigned to the continuity of professional or business operations, the rescission of which was not requested, will be assigned to the acquirer. The acquirer will subrogate in the contractual position of the bankrupt company without the need for consent from the other party. The assignment of administrative agreements will occur in accordance with the provisions of Article 226 of the restated text of the Public Sector Contracts Law (*Ley de Contratos del Sector Público*), approved by Royal Legislative Decree 3/2011, dated November 14. (2) Also the administrative licenses or authorizations related to the continuity of business or professional activities, and included as part of the productive unit will be assigned, provided the acquirer continues the activity in the same facilities. (3) The provisions of the two above subsections will not apply to licenses, authorizations or agreements where the acquirer has expressly stated its intention not to subrogate. This, without prejudice to the labor effects of the application of the provisions of Article 44 of the Workers Statute (*Estatuto de los Trabajadores*)

applicable to a variety of different contractual arrangements, including administrative licenses, authorizations, and agreements relating to the continuity of the bankrupt business.

The Bankruptcy Law should be amended to include exceptions to the federal civil law consent requirements for contractual assignments because they frustrate the efficient sale of distressed companies that the legislation is meant to promote. In drafting amended legislation, the Mexican Legislature should consider codifying certain situations where the exceptions would not apply for public policy reasons. For example, an exception should not be available to assign a contract without a consent for an arrangement where the identity of the original counterparty (the bankrupt company) was material to the payee's decision to enter into the contractual relationship in the first place (*motivo determinante de la voluntad*). However, consistent with the discretion afforded the conciliator in the Bankruptcy Law in the context of approving any distressed asset sale, the conciliator should have flexibility to weigh the importance of a particular contract to the bankrupt company's ability to operate as a going concern and make decisions as to the availability of an exception on a case-by-case basis. Similar to Spanish law, the amended legislation should be broadly applicable to a variety of different contractual arrangements related to the continuity of the business.

Even if the acquirer satisfies the burdensome notice and consent requirements under Article 2051 of the Federal Civil Code and the sale moves forward, he will be faced with potential labor, social security, and tax obligations upon the transfer of the enterprise as a going concern despite the fact that the Bankruptcy Law does not recognize a theory of *de facto* merger mandating the assumption of outstanding debt.

In the case of labor and social security debts, which tend to be the most prevalent in a bankruptcy proceeding, the Federal Labor Law (*Ley Federal del Trabajo*) and the Social Security Law (*Ley del Seguro Social*) establish that the bankrupt company will be jointly and severally liable with the acquirer for the labor and social security obligations arising before the acquisition effective date for a term not exceeding six months measured as follows: (i) for labor obligations, from the date the replacement notice was given to the workers

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in the events of company succession. (4) The transfer will not contain a payment obligation of the debts that have not been paid by the bankrupt company prior to the transfer, whether they be in bankruptcy or against the estate, unless the acquirer expressly assumed it, or there were a legal provision to the contrary, and notwithstanding the provisions of Article 149.4. The exclusion described in the preceding paragraph will not apply if the acquirers of the productive units are especially related persons of the bankrupt company.

union, and (ii) for social security obligations, from the date notice was given to the Mexican Social Security Institute (*Instituto Mexicano del Seguro Social*). After the six-month term has passed, the new employer is left with the grim reality of being solely liable for all of the labor and social security liabilities accrued prior to the date it acquired the business. The uncertainty of post-acquisition liabilities associated with labor, social security and tax obligations, then, presents an additional obstacle to promoting the acquisition of distressed businesses at their maximum enterprise value during the reorganization phase.

In contrast, although the transfer of enterprises constitutes an employer substitution for labor and social security purposes under applicable law, in Spain companies may contributions to a Wage Guarantee Fund (*Fondo de Garantía Salarial*, "FOGASA") that has the authority to satisfy employee claims (other than social security benefit claims) that remain unsatisfied by insolvent employers. It follows that in the context of the sale of a distressed company, a Spanish judge has the authority to insulate the acquirer from liability for the outstanding wages or labor indemnities assumed by FOGASA.[14] A Spanish judge's ability to limit distressed asset acquirer's from a substantial portion of labor claims promotes the submission of offers to acquire the enterprise as a going concern.[15] While judicial authorization is required to transfer ownership of the enterprise as a going concern, such transfer is made to the acquirer

[14] In accordance with Article 33.1 of the Workers Statute and Article 1 of Royal Decree 505/1985, dated March 6, on the Organization and Operation of the Wage Guarantee Fund (*Organización y Funcionamiento del Fondo de Garantía Salarial*), the wage guarantee fund (FOGASA) is an autonomous administrative body affiliated to the Ministry of Labor and Social Economy (*Ministerio de Trabajo y Economía Social*) with legal capacity and the capacity to act in compliance with the purposes set forth in Art. 33 of the Workers Statute. The basic purpose for which it was created through Article 31 of Law 16/1976, dated April 8, on Labor Relations, is that of creating a wage credit guarantee, in case of the insolvency of the employer. To date, it has the authority to pay workers the wages and indemnities that the companies for which they work were unable to satisfy as a result of being in a legal situation of insolvency, or as a result of having been declared bankrupt. Having paid the benefits, the FOGASA mandatorily subrogates in the rights and actions of workers to claim and go against the employers that owe them. We consider that it is important for Mexico to have a similar fund, but this would be a subject for another article.

[15] Indeed, in accordance with Article 149.4 of the Spanish Bankruptcy Law, where, as a result of the enterprise as a going concern, an economic entity maintains its identity, understood as the set of organized means to carry out an essential or ancillary economic activity, for labor and social security purposes, a company succession will be considered to have occurred. In such case, the judge may resolve for the acquirer not to subrogate in the part of the amounts of outstanding wages or indemnities before the disposal that is assumed for the wage guarantee fund in accordance with Article 33 of the Workers Statute.

practically free from all burdens (except for social security fees) due to the sophistication of the Spanish legislative framework for bankruptcy and the tools that it gives its judges to give effect to value-maximizing distressed M & A transactions.

In Mexico, while judges also shepherd the bankruptcy process, the Bankruptcy Law does not give them the tools to advance the main purposes of the Bankruptcy Law: preserving bankrupt companies through value-maximizing distressed M & A transactions and preventing companies in general default of their payment obligations from jeopardizing their own viability and the viability of those with which they maintain a business relationship. Moreover, the silence of the Bankruptcy Law regarding exceptions for labor-related debts harms employees who would theoretically benefit from legislation incentivizing multiple, third party purchase offers more likely to result in a successful distressed M & A transaction and ongoing employment. Under these circumstances, not only could bankrupt companies fail to be rescued during the reorganization stage, but also, once the liquidation stage begins, all employees will be terminated and left unemployed, which, measured on a systemic basis, could generate a domino effect contrary to the purposes that the Bankruptcy Law seeks to protect.

With respect to tax liabilities, Article 26 of the Federal Tax Code (*Código Fiscal de la Federación*) provides that the acquirer of an enterprise is jointly and severally liable with the taxpayer (the seller) for taxes accrued in connection with the activities carried out by the business prior to its sale. Unlike the exception contained in Article 42 of the Spanish general tax law (*Ley General Tributaria*) that insulates acquirers of businesses of a bankrupt debtor within bankruptcy proceedings from tax liability prior to the transfer date, the Bankruptcy Law features no such exception for sales of distressed companies during bankruptcy proceedings.

The failure of the Mexican Legislature to, on one hand, create exceptions for contractual assignments and, on the other hand, disallow exceptions relating to labor, employment and tax debts in the case of asset sales during a bankruptcy proceeding, create strong disincentives for distressed M & A transactions that translate into a weak market overall. In contrast to a par M & A transaction where the acquirer negotiates significant seller representations and warranties regarding the actual condition of the company and post-closing indemnity provisions enforceable upon any breach, an acquirer in a distressed M & A transaction cannot avail itself of such protections which are atypical or unenforceable in bankruptcy procedures. Indeed, the seller of the bankrupt company will distribute the sale proceeds to its recognized creditors, rendering any acquisition agreement a non-recourse transaction with very limited grounds for acquirer indemnification. Lacking efficient tools, either by law or under contract, to protect its investment, a potential acquirer's risk for joint and several liability with respect to labor, tax and social security liabilities designed for non-bankruptcy scenarios can only be mitigated by (i) conducting a thorough due diligence process that substantially increases transaction costs and extends the transaction timeline, and (ii) reducing the acquisition price. In light of the foregoing, it is imperative to amend the Bankruptcy Law to create exceptions for contractual assignments and limit successor liability, leading to increased investor interest and a more competitive market for the acquisition of bankrupt businesses.

Sale Process

Another significant deficiency of the Bankruptcy Law is that it does not offer clear guidelines regarding the disposition of the assets of a distressed company during the reorganization stage. While the Bankruptcy Law provides that the conciliator must follow the disposal procedures and other general rules set forth in Articles 197, 198, 205 and 210 thereof, it is unclear whether the supplementary rules governing the sales procedure for the liquidation stage such as:

(i) The call to sell the assets;

(ii) The bids to acquire them;

(iii) The qualities or characteristics of the bidders;

(iv) The procedure and formalities of the auction hearing;

(v) The assignment of the assets;

(vi) The procedure to sell the assets outside of the auction; and

(vii) The warranty of title (*saneamiento para el caso de evicción*) apply in the context of an auction of distressed assets or otherwise during the reorganization stage.[16]

We consider that such supplementary rules should apply since, in their absence, the legal framework provided by Articles 75 and 198 of the Bankruptcy Law governing the sale of distressed assets during the reorganization mandates a public auction without providing any details regarding the characteristics of such process. Accordingly, the procedural rules described in Section V.2 should be analyzed to read all references to the receiver as references to the debtor (with the intervention of the conciliator).

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[16] That is, those contemplated in Articles 199, 200, 201, 202, 203, 204, 206, 207, 208, 209, 211 and 212 of the Bankruptcy Law.

Regardless of whether the procedural legal rules relating to the sale of the enterprise assets in the liquidation stage are deemed to apply under similar circumstances in the reorganization stage, the following discussion seeks to analyze, from a practical standpoint, how the asset disposal procedure in the reorganization stage should be configured to maximize the sale price. For purposes of this discussion, we engage in a comparative analysis of the asset sale procedure contained in Section 363 of the U.S. Bankruptcy Code (the "363 Process"). Please note that we will only refer to the 363 Process if we consider that the applicable practice used in the United States can be effectively applied in Mexico.

Before starting the asset disposition process, the bankrupt company should designate a team that will be responsible for promoting and marketing the assets that comprise its business and for negotiating the asset purchase agreement with potential buyers. In the United States, an investment banking firm or a financial advisory firm with experience marketing these distressed assets is a customary appointment. As the execution of the services agreement is not a transaction entered into in the ordinary course of business, it should be previously approved by the conciliator, especially because it will result in a reduced net recovery after the payment of the firm's corresponding fees expressed as a percentage of the final sales price.

Before submitting an offer, the potential acquirers of the assets must carry out a due diligence process. Prior to obtaining access to the corresponding information, potential acquirers must comply with certain requirements, such as signing non-disclosure agreements and, in most cases, paying a deposit or a financial bona fide. The debtor must provide them with access with sufficient information to assess the actual situation of the business. Generally, access to said information is given through a virtual data room ("VDR"), through which acquirers can review certain legal, tax, financial and operational information necessary to assess the risk they would face in the event of acquiring the enterprise as a going concern. It is also common to arrange site tours and management presentations, and to conduct interviews with relevant managers and employees in the context of a due diligence process. Performing adequate due diligence is essential for potential buyers, as it would be difficult for them to enforce indemnification clauses after the closing of the transaction as a result of the seller's breach of its representations and warranties in the purchase agreement given that sale proceeds will be distributed to the recognized creditors in the bankruptcy proceeding. In-depth due diligence also allows the acquirer to identify and cherry-pick the contracts that he wishes to acquire as a result of the purchase of the company.

In-depth due diligence is often the best method for discovering further

> details about a troubled company's financial distress. Once a buyer understands the reasons a company is struggling, it can more realistically assess the likelihood of returning the company to profitability. Note, however, that in looking for the sources of a company's distress, buyers should avoid the common misconception that financial distress is solely caused by a company taking too much debt upon itself. Focusing too much on a company's debt levels can fool a buyer into thinking that the company's problems can be solved simply by restructuring the debt.[17]

Although the seller is free to impose these requirements in a private auction procedure, they are not practical in the context of a public auction for the sale of the assets in the reorganization stage and their imposition may give rise to challenges regarding the sales process. For example, the bankruptcy process requires that for the court to recognize any bid for a distressed asset during the liquidation phase it must be accompanied with a deposit equal to ten percent of the purchase price.[18] While it is not clear if this restriction also applies to the auction in the reorganization stage, we consider that the request for a deposit or a financial bona fide is a valuable screening tool for the conciliator and if the winning bidder fails to timely satisfy its obligation to purchase the assets then it forfeits the deposit, which becomes a source of payment to the debtor and its estate. However, establishing additional requirements that limit or restrict the possibility of potential buyers to obtain the necessary information to be able to submit their bids in the auction procedure could be problematic. As the Bankruptcy Law does not contain clear rules governing asset sales during the reorganization stage, establishing additional requirements for participation in the public auction procedure may be subject to procedural challenges that affect the sale process and special care must therefore be taken when establishing said requirements.

Notwithstanding the foregoing, in Mexico, we still do not have a developed M & A market for distressed assets. Accordingly, one strategy to maximize recovery value may involve the debtor's identification of a bidder willing to present an offer or letter of intent before the start of the public auction. The submission of said offer could raise the interest of potential bidders (including competitors) in the assets subject to auction. In the United States, this early bidder is called the "stalking-horse" and it usually sets the floor purchase price in the auction and attracts other prospective buyers to bid on the assets. In order to attract such a bidder, an unofficial private auction procedure could be

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[17] *Id.*, pp. 2–3.

[18] Rule 56 of the General Rules applicable to the Bankruptcy Law.

carried out (either before filing the insolvency petition, during the visit stage or at the beginning of the reorganization stage). We believe that it would not be convenient to postpone the insolvency petition but to run both processes simultaneously so that the search for bidders can begin during the visit procedure. During the private auction, potential bidders would be allowed to review company information. The winner of the private auction will be able to negotiate the main terms and conditions of the asset purchase agreement, which will be considered the starting point for the official public auction in the reorganization stage. A drawback of starting the unofficial private auction procedure before the declaration of insolvency is the uncertainty regarding the time that the visit stage, the declaration of insolvency by the judge and the appointment of the conciliator will last. Likewise, the conciliator appointed by the Federal Institute of Specialists in Commercial Insolvency ("IFECOM") may not be sufficiently familiarized with the private auction procedure carried out in search of the stalking-horse. This drawback could be solved if the debtor and its recognized creditors representing at least half of the total amount recognized request the IFECOM through the judge, the substitution of the conciliator.

Apart from presenting a strategy to maximize asset disposition price, a stalking-horse also enjoys substantive and procedural benefits as compared with other prospective investors.. Among these advantages are:

(i) Having more time to carry out the due diligence process and therefore being better informed regarding the real situation of the business, its risks, and the causes that led it to insolvency;

(ii) Being able to negotiate and establish the main terms and conditions of the asset purchase agreement;

(iii) Establishing a working relationship with management before other bidders come to the scene that would divide their attention; and

(iv) The opportunity to acquire the assets at the established floor price, if no other bidders are qualified to participate in the auction process.[19]

The debtor may not have sufficient liquidity to continue operating the business in the ordinary course until the transaction is closed. Therefore, in order to cause the consummation of the asset sale in the reorganization stage, it may be necessary for the stalking-horse to grant financing to the debtor in the

[19] Frazier, Kelly K.; Friedland, Jonathan P.; Brady, Erin N.; Cho, Shirley S.; Itkin, Robbin L.; Sinanyan, Lori; Spiegel, Bennett L.; Wynne, Richard L. and Zarlenga, Lisa. *A Comparison Shopping Guide For 363 Sales*. American Bankruptcy Institute, 2009, p. 24.

absence of financing sources.[20] If this is not possible, the stalking-horse must negotiate clauses in the asset purchase agreement that protect it against possible damages to the enterprise or the value of its assets before the closing of the transaction (either as a result of lack of funds, mismanagement by the administrators of the company, or other factors). Such clauses may include the stalking-horse's right not to close the transaction if a material adverse effect has occurred or if the seller fails to comply with certain obligations regarding the conduct of business in the interim period.

ACQUISITIONS OF BANKRUPT COMPANIES THROUGH THE RESTRUCTURING PLAN

Acquisition of Companies Through Capitalization or Conversion Agreements

The Bankruptcy Law does not offer an efficient framework to structure a distressed acquisition transaction, since, unlike the Spanish bankruptcy law, it does not provide that the restructuring plan may serve as an instrument to acquire a bankrupt company or satisfy outstanding creditor claims by assuming an equity position. Under the Spanish bankruptcy law, it is possible to document sale proposals in the restructuring plan, whether of the assets and rights of the bankrupt company relating to its business or professional activities, or of certain businesses for the benefit of a specific natural or legal person. Article 100 of the Spanish bankruptcy law provides that the restructuring plan may contain, in addition to debt haircuts or term extensions, alternative proposals for all or some of the creditors or classes of creditors (except for government creditors). Such alternative proposals may include offers to convert debt into shares, interests or membership interests, convertible debentures, subordinated loans, participated loans, loans with capitalizable interest, or any other financial instrument with a ranking, maturity or characteristics that differ from the original debt. Accordingly, it is possible to agree to a debt capitalization mechanism as a form of payment to the recognized creditors, which effectively results in the recognized creditors replacing their outstanding debt claims with equity interest in the bankrupt company (which may result in a change of control).

The restructuring plan under the Bankruptcy Law, in contrast to the Spanish case, is limited to the following terms:

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[20] This type of financing, also known as "DIP Financing," presents several risks and drawbacks in practice, the explanation of which exceeds the purposes of this article. *See*, *DIP Financing Regulation in the Commercial Bankruptcy Law of Mexico*, where the aforementioned risks are explained. *Pratt's Journal of Bankruptcy Law*, LexisNexis, February-March 2019, pp. 99–122.

(i) The payment of pre-bankruptcy debts;

(ii) The payment of the bankruptcy debts (i.e., those that became enforceable following the ruling declaring the initiation of the bankruptcy procedure, until the approval of the restructuring plan); and

(iii) The payment of all post-bankruptcy obligations (i.e., those that become enforceable following the approval of the restructuring plan).

Furthermore, Article 159 of the Bankruptcy Law only contemplates debt haircut or term extensions proposals, or a combination of both features.

Article 155 of the Bankruptcy Law provides a deficient mechanism to repay outstanding creditor indebtedness through shares or a debt capitalization but, as the legislation is not mature and it is in conflict with other aspects of Mexican law, including Constitutional law, including these features in the context of a restructuring plan has not been without controversy. If approved by the majority of the recognized creditors, the conciliator will inform the judge of the proposed capital increase agreed in the restructuring plan so that the judge notifies the debtor's shareholders, who will have fifteen calendar days to exercise their preemptive rights. This mechanism has been successfully used in recent, high profile cases such as the construction companies Homex[21] and ICA.[22]However, as previously stated, this method is not free of legal and Constitutional risks.

The legal controversy first stemmed from an inaccurate interpretation of Articles 158 and 159 of the Bankruptcy Law by the Unitary Court (*Tribunal Unitario*) whose holding was later reviewed and overturned by the Third

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[21] On June 13, 2014, Desarrolladora Homex, S.A.B. de C.V. (jointly with some of its subsidiaries) was declared in bankruptcy with prior restructuring plan, which ended through a ruling dated June 3, 2015, and whereby the First District Judge of the State of Sinaloa approved, as a final judgment not subject to appeal, the restructuring plans executed with the majority of its recognized creditors. In such restructuring plans, it was agreed, among other things, to convert unsecured loand into the reorganized capital stock 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*) in: http://www.bmv.com.mx.

[22] On September 4, 2017, Empresas ICA, S.A.B. de C.V: (jointly with some of its subsidiaries) was declared in bankruptcy with prior restructuring plan, which ended with the ruling dated March 1, 2018, and whereby the Twelfth District Judge on Civil Matters in Mexico City issued judgments that approved the restructuring plans entered into with the majority of its recognized creditors. In such restructuring plans it was agreed, among other things, to capitalize liabilities as payment to common creditors. For more information, see the information filed as a relevant event by the issuer to the Mexican Stock Exchange (*Bolsa Mexicana de Valores*) in: http://www.bmv.com.mx.

Collegiate Court (*Tribunal Colegiado*) on civil matters of the First Circuit in an *amparo* trial.[23] Specifically, the Unitary Court (*Tribunal Unitario*) held that restructuring plans that modify payment terms by imposing that the recognized creditors receive the capital stock of the bankrupt company as repayment would not result in the valid repayment of such outstanding creditor claims because a payment in kind arrangement (*dación en pago*) would require the agreement of all interested parties or, in this case, the consent of all unsecured creditors.[24] The Collegiate Court (*Tribunal Colegiado*), however, in a judicial precedent (*tesis aislada*) issued in connection with the *amparo*, limited the application of Article 159 of the Bankruptcy Law to agreements regarding the minimum and maximum amounts specified in the restructuring plan in connection with a term extension, haircut, or a combination of the foregoing agreed by at least 30 percent of the unsecured creditors who executed the plan. The Collegiate Court (*Tribunal Colegiado*) concluded that Article 159 of the Bankruptcy Law does not regulate payment through an increase to the capital stock pursuant to Article 155 of the Bankruptcy Law and, in its absence, the bankruptcy judge can validly cram down a restructuring plan that includes the repayment of recognized creditors with shares resulting from a debt capitalization to the unsecured creditors that did not execute it.

The Collegiate Court's (Tribunal Colegiado) treatment of the possible Mexican Constitutional issues falls short.[25] Specifically, the court responded to

[23] Articles 158 and 159 of the Bankruptcy Law set forth the rules under which the debts held by the unsecured creditors must be determined and paid, which rules do not contemplate the conversion of debt to equity. The Bankruptcy Law provides that a restructuring plan may only be "crammed down" if it contemplates the payment of their unpaid obligations in one of the following three ways: (i) a term extension, with a capitalization of ordinary interest, with a maximum duration equal to the shortest term agreed to by the unsecured creditors that did execute the restructuring plan; (ii) a haircut of the principal balance and accrued unpaid interest, equal to the lesser amount agreed to by the unsecured creditors that have executed the restructuring plan; or (iii) a combination of haircut and term extension, provided the terms are identical to those accepted by at least 30% of the amount recognized for the unsecured creditors that executed the reorganization plan.

[24] The unitary court specifically held that the exception to the "privity" principle (res inter alios acta) set forth in Article 159 of the Bankruptcy Law does not cover the case of payment in kind. Moreover, pursuant to Article 2012 of the Federal Civil Code, a creditor may not be obligated to accept something other than what it contracted for, even if the alternative compensation is more valuable.

[25] The Collegiate Court's (*Tribunal Colegiado*) held as follows regarding the Mexican Constitutional issues surrounding mandatory affiliation concerns: "The issue is not being bound to be a member of the bankrupt company, but rather the possibility of recovery of the recognized creditors ranked as unsecured, through the opportunity to sell the shares in the market, once the respective exchange is carried out and the shares are formally provided. Given that the shares

mandatory affiliation concerns under Article 5 of the Mexican Constitution with weak arguments that restructuring plans with an agreement to exchange debt for shares do not impose mandatory circumstances on the affected creditors as such shares would be freely alienable and could be liquidated in market and applied towards repayment. However, not all Mexican companies are listed on the stock market (in fact, most are not) and market factors may not support an immediate transfer. Moreover, a creditor's ability to freely transfer the shares or membership interests of the bankrupt company received in satisfaction of an outstanding debt obligation does not change the fact that, for an (indeterminate) period, the creditor is effectively forced to not only become the partner of the other creditors but also to become a member or a shareholder of the bankrupt company.[26] Indeed, there is a risk that, if presented with the issue in question, the Supreme Court of Justice may be persuaded to declare such restructuring plans unconstitutional because they inappropriately bind the unsecured creditors that opposed the debt capitalization approved in the reorganization plan in violation of the principle of freedom of association provided in the Mexican Constitution.

The Bankruptcy Law must therefore be urgently amended to explicitly permit (i) the possibility of agreeing on the conversion of debt to equity as a form of payment to recognized creditors, and (ii) the possibility of agreeing to the sale terms for the disposal of a bankrupt company through the restructuring plan. Moreover, this amended legislation would benefit from a Supreme Court

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representing the capital stock are traded daily in the securities market, which entails that they are fungible and easily disposable, which, according to the operation of the securities market and securities brokerage, at the instant when the creditors receive the relevant certificates, these, in a matter of seconds, may trade them in the market through their broker; therefore, it is incorrect that an obligation is imposed on the creditor to remain as a shareholder of the company, that this situation must remain during a mandatory and indefinite period, or that specific locks have been imposed to prevent their free transfer. It is evident that the shares may be sold and each creditor may settle the amount that such certificates represent, receiving the relevant consideration. In this context, if the unsecured creditors accepted and executed the restructuring plan proposal, for their debts to be paid through the capitalization of shares that would be issued as a result of the increases to the capital stock of the bankrupt company, then the dissident unsecured creditors may likewise accept this form of capitalization payment since those that consented did not accept any haircut, term extension, or combination thereof." See precedent I.3o.C 355 C (10a), which is published in Weekly Federal Judicial Gazette, Tenth Period, Volume IV, August 2019, page 4516, titled: "BANKRUPTCY PROCEDURE. THE PRINCIPLE OF DEMOCRACY GOVERNS IN THE EXECUTION OF THE RELATED RESTRUCTURING PLAN."

[26] See the jurisprudence on the subject matter: COMMERCE AND INDUSTRY CHAMBERS, MANDATORY AFFILIATION. ARTICLE 5 OF THE LAW ON THE SUBJECT VIOLATES THE LIBERTY OF ASSOCIATION SET FORTH BY ARTICLE 9 OF THE CONSTITUTION.

review to render the aforementioned tensions surrounding Constitutional issues silenced as the need to rescue companies and preserve employment is arguably of greater transcendental significance than the protection of an unfettered right of a minority of disgruntled unsecured creditors to freedom of association.

"Loan-To-Own" Acquisition Strategies

While the Spanish bankruptcy law restricts investments in companies undergoing a bankruptcy process through debt purchases, the Bankruptcy Law contains no such limitations despite the fact that the law that it replaced, the Bankruptcy and Payment Suspension Law of 1943 (*Ley de Quiebras y Suspensión de Pagos*) included similar restrictions.[27] Specifically, Article 3 of the Spanish bankruptcy law prohibits creditors acquiring debt through *inter vivos* acts for their own benefit after its acceleration and within six months prior to the filing of the insolvency petition from filing for the debtor's bankruptcy. Furthermore, Article 122 of such law provides that the creditors of subordinated debt, including any debt that is acquired by affiliated entities after the declaration of bankruptcy through *inter vivos* acts, will not be entitled to vote in the creditors meeting. These restrictions exist to discourage debt acquisition strategies aimed at capitalizing debt to secure an ownership position in the distressed company and an unfair advantage *vis-à-vis* other creditors.

In general terms, the Loan-to-Own acquisition strategy consists in acquiring *de facto* control of the company by identifying and acquiring, at a substantial discount, a simple majority interest in its common unsecured debt. The first step involves identifying the debt that is easiest to eventually capitalize while affording the buyer a majority vote to approve a restructuring plan that converts creditor debt to equity. A key strategy point consists of assessing the minimum purchase amount required to neutralize the participation of creditors that may thwart efforts to advance a debt to equity conversion plan. The investor must be particularly careful in identifying and selecting a structure that works from a tax and corporate governance standpoint and has the potential to generate returns. For this, the investor must ensure that, after acquiring the debt and subsequently capitalizing it, the debtor acquires effective control of at least the majority of the common capital stock of the company in question. From a procedural standpoint, Article 144 of the Bankruptcy Law mandates that any assignment of a creditor's debt in the context of a bankruptcy proceeding must be notified by such creditor and the assignee to the conciliator using the

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[27] Article 326 of the repealed law set forth that "the debts assigned through *inter vivos* acts will not be entitled to vote, and such debts will be discounted for the calculation of capital majorities, even if these were through endorsement after the date on which the declaration of bankruptcy ruling was issued."

prescribed IFECOM forms. The conciliator shall publish such notifications in accordance with the relevant IFECOM provisions. Moreover, as in a par M & A acquisition transaction, any assignee seeking to become a controlling shareholder must obtain the applicable authorizations if a change of control occurs, including, as applicable, from the Federal Antitrust Commission (*Comisión Federal de Competencia Económica*), and ensure that the minority and preemptive subscription rights set forth in the law and, as applicable, the bylaws of the bankrupt company, are respected.

Without delving into an analysis of the complex strategies that are often implemented for such purposes given that the Bankruptcy Law does not prohibit loan-to-own strategies, set forth below is a summary of the applicable regulations in Mexico both for the acquisition of debts and accounts receivable, and for the capitalization thereof.

Debt Acquisition

- *Rights Assignment*

In Mexico, assignment of rights is regulated in Articles 2029 to 2050 of the Federal Civil Code. The main purpose of an assignment of rights is transferring debt from the assignor to the assignee, which may be an individual or a legal entity. Any assignment will be construed in terms of the applicable law governing the interpretation of the original instrument giving rise to the assigned interests. It follows that, to the extent that no specific interpretative framework applies to the original instrument, the framework of the most similar legal act will apply.[28] As a general rule, the debtor's consent is not required, unless the assignment is prohibited by law or contract, and assignments of debt that is not payable on demand or bearer debt may be made in a private instrument signed by the assignor, the assignee and two witnesses. Please note that the law provides the specific cases in which assignments of debt must be documented in a public instrument.

However, for an assignment of rights to be effective *vis-à-vis* the debtor, it must be notified by the assignee before two witnesses or before a notary public. Moreover, for an assignment to be enforceable *vis-à-vis* third parties other than the debtor, certain formalities must be satisfied pursuant to applicable law. The most significant examples for purposes of this discussion follow: (i) for any assignment for which the original instrument was recorded in a public registry, such assignment shall be effective once registered in the Public Registry of Property (*Registro Público de la Propiedad*), with respect to assignments

[28] Rico Álvarez, Fausto, et. al. *Tratado Teórico-Práctico del Derecho de Obligaciones*, Editorial Porrúa, Mexico, 2013, p. 553.

governed by the Civil Code (*Código Civil*), or in the Sole Registry of Collateral (*Registro Único de Garantías Mobiliarias*), with respect to assignments governed by the Commerce Code (*Código de Comercio*), and (ii) for any assignment solely requiring formalization in a public instrument, such assignment shall be effective once so formalized.

- *Factoring Agreements*

In Mexico, factoring agreements are regulated under Articles 419 to 431 of the LGTOC. Factoring agreements facilitate the factor's sale of its client's accounts receivable arising from the sale of assets or provision of services by the factor to such client to a purchaser, which may be a financial institution or a hedge fund, typically at a discount through an advance payment of the invoice value of such accounts receivable. In accordance with Article 419 of the LGTOC, factoring may be done with or without recourse, depending on whether the seller is liable or not *vis-à-vis* the factor for the payment of uncollected collection rights that were transferred to the latter.

Furthermore, in accordance with the Article in question, the management and collection of the accounts receivable subject to the factoring agreements, must be carried out by the factor or by its third party agent. The factor's credit rights may be transferred through a factoring agreement, without the consent of the debtor client, unless the transfer is prohibited by law, the nature of the right does not allow it, or the contractual terms or invoices giving rise to the accounts receivable to be factored contain express language that requires the client's consent for any assignment of the client's obligation to pay amounts corresponding to the contracted for goods or services to the factor or language that prohibits the factoring of such accounts receivable. However, even the factoring of a client's accounts receivable may be done without such client's consent, with the understanding that if such consent is not documented then a debtor client may be released from its obligation by paying the factor or the last holder of such rights notified to the debtor client. In order for a transfer of credit rights to be enforceable against a debtor, the factor must notify the debtor of such transfer.

Capitalization of Debts Against the Company

As previously discussed, a bankrupt company may theoretically agree to a debt capitalization in the context of its restructuring plan with its recognized creditors, whereby, the bankrupt company repays it debt in whole or in part with newly issued shares in lieu of making a cash payment.

ACQUISITIONS OF BANKRUPT COMPANIES DURING THE LIQUIDATION STAGE

General Provisions

In accordance with Article 167 of the Bankruptcy Law, the bankrupt business will be declared in the liquidation stage if any of the following conditions exists:

(i) The debtor requests it;

(ii) The reorganization term and its extension (if granted) expire, without the recognized creditors and the debtor having agreed and the conciliator approved a restructuring plan;

(iii) The conciliator requests the judge initiate the liquidation stage and the judge grants it under the terms provided in Article 150 of the Bankruptcy Law; or

(iv) If the debtor accepts a claim filed by one or more creditors, requesting the judicial decree of the debtor's bankruptcy, bypassing the reorganization stage to commence the liquidation stage.

The liquidation stage is the phase in which the Mexican legislature contemplated the sale of the assets of the bankrupt company. Pursuant to Article 197 of the Bankruptcy Law, once liquidation is declared, even if the debt recognition has not been completed, the receiver will proceed to dispose of the assets and rights that comprise the bankrupt company's estate, seeking to obtain the highest possible proceeds from their disposal. Accordingly, the receiver will seek the highest asset disposition price subject to the shortest terms to recover funds.

The procedures and general terms under which the property disposal is carried out must be based on the market for similar transactions, current sound commercial practices and customs, the location(s) of the property, and the time, general, and specific conditions under which the transaction is carried out, even considering a reduction, as applicable, of the management costs.

The Bankruptcy Law requires the receiver to maximize the proceeds from the sale of the assets, meaning that the receiver must always consider the convenience of selling the business as a going concern. On the other hand, if it is not possible to maintain the business as a going concern, the assets may be sold in bundles to promote efficient sales that reduce transaction costs and maximize recovery value.

Procedural Rules

As a general rule, the sale of distressed assets must be carried out through a public auction procedure. However, as mentioned above, the Bankruptcy Law provides in Articles 205 and 208 the possibility that such assets may be sold outside of the public auction under certain circumstances.

Public Auction Procedure

Pursuant to the provisions of Article 198 of the Bankruptcy Law, the sale of the distressed assets must be carried out through a public auction procedure (with certain exceptions that we will analyze below). For this, the receiver shall publish the call for the auction in accordance with the general provisions issued for such purpose by the IFECOM.[29] The article in question does not require the receiver to submit expert valuations consistent with Article 470 of the Federal Code of Civil Procedure (*Código Federal de Procedimientos Civiles*) governing judicial auctions outside of a bankruptcy proceeding. Although, in accordance with Article 210 of the Bankruptcy Law, the receiver has the authority to request expert reports, valuations, and such other studies and reports as it may from time to time deem necessary or advisable to fulfill its duty to maximize liquidate sale price, it is not obligated to do so and the failure to request such reports or studies will not invalidate the terms of a sale conducted by public auction.

From the date on which the publication is made until the date immediately preceding the date of the auction, any party interested in participating in the

[29] The call must contain: (i) a description of each of the assets or set of assets of the same kind and qualities intended to be sale; (ii) the minimum price that will serve as the benchmark to award the auctioned assets, accompanied by a reasoned explanation of such price and, as applicable, the documentation on which it is supported; (iii) the date, time and place proposed for the auction, and (iv) the dates, places and times in which the interested parties may know, visit or examine the property in question. In accordance with the Rules, for the purpose of giving publicity to the call for the public auction within the term mentioned in Article 198 of the Bankruptcy Law, the receiver must comply with the following processes: (i) within five days following that on which it obtained possession of the property and rights that compose the bankruptcy estate, in accordance with the second paragraph of Article 191 of the Bankruptcy Law, if it deems it necessary, it will request the relevant valuations to carry out the auction, which it will only file so that they are included in the file within three days following that on which it obtains it; (ii) within three days following the filing made to the judge of the valuations referenced in the preceding paragraph, it will propose to such court, on a reasoned basis, that it order the public auction providing the information referenced in Article 199 of the Bankruptcy Law, and the other circumstances it deems useful; and (iii) within three days following the authorization referenced in the preceding rule, the receiver will process the publication of the call for the disposal in a public auction of the property and rights that compose the bankruptcy estate, with the content ordered by Article 199 of the Bankruptcy Law, in one of the newspapers with the greatest circulation in the city where the trial is being conducted. Additionally, within three days following the publication, it shall provide to the judge a copy of the newspaper, and another one to the IFECOM, for the purpose that the latter include the publication in its website.

auction must submit to the judge, in a closed envelope, bids for the property subject to the auction. Those that are filed after the deadline will not be considered.[30] The auction procedure set forth in the Bankruptcy Law includes an exception whereby a federal law (such as the Bankruptcy Law) may establish modalities on private property and even regulate the auctions of real property of the company subject to bankruptcy, notwithstanding the location of such real property. The authority in question is based on public interest reasons, as a result of the commencement of a special and exceptional procedure, justified by the state of insolvency of the company.[31]

When submitting the bids or offers to the judge, bidders or offerors must attest to, under oath, their family or property links with the bankrupt company, its managers, or other persons directly related to its operations.[32] Individuals submitting a bid or offer on behalf of another person shall state their relationship to the person he represents. Before selling the assets, the receiver must notify the judge the names of the shareholders of the bankrupt company, their shareholding interest, and the name of the directors and persons that may

[30] The bids or offers made in the disposal procedure must satisfy the following requirements: (i) they must be submitted in the forms published by the IFECOM for such purpose; (ii) they mush provide for the payment in cash (in the cases where it is possible to precisely determine the amount to which any recognized creditor would be entitled as a bankruptcy fee derived from a sale, the relevant creditor will be allowed to try to apply such amount to an offer, making it equivalent to a payment in cash); (iii) they must have a minimum term of 45 days following the date when the auction is held or, as applicable, the date on which the offer is submitted; and (iv) they must be secured under the terms determined by the IFECOM through general rules.

[31] See precedent 1a. LXXXII/2008, which is published in the Weekly Federal Judicial Gazette, Ninth Period, Volume XXVIII, August 2008, page 45, titled: "BANKRUPTCIES: THE ISSUE OF THE LAW ON THE SUBJECT MATTER, WHICH REGULATES AUCTIONS OF REAL PROPERTY OF BUSINESSES, DOES NOT INVADE THE SCOPE OF JURISDICTION OF LOCAL LEGISLATURES."

[32] In accordance with Article 202 of the Bankruptcy Law, a family link will be deemed to exist with the spouse or domestic partner, and with blood relatives up to the fourth degree; up to the second degree if the relationship is by marriage, and with relatives by adoption. As applicable, the family link will be understood to refer to the administrators, managers, executives, attorneys-in-fact and members of the board of directors of the business. Furthermore, if the business is a legal person, a property link will be understood to exist between it and the following persons: (i) the holders of at least five percent of its capital stock; (ii) those that effectively control the legal persons that hold at least five percent of its capital stock; (iii) the legal persons where their managers or the persons mentioned in the preceding sections hold, jointly or severally, at least five percent of the capital stock; (iv) those that may bind it with their signature; (v) those where they have a direct or indirect interest of at least five percent of its capital stock; (vi) the managers and persons that may bind the persons mentioned in item (v) above with their signature; and (vii) any other persons that, due to being directly related to the operations of the bankrupt company, have access to privileged or confidential information on its company.

act on behalf of the bankrupt company. Omissions or misrepresentations will render the terms of any sale null and void.

The auction must be carried out within a minimum term of 10 calendar days and a maximum term of 90 calendar days following the date on which the call is published for the first time. The judge or, as applicable, the court clerk, will chair the auction on the date, time, and place authorized by the judge, observing the following requirements provided by the Bankruptcy Law:

1 Access to the auction will be public;

2. At the scheduled time, the chair will announce the commencement of the auction and, will immediately proceed to open the envelopes with the bids received before those in attendance, dismissing those that do not satisfy the aforementioned requirements or that contain a price below the minimum mentioned in the call;

3. If no party submits a valid bid, the auction will be declared abandoned;

4. Whoever chairs the auction will read each of the admitted bids out loud, expressly announcing those made by persons that have a family or property link with the bankrupt company;

5. After all of the bids have been announced, the auction chair will identify the highest bid and will ask if any of the attendees wish to improve it. If someone improves the bid within a term of fifteen minutes, the auction chair will once again ask if another bidder is interested in improving it until such requests render no offers to improve the bid terms; and

6. Once there is no offer of an improved bid, the bid for which the auction chair sought improvement shall be declared the successful, final bid.

At the end of the auction, the judge will order the judicial award of the property to the winning bidder, subject to prior payment, to the bidder that made the successful bid. In all cases, full payment must be submitted within ten calendar days of the date on which the auction was held. If payment is not made in full, the bidder will lose the deposit, and the relevant collateral will be enforced for the benefit of the estate.

Procedures Relating to Auction Alternatives

Article 205 of the Bankruptcy Law authorizes the receiver to request judicial authorization to sell the assets outside of an auction if the proposed alternative would maximize asset value from a comparative vantage point.[33] Within one business day of receiving such request for authorization to sell outside of an auction from the receiver, the judge will furnish the terms of such request for authorization to the debtor, the recognized creditors and the conservators, who will in turn have a ten calendar day period to review it. During such term, the following persons may express their disagreement with the sale proposal in writing:

(i) The debtor;

(ii) One-fifth of the recognized creditors;

(iii) The recognized creditors that represent, as a whole, at least 20 percent of the total amount of the recognized debts; or

(iv) The conservators that have been designated by the recognized creditors that represent, as a whole, at least 20 percent of the total amount of the recognized credits. If there is no written objection during the ten calendar day term, the judge will order the receiver to proceed with the disposal in accordance with the terms of the authorization request.

Please note that Article 208 of the Bankruptcy Law provides a specific exception for the receiver to sell outside of the context of an auction for assets for which value deterioration is an issue. Specifically, it refers to the authority of the receiver to sell, outside the auction procedure, the property from the estate which, given its nature, requires immediate disposal if one or more of the following conditions is met:

(i) It cannot be preserved without deterioration or decay;

(ii) It is subject to extreme price volatility or reduction;

(iii) The cost to preserve or maintain such property exceeds its value; or

(iv) Its disposal value does not exceed the amounts that the IFECOM sets through general rules.[34]

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[33] In this case, the request from the receiver must contain: (i) a detailed description of each of the property or group of properties of the same kind and characteristics as those intended to be sold; (ii) a description of the procedure whereby the sale is intended to be carried out, and (iii) a reasoned explanation of the rationale of carrying out the sale as proposed, and not in accordance with the public auction, which reasoning must explicitly set forth why a sale outside of the context of an auction would maximize value.

[34] The Board of Directors of the IFECOM established on January 16, 2015 a value of up to 100,000 investment units (*unidades de inversion*), without considering value added tax, which amount may be exhausted in one or several sales.

In these exceptional cases pursuant to Article 208, within three business days following the applicable sale, the receiver, through the judge, will notify the debtor, the conservators, and the recognized creditors of the sale terms, including the identity of the buyer, a description of the property in question, its prices and sale conditions, and the rationale for its urgent disposition.

CONCLUSIONS

Although the Bankruptcy Law does not prohibit the sale of distressed businesses in the reorganization stage, there are several practical limitations presented by the current legal framework that should be addressed by the Mexican Legislature to grant greater legal certainty to the eventual acquirers of bankrupt companies (both in the reorganization and in the liquidation stage) and encourage distressed M & A transactions in the Mexican market. By eliminating the unnecessary risks, costs, and disadvantages that are unreasonably imposed on potential institutional investors through mandatory contractual assignments and a failure to provide exceptions for asset dispositions occurring during a bankruptcy proceeding from labor, tax and employee claims, Mexican courts will have the necessary tools to approve value-maximizing distressed asset sales in furtherance of the public interest purposes set forth in the Bankruptcy Law.

In the past few years, institutional investors (both hedge funds and private equity firms) have demonstrated a growing interest in acquiring distressed businesses in the Mexican market. Mexico's current economic outlook (mainly since the economic crisis caused by the health emergency derived from Covid-19) has caused and will likely cause more Mexican companies initiate a bankruptcy process, presenting many opportunities for specialized investors to acquire their assets. If, after analyzing the financial condition of the business and the reasons that led to such situation, such investors determine that the business has potential, they may assume the risks of acquiring and rescuing it to resell it to the benefit of the Mexican economy as a viable and solvent enterprise despite the disproportionately burdensome transaction costs presented by the current Mexican legislative framework.

Mexico should amend its Bankruptcy Law to create a competitive market for the acquisition of distressed businesses. Analogous laws such as those of the Spanish and American legal systems offer tools that, if incorporated into the Bankruptcy Law, could modernize it and enhance its ability to protect the interests with which the Bankruptcy Law is concerned. Such tools are necessary for the conciliator to be able to authorize the sale of distressed businesses for the benefit of all parties to the bankruptcy procedure and of society in general.

Given the present complicated global economic reality, it is crucial to provide legal solutions that allow us to improve the economic and social conditions in

Mexico. The proposed legislative reforms described in this article would result in more rescued companies, avoiding the deterioration of their main assets, protecting the rights of the recognized creditors, and preserving employment in the Mexican labor market.