Client Alert

Financial Restructuring and Insolvency

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Mitigating the "Vitro Effect": Mexican Lawmakers Approved the Most Ambitious Bankruptcy Law Reform Since its Enactment back in 2000, Aiming to Ensure Creditors' Rights

On January 10, 2014, the Federal Executive Branch of México published in the Official Gazette the legal amendments to México's Commercial Bankruptcy Law (*Ley de Concursos Mercantiles*, or LCM), effecting the most comprehensive set of changes to the LCM since its enactment over 13 years ago, and establishing new rules for bankruptcy proceedings in México with the intent to improve the position of creditors dealing with the insolvency of local companies. The law reform made several major changes to bankruptcy law eliminating long-standing bankruptcy-law loopholes that undermined México's consideration as a safe jurisdiction for the adjudication of legitimate claims. Among other relevant changes, the LCM now subject intercompany debtholders to stricter rules in forming a sufficient majority for approvals of a reorganization plan in order to minimize the abuse in using intercompany debt to "cramdown" other creditors (as experienced in the case of Vitro, SAB de CV), establishes the subordination of intercompany loans, sets forth clear rules for DIP financing and creates creditor-protection measures that ensure the effective rights to recover claims from financially distressed debtors, among others.

If you have questions or comments regarding this Alert, please contact one of the lawyers listed below:

Vicente Corta
Partner, México City
+ 52 55 5540 9602
vcorta@whitecase.com

Enrique Espejel
Partner, México City
+ 52 55 5540 9683
eespejel@whitecase.com

Ma. Teresa Fernández-Labardini
Partner, México City
+ 52 55 5540 9688
tfernandez@whitecase.com

Manuel Groenewold
Partner, México City
+ 52 55 5540 9657
mgroenewold@whitecase.com

The amendments to the LCM

The changes to the LCM aim to establish a true balance between the debtor and its creditors, as well as to expedite the bankruptcy proceedings in order to maximize the value of the bankruptcy estate for the benefit of all the stakeholders. The foregoing objectives can be achieved, considering that the legal reform will imply a material reduction on the risk of delayed proceedings and uncertainty as to the application of the law. Minimizing these risks shall result in the benefit of creditor's rights, which as a consequence will increase the access to loans and credits in better financial conditions.

The amendments primarily make the following changes:

1. Intercompany and insiders' debt is now ranked as subordinated.

Some of the so called anti-Vitro provisions, which are restrictions commonly included in borrowing/credit agreements, indentures, bond offerings, etc, that followed the Vitro case, aiming to limit, control and/or subordinate intercompany indebtedness, were considered in the discussion of the legal reforms and adopted by the legislators, among others by creating a new rank of subordinated creditors, and controlling the vote of intercompany loans and/or insiders.

White & Case, S.C.
Torre del Bosque- PH
Blvd. Manuel Avila Camacho #24
Col. Lomas de Chapultepec
México, D.F., 11000
México
Tel: + 525555409600
Fax: + 525555409699

Subordination agreements are now recognized by the law. Any contractual agreement which establishes one debt as ranking behind the unsecured debt in the priority for collecting repayment from a debtor is now enforceable in bankruptcy.

In absence of a subordination agreement, subordination is mandatory in case of unsecured debt held by subsidiaries or affiliates of the debtor and certain insiders, with the exception of the claims of parent companies and individuals that have control over the debtor. The exclusion from statutory subordination of claims belonging to controlling individual shareholders and holding companies should have effect just for ranking purposes and not in the case of casting votes for the plan of reorganization, fraudulent conveyance actions, among others.

With the purpose to align the fraudulent conveyance actions under the LCM with more robust controls and scrutiny of intercompany indebtedness, and to give certainty to investors and creditors that their debt would be paid first before certain intercompany obligations, the law reform provides that in case the debtor is a corporation, the following unsecured creditors (statutory insiders) shall be characterized as subordinated in ranking:

- Subsidiaries and affiliates of the debtor;
- Director, members of the Board of Directors, and key officers of the debtor, as well as those in its subsidiaries and affiliates;
- Corporations with the same managers, members of the Board of Directors or key officers similar to those of the debtor (commonality of management).

In the event the insolvent company is put into liquidation, all of the aforementioned creditors shall receive payment only after senior debt claims are paid in full.

Claims held by controlling individual shareholders and by the holding company of the debtor were excluded from subordination in payment as Mexican lawmakers considered that including such claims would impair their ability to obtain financing from lenders.

2. Stricter rules to avoid "cramdown" by the vote of intercompany payables and insiders' claims.

The amendments introduce a set of rules to avoid the imposition of a plan on dissenting unsecured creditors by using intercompany and insiders' debt to become the debtor's own biggest creditors in restructuring with their vote controlled by shareholders or management. The voting rules set out in the reform are designed to be fair for legitimate third party liabilities and assets and should ensure that a restructuring effected under them will be capable of international recognition before foreign courts (such as US, UK, European and Asian courts, among others).

The reform maintains the same plan-passing system by applying the simple majority (in amount) voting rule.

To become effective, the plan must be accepted (i.e., signed) by the debtor and creditors representing more than 50 percent of the sum of: [x] all the debtor's unsecured and subordinated claims (regardless of whether the holders of such claims have accepted the reorganization plan), plus [y] all the claims of the debtor's secured or priority creditors accepting the reorganization plan.

Just in case that intercompany claimholders and insiders (including controlling individual shareholders and holding companies) as subordinated creditors, hold at least (jointly or severally) 25% of the total amount of the credits referred to in [x] and [y] above, in order to become effective the plan must be accepted by creditors representing at least 50% of such credits, excluding from this amount the claims of the insiders.

The foregoing rule shall not apply when intercompany claimholders and insiders accept the plan as agreed by the rest of the voting claimholders, in which case the standard plan-passing system shall be followed by the court.

Consequently, now with the reform, the voting of insider/intercompany claims together with third-party claims is effective for the approval of any reorganization only if at least half of the non-insiders cast their votes in support of the plan.

3. Bondholders and their trustees: Clear rules for their interaction before Mexican courts.

In México, in principle, as long as an individual bondholder is recognized by the court as creditor, it will have the right to be considered a party to the bankruptcy proceedings and, among other rights, such bondholder will be able to file a proof of claim, vote the plan of reorganization, and challenge any intercompany/insider debt when proposed for recognition. Notwithstanding the foregoing, in practice collective credits such as the bonds are commonly recognized by the court through the indenture trustee, which will generally be recognized as the sole creditor (mainly acting as a representative of the bondholders) under an indenture. Until the legal reform there was no consensus on the bondholder representation in a *concurso*, but the LCM now establishes clear guidelines and is as explicit as Section 501(a), Chapter 5 (Subchapter I), Title 11 of the U.S. Code, and expressly permits an indenture trustee to file a proof of claim. As well, it is clearly established that individual bondholders can separately file a proof of claim and the *conciliador* (similar to a bankruptcy trustee) shall simply deduct such amount from the claim filed on behalf of the holders of all bonds issued under a trust indenture.

Separate recognition of bondholder claims by Mexican bankruptcy courts despite an overall proof of claim filed by the indenture trustee on behalf of all holders, may represent the need to change trust indentures to foresee the implication of the legal reforms to the LCM in matters such as trustee's lien, direct distribution to separately recognized holders, and recovery of the portion of fees and costs any individual holder fails to cover, among others.

In the absence of any rule or agreement for the plan confirmation or vote, holders of bonds/notes issued through the stock market or other means, may elect to cast their vote in either: (i) an *ad-hoc* proceeding to be established by the same bondholders, or (ii) the specific voting process introduced by the legal reform, which among other benefits establishes that the resolutions legally adopted in the bondholders' meeting obliges all holders, including the plan confirmation, and legal actions exercised by individual bondholders which may be similar to those already exercised by the common representative or contrary to any resolution approved by the bondholders' meeting, shall be dismissed.

By adopting this statutory voting process under the LCM, bondholders supporting the plan of reorganization shall contribute to a court's ruling carrying more weight with creditors around the world.

4. DIP financing in the wake of México's Financial Reform.

In line with México's financial reform that seeks to boost economic growth by making it easier for companies to access credit, amendments to Debtor-in-possession (DIP) financing in the LCM aim to facilitate funding for projects that increase the likelihood of the debtor's reorganization and reduce time in bankruptcy, providing the essential liquidity to allow time for restructuring or an orderly sale of the financially struggling company.

Before the legal reform, post-petition loans, although possible under the LCM, lacked a specific mechanism as well as clear provisions on key issues such as priority of the claim in bankruptcy and timing for the respective loan, all of which froze the DIP financing market for many years in México. Absent the financing necessary to reorganize, many companies were forced into liquidation, increasing the number of failing debtors against the cases of successfully reorganized companies.

Under its amendments, the LCM now provides for a fairly straightforward process for post-petition borrowing at any stage of the bankruptcy proceeding, since its filing empowering the judge to authorize the DIP financing and securing it with a court order issued within the proceedings, which, if requested, will also grant a charge on the property and assets (unencumbered) of the debtor in favor of the DIP lender, in terms of the LCM. During the Work-out stage the *conciliador* keeps on being in charge of authorizing post-petition loans and upon the previous request of the company and the lender (s), shall define their terms and conditions (including any collateral requested) considering their priority ranking under the LCM. Within this period, the bankruptcy court shall not take an interventionist role in DIP financing issues unless a dispute arises. Also, and in order to avoid any doubt, the legal reform clearly states that DIP loans have a priority claim in the bankruptcy, which means that except for certain labor claims (i.e. severance payment) and secured claims, the DIP lender has a privileged claim derived from either new liens on unencumbered assets, and/or priority administrative/DIP financing claim status.

With the legal reform to post-petition borrowing provisions of the LCM, the insolvent company can now incur unsecured or secured indebtedness "in the ordinary course of business" or just for maintaining essential liquidity, if approved by the court or by the *conciliador*, granting a priority administrative claim or a lien to a lender on any of the debtor's unencumbered property or a junior lien on encumbered property.

Furthermore and in connection with the important role of the *conciliador*, the reform allows the debtor together with the holders of at least half of the recognized claims (excluding the insiders), to replace the appointed *conciliador* with the person or corporation/firm of their preference.

5. Corporate groups and "procedural consolidation".

The amendments to the LCM provide a new approach to the reorganization or liquidation of insolvent corporate groups by introducing new definitions and a procedural consolidation encompassing all or most of the members of the group, with a view to reorganizing the affairs of the whole enterprise.

The reform introduces a broader definition of "holding company" considering as such any company that directly or indirectly holds ownership of voting rights with respect to more than half of another company's stock, has control over its decision-making process in the shareholders' meetings, has the capacity to appoint the majority members of its managing board, or that by any other means has the authority and power to make all major decisions of a company.

As to subsidiaries, the amendments to the LCM define them not only as those companies whose voting stock is more than 50% directly or indirectly controlled by another company, but also those upon which a company has the authority and power to manage the parent company and all of its major strategies or politics by means of stock ownership, agreement or any other means.

Both holding companies and subsidiaries, as defined, now constitute a corporate group under the LCM.

With the purpose of minimizing potential damages to good faith outside creditors' rights derived from transactions in a group structure, the possibility to collapse corporate structures is now allowed. The changes to the LCM set forth an option for a procedural consolidation among members of a corporate group of related companies when one or more of them become insolvent and places another member or members of the group on the verge of insolvency. Creditors (as well as debtors) may file for this administrative consolidation, where the same court is declared to have jurisdiction so as to order and monitor the bankruptcy proceedings of all group companies and the same bankruptcy expert (i.e. *visitador,* or *conciliador* or *síndico*) can be appointed for all or more than one of the affiliated companies.

6. An additional criteria for voluntary filing: "Imminent insolvency".

The changes to the LCM introduce a new commencement standard derived from pre-insolvency situations and economic distress. Voluntary petition under the "imminent insolvency" concept is now available for the financially struggling company. As defined by the LCM, imminent insolvency takes place when the debtor anticipates that within a period of 90 days from the voluntary filing, it will not be able to meet its obligations regularly and punctually.

Only the debtor itself can present a voluntary petition in the event of imminent insolvency.

7. Forced into liquidation: The new involuntary liquidation proceeding.

Pursuant to the new provisions set forth by the reform of the LCM, creditors may now request the direct liquidation of the debtor. If the failing company consents with such involuntary petition, then and only if the debtor meets the commencement standards, an Order for Relief is entered and the company is officially placed into liquidation.

8. Bankruptcy and Directors' & Officers' (D&O) liability: A novel regime for protecting the bankruptcy estate.

With the legal reform a whole new set of rules governing potential liability for directors and officers of a distressed company have been introduced to the LCM.

The rationale behind the reform is that during the "zone of insolvency" (when in equitable insolvency and/or balance sheet insolvency) of the debtor, its directors and officers owe fiduciary duties to exercise their business judgment in the best interest of the insolvent company for the benefit of its shareholder owners, while continuing to bear the task of attempting to maximize the economic value of the firm for any potential residual benefit to the shareholders.

Directors and officers liable to the corporation for loss incurred in corporate transactions during the zone of insolvency will be subject to claims for damages.

Some of the statutory sources of potential exposure for D&O's introduced by the legal reform are:

- Transactions for personal benefit or in favor of third parties, including a specific shareholder or group of shareholders;
- Destruction or modification of the debtor's books;
- Material omissions from public statements relating to a company's affairs;
- Altering, or modifying accounts or the terms and conditions of contracts of the debtor, ordering the registration of false transactions and expenses or increasing the amounts of the ones already registered, and carrying out any illegal activity generating a debt or loss to the corporation for personal benefit, including the registry of claims in favor of insiders;
- Allowing fake accounting entries (false accounting);
- Voting on matters discussed at board meetings or making decisions related to the debtor's assets despite having a conflict of interest;
- Producing or disclosing information while knowing it is false;
- Insolvent trading;
- Unreasonable director related transactions;
- Uncommercial transactions;
- Wrongful acts in the course of their work for the corporation.

The amendments to the LCM adopt the business judgment rule to shield directors and officers from liability arising from decisions that are made on an informed, statutory, good-faith basis and with reasonable skill and prudence with an honest belief that the decisions are in the firm's best interest.

9. Strengthening creditor control: Inspector's role before the bankruptcy of a debtor.

The amendments to the LCM provide additional ways for creditors to protect their interests by appointing an inspector (an individual or a firm) without the risk of having other creditors or even the debtor opposing the same before its formal confirmation by the bankruptcy judge.

Inspectors give direction and advice to the creditors regarding the administration of the estate and the debtor's books and transactions. They also supervise both the *conciliador* and the *síndico's* administration.

Holders of at least 10% of the total indebtedness of the company may appoint an inspector to represent them during the bankruptcy proceedings, to monitor and review the debtor's transactions and assets, and to act as a mediator before the debtor, *conciliador* or the *síndico*, for purposes of both facilitating and achieving a plan of reorganization or for ensuring an orderly liquidation proceeding maximizing the value of the debtor's assets.

Although persons appointed as inspectors generally are creditors, a person or firm who is not a creditor can be appointed as an inspector.

It should be noted that inspectors must perform their duties in the best interests of all appointing creditors. Inspectors must not act for their personal advantage and must keep full confidentiality of all documents and information handled and reviewed.

10. *Fideicomisos*: A fully recognized form of bankruptcy remoteness.

Contractual flexibility and bankruptcy-remoteness are key features of a Mexican *fideicomiso* (similar to a business trust).

With the reforms, the stated policy of the LCM is to give maximum effect to the principle of bankruptcy remoteness and to the enforceability of the bankruptcy remote entities such as the *fideicomisos*.

The LCM now expressly recognizes that assets of the insolvent company settled in a *fideicomiso* should no longer be considered as part of the bankruptcy estate and their beneficiary may request the bankruptcy court to declare its separateness.

11. Fine tuning the notions of "look-back" period (ordinary and insider preferences), D&O's liability when involved in fraudulent transfers and that of "insiders".

The legal reform makes substantive changes in the law of fraudulent transfers. All pre-commencement *per se* fraudulent transactions are avoidable, as well as all other avoidable transactions (cases of constructive fraud, objective preferences and subjective preferences), if both types of transactions are carried out within the retroactive period or "look-back" period. The LCM provides a statutory period (called the "Retroactive Period") which is 270 calendar days prior to the date an Order for Relief or *concurso mercantil* declaration is entered, during which transactions are reviewed for fraudulent conveyance and other reasons that can make a transaction voidable. However, if such period proves to be insufficient to annul transactions that may constitute preferences or fraudulent transfers, the amendments to the LCM provides a new mechanism to extend the Retroactive Period back up to 3 years.

The judge may extend the Retroactive Period to an earlier date upon the reasoned request of the *conciliador*, the *síndico*, the inspectors or any creditor, to which should be attached the available evidence, without the need to prove first the fraudulent transfer in order to extend such period.

In addition, the look-back period for determining what transfers can be avoided has been extended up to 540 calendar days prior to the date the *concurso mercantil* declaration is entered (as opposed to the ordinary period of 270 calendar days), for all transfers deemed fraudulent by the LCM, where the entity that receives the money, asset or benefit is found to be a "related entity" to the debtor or an insider.

As to the D&O liability regarding fraudulent transfers, the general rule under the LCM is that a director or officer of a corporation does not owe fiduciary duty to creditors of the corporation. However, when a director or officer is involved in any fraudulent conveyance as defined by the LCM, according to the new rules, he becomes liable also to the debtor's creditors. Consequently, under the amendments the following parties in a bankruptcy can file a fraudulent transfer claim against D&O's:

- One fifth of the creditors;
- Creditors holding at least 20% of the claims against the company;
- Inspectors appointed by the creditors.

The LCM is amended to render as potential fraudulent conveyance any transaction against the bankruptcy estate that involves the financially distressed corporation and any of the following parties:

- Director, members of the Board of Directors, or key officers of the debtor, as well as those of its subsidiaries, parent company and affiliates, and with the husband, spouse, concubine, relatives up to the fourth degree of consanguinity, or second in case of affinity and with civil kinship in respect of such persons;
- Controlling individual shareholders of the debtor or of its subsidiaries, parent company and affiliates;
- Corporations with the same directors, members of the Board of Directors or key officers similar to those of the debtor (commonality of management);
- Subsidiaries, holding company and affiliates of the debtor.

12. An end to endless court-assisted reorganizations: One year is the limit.

Although the LCM provides that the Work-out period (*conciliación*) may not extend beyond 365 calendar days from the date of the publication of the *concurso mercantil* declaration, in certain cases Mexican courts have granted material extensions to some business reorganization proceedings far beyond the statutory time limit of one year in damage of creditors and the bankruptcy estate.

The amendments to the LCM expressly limit the *conciliación* to strictly one year. Such period is divided as follows:

First: An ordinary period of 185 calendar days established by operation of law when the Order for Relief in entered.

Second: An extension for up to an additional 90 calendar days, which shall only be granted by the bankruptcy court in case it is requested by either of the *conciliador* or creditors holding more than 50% of the total claims against the debtor, and only if a plan of reorganization is about to be executed. To obtain the extension, the debtor has the burden of showing a reorganization is likely.

Third: A final additional 90 calendar days, which has to be requested by both the debtor and creditors holding at least 75% of the total claims.

Once such ordinary period and its extension elapse without agreeing on a plan, the bankruptcy judge will simply certify the lapsing of the Work-out stage and consider the debtor as eligible for liquidation.

13. Putting effectiveness in reorganization: Clear definitions on post-confirmation issues.

The provisions in the amendments to the LCM addressing the plan of reorganization aim to avoid discrepancy between the LCM and laws of different jurisdictions, as well as to ensure and expedite its performance.

- Non-debtor releases in reorganization plans

Unless expressly agreed in the plan by the creditor, the LCM precludes the discharge of claims against non-debtor entities, not allowing anymore a non-consensual discharge of non-debtor obligations under a guaranty.

- Secured capital markets instruments: Full recognition to "majority action" clauses.

Provisions enabling a specified percentage of the security holders to modify the rights of the class, including the enforcement or not of guarantees are now fully recognized by the LCM. Under the amendments, in case of secured bonds, the enforcement of the collateral is only valid if such action was adopted by the majority vote set forth in the laws and regulations governing the credit or in the documents related to its execution, or if agreed by means of the specific voting proceeding of the bondholders' meeting introduced by the reform.

- Veto of the plan

The plan of reorganization may only be vetoed by non-voting unsecured creditors holding more than 50% of the total claims recognized to such class of creditors.

- Plan modification: Debtor's right to modify plan payments

The legal reform introduces a summary proceeding which can be accessed only under special circumstances in order to expedite any urgent amendments to the reorganization plan if its performance and fulfillment is jeopardized by material and adverse circumstances and the reorganized company is in danger of conducting business in the ordinary course. The request for amendment needs to be filed by the debtor together with the holders of the claims representing at least the plan-passing majority under the LCM, before the judge that was in charge of the bankruptcy proceeding.

- Post-confirmation enforcement of a plan

A summary proceeding similar to the one for plan modification is established for its execution. The statutory mechanism for the enforcement of a confirmed plan allows any recognized creditor to request the bankruptcy court which approved the reorganization to order the debtor to carry out the plan and comply with any orders of the court issued for that purpose.

- General Retention of Bankruptcy Court Jurisdiction

Post-confirmation bankruptcy court jurisdiction is not limited to matters relating to plan implementation or execution. Another relevant change proposed is that a bankruptcy court also retains jurisdiction over a voluntary or involuntary petition filed as a consequence of a payment default under the original plan deriving from a previous bankruptcy proceeding managed by such court.

14. Pre-packaged bankruptcy: Modifications to shorten and simplify the process.

To get on the right track of "pre-packs", the amendments to the LCM provide that the plan for reorganization that a company prepares in cooperation with its creditors that is attached to the petition, shall be the same one that the *conciliador* must present for voting and approval. Prior to the reform the plan agreed in advance would only serve as a mere reference to the *conciliador* who was not constrained to propose such plan for confirmation. Now, the out-of-court process in México does produce a "done deal".

In addition, the person or corporation of the debtor and creditors' preference (i.e. a workout/reorganization expert, or major accounting or law firm), may now be appointed since the filing of the petition to act as *conciliador*.

Under the legal reform, a pre-pack restructuring can be presented to the court only if at least the simple majority in face value of all claims has signed the petition together with the insolvent company.

Lastly, the "imminent insolvency" period for pre-packaged bankruptcy is extended from 30 to 90 days from the filing of the petition.

15. *Quiebra*: A second opportunity available for reorganization.

Along come further amendments that aim to optimize the liquidation proceeding with the possibility to emerge from *quiebra* if an agreement is reached with the debtor by applying the plan-passing majority set forth by the LCM for the plan of reorganization along with the payment of all claims.

Furthermore, the reforms allows the debtor together with the holders of at least half of the recognized claims (excluding the insiders), to replace the appointed *síndico* (similar to a receiver) with the person or corporation/firm of their preference.

16. Liquidation of the bankruptcy estate: Maximizing the value of non-exempt assets.

The amendments to the LCM provide faster mechanisms for realizing and maximizing value. Liquidation of assets shall be performed by the *síndico* or he can simply outsource and hire specialized firms for such purpose. The sales efforts shall consider the best market conditions and the shortest periods for collection, ensuring that the debtor's assets are properly marketed.

If the financially struggling company lacks going concern value, it may be sold in business or asset units.

The *síndico* may opt for *ad hoc* sales in the case of those assets that require an immediate sale because they cannot be preserved, those in danger of a substantial decrease in value, or their sale price does not exceed the statutory limits, and within a period of 30 calendar days from the commencement of the liquidation stage, he may only oppose the individual enforcement of guarantees on assets related to the ongoing business if he deems it convenient to sell it together with a group of assets.

17. D&O bankruptcy crime.

The reform introduces the D&O bankruptcy crime which refers to the offense of altering, or modifying accounts or the terms and conditions of contracts of the debtor, ordering the registration of false transactions and expenses or increasing the amounts of the ones already registered, and carrying out any illegal activity generating a debt or loss to the corporation for personal benefit, or for that of third parties, including the registry of claims in favor of insiders. The offender may be imprisoned 3 to 12 years.

In addition, the prison sanction related to the offense of any wilful misconduct performed before or after the Order for Relief or *concurso mercantil* declaration causing or worsening the insolvency of the debtor, was increased from 1 to 9 years, now up to 3 to 12 years.

18. New Bankruptcy Courts in México and e-filing: The next big step.

Another important feature introduced by a parallel amendment to the law that establishes jurisdiction and powers of Mexican Federal Courts, related to the legal reform, is the future creation of the new bankruptcy courts in México which shall specialize in handling bankruptcy matters and will have subject-matter jurisdiction over bankruptcy cases.

The amendments to the LCM also make provision for the coming establishment of the electronic docket and court electronic records in México that will enable the parties to file documents electronically. This will surely become an important tool for the bankruptcy proceedings, especially in cross-border cases, as it will allow Mexican bankruptcy courts to accept filings and provide access to filed documents over the Internet.

Finally, the newly enacted amendments to the LCM are expected to significantly boost efficiency and reliability of the bankruptcy proceedings in México. Such legal reforms constitute an important milestone in establishing a comprehensive and coherent set of bankruptcy laws to improve court-assisted reorganization and liquidation in México.

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