


3-1-1997

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### Recommended Citation

J. Labastida-Martinez, *Suspension of Payments and Bankruptcy Law for Mexican Businesses*, 5 U.S.-Mex. L.J. 37 (1997).  
Available at: <https://digitalrepository.unm.edu/usmexlj/vol5/iss1/6>

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# SUSPENSION OF PAYMENTS AND BANKRUPTCY LAW FOR MEXICAN BUSINESSES

J. LABASTIDA-MARTINEZ\*

## I. INTRODUCTION

Under Mexican law an insolvent debtor may proceed with either *Ley de Quiebras* [Bankruptcy Law] or *Suspensión de Pagos* [Suspension of Payments].<sup>1</sup> Bankruptcy is the partial or total liquidation of the assets of the debtor in order to satisfy outstanding creditor claims. Suspension of payments relieves the debtor's requirements to pay outstanding debts and interest while the debtor negotiates a reorganization plan with its creditors. If, during the suspension of payments proceedings, the reorganization plan is rejected or the required majority of creditors do not approve the plan, bankruptcy proceedings will then commence.<sup>2</sup>

## II. SUSPENSION OF PAYMENTS PROCEEDINGS

Suspension of payments proceedings are more prevalent in Mexico than bankruptcy proceedings because debtors are more inclined to restructure their financial situation rather than to give up and liquidate assets for satisfaction of debt. To qualify for a suspension of payments proceeding, the debtor's assets must exceed its liabilities. If the debtor's liabilities are greater than their assets, they must file for bankruptcy rather than suspension of payments proceedings.<sup>3</sup>

The debtor is the only person who can file a petition for a suspension of payments proceeding and the petition must be filed in the place where the debtor has corporate domicile.<sup>4</sup> If the petition is filed in Mexico City, the petition will be heard by a specialized bankruptcy court. If the petition is filed anywhere else in Mexico, the petition will be reviewed by a common civil court.

The suspension of payments petition must include: a list of all the company's debtors and creditors; the nature and amount of pending debts; the status of loss and gains for the last five years; a description and value of all movable and nonmovable property; a valuation of the entire company; and accounting records which include a balance sheet for the last two months of operations prior to the filing of the suspension

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1. "Ley de Quiebras y Suspensión de Pagos," [L.Q.S.P.], D.O., 20 de abril de 1943.

2. L.Q.S.P. art. 419.

3. L.Q.S.P. art. 2.

4. L.Q.S.P. art. 13 (applicable to suspension of payments by virtue of art. 429).

of payments petition.<sup>5</sup> In addition, a debtor filing for suspension of payments must present a proposal for a reorganization plan.<sup>6</sup> This proposal is usually a very brief document suggesting absurd grace periods and absurd discounts. The proposal rarely ever makes it to the negotiating table since it is only created to meet formal requirements. Typically, the court declares the suspension of payments within a week of the filing of the petition.<sup>7</sup> If some of the documents that are required to be filed with the petition are omitted, the debtor will usually be granted a period of three days to cure the omission.<sup>8</sup>

After the court declares suspension of payments, the judge must choose a *Síndico* [Trustee] to monitor the operations of the proceeding. A trustee is usually either a chamber of commerce to which the debtor belongs or a Mexican bank if the debtor does not belong to a chamber of commerce.<sup>9</sup> The trustee must be notified of its appointment, and has the opportunity to accept or decline the appointment. The trustee must make acceptance of the appointment known to the court within twenty-four hours of being offered the appointment.<sup>10</sup> If the entity declines the acceptance, the judge must then appoint another entity to be the trustee.<sup>11</sup> Once the trustee is appointed, the trustee must name a delegate who will actually be in charge of monitoring the conduct of the company throughout the proceedings.<sup>12</sup> Once the delegate is appointed, an inventory of the debtors assets is created and all parties must agree that the inventory correctly reflects the debtor's assets.<sup>13</sup>

Once the court declares suspension of payments, the following results occur: the debtor is relieved from the obligation to pay outstanding debts;<sup>14</sup> interest ceases to accrue on debts;<sup>15</sup> the debts are converted to pesos at the rate of exchange prevailing on the date of declaration of suspension or payments;<sup>16</sup> orders of enforcement and attachment filed by creditors cease to exist and are transferred to the bankruptcy court;<sup>17</sup> and, the management and possession of the assets remains with the debtor. The trustee monitors the conduct of the debtor throughout the proceedings.<sup>18</sup> With regard to relief of the debtor from payment, the debtor is prohibited from paying debts of favored creditors that were outstanding prior to the declaration of suspension of payments. No

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5. L.Q.S.P. art. 6 (applicable to suspension of payments by virtue of art. 429).

6. L.Q.S.P. art. 398.

7. L.Q.S.P. art. 404.

8. L.Q.S.P. art. 401.

9. L.Q.S.P. arts. 28-37 (applicable to suspension of payments by virtue of art. 429).

10. L.Q.S.P. art. 38 (applicable to suspension of payments by virtue of art. 429).

11. L.Q.S.P. art. 40 (applicable to suspension of payments by virtue of art. 429).

12. L.Q.S.P. art. 45 (applicable to suspension of payments by virtue of art. 429).

13. L.Q.S.P. art. 46 (applicable to suspension of payments by virtue of art. 429).

14. L.Q.S.P. arts. 408-13.

15. *Id.*

16. L.Q.S.P. art. 132 (applicable to suspension of payments by virtue of art. 429).

17. L.Q.S.P. arts. 122-27 (applicable to suspension of payments by virtue of art. 429).

18. L.Q.S.P. art. 410.

distributions of any kind can be made to creditors unless every single creditor, regardless of class or ranking, is paid on a pro-rata basis.

The trustee and the delegate must publish the declaration of suspension of payments in order to allow the creditors a forty-five day period to have their debts acknowledged.<sup>19</sup> The trustee must publish the declaration three consecutive times in the *Diario Oficial de la Federación* [Official Gazette of the Federation] and also in a newspaper that is widely circulated. Creditors are considered to have sufficient notice when the third declaration has been published.<sup>20</sup> The cost of publication is usually paid by creditors, because the trustee will not publish the declaration until a party other than the trustee pays for the publication.

A creditor will not lose their rights against an entity because they failed to file a claim within the forty-five day period. However, if a preferred creditor fails to file within the forty-five day period, it will become an unsecured creditor and will receive a distribution only after all preferred creditors have been paid.<sup>21</sup> If a creditor has a justifiable reason for not filing within the forty-five day period, they will not lose their status as a preferred creditor.<sup>22</sup> However, a creditor will be unable to make a claim if the entire estate has already been distributed.<sup>23</sup>

Once the creditors have filed claims, the process for establishing the allowance of each particular claim begins. Each creditor is examined independently to determine whether the creditor's claims are legitimate.<sup>24</sup> Any party to the proceedings including: other creditors who filed claims; the debtor; the trustee; and the judge may raise questions and concerns regarding the proposed credit acknowledgement.<sup>25</sup> Essentially there is a mini-trial establishing the validity and amount of each claim the creditor seeks to have recognized. The entire process can take from two to four years depending on the number of creditors requesting acknowledgment. Creditors try to compromise among themselves, because even the smallest creditor can become an obstacle to the recognition of a claim. The creditors realize it is more beneficial to minimize the acknowledgement portion of the proceedings to avoid making the experience agonizing for all parties involved.

Once the creditors' claims have been established, the creditors must be ranked to determine which creditors are entitled to collect first. The creditors' priority for both suspension of payments and bankruptcy is: (1) one years worth of back wages; (2) creditors secured by a mortgage or a pledge; (3) government entities owed back taxes; (4) creditors with a special privilege which may include building contractors and commission agents; (5) unsecured creditors; and (6) civil creditors.<sup>26</sup>

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19. L.Q.S.P. art. 15 (applicable to suspension of payments by virtue of art. 429).

20. L.Q.S.P. art. 16 (applicable to suspension of payments by virtue of art. 429).

21. L.Q.S.P. art. 224 (applicable to suspension of payments by virtue of art. 429).

22. *Id.*

23. L.Q.S.P., art. 225.

24. L.Q.S.P. arts. 226-34 (applicable to suspension of payments by virtue of art. 429).

25. L.Q.S.P. art. 243 (applicable to suspension of payments by virtue of art. 429).

26. L.Q.S.P. art. 261 (applicable to suspension of payments by virtue of art. 429).

The next step is the proposal for a reorganization plan called the preventive agreement. At this point, creditors have been acknowledged, each creditor's status has been established, and now it must be determined whether the company will be able to pay its debts. Proposals may be submitted by any party involved in the proceedings. However, if all proposals for a preventive agreement are rejected or the majority of creditors do not approve a plan, bankruptcy proceedings will begin.<sup>27</sup>

A problem with the preventive agreement is that the law does not allow the creditor and the debtor to freely agree on the terms of the preventive agreement. The law establishes a maximum grace period of three years and a maximum discount rate for payment by the debtor.<sup>28</sup> The law causes the preventive agreement to be inflexible and almost impossible to agree upon. Therefore, the debtor can only hope the creditors agree to fair terms leaving the company sufficient working capital and cash flow to service the creditors.

### III. BANKRUPTCY PROCEEDINGS

If an agreement cannot be reached during the suspension of payment proceedings, bankruptcy proceedings will commence. Bankruptcy proceedings are similar to suspension of payments proceedings except for a few differences. First, bankruptcy proceedings may be initiated by the debtor filing a petition or by a creditor filing a petition for involuntary declaration of bankruptcy.<sup>29</sup>

Second, in a bankruptcy proceeding, the trustee takes both the management of the company and possession of the estate of the company.<sup>30</sup> Initially, the trustee must determine whether the company should attempt to continue to do business throughout the proceedings.<sup>31</sup> If the company continues to operate throughout the proceedings, the company will be bound to comply with the terms of any agreements essential for its business operations. The trustee must marshal all assets of the company, liquidate those assets, and then distribute the proceeds among the creditors. The terms of the liquidation must be agreed upon by the trustee and the judge. Distributions must be made according to the priority list enumerated earlier during the discussion of suspension of payments proceedings.<sup>32</sup>

Third, for legal purposes, the judge must determine whether the bankruptcy was accidental, culpable, or fraudulent.<sup>33</sup> If the company becomes insolvent because a disfavorable economic environment occurred, it is considered an accidental bankruptcy. A culpable bankruptcy occurs when management makes erroneous decisions which cause the company to

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27. L.Q.S.P. art. 419.

28. L.Q.S.P. arts. 403, 410.

29. L.Q.S.P. art. 5.

30. L.Q.S.P. art. 46.

31. L.Q.S.P. art. 48.

32. L.Q.S.P. art. 269.

33. L.Q.S.P. art. 91.

deteriorate. Finally, fraudulent bankruptcy occurs when management is involved in unethical or criminal activity. If a bankruptcy is determined to be fraudulent, the management will be punished with a five to ten year prison sentence and fines equal to as much as ten percent of the liabilities of the company.<sup>34</sup> In a culpable bankruptcy, management will be punished with a one to four year prison term.<sup>35</sup> In an accidental bankruptcy, management will not be assessed any criminal penalties or fines.

Fourth, within twelve days of recognizing creditor claims, the court must permanently set a retroactive date.<sup>36</sup> There is a stricter standard of review for conveyances occurring after the retroactive date than occurrences prior to the retroactive date. If a fraudulent conveyance is discovered, the transaction will be void, the parties will be charged with criminal liabilities, and the recovery of damages will be sought.<sup>37</sup> Fraudulent conveyances do not necessarily have to occur after the retroactive date in order for them to be void, but there is a stricter standard for conveyances after the retroactive date.

Finally, the trustee will review ongoing bilateral contracts and will determine whether it is in the best interest of the company to continue or to terminate the agreement.<sup>38</sup> There has to be court authorization before a trustee can determine that a contract should be continued.<sup>39</sup> The non-bankrupt party can delay execution of the contract until the trustee can guarantee that the bankrupt party will comply with the contract.<sup>40</sup> Deposits, consignments, undisbursed credit facilities, and revolving credit facilities automatically terminate upon the declaration of bankruptcy, unless the court authorizes the continuation of them.<sup>41</sup>

#### IV. CONCLUSION

Under Mexican law, a company can either choose suspension of payments or bankruptcy proceedings if they are experiencing financial problems. Which proceeding is utilized depends on several factors including who is initiating the proceedings, the financial status of the company, whether resolution will likely occur between the debtor and the creditor, and the results the debtor and creditor desire. This is not meant to be an all inclusive list but only illustrates the type of issues that need to be considered when determining which proceeding to select. Both proceedings are intended to help resolve the debtor's financial difficulties.

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34. L.Q.S.P. art. 99.

35. L.Q.S.P. art. 95.

36. L.Q.S.P. art. 121.

37. L.Q.S.P. arts. 168-74.

38. L.Q.S.P. art. 139.

39. *Id.*

40. *Id.*

41. L.Q.S.P. art. 141.

