DOI: http://dx.doi.org/10.22201/iij.24485306e.2018.1.12516

Mexican Law Review
New Series
VOLUME XI
Number 1

EXECUTORY CONTRACTS IN MEXICAN INSOLVENCY LAW

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Abstract: *The Mexican Law Review published an article by Dr. Susana Dávalos entitled "The Rejection of Executory Contracts"*[1] *that addresses the comparison of three legal systems in Spain, Germany and the United States of America when dealing with contracts pending execution when a debtor is declared insolvent. From the analysis of these three systems, the author concludes, for the reasons given therein, that the Spanish regime is the most adequate to reach the objectives pursued by insolvency procedures. Motivated by the reading of this interesting work, the objective of this comment is to show how the regime Mexican legislation has adopted to deal with this issue.*

Key words: *Executory Contracts, Insolvency, Mexico*

Resumen: *La Revista de Derecho Mexicano ha publicado un artículo de la Dra. Susana Dávalos, titulado "Rechazo de contratos pendientes de ejecución", que trata de la comparación de tres regímenes jurídicos: España, Alemania y los Estados Unidos de América sobre el tratamiento dado al fenómeno de los contratos pendientes de ejecución cuando un deudor es declarado insolvente. Del análisis de estos tres sistemas, la autora concluye, por las razones allí expuestas, que el régimen español es el más adecuado para el logro de los objetivos perseguidos por los regímenes de insolvencia. Motivado por la lectura de esta interesante obra, el propósito que anima el presente trabajo es mostrar cuál es el régimen adoptado por la legislación mexicana sobre el tema.*

Palabras clave: *Contratos, ejecución, pendientes, concurso, insolvencia, México.*

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[1] Susana Dávalos, *The Rejection of Executory Contracts: A Comparative Economic Analysisv*, Vol. 1, núm. 1, Mexican Law Review, IIJ-UNAM, 69, 101, (2017).

DOI: http://dx.doi.org/10.22201/iij.24485306e.2018.1.12516

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I. What is an Executory Contract?

"Executory contracts" refer to binding agreements that have been entered into by a debtor, who becomes subject to a bankruptcy procedure, with several third parties and which at the time of being declared bankrupt is pending full compliance.

Some definitions put forward by various theorists read as follows:

> Executory contract: A contract in which some or all of the obligations of each party have not yet been completed. The debtor-in-possession (or trustee) is allowed to reject unilaterally certain executory contracts.[2]
>
> Pre-existing legal relationships - "Those that bankruptcy finds celebrated - between a bankrupt debtor and third parties - but are not yet completed or consummated at the time of filing for bankruptcy." [3]

French law makes a difference between contracts *"en cours de existence"* and contracts "*en cours d'execution*". In the first ones, the obligations have not yet been borne, in the latter the obligations have been borne, but their execution is pending. For the purposes of this comment, the situation is the same since both types of contracts pose the same problem: what to do with them once one of the parties is involved in insolvency proceedings?

These are contracts entered into before insolvency is declared and whose compliance is in process or pending, either because the contracts are of a successive nature or because they are subject to a term or condition. Contracts concluded after the commencement of insolvency proceedings are treated

[2] Bankruptcy Data. *Executory contract*, *https://www.bankruptcydata.com/p/glossary-of-bankruptcy-terms.*

[3] José A. Ramírez, José A. La Quiebra Derecho Concursal Español. 1255 tomo II, (Bosch Casa Editorial. Barcelona. Segunda edición 1998) (1959)

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as part of an ongoing concern and should normally be treated as ordinary expenses in the business operation[4]

It should be clarified, as Spanish law does, that there are various cases. One is when one of the parties has completely fulfilled its obligations and the other party has not. Apparently in a case like this, the debtor must add the assets or obligations due that he may have in that case to his balance sheet. Another situation is when there are reciprocal obligations on both sides. This seems to be the case with regard to the issue of executory contracts. [5]

II. Significance of the matter

This issue is important because of its weight in insolvency proceedings and the complexity in dealing with it. These procedures (called "*insolvenz*" in German law, "bankruptcy" in Anglo-Saxon law, "*faillite* or *redressement*" in French law, " *fallimento* " in Italian law, "*falencia*" in Portuguese, "*quiebra*" in various Latin countries, "*concurso*" in Spanish, Colombian, Chilean and Mexican law) are concerned with broaching the universality of legal relationships in which the debtor has incurred in order to make a global decision, either to effect a restructuring that allows him to continue operating, or to liquidate and conclude the operation completely.

For a debtor in insolvency proceedings, any existing contractual situation means that rights and obligations derive from it; or to put it in financial terms: assets and liabilities appear in the balance sheet. If these relationships are primarily liabilities, the best way to resolve insolvency is to eliminate them as soon as possible. If, on the other hand, they constitute an asset, it is necessary to make the most of its value. The decision made regarding assets and liabilities can make a difference in both the choice of reorganization or liquidation and, in both cases, the final result.

The paradigmatic approach that all insolvency regimes have experienced since the last decade of the twentieth century is that it must tend to maximize the value of the insolvent company and its assets for the benefit of the debtor himself, his creditors, his employees, its shareholders, the State, society, and in general all its stakeholders. Part of this approach covers the problem of how pending contracts should be addressed.

The insolvency regime should address the subject by considering that the designed system can create either healthy or perverse incentives in the con-

[4] Ley de Concursos Mercantiles [L.C.M.] (Business Reorganization Act) as amended Diario Oficial de la Federación [D.O.] 10 de Mayo de 2000 (Mex) *Artículo 75.- Cuando el Comerciante continúe con la administración de su empresa, efectuará las operaciones ordinarias incluyendo los gastos indispensables para ellas y el conciliador vigilará la contabilidad y todas las operaciones que realice el Comerciante...*

[5] See: Rafael, Bonardell Lenzano, Régimen de los contratos sinalagmáticos en el concurso 44, (Tirant monografías, Tirant Lo Blanch, Valencia), (2006).

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duct of the debtor, his creditors and the suppliers of goods and services, in the aim of adequately managing the insolvency situation.

Susana Dávalos' analysis of "The Rejection of executory contracts", published in the Mexican Law Review[6], starts from two basic questions: 1) Who is involved in the decision to reject contracts pending execution? And, 2) How should the damages resulting from the annulment of the contract be dealt with? A quick summary of the analysis of the referred article is as follows:

— In the US system, it is the trustee, along with the sitting judge, who decides the rejection. Damages are treated as common credit.
— In the German system, the trustee is solely responsible for making the decision and damages are treated as common credit.
— In the Spanish system, the Insolvency Administrator together with the judge who sits in on the proceeding decides and damages are treated as expenses of the insolvency mass.

Dávalos sets out the advantages and disadvantages of the systems adopted in those three jurisdictions. However, the summary of the positions and variants of treatment adopted by different jurisdictions as presented in the "UNCITRAL Legislative Guide on Insolvency Law" should not be omitted in a comparative analysis.[7]

III. The Mexican Bankruptcy Law (*Ley de Concursos Mercantiles)* (LCM) System Regarding Contracts Concluded before the Bankruptcy Judgment

The Mexican Insolvency Law (LCM) establishes a series of basic rules that apply to the agreements entered by the debtor. The basis is a general principle: the provisions regarding obligations and contracts and the stipulations of the parties will continue to apply (Article 86). Even then, the bankruptcy law itself establishes some exceptions. This is a principle that enjoys widespread acceptance in most insolvency regimes throughout the world.[8]

These exceptions consist in changing the terms of the law and the will of the parties under the terms of the general purposes of insolvency law, which is precisely a law of exception. Some rules (Articles 87 to 90) modify

[6] Dávalos, *supra* note 1.

[7] UNCITRAL Legislative Guide on Insolvency Law. Paragraphs 120 to 136, pages 123 to 129. *http://www.uncitral.org/pdf/english/texts/insolven/05-80722_Ebook.pdf.*

[8] *"Il est en général considéré que l'ouverture de la procédure d'insolvabilité est sans effet sur les contrats en cours. Tel est le cas en France, au Maroc, aux Pays Bas, en Roumanie et au Sénégal*", Jean Luc Vallens, Giulio Cesare Giorgini, Étude comparative des procedures d'insolvabilité 57 (Société de Législation Comparée, Paris, 2015)

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the established contracted terms, which proves that insolvency law is not a merely procedural law, but rather a substantive one, since it defines the extension of rights and obligations of the legal situations in which the debtor has incurred.

These specific rules are:

1st rule: Nullity (the law states that it should be understood as not written) of those clauses that by merely filing a claim for insolvency proceedings aggravate the terms of the contract (Article 87).

2nd rule: In the case of credits payable by the debtor, that is to say, those obligations that imply a credit for which the debtor is responsible as may be the case of financial transactions or debts to term, become due, the period in which they may be met, whether in favor of the creditor, the debtor or both parties, is fulfilled.

3rd rule: In the case of obligations subject to condition, if it is a suspensive condition, it is assumed that the condition was not performed while if it is a resolutory condition, it is implied that the condition was fulfilled. In other words, all considerations related to a term inherent to a condition are terminated. The purpose is to conclude the state of uncertainty that arises between the contraction of the obligation and the realization or not of the condition, concluding, as a result, the existence of the obligations.

4th rule. All those credits that imply periodic or successive benefits are brought to their present value including the generation of the corresponding accruing interest.

5th rule: Credits whose value is not yet determined or non-pecuniary obligations should be valued. If this is not possible, will be credits that will not be recognized in the insolvency proceeding.

6th rule: Handling financial interests and accessories. These accessories are suspended and cease to accrue in those credits that are not guaranteed. In the case of secured credits, interests will continue to be generated until the value of the guarantee is equalized with the value of the credit.

7th rule: Indexing. In order to maintain the value of credits, even foreign currency debts, they must be converted to Mexican Peso-denominated Investment Units (UDIS).

8th rule: Offsetting regime. Unlike the rules stipulated in the civil code to this respect, only credits and obligations that come from the same operation, as in the case of derivative transactions, can be offset.

IV. The Treatment of Executory Contracts in the Mexican Insolvency Law

The LCM dedicates a series of articles to the subject; the core is Article 92 that reads:

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> Article 92. Any preliminary or final contracts pending enforcement must be fulfilled with by the Merchant, unless the conciliator objects to such fulfillment on the grounds that such objection is in the best interests of the Estate.
>
> Anyone who executed a contract with the Merchant shall be entitled that the conciliator declares if he will object to the contract fulfillment. If the conciliator declares that he will not object, the Merchant must fulfill or guarantee fulfillment of the contract. If the conciliator declares that he will object, or does not provide an answer within twenty days, the party that executed the contract with the Merchant may at any time rescind the contract and so notify the conciliator.
>
> If the conciliator has assumed the management or authorized the Merchant to enforce any outstanding contracts, he may avoid the setting aside of the goods or else demand their delivery, upon payment of their price.

The first principle, which consists of the general treatment of contracts entered into by the debtor, is that contracts must be complied with in their terms.[9]

The exception is when the conciliator (the insolvency practitioner brought in during the reorganization period with the aim of reaching an agreement with creditors so that the company can continue to operate) decides to reject the contract because he is not satisfied that the performance of the contract suits the interests of the mass, regardless of the restrictions stipulated therein.

The power to decide whether an executory contract must be complied with under its terms or the power to reject it therefore lies in the hands of the insolvency professional. Whether the debtor is in possession of his business or not, creditors do not have the power to decide.

The concept of "estate" in Mexican law *"Masa"* is somewhat different from the concept used by other legislations, especially those of common law. In other systems, the concept of "estate" indicates a complete amalgamation of assets and liabilities and even as a legal entity independent of the debtor.[10] In the case of the Mexican law, *"masa"* refers only to the debtor's assets upon which a restructuring can be constructed, or, in the case of liquidation (which the Mexican system calls bankruptcy), is used to pay off debts.[11] The Spanish legislation follows a similar principle although it differentiates the active "masa"[12] from

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[9] See supranote 4.

[10] "*In the bankruptcy context, the estate is the legal entity created by the filing of the petition, which succeeds to the debtor´s property rights.*", Brian A. Blum, Bankruptcy and Debtor/Creditor. 586 Fifth edition, (Wolters Kluwer. New York 2010) (1993).

[11] Ley de Concursos Mercantiles [L.C.M.] (Business Reorganization Act) as amended Diario Oficial de la Federación [D.O.] 10 de Mayo de 2000 (Mex) "*Artículo 4º. Para los efectos de esta ley se entenderá por... V. Masa, a la porción del patrimonio del Comerciante declarado en concurso mercantil integrada por sus bienes y derechos, con excepción de los expresamente excluidos en términos de esta Ley, sobre la cual los Acreedores Reconocidos y los demás que tengan derecho, pueden hacer efectivos sus créditos, y*".

[12] Ley 22/2003, de 9 de julio, concursal. "*Artículo 76: Constituyen la masa activa del concurso los bienes y derechos integrados en el patrimonio del deudora la fecha de la declaración de concurso, los que se*

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the passive "masa".[13] The concept of "estate" in German law refers more to the same concept used by the Mexican legislator in Articles 224 and 225 of the Mexican Bankruptcy Law (Ley de Concursos Mercantiles).[14]

Thus, the criterion to be followed to reject executory contracts is that such breach is in the interests of the "masa". There are no other interests than that of the estate, as provided by the definition that the law gives the "masa", which is to take care of the possibility that recognized creditors recover their credits.

That is, if the rejection enhances the possibilities of recovery for the creditors, then it is correct to decide not to execute. If, on the other hand, keeping the contract alive and providing for its execution increases the possibility of return, then, the contract must be kept alive. Another view is that the contract may itself be an asset whose value may give it negotiability, in which case its sale or assignment could give liquidity to the "masa"; or it may be a liability in which case it is better to get rid of it.

An intermediate possibility, especially in complex contracts, could be its partial rejection and the acceptance of the execution by the other party that would remain in force.

Legislation does not mention whether the conciliator's decision to execute a contract or not affects the possibility of restructuring (conciliation in Mexican lexicon). To give an example: a supply contract according to which a supplier is obliged to deliver raw material supplies to the debtor so that he can manufacture his products. The conciliator may think that if the contract is suspended, the debtor will not be able to continue manufacturing and remain in operation and therefore, the hope of reaching a suitable settlement would disappear so he decides to keep the contract in operation. However, creditors may claim that if the business has proven to be bad, trying to keep it afloat by making new payments to the supplier under the contract, the only result will be the reduction of the "masa" and, therefore, a lesser recovery.

Subsequently, the law devotes Articles 93 to 111 to the regulation of managing several contracts in particular, such as: the sale of goods in which the debtor is the buyer, loan, deposit, commission, mandate, current account, repurchase, securities lending, derivatives, futures, real estate leasing, service provision, price work, insurance, partnerships of persons, as well as the contracts in which the debtor has acted as the seller of real estate or furniture.

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reintegren al mismo o adquiera hasta la conclusión del procedimiento." Ley Concursal, 123 (Lefebvre El Derecho, SA, 2015).

[13] "La delimitación de las masas constituye uno de los aspectos más importantes del concurso, con ella se pretende conocer exactamente que acreedores existen y con qué bienes cuenta el deudor para satisfacerles, bien mediante la liquidación de ese patrimonio, bien llegando a un convenio con ellos". María Enciso Alonso-Muñumer, Memento Práctico Lefebvre 366. (Francis Lefebvre. Lefebvre El Derecho,SA. Madrid, 2016).

[14] See Insolvenzordung § 55: Eberhard Braun, Commentary on the German Insolvency Code. 154 Editor: himself, Düsseldorf, (2006), (ISBN 10:3-8021 – 1237-7).

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For these contracts, the law stipulates a series of possible ways to deal with them, in some cases, giving options to the parties, for example, to maintain a contract if the payment is concluded or if guarantees are granted.

One question to be discussed is: What happens if the conciliator insists on rejecting the executory contract even though the law gives a different treatment, what should prevail, the conciliator's criterion or the rule of law? Is possible to waive the rule of law?

For example, Article 97 begins with the words "if the performance of the contract is to be decided..." with reference to a contract of sale in which the good has not yet been delivered. Does this mean that it can be decided otherwise (interpretation *a contrario sensu)*? For example, can the conciliator decide that he should not surrender the goods because he does not consider it useful for the mass, or that the payment should be made because the debtor is de-capitalized?

Article 105 states that in the case of derivative financial transactions, repurchase agreements, futures and securities lending under the framework of a regulatory or specific contract, the rules of early termination and set-off shall be applied without applying the powers given by Article 92. This express exclusion does not appear in other contracts to which the law gives specific treatment.

From the foregoing, it may be concluded that, except for the express exclusion made in Article 105 on the conciliator's power to decide whether to execute a pending contract, this power operates in all other cases.

This conclusion is congruent with the spirit embodied throughout the Insolvency Law: to seek to maximize the value of the enterprise (either to achieve its reorganization and subsistence, or to liquidate and pay creditors). Therefore, when there is some doubt in the interpretation of the legal provisions, that principle should serve as the guideline.

The procedure for deciding what to do with a pending contract is simple: the obligation to take the decision lies with the conciliator. If he does not make any decision, the general basic rule mentioned above applies: contracts must be fulfilled in their terms.

The foregoing means that the conciliator must necessarily take a decision on whether or not the executor contracts must be executed although the decision can be communicated tacitly as stated in the legal text. The last paragraph of Article 92 reinforces this interpretation, as it states that if the conciliator is in charge of the administration or if the debtor is in possession and has received the authorization to execute, it may prevent the separation of assets, or, in its case, demand their delivery, paying its price.

A term is not established during which the conciliator must exercise his power to reject a contract. Logic indicates that it should be during the time that he has to prepare the recognition of credits because of his decision will depend on the existence of a credit that must be recognized to the contractor whose contract has been rejected.

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The third party that has contracted with the debtor is authorized to question the conciliator as to whether it will object to the performance of the contract. In case the response is that it will not oppose, then the contract will follow its course of execution. In the event that it rejects the execution or simply does not respond (the law assigns this procedure a period of 20 days), the party that has contracted with the debtor will be free to terminate the contract.[15]

This is a peculiar power: Can the co-contractor terminate the contract simply because its counterpart is in insolvency proceedings? Is being involved in insolvency proceedings a cause for the termination of contracts? The text of the law seems to indicate so. The rationale seems to be that either the conciliator has expressed his opposition to the execution or his silence must be interpreted as a fictitious refusal to continue the contract.

What the law does not prescribe is the term that the counterparty has to exercise the right to terminate the contract. It is not possible to let time elapse to see when it is convenient for him to do so since it leaves the fulfillment of the contracts at the arbitrariness of one of the parties and produces legal insecurity for the debtor who lives under the sword of Damocles. The only rule of supplementary terms of the Insolvency Law (LCM) is Article 58 on the obligations of insolvency representatives (so called "specialists": inspector, conciliator, receiver) that allocates 30 days, which a judge can extend for up to 30 days more. This analogy might be an indicator, but it can only be used as a guide. The reasonable option is to ask the judge to rule an extension via an ancillary proceeding like those used to resolve any controversy borne in insolvency proceedings and do not have a prescribed treatment.

What say do the merchant (debtor) and the creditors have in this? Both can have reasons that lead them to think differently than the conciliator does. Basically it is about their rights: the merchant is the owner of the mass and any decision that influences its value will undoubtedly affect him; the same can be said of the recognized creditors. After all, the concept of mass, as has been seen, represents the source of repayment of the credits owed to them.

In some places, the law gives auditors the power to express opinions on some of the decisions made by insolvency representatives, as in the case of contracting of credits after the commencement of the proceedings.

It is precisely the provision that gives this power (Article 75, second paragraph) that the work of the conciliator is mentioned: *"The conciliator shall decide on the rescission of outstanding contracts and shall approve, on the basis of the auditors' prior opinion, if any, the contracting of new credits, the creation or replacement of collateral and the disposal of assets not related to the regular operations of the Merchant's enterprise. The conciliator shall report these activities to the judge."* In turn, Article 76 states: "*For the purposes of the opinion referred to in the second paragraph of the foregoing article, the*

[15] Aldo Casasa, et al., Ley de Concursos Mercantiles Comentada, 158, Editorial Porrúa. Segunda Edición. México (2015).

DOI: http://dx.doi.org/10.22201/iij.24485306e.2018.1.12516

conciliator shall inform the auditors of the characteristics of the transaction in question, in the formats issued by the Institute for such purposes."

It seems that the prior opinion of the auditors (*interventores*) only applies to requesting a new loan since the request for an opinion only concerns that. In addition, the IFECOM (LCS-2/76 H) format only includes the options contained in the last part of the paragraph: new loans, constitution of guarantee, substitution of guarantee and disposal of assets.[16]

The situation is a marked change in the *Pacta sunt servanda* and legal certainty principles. The conclusion of a contract is the construction of a specific legal framework to govern the conduct of the parties involved and to lose the possibility of executing it is a breach of that legal framework. It is not an unusual case; legislation is already familiar with the theory of unpredictability, the existence of unfair terms, abusive clauses and the notorious inequality of agreed benefits that force alterations in said legal framework.

In the case in point, a circumstance of the same force as the exceptions mentioned above occurs: insolvency proceedings entail an extraordinary legal situation in which all the legal relations of the insolvent trader are reviewed and must be redefined

47. One point remains: Can the termination of contracts give rise to compensation? If so, how does such credit add to claims against the debtor? This is a subject to which Mexican legislation makes no reference, so it is necessary to resort to the system of law in general and the insolvency law in particular, in order to arrive at a conclusion.

It can certainly not be said, as in the case of Spain, that the costs of early termination of a contract are part of the administrative costs against the estate (Article 224) since it is not a matter of expenses to administrate the mass or to safeguard the assets, reparation, conservation and administration. When drafting the law, legislature would need to have referred to them expressly, as it does in the case of the fees of representatives of insolvency – inspector, conciliator and trustee - (*visitador, conciliador y síndico) Articles* 333 and 75).[17]

In accordance with the principle that states that the accessory must be treated as the main issue, it can be concluded that damages arising from the non-execution of a contract must follow the general principle of the credits in favor of the counterparty of the contract which becomes a creditor that must be recognized either as a common creditor or a guaranteed one in the event that the contract had a mortgage or collateral security in its favor. A penalty clause regulating that amount in the event of insolvency proceedings could be useful.

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[16] Formatos, *http://www.ifecom.cjf.gob.mx/*.

[17] Another reference can be given: Uruguay follows Spain's path: "*Créditos contra la masa… en el segundo grupo se ubica la indemnización por daños y perjuicios que cause la resolución por el síndico o el deudor (con autorización del interventor) de contratos pendientes de ejecución (arts. 98.3 y 170)*. Zamira Ayul, *Los Créditos contra la Masa en el Régimen Concursal Uruguayo*, in Libro Homenaje al Profesor Emilio Beltrán. 891 (Instituto Iberoamericano de Derecho Concursal. Bogotá, 2014).

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V. The Incentives this System Produces

It is necessary to ask whether the system adopted by Mexican law regarding executory contracts prompts good decision-making in the course of insolvency proceedings.

First, the one who is empowered to make the decision is the insolvency representative, with the power of the third party with whom he has contracted to bring about the decision. This is left in the hands of the person who is deciding the fate of the debtor and, therefore, of the entire bankruptcy procedure, which reasserts his authority and the objective sought.

In effect, the conciliator's first objective is to reach an agreement with the creditors in such a way that the business can be kept operational and it is not necessary to reach the point of liquidation.[18] In order to do so, it is essential to consider whether executory contracts should be carried out or rejected.

Failure to give other parties (the counterpart, the creditors or the court *ex officio*) the initiative in this regard, without limiting the possibility of being heard, facilitates diligence in the process of resolving the insolvency situation.

Second: Failure to address the issue of how damages resulting from noncompliance will be covered produces a positive stimulus for the conciliator. He must make the decision with no other parameter than that of making an adequate assessment of the situation: Does leaving the contract alive, or rejecting it assuming the cost, help maximize the value of the mass and the company's operations? A well-taken decision in this regard will reduce the possibilities of challenges and will give the judge, the person presiding over the procedure, the elements to ratify, if necessary, the decision taken.

[18] Ley de Concursos Mercantiles [L.C.M.] (Business Reorganization Act) as amended Diario Oficial de la Federación [D.O.] 10 de Mayo de 2000 (Mex) Article 3. *The conciliation stage is aimed at preserving the Merchant's enterprise through the agreement signed with his Recognized Creditors.*

Received: March 22nd, 2017.
Accepted: August 14th, 2017.