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The International Comparative Legal Guide to: Corporate Recovery and Insolvency 2010

A practical cross-border insight into
corporate recovery and insolvency work

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1 Issues Arising When a Company is in Financial Difficulties

1.1 How does a creditor take security over assets in Mexico?

In order to secure an obligation (usually the payment of a credit) the creditor may take a security interest on certain valuable assets. The law governing the creation, attachment and perfection of such security interest may be State law or Federal law, depending among others, on the location and nature of the assets.

A security interest is ordinarily created by the execution of a security agreement, and is perfected by filing such agreement in the corresponding registry or record of deeds. Said filing has the effect of warning any third party about the existence of the security interest and gives priority to the secured creditor.

A security interest on movable property is ordinarily created as a pledge. In this case, it is necessary for the secured creditor to retain the possession of such property to perfect the security interest. Therefore, only those assets that can be possessed by the secured creditor can be pledged. On the other hand, a security interest on real estate and other real property is usually created as a mortgage. However, there are other options to take security interests on both personal and real properties.

1.2 In what circumstances might transactions entered into whilst the company is in financial difficulties be vulnerable to attack?

The Commercial Insolvency Law ("Ley de Concursos Mercantiles" or "CIL") regulates fraudulent conveyances or transactions defrauding other creditors (arts. 112-119 of the CIL) and provides that such fraudulent transactions are void and ineffective against the Estate (the "Estate" shall be understood as the portion of the estate of the Merchant which, by a judgment, has been declared in "concurso mercantil" or business reorganization, liquidation or insolvency, as the case may be, and which is integrated by the assets and rights specifically set forth in the CIL). A fraudulent conveyance is any transaction entered into by the Merchant with any person before the judgment declaring the commercial insolvency of the Merchant, provided that the Merchant or such third party had knowledge about the transaction being fraudulent or that the transaction was gratuitous or for no reasonably equivalent value (articles 113 and 114 of the CIL).

Likewise, the CIL sets forth a look back period from the date of the judgment declaring the commercial insolvency (which period could be extended if so requested by any creditor, the trustee or the Conciliator, per art. 112 of the CIL) during which certain

transactions are to be either: (i) necessarily characterized as fraudulent conveyances and rendered ineffective (fraudulent conveyances are transactions for not a reasonable equivalent value or closed in terms and conditions different from those prevailing in the market, revision of debt and voidable preference payments ex. art. 114 of the CIL); or (ii) be presumed as fraudulent conveyances unless proves otherwise, in which case, the relevant party or the Merchant may introduce evidence that they acted in good faith (creation or extension of guarantees not originally granted, payments in kind (art. 115 of the CIL) and in the case of corporations those transactions with related parties and affiliates (art. 117 of the CIL).

1.3 What are the liabilities of directors (in particular civil, criminal or disqualification) for continuing to trade whilst a company is in financial difficulties in Mexico?

The CIL contains a criminal chapter (arts. 271-277 of the CIL) defining certain actions by the Merchant subject to a commercial insolvency procedure as criminal offences, such as: 1) any malicious behaviour worsening or causing the deficit (including the alteration, fabrication or destruction of the accounting books and records) (art. 271 of the CIL); 2) not to deliver and give full access to the accounting books and records to the persons so authorized by the judge (art. 272 of the CIL), and if the Merchant is a corporation "the members of the board of directors, the managers, officers or liquidators of the Merchant that caused or participated in committing the crime" (art. 275 of the CIL).

Civil liability may potentially be imposed to the Merchant and its officers pursuant to the applicable civil law.

2 Formal Procedures

2.1 What are the main types of formal procedures available for companies in financial difficulties in Mexico?

The CIL provides only one procedure available to a Merchant experiencing difficulty is the payment of its obligations. Said procedure is the "concurso mercantil" or commercial insolvency procedure. The procedure is initiated either by the Merchant or its creditors, and once said procedure is declared open by the competent court, it has two stages (art. 2 of the CIL): the conciliatory stage which intends to "achieve the conservation of the business of the Merchant through an agreement entered into by him and his Acknowledged Creditors" and the liquidation stage (or "bankruptcy" in strict sense) which aims to "sell and liquidate the business of the Merchant, its productive assets or the assets

insolvency then for the payment to the Acknowledged Creditors" (art. 3 of the CIL).

2.2 What are the tests for insolvency in Mexico?

The commercial insolvency proceeding (*concurso mercantil*) could be understood as a universal or collective debt collection remedy to which the Merchant is subjected when it incurs in a generalised default of its obligations. As mentioned above, it aims to preserve the business of the Merchant through the execution of an agreement with its Acknowledged Creditors, and, if this is not possible, to sell or liquidate all the assets and rights of the Merchant (business and its productive assets and such), seeking to maximise their value, applying the amounts received to pay such Acknowledged Creditors.

The Merchant may file for commercial insolvency, as well as its creditors or the "procurador público" (Mexican District Attorney's Office).

Prior to the declaration of commercial insolvency, an "inspection visit" is performed by a registered specialist called a "visitador" ("Visitador") appointed by the Federal Institute of Commercial Insolvency Specialists "Instituto Federal de Especialistas de Concursos Mercantiles" (called "IFECCOM" for its initials in Spanish), an entity of the Mexican Federal Judiciary Council, who, based on the accounting and financial information of the Merchant, will determine if it falls into one of the hypothesis defined as general default of payment obligations.

The cases in which a commercial insolvency proceeding may be initiated could be summarised as those causing the generalised breach of payment obligations of a Merchant to two or more creditors, and depending on if the commercial insolvency procedure is requested by the Merchant or claimed by the creditors, that one of the following is complied with:

- The payment obligations overdue for no less than 30 days, represent at least 35% of the aggregate liabilities of the Merchant.
- The Merchant does not have any cash or liquid assets to pay at least the 80% of its overdue obligations to the date in which the commercial insolvency is requested by the Merchant, or a commercial insolvency claim is brought by the creditors against the Merchant (arts. 9, 10, 20, 21 and 30, section I, of the CIL).

2.3 On what grounds can the company be placed into each procedure?

The commercial insolvency procedure ("concurso mercantil") is the only procedure regulated in the CIL. It initiates when the motion is filed to the Federal District Judge by the Merchant, its creditors or the District Attorney's Office, requesting that a Merchant be declared commercially insolvent.

In order to be declared commercially insolvent a Merchant must be in a state of generalised default of its payment obligations, with such default of the Merchant's payment obligations being applicable to two or more different creditors.

- If the Merchant files for commercial insolvency, it must have at least 2 creditors and comply with at least one of the hypothesis of art. 10 of the CIL (it could file for the conciliatory stage in order to reach an agreement with its creditors for the payment of its debts or it could file directly for the bankruptcy stage)(art. 167 section I) of the CIL).
- If the creditors file a motion requesting the commercial insolvency declaration of the Merchant or if such filing is made by the District Attorney's Office, the Merchant must be

in compliance with both hypothesis of art. 10 of the CIL (in this event, the conciliation phase will be mandatorily followed).

- The Merchant and its creditors representing at least 40% of the liabilities are entitled to file a motion for the commercial insolvency declaration of the Merchant with a restructuring plan approved by them (art. 339 of the CIL).
- If a judge, during the processing of a commercial lawsuit, detects that the Merchant falls into any of the hypothesis of arts. 10 or 11 of the CIL, he will denounce such circumstances to the competent tax authorities and the District Attorney's Office, so that the latter, if proper, can file a motion for the commercial insolvency declaration of the Merchant (art. 21 of CIL).

2.4 Please describe briefly how the company is placed into each procedure.

We should differentiate if the procedure begins with a filing made by the Merchant or with a suit brought by the creditors or the District Attorney's Office (arts. 17-42):

- The Merchant may file for a commercial insolvency declaration on its own authority. Once the judge admits the filing, he notifies the IFECCOM who appoints a registered Visitor who audits the Merchant to ensure that he is in a state of generalised default of its payment obligations and complies with at least one of the hypothesis of art. 10 of the CIL. Once the circumstantiated opinion of the Visitor is rendered, the judge reviews the opinion together with the commercial insolvency filing and the documents attached to the same and if he finds that the requirements for the commercial insolvency declaration are fulfilled he will declare it.
- In case a commercial insolvency declaration is claimed by creditors or by the District Attorney's Office introducing documentary evidence together with the lawsuit, the Merchant is served the process. The Merchant may reply to the commercial insolvency claim filed by the creditors and introduce evidence, in which case, the relevant plaintiff is granted the opportunity to argue in connection with such reply, and if necessary, to introduce further evidence. The judge shall request the IFECCOM to appoint a Visitor who shall perform the audit referred to above. Once the Visitor briefs the court, the judge will allow the parties to contest in writing the report of the Visitor. Afterwards, the judge shall review and analyse all the actions and exceptions of the parties together with all the evidence, and then the judge will decide whether or not the commercial insolvency proceeding should be declared pursuant to the CIL.
- If the motion for a commercial insolvency declaration is filed by the Merchant and its creditors with a prior restructure plan previously agreed (art. 339 of the CIL) such creditors must represent at least 40% of the Merchant's liabilities. The Merchant shall certify and declare under oath that the plan has been approved by the creditors holding at least 40% of its liabilities and that it falls into the events provided by law for the admission of such motion. The judge shall review the petition and if it conforms with the law shall declare the commercial insolvency.

The commercial insolvency proceeding begins with the conciliatory stage, unless the Merchant motions for the bankruptcy stage at any moment of the proceeding.

The liquidation or bankruptcy stage shall be declared in the event set forth in art. 167 of the CIL:

"Article 167. Any Merchant under commercial insolvency shall be declared bankrupt:

- upon the Merchant's request;

- II. upon expiration of the term for the conciliatory stage and any extensions thereof granted, without an agreement being submitted to the judge for approval pursuant to this Act; or
- III. upon the Conciliator's request and upon the judgment granting the bankruptcy declaration pursuant to Article 150 of this Act."

2.5 What notifications, meetings and publications are required after the company has been placed into each procedure?

Pursuant to art. 44 of the CIL, the day after the commercial insolvency is declared, the judge shall issue a personal notification to the Merchant, the IFECOM and the Viceroy, as well as to the creditors whose domiciles are known and to the competent tax authorities via certified mail. The District Attorney's Office shall be notified if he requested the commercial insolvency declaration. Likewise, the labour union representative and the labour authorities will also be notified through an official notice.

Article 45 of the CIL sets forth that within the 5 days following the appointment of the Conciliator (who is a specialist registered with the IFECOM that, among others, has the necessary expertise in financial structure and corporate recovery. Some of his functions as an officer of the commercial insolvency proceeding are to procure that the Merchant and its Acknowledged Creditors arrive to a settlement, follow up the proceeding of acknowledgment of liabilities and to supervise the administration of the Merchant, in the understanding that under certain circumstances, the Conciliator may substitute him), and he will request the filing of the judgment declaring the commercial insolvency declaration in the relevant public registries and will publish a summary of the judgment in the Official Gazette of the Federation (the official gazette of the Mexican Federal Government), and in a major newspaper of the place in which the process is being followed.

In case of liquidation or bankruptcy, the Trustee (a specialist registered with the IFECOM who participates in the commercial insolvency proceeding only once the liquidation or bankruptcy has been declared. As a consequence of the judgment of bankruptcy it receives the possession of the Estate by preparing an inventory thereof, assumes the administration of the Merchant and proceeds to liquidate the assets of the Merchant measuring its value, paying the acknowledged liabilities) shall request the filing of the judgment declaring the bankruptcy in the relevant public registries and will publish a summary of the judgment in the Official Gazette of the Federation, and in a major newspaper circulating in the place in which the process is handled (art. 171 of the CIL).

3 Creditors

3.1 Are unsecured creditors free to enforce their rights in each procedure?

Once the bankruptcy has been declared, the creditors (both secured and unsecured) may file with the Conciliator an application for credit acknowledgment; they may object the provisional list of creditors prepared by the Conciliator or appeal the judgment of acknowledgment and ranking of liabilities (arts. 120-144 of the CIL).

3.2 Can secured creditors enforce their security in each procedure?

Secured creditors may proceed as indicated in the last question, with the purpose of acknowledging their security interest and obtain the corresponding priority.

3.3 Can creditors set off sums owed by them to the company against amounts owed by the company to them in each procedure?

Article 90 of the CIL sets forth the general provision for the set-off in the following terms:

"Article 90. As from the commercial insolvency declaration date, only the following may be set-off:

- any rights in favour of and obligations payable by the Merchant deriving from the same transaction which are not interrupted by virtue of the commercial insolvency declaration;
- any rights in favour of and obligations payable by the Merchant that mature before the commercial insolvency declaration and whose set-off is provided by the laws;
- any rights and obligations arising from the transactions in which Article 102 to 105 of this Act refer to; and
- any taxes refundable to and payable by the Merchant."

4 Continuing the Business

4.1 Who controls the company in each procedure? In particular, please describe briefly the effect of the procedures on directors and shareholders.

During the conciliatory stage, the management of the ordinary business of the Merchant is vested on the Merchant, in terms of art. 74 of the CIL, similarly to the Merchant in possession recognised in other jurisdictions. An exception is set forth in art. 81 of the CIL, pursuant to which, in case the Conciliator finds that it is in the best interest of the Estate, may request the judge to remove the Merchant in possession.

If the Merchant in possession is removed, the authority of the governing bodies of the Merchant will be suspended in connection with their control of the management, directors and affairs (art. 83 of the CIL).

According with the foregoing, we must differentiate between two types of liabilities of the manager under the bankruptcy procedure: the criminal liability; and the liability in connection with the Estate.

Regarding the liability in connection with the Estate, this arises during a period known as the "suspicious" period or look back period (understood as the period beginning on the 270th day from the date in which the commercial insolvency declaration is issued).

On the other hand, in the liquidation or bankruptcy stage, the Merchant ceases in its management functions and the Trustee is given full authority to take care of the management of the Merchant in terms of art. 178 of the CIL.

Finally, in case that a creditor brings a suit to initiate the commercial insolvency declaration of the Merchant, the CIL provides that the relevant judgment will have the effect of restraining the ability of the Merchant for changing his domicile, and for the case of corporations it will restrict the ability of its managers and director for changing their domicile. If the Merchant files for bankruptcy, this restraint is not applicable.

4.2 How does the company finance these procedures?

As long as the Merchant continues to be in charge of the management, the Merchant does not have any restriction to cover its ordinary expenditures, such as the payment for power service, the payment of legal services and the payment of pay-rolls, if its financial condition allows it to do so.

Notwithstanding the foregoing, there is a specific provision that these expenses shall not diminish the value of the Estate pursuant to the terms of art. 92 of CIL.

4.3 What is the effect of each procedure on employees?

- Firstly, the judgment declaring the beginning of the commercial insolvency procedure has the effect, among others, of ordering the Merchant to suspend the payment of liabilities incurred before the date in which such resolution comes into effect except for those strictly necessary for the ordinary course of business (see art. 43, section VIII of the CIL).
- Likewise, the wages that shall be paid are those that have a relationship with the Merchant in the ordinary course of business (art. 44 of the CIL). The liabilities of the Merchant due to its employees are included as a liability of the Estate, which is guaranteed with the Estate. If the labour authority orders the seizure of assets to guarantee the payment of wages and indemnifications to the employees or unions, the person in charge of the administration of the business will be deemed as a receiver of such assets, and shall perform all acts necessary to pay said liabilities and to release such assets (art. 67 of the CIL).
- If the labour authority orders the liquidation of any encumbered asset, the Conciliator may request the substitution of said asset with a surety policy covering the payment in a term of 90 days, and only if the labour authority does not authorize such action, then such asset will be liquidated and the relevant credit of the creditor shall be acknowledged and registered against the Estate (art. 68 of the CIL).
- The judgment declaring the commercial insolvency will not interrupt the payment of social security contributions (art. 178 of the CIL).
- Finally, pursuant art. 152 of the CIL, the Merchant, under a commercial insolvency proceeding, may enter into agreements with its employees, as long as those agreements do not aggravate the terms of the obligations due by the Merchant.

4.4 What effect does the commencement of any procedure have on contracts with the company and can the company terminate contracts during each procedure?

The CIL sets forth the following general provision in its arts. 84 and 92:

"Article 84. With the exceptions set by this Act, the provisions regarding obligations and contracts and the stipulations of the parties, will continue to apply.

Article 92. Any preliminary or final contract pending enforcement must be fulfilled 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 unless the Conciliator declares he will object to the contract fulfillment. If the Conciliator declares that he will not object, the Merchant must fulfil 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 rating aside of the goods or else demand their delivery, upon payment of their price."

Even when the CIL provides for special rules applicable to specific agreements that shall be analyzed on a case-by-case basis, the general rule mentioned above covers most cases (arts. 91-113 of the CIL).

5 Claims

5.1 Broadly, how do creditors claim amounts owed to them in each procedure?

Pursuant to art. 122 of the CIL, the creditors may file their request of acknowledgment of credits:

- a) With the Conciliator within 20 days following the date of the publication of the judgment of the commercial insolvency declaration in the Federal Official Gazette.
- b) Within the term to file allegations against the provisional list of credits (5 days).
- c) Within the term to appeal the judgment of acknowledgment of liabilities (nine business days).

The request is filed in the domicile of the Conciliator, in the format specially prepared by the IFECOM, which can be downloaded from the internet site www.ifecom.gob.mx and shall be accompanied with the original documents or certified copies of the documents evidencing the rights of the creditor.

5.2 What is the ranking of claims in each procedure? In particular, do any specific types of claim have preferential status?

The preference of the credits of the Estate is set forth in arts. 217 and 228 of the CIL as follows:

- Credit against the Estate.
- Creditors singularly privileged (as defined by the CIL).
- Creditors with a security interest in property.
- Labour and Tax credits.
- Unsecured and common creditors.

The above-mentioned credits, in the aforementioned order, are the following:

- those referred to in section XXIII, subsection A, of article 123 of the Mexican Constitution and its regulations, increasing the salaries to those corresponding to those vested within the 2 years prior the declaration of the commercial insolvency proceeding; and
- those incurred during the administration of the Estate by the Merchant with the approval of the Trustee or the Conciliator, or, as the case may be, those incurred by the Conciliator, those incurred when addressing the normal expenses to preserve the assets of the Estate, their repair, conservation and management and those arising from the judgment or off-court for the benefit of the Estate. If relevant, the burial expenses of the Merchant, in case that the commercial insolvency declaration is issued after the death of the Merchant, and the hospitalization and healthcare expenses related with the cause of death of the Merchant in case such declaration is issued after the death of the Merchant, the mortgage credits and those credits secured with a pledge; the labour credits different from those set forth in section I of art. 224 of the CIL; and all the credits that, according with the Commercial Code or the relevant laws, are privileged or include any withholding right. The common or unsecured creditors are those that are not considered in arts. 218 and 221 through 224 of the CIL.

5.3 Are tax liabilities incurred during each procedure?

Yes, the taxes continue to accrue during the commercial insolvency proceeding pursuant to art. 69 of the CIL:

"Article 69. After the commercial insolvency declaration, any tax liabilities will keep on being subject to inflation adjustments, the corresponding fines and related charges, pursuant to the applicable provisions. If an agreement is reached pursuant to Title Fifth of this Act, the fines and related charges that took place throughout the conciliatory stage will be cancelled.

The commercial insolvency declaration will not cause the interruption of the payment of regular taxes or social security dues by the Merchant; as such payments are essential for the enterprise's regular operations.

Following the commercial insolvency declaration and up to the expiration of the term granted to carry out the conciliatory stage, any administrative enforcement proceedings to collect taxes will be suspended.

The competent tax authorities may pursue the necessary action to determine and guarantee any taxes payable by the Merchant."

6 Ending the Formal Procedure

6.1 Is there a process for "cramming down" creditors who do not approve proposals put forward in these procedures?

The approval of the agreement during the conciliatory stage phase depends on majority voting; therefore, dissenting creditors will be forced by the majority decision (more than 50% of the sum of (i) the acknowledged amount of the aggregate liabilities due to Acknowledged Creditors that are unsecured, and (ii) the amount acknowledged and due to all the Acknowledged Creditors that lack a security interest or that have a special privilege (art. 137 of the CIL)).

6.2 What happens at the end of each procedure?

The conciliatory stage could end through an agreement whereby the parties settle on the terms and conditions of the payments to be done by the Merchant, but if a settlement is not reached within the legal term, the Merchant shall be liquidated. If the conciliatory stage ends without a settlement approved by the judge, the liquidation of the Merchant shall be ordered.

7 Alternative Forms of Restructuring

7.1 Is it common to achieve a restructuring outside a formal procedure in Mexico? In what circumstances might this be possible?

In Mexico it is not common to reach a restructure plan out of the commercial insolvency proceeding. Notwithstanding the foregoing, pursuant to art. 359 of the CIL, it is possible to reach a pre-bankruptcy plan if it is approved by 40% of the creditors in the following 4 hypotheses:

- 1) The request accipies with the general requisites set forth by art. 20 of the CIL.
- 2) Said request is executed by the Merchant, with the approval of at least the creditors holding at least 40% of the liabilities of the Merchant. It would suffice to declare, under oath, that the creditors signing the request represent said percentage.

- 3) The Merchant declares, under oath, that (i) it is under one of the hypotheses set forth in arts. 10 and 11 of the CIL, explaining the relevant grounds for its petition, and (ii) it is imminent that the Merchant falls in one of those legal hypotheses (imminence for this purposes, shall be construed as the Merchant falling in one of the said hypotheses within the following 30 days).

- 4) The request arises from a proposal of a liabilities restructure plan.

7.2 Is it possible to reorganise a debtor rather than realise its assets and business?

Yes, it is possible to rehabilitate the Merchant instead of proceeding to its liquidation in terms of arts. 1 and 3 of the CIL. It is a matter of public interest and public policy to preserve the companies and their businesses and to avoid that the generalised breach of their obligations jeopardise the viability of said companies as well as the viability of those with which it maintains business relationships. Therefore, the purpose of the conciliatory stage is to allow the Merchant to reach a settlement with its creditors in order to avoid the liquidation.

7.3 Is it possible to achieve an expedited restructuring of the debtor by means of a pre-packaged sale? How is such a sale effected?

See the answer to question 7.1.

8 International

8.1 What would be the approach in Mexico to recognising a procedure started in another jurisdiction?

The cooperation by Mexican authorities in international bankruptcy proceedings is regulated in arts. 278 and 318 of the CIL. Said regulation is based in the globalisation and the potential economic and financial difficulties of any given Merchant due to the location in which it is headquartered and the location of its business units throughout the world. The cooperation proceeding of the CIL tends to facilitate the acknowledgment of a foreign proceeding, cooperation and coordination between courts and the commercial insolvency bodies and authorities in diverse jurisdictions. In terms of art. 278 of the CIL, the provisions regulating the cooperation of international procedures will be applicable only in the following cases:

- a) a foreign court or a foreign representative requests the assistance of the Mexican State in connection with a foreign proceeding; assistance in a foreign proceeding in connection with a Mexican bankruptcy proceeding;
- b) there are simultaneous proceedings in connection with the same Merchant, provided that one of those proceedings is followed in a foreign jurisdiction and at least one in Mexico; or
- c) the creditors or other interested persons that are located in a foreign state are interested in requesting the commencement of a commercial insolvency proceeding or in participating in a proceeding followed pursuant to the CIL.