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QUESTIONS AND COMMENTS ON MEXICAN SECURED TRANSACTION LAWS*

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KRUMBEIN: This question is for Mr. Aiza on the *prenda mercantil*[1]. I have two quick questions. First, what happens to the non-recourse concept if you have either a cosigner or guarantor? Second, can you elect to execute on a promissory note to get around the issue of executing on the *prenda*?

AIZA: Actually, that is one of the most interesting parts of what we have been analyzing. I think your questions are related. As a general matter, there are two theories: I agree with one of them and I have only heard about the other. First, there is the basic theory, a secondary obligation, such as the obligation of a guarantor, is an accessory, meaning that its existence is dependent upon the existence of the principal obligation. To the extent there is legal remittance, or cancellation of the indebtedness by virtue of the non-recourse statute, then the guaranty would be equally terminated or equally reduced. Again, the idea is that it follows the nature of the principal obligation.

There is also an interesting theory that goes something like this: the obligation continues to exist and the statute only affects the enforceability of the obligation. Therefore, the creditor might be unable to enforce its right against the principal obligor. In the statute, the nonrecourse provision refers only to the settlor or debtor, and does not relate to the guarantor. So, if you agree with this theory, hopefully it will be addressed in court soon, only the enforceability right of the lender, and not the obligation of the debtor, is affected by the non-recourse obligation. So, perhaps there is recourse against the guarantor. I personally doubt it.

Now, on the negotiable instrument side we saw quite a few different drafts of the amendment that did not contain Article 412[2], which on the trust side is a non-recourse problem, or the concept of the *avalista*. If you do have a promissory note, a *pagaré*, that is made by the principal obligor and then guaranteed by an *avalista*, the particular nature of the obligation of the *avalista*, as opposed to the obligation of an ordinary guarantor, is quite different. It is an independent obligation. It is not a joint obligor but rather a new obligor or a different obligor. The conclusion we arrived at was that Article 412 with the nonrecourse effect does not in any way reduce or terminate or invalidate or affect the obligations of the *avalista*. The *avalista* would continue to be held liable for the full amount. In practice this would mean you pursue recourse against the assets since you cannot really go against the debtor, or collect from the proceeds of the sale of the assets. If there were a deficiency, you would seek payment of that deficiency against the *avalista*, which

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* The views expressed here are the panelists' own, and should not be taken to represent those of their employers or other organizations with whom they may be affiliated.

** A summary of the background of each of the participants in this panel follows on the last page of the panel discussion.

1. The *prenda mercantil* under Mexican commercial law traditionally provided that an enforceable pledge of collateral required transfer of possession of the collateral to the creditor whereas the amended secured transaction provisions provide explicitly that the *prenda sin transmision de posesion* creates an enforceable pledge of the collateral as security for the debt without transfer of possession of the collateral as recognized under Article Nine of the United States Uniform Commercial Code.

2. Ley General de Títulos y Operaciones de Crédito, Artículo 412.

does not follow the rule that the secondary obligation follows the primary obligation because the obligation of an *avalista* is not a secondary obligation but rather a primary obligation.

STEPHENSON: Let me give you a hypothetical. Suppose that a U.S. lender makes a loan to both a Mexican company, that is a subsidiary of a U.S. company, and to a U.S. company. Assume that both sign as borrowers. In addition, the U.S. lender makes a direct loan to the Mexican company. A *fideicomiso de garantías* is put in place, so that now you have the *fideicomiso de garantías* guaranteeing the debt of the U.S. company. What happens to the obligation in the U.S. when you have a separate debt obligation if the assets of the trust are sufficient to cover the direct debt of the Mexican obligation and would have an additional amount available? Can that additional amount be applied to the debt owed in the U.S., where there was a guaranty from the Mexican company?

AIZA: First of all, the benefit of the non-recourse monster is really only for the debtor. The actual statute does not even talk about the settlor of the trust, which may be a person different than the debtor. It just talks about the debtor. The issue that we discussed about the guarantor is really just a consequence of the nature of the obligation of the guarantor. Now, the concept here is that assets held in the trust cannot secure any obligation other than the original obligation for which they were transferred into the trust. Now, I think that to the extent that you can establish that they are related transactions and that the lenders were induced to conduct, for example, the transaction that you had mentioned in the U.S., that transaction was done by virtue of the guaranty trust. They are a package deal, if you will. Then I think, to the extent that there are excess assets in the trust, it could be possible to conclude that those could be used to satisfy payment of the obligation of the U.S. company.

I think the issue really works the other way around. To the extent that the assets that are held in the trust are sufficient, without the amendments, the trust agreement works very well. It could be used for whatever purpose you can think of. Again, that includes the satisfaction of another obligation of an affiliate company of the settlor of the trust if it was originally contemplated in setting up the trust.

The issue again becomes complicated when a U.S. borrower is the settlor of a trust in respect to assets that it holds in Mexico. A U.S. company transfers assets under Mexican law, because they are physically located in Mexico, into a trust as collateral for an obligation that it has with a U.S. lender. New York law governs the documents, and the only point of contact with Mexico is the situs of the collateral. The question that I have for the New York lawyers, or the U.S. lawyers generally, is if Article 412 were to be examined by a New York or a U.S. judge, assuming that there is a deficiency, would he or she say that your collateral security agreements were governed by Mexican law? Or, will he or she say the loan documents are governed by U.S. law and under U.S. law this is a full recourse obligation and you are required to pay the full amount? Therefore, would a U.S. court actually enforce the judgment against the U.S. company with respect to assets that are not located in Mexico? This way, a Mexican court will never really have anything to say about the matter. I think that is a very interesting question, for which I have never received a straight answer. Maybe someone could share his or her views with us on this point.

STEPHENSON: If I might impose one more. Suppose the assets of the guaranty trust were set up to cover both the obligations of the Mexican company and to guaranty the debt of the U.S. company. It was a Mexican company that owned the assets. If the assets are insufficient to pay the Mexican company's direct debt, does that mean you argue that the U.S. company has no obligation because the creditor has no rights at all?

AIZA: I think so. Again, I do not think that is in spirit of what the legislature intended. I fail to see or understand what they intended on many grounds of this amendment. But in particular, I think it makes sense when you talk about the settlor, to the extent that the settlor of the trust and the debtor are the same person, and that this cancellation of indebtedness or this non-recourse benefit applies to that person. Nothing is said in the statute about the possibility, which is quite common in Mexico, of having the settlor of the trust be one person, and the debtor another person. As to who has the benefit of the non-recourse obligation, the statute says the debtor does. So in your example, Mr. Stephenson, I think you are talking about two different debtors, one is a Mexican company, the other one is a U.S. company. Only the Mexican company is transferring assets into the trust. But the benefit of the non-recourse obligation is strange, since it arises from a collateral document as opposed to the principal document. The collateral document says that if these assets are not sufficient to pay the secured obligations, then the debtor is relieved from those obligations. It actually does not say the debtor is relieved from the obligation; it says the lender loses its right to enforce the collection of any deficiency.

ORLANDO LOERA: Let me see if I got this right. I can avoid the non-recourse problem by having an *aval*?

AIZA: Perhaps.

LOERA: Okay. So I grab the assets, transfer them to a special purpose vehicle create the lien and get an *aval* from the borrower.

AIZA: Correct.

LOERA: Will it work?

AIZA: Perhaps. There is reason to believe that it should work. However, it has not been tested.

ALCOCER: It is very interesting how things ended up with this reform. I consistently agree with what Licenciado Aiza has said. There is, however, a need for a solution. Sometimes we are going back to the old ways we used to protect secured interests. For example, you could use an industrial mortgage, which creates a lien on every single piece of property and asset of a corporation. You could also do either a double lien with a guaranty trust dealing with certain parts of the assets, or a lien on the intangible assets, such as other intellectual property rights you may have. In addition to that, you have the personal guaranty. So, if you put these options in a basket, what do you suggest to a person that is basically trying to just get the right guaranty and perfect it to the end based upon your credit examination? Probably the conclusion is to request personal guaranties and select these through the new ways of perfecting security interests, or the mechanisms that allow you to choose on which guaranty you execute first. Would you first go to the personal guaranty and leave at least these floaters, considering the fact that you may not collect on them because either the value of what you put in and pledged was not enough for payment?

AIZA: Let me try to address your question from two different perspectives. First, what I think is being done in practice is to go around the amendments and simply put aside the concept of the floating lien pledge, because the floating lien pledge did not really damage anything. It is there and if people want to use it, fine; if they don't, they don't. But the guaranty trust agreement amendments were quite dramatic. They affected the way in which business was being conducted before the amendment in a very serious way. So what is being done in practice is, first, to stay away from the concept of the guaranty trust agreement to the extent that, as in most cases, the parties do not intend to have a non-recourse-type transaction. Second, the trust agreement is being used for different purposes. Licenciado Loera touched upon one of them a little while ago, which involves negative pledge-type purposes and the segregation of assets. The trust continues to be used, but the key factor is to make sure that the trust is not in any way interpreted or construed as a guaranty trust agreement. Typically, the assets are transferred and the purpose is simply stated as management. There are no default provisions, no early acceleration and no sale. But it is still useful for other reasons.

Additionally, people are also going back to the old forms of security interest. We are working on a transaction now, for example, that involves a telecom company. There is a specific form of security interest under the telecom statutes called mortgage security, which is a particular kind of security interest that attaches to a lot of assets. If that is not available, then you go to an ordinary mortgage in the context of real estate. You use a commercial pledge, an ordinary commercial pledge with the possessory problem. Then you try to deal with things the way that they were dealt with before the guaranty trust agreement was really being used.

Again, the purpose of these amendments has been entirely defeated. They are pushing practitioners to go back to what was used in the past instead of affording new options, which is what the actual *Exposición de Motivos* says. Now what I would do to solve the problem is anything I can. I see some important personalities in the legal community here who could do what our counterparts in the United States did. It is the right time to join forces as a group and talk to our legislators and make sure they understand that the amendments are not working. In the context, for example, of the trust, they completely destroyed its legal concept and nature under Mexican law with the amendment. So, I think it is important to work with the bankers in the efforts that they have started. That may be somewhat dangerous because bankers always have Mr. Barzon and other people complaining about anything the bankers say, even if it is completely right. So although there may be smarter ways to go about it, we must get the legislators to change this back, to use some of the amendments which are good and get rid of the bad ones to make sure that the purposes are accomplished. We should not simply try to solve the problems in practice by going back to the old forms of security interest. So, this is an invitation to all the Mexican lawyers here: let us try to do something about this and not just cross our arms and complain like we have been doing for the past eighteen months.

SPANOGLE: Suppose there is a debtor located in Mexico with assets in the U.S. The forms are filed in Mexico, maybe also in the District of Columbia. After the assets are sold and there is still a deficiency, you bring your request for a deficiency either directly to the Mexican courts or obtain an American judgment and seek recognition of it in Mexico. Under the non-recourse agreement sections of the

statute, will a Mexican court grant this deficiency or recognize the deficiency judgment? If that turns out the way I think it might, suppose you go for the deficiency judgment in an American court? Should it take into cognizance the fact that a Mexican court might say there is no deficiency since you filed there? Have we started importing Mexican law into the United States?

AIZA: I guess the short answer to the Mexican law side of the question is that to the extent the parties did not enter into a specific guaranty trust agreement under the new statute, if it is not something that in substance is a guaranty trust agreement under the new statute, or a floating lien pledge or *prenda sin transmisión de posesión*, then the non-recourse statute would not apply. As most of you know, Mexican law looks to the laws of the jurisdiction in which the assets are physically located to determine laws for attachment and perfection of security interests. The interesting thing is that the revisions to Article 9 as I understand them, irrespective of the situs of the assets, direct you to Mexican law if the principal place of business of the borrower is in Mexico. Again, the interesting thing is that Mexico does exactly the opposite. Last week, I had a discussion with a U.S. lawyer on what the revisions to Article 9 are doing. Are they saying that if there is a filing system in Mexico, we need to file in Mexico? If so, then we can just go ahead and file. That has nothing to do, really, with the non-recourse aspect because all we are doing is filing a New York law-governed security agreement, for example. However, as I understand it, the revisions to Article 9 direct the parties to look to Mexico for perfection rules as opposed to just a simple filing. I think what the revisions say is if the principal place of business of the borrower is Mexico, irrespective of the situs of the assets, we will look to Mexican law to determine if a security interest is duly perfected or not. That triggers a very interesting discussion as to what that means, because we have a possessory system as far as movable assets are concerned, and the only case in which we record in the context of a pledge is under this new commercial pledge and other very exceptional cases. Typically it is a question of possession. So, if a U.S. lawyer asks me, are we perfected even if we did not file? The answer is most probably going to be yes so long as we hold possession, so that the lender or a person other than the debtor holds possession of the asset.

OWEN: I would like to respond to the second part of Professor Spanogle's question. The test for perfection under Article 9 is whether the foreign country where the borrower is organized has a general registration requirement to record non-possessory liens. Although people may disagree with me, I think the answer in Mexico would be no. In that case, I think you would want to perfect in both Mexico and in the U.S. by filing in the District of Columbia. Now, getting to Professor Spanogle's example, it would seem to me that you would want to develop a security interest that covers the property in the U.S. You would have a security agreement that you would file in the District of Columbia. Then you would have a guaranty trust, or whatever you have in Mexico that specifically covers property in Mexico. Then I would see no reason why you could not enforce your security interest in the U.S. property, and it should not be tainted by the non-recourse provision in Mexico. Now, problems could arise if the collateral is not tangible property and you somehow need the cooperation of the debtor to foreclose, and you go ahead and get a judgment in the U.S. You would have to bring that judgment down to Mexico and have it enforced. Then we get to the question of whether a

Mexican judge would enforce a judgment based on U.S. security documents. My answer is, he should. I do not know whether he would, but I think he should.

AIZA: I would agree with you that he should, so long as there is not a Mexican guaranty trust agreement or floating lien pledge securing the same obligation. Again, if you have a series of different security interests in different jurisdictions and you do not have a Mexican component such as a Mexican guaranty trust agreement or floating lien pledge agreement, a Mexican court should definitely enforce that foreign judgment. However, if you do have a guaranty trust agreement or a floating lien pledge agreement in Mexico that has been foreclosed on, and there continues to be a deficiency, a Mexican judge should not enforce a foreign judgment for the deficiency because public policy dictates that the parties should not be able to waive the provision. So, again, a Mexican judge in that particular case would not or should not enforce that foreign judgment.

OWEN: So I think the important qualification from Licenciado Aiza is that you need to split the debt. Not only have separate security interests but also split the debt.

AIZA: Right.

MACPHERSON: I thought that Mexico was creating a system to register or to file or record all security interests, and that you would be able to look up through the computer and find out if there was any prior claim against the asset. The discussion here gives me the impression that you are of the opinion there is no recording system and there will not be a recording system.

AIZA: That is a very good question, and I am glad we can clarify this point. As a matter of fact, there is a recording system in Mexico, and there has been for many, many years. I think again that is fairly universal in civil law countries. However, in the context of a security interest that is created with respect to movable property, the perfection requirement is typically by means of possession as opposed to filing. For example, in the context of real estate, by definition, the requirement for perfection is filing in the context of a mortgage and there is a public registry of property that is there specifically for that purpose. There is also a public registry of commerce where corporate-type matters concerning companies are registered. Things such as a deed of incorporation, powers of attorney, certain resolutions and certain kinds of security interests on movable property may be recorded in the public registry. Now, under the new statute with the floating lien pledge, for perfection purposes, the perfection mechanism there changes from possession to filing. There is a registration system already set up. Perhaps what you heard about as far as a computer system is that they are revamping the systems and making them somewhat more modern. Some jurisdictions have done a pretty good job about that, and you do have access or will have better access in the near future to understand what the status of assets of a particular debtor are in real estate and in movable property to a certain extent. However, the possession requirement continues to be generally the most important for moveable property.

BIOGRAPHICAL SUMMARIES

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