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SECURED FINANCING OF MACHINERY AND EQUIPMENT, INCLUDING CROSS-BORDER LEASING AND CONDITIONAL SALES CONTRACTS

THOMAS S. HEATHER* AND MARTHA TRAUDT COLLINS**

A MEXICAN PERSPECTIVE

Thomas S. Heather: Any decision about cross-border financing into Mexico will undoubtedly involve some discussion of the current state of the Mexican economy. For that reason, I am going to begin with a brief outline of where the Mexican economy stands after the December 1994, devaluation of the Peso.

Nineteen ninety-five was the worst year in Mexico's modern economic history because of the recession principally caused by a macro devaluation in the Mexican currency. During the last eighteen months, Mexico's government managed a serious economic problem by promoting a number of adjustments in a very positive fashion. The economy is rebounding. There are sixty-five sectors into which the economy is divided for statistical purposes, and approximately fifty-one of those sectors reported significant growth. Construction, which is one of the main motors of the economy is still sluggish. Debt management is very active, both within the public and the private sector. The public sector is looking for longer maturities. In this regard, Mexico successfully placed a one billion dollar facility for twenty years at a fairly reasonable rate in late 1996, only about 200 basis points over U.S. Treasuries. This corrective debt management continues to be an integral element of Mexico's policies. Mexico is still, however, a highly indebted country both in the private and public sectors, and most entities are looking for extension of terms and a lowering of the rates. Improvements in Mexico's credit-worthiness outpaced the decline in its credit spreads. In August 1996, a six billion dollar facility was securitized with oil proceeds and the government successfully placed the debt. The offering was oversubscribed by seven billion dollars, indicating substantial appetite for Mexican paper.

Sound public financial policy and the tightening of the monetary supply reduced inflation, and stabilized local financial markets. During the period before 1991, the budget balance as a percentage of gross domestic product was very steep, almost nine percent. As of 1992, the budget reflected surpluses.

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At the height of the crisis, in February and March of 1995, interest rates for consumer loans and mortgages exceeded one hundred percent. This caused defaults across the economic system on all types of consumer loans and receivables as well as mortgages. Nevertheless, interest rates stabilized around the 23-24% level on the 28-day *Cetes*, which is the Mexican treasury note rate. Volatility decreased both in the foreign exchange market and in the *Cete* interest rate as a result of the sound public financial policy.

Recovery is increasingly evident in all sectors of the Mexican economy. Manufacturing has increased and even the depressed construction sector shows noticeable upward movement. Measured by both industrial production and by the number of employees enrolled in the social security system, the economy is starting to pick up. Although exports still represent only about 15% of the total gross domestic product, they are running at historical highs in both manufacturing and service industries.

In 1996, key policy considerations were accomplished. Macroeconomic stability was achieved in areas such as reserves, lowering of interest rates, maintaining a competitive rate of exchange, and a reduction in inflation. This was necessary both to ensure economic growth and to reduce unemployment, which continues to be a major problem. Within limitations of available credit, Mexican industry will increase its demand for financing. This leads us to the topic of the applicable laws for financing of goods and equipment in Mexico.

Contracts involving business corporations, banking corporations, and asset financing are considered to be mercantile in nature as opposed to civil. This determines whether the applicable law, where a security interest is to be created, will be the Civil Code,¹ the Code of Commerce,² or the General Law of Credit Instruments and Transactions.³ In structuring any type of secured financing in Mexico, it is important to consider the entire package. None of the specific devices available is preferred in all situations; there are pitfalls in all. Of course, the best security may be cash in New York. After that, one may consider corporate guarantees by parent companies or subsidiaries, bonding, development bank support, agent bank loans, securitization packages, and this list is not exclusive. There is also the *caución bursátil* which is an interesting security device in itself: a security interest, similar to a pledge, existing in respect to instruments that are placed on the Mexican stock exchange. The interesting fact about a *caución bursátil* is that the *Ley del Mercado de Valores*⁴ [Securities Market Law] allows for the execution of the pledge without the interference of a court, as long as certain procedural requirements are met. Although this sounds like a good alternative, it is likely that

1. "Código Civil para Distrito Federal," D.O., 26 de marzo de 1928, effective 10 de octubre de 1932, as amended.

2. "Código de Comercio," D.O., 4 de junio de 1889, as amended.

3. "Ley General de Títulos y Operaciones de Crédito" [L.T.O.C.], D.O., 27 de agosto de 1932, as amended.

4. "Ley del Mercado de Valores," D.O., 2 de enero de 1975, as amended.

the courts will find invalid all those statutes that allow for a remedy outside of the courts. The Sedillo—appointed Supreme Court has tended to adopt a very literal interpretation of the rights of due process. Letters of credit are always a preferred alternative to sustain a transaction, whether it be with a Mexican bank confirming or Mexican bank as issuer, supporting the importation of equipment and payment of the credit.

Increasingly, financial officers and advisors are isolating receivables to provide security for payment of loans. This practice is very common in pre-export financing. By using the foreign assets of Mexican corporations, it is possible to securitize almost anything such as airline ticket payments, telephone services, commodities, export sales, credit card receivables and money orders.

Securitization is an important trend. However, foreign banks are comfortable lending to only about 100 companies. These top tier companies have a proven track record and are engaged in substantial exporting. There continues to be a great need of financing for the middle-sized and small companies that are suppliers to these giants. There is a huge vacuum in this area. Even if the laws regulating secured financing were modernized, I doubt that foreign banks would be interested in that market.

Let me turn now to some of the specific issues relating to the pledge. The pledge in commercial matters is governed by Article 334 of the General Law of Credit Instruments and Transactions.⁵ The problem with these provisions is that the Mexican law on credit transactions follows the traditional principle requiring that the debtor dispose of the object pledged in order to create a perfected security interest. This possession aspect for financing machinery and equipment is fundamental. Alternative arrangements require creation of a *fideicomiso* [trust] or a *crédito refaccionario* [asset financing agreement]. General provisions of the *Código de Comercio* provide that in mercantile matters, the parties can agree to whatever terms are in their best interests. There have been cases where the parties believe that they can create a civil pledge and leave the general manager of a company as the depository of the equipment. The Supreme Court of Mexico has fairly consistently said that if it is a mercantile act such a pledge would be invalid under Article 334.⁶ The parties must apply commercial law. Thus, there are possession issues under a pledge and a requirement for the registration of the financing agreements.

Numerous pledges are created every day within the Mexican market. However, U.S. banks, except for very sophisticated lenders, are generally not prepared to lend money under these circumstances. Furthermore, there are costs involved with such a transaction. The intended location of the equipment must be determined. The security agreement must be registered; the law refers to the fact that the security interest will be valid as of the date and hour of registration and this will be an expensive formality. There are registration duties to be paid to the Public Registry

5. L.T.O.C. art. 334.

6. *Id.*

and the lender may have a security interest which, at the end of the day, may be of little assistance in collection because of the super priorities afforded to workers and the tax authorities as will be discussed later. Mexican banks have an advantage because they can perfect a security interest on equipment by simply delivering invoices and naming the company as depository. This constitutes another privilege that should be extended generally to all lenders and not only to Mexican banks. There is also the very popular "344 Letter" that allows the lender to appropriate the security so long as the letter, which is referred to in Article 344,⁷ is signed after the creation of the pledge. However, the enforceability of these 344 Letters is doubtful at best.

There also is a proceeding in respect to pledges under Article 341 of the L.T.O.C. This protects a creditor's interest in machinery and equipment by allowing the creditor to petition the court for permission to sell collateral if its value drops below twenty percent of the loan amount or if the debtor defaults on maturity of the debt. There is a procedure under the law for a "summary proceeding." However, "summary" does not really mean summary. The court may allow the creditor to sell off the equipment with certain formalities. The new eleven member Supreme Court of Mexico, which was appointed in 1995, has said that Article 341 is unconstitutional because the pledge is an accessory agreement to a principal contract.⁸ Thus, any defense available to a debtor under a principal contract must be considered in a court of law prior to the execution and sale of pledged property. This is a very important decision because its principles are also being applied to Mexican trusts. In other words, any type of sale of collateral outside of the court system may result in problems of a constitutional nature.

The *crédito refaccionario* [installation credit] provides another technique for secured financing which collateralizes equipment purchased with the proceeds of the loan. The use of proceeds has to be monitored and there are formalities of registration about the equipment.

Industrial mortgages are also available to Mexican banks under the general concept of the L.T.O.C. applied in creating real estate based security interests. Article 67 of the Law of Credit Institutions⁹ provides for the basic industrial mortgage. It covers every asset in a business. There is a recent tendency to use industrial mortgages, even where no Mexican banks are involved, with large corporations with a proven track record. Those companies, which went through the 1980's negotiating their debt and complying with their covenants, are now involved in multi-hundred million dollar projects financed with credits secured by industrial mortgages even though there are no Mexican banks in the transaction. Legal counsel in this type of transaction must be careful that the language

7. L.T.O.C. art. 344.

8. "Amparo en Revisión 1613/94," Jorge Amado López Estolano, SCJ, Serie Debates Pleno, No.2, Mexico, 1996 (special publication of Supreme Court debate).

9. "Ley de Instituciones de Crédito," D.O., 18 de julio de 1990, as amended.

of the mortgage, at a minimum, provides the lender with protection through the real estate. If the transaction should be challenged on the ground that industrial mortgages are only available to Mexican credit institutions, the real estate will nevertheless be covered if the mortgage was carefully prepared.

In some cases, legal counsel does not have a choice. If financing a significant mining project, for example, and a secured interest is required on the machinery, the equipment, the receivables, and the replacements, what does one recommend? The practical solution is an industrial mortgage, but I emphasize that this should be based on the existing credit-worthiness and track record of the company. It may be legally doubtful that an industrial mortgage can be extended to a non-Mexican bank, but if carefully crafted negative pledge clauses are incorporated, the lender can avoid the possibility of the company granting a further security interest to any subsequent lender. The other lender has an obligation to check the Public Registry when it seeks to register its own interest. That puts the subsequent lender on notice of a preexisting interest.

Recently the Public Registrar in the Federal District of Mexico refused to register industrial mortgages in favor of non-Mexican banking institutions.¹⁰ This matter will eventually be addressed by the courts.

There are really no chattel mortgages except in respect of ships and aircraft, and those are covered by specific statutes. Nevertheless, there is a state of disarray in recent aircraft financing because of the fact that recent legislation has failed to incorporate provisions on mortgage financing as intended.

Another interesting technique involves the *fideicomiso*, or the trust. The main difficulty with this type of transaction is one of costs. The Mexican trustee institution will charge a registration fee that will vary depending on the nature of the property. This option may be worthwhile if it keeps the parties out of the courts and provides an orderly procedure to realize upon the collateral. However, there may also be constitutional issues of due process with this technique and a trustee may not be willing to execute and realize upon the collateral if such action would create personal liability.

Other financing techniques include the use of financial leases and operating leases. These leases must be in writing, but they generally do not have to be registered. The problem is one of economics; there could be a substantial withholding tax for operating leases under the Mexican income tax law.¹¹ The income tax law provides for withholding from certain Mexican source income to non-residents, for example, a foreign leasing company. Generally, the tax is 21% with respect to an operating lease, although the U.S.-Mexico tax treaty for the avoidance of double taxation provides some relief, reducing the withholding tax to 10%. The Mexican company also has to pay value added tax on the importation

10. Interview, with the Comité de Vigilancia, Colegio de Notarios, Mexico, D.F.

11. "Ley del Impuesto Sobre la Renta," D.O., 30 de diciembre de 1980, at art. 149.

of the equipment. Finally, structuring a financial lease that provides for terminal elections to the company, such as extending the lease for a term longer than the initial lease at a lower rate or similar terminal aspects, is considered financing. Therefore, the withholding tax would only be imposed on the interest factor and the financing factor, and not on the total payments.

Both in leasing and conditional sales agreements, title retention arrangements are common in the Mexican market. The most common way of financing consumer goods is by conditional sales agreements. The problem is that technically one has to register the title retention or the rescission clause in the Public Registry. The question then becomes at which Public Registry? The answer is it depends on where the company is located. Again, one must note that all the registration requirements are necessary to insure that the lender has the status of a secured creditor.

Warehoused collateral is another financing possibility, but it is very impractical. The company, of course, buys the equipment to be used, not to be placed in some bonded warehouse. However if the lender is financing a company that is purchasing a large stock of equipment in Mexico, a bonded warehouse could be set up within the premises of the debtor.

In conclusion, there are many difficulties in securing equipment and machinery. Mexico's laws are outdated. They provide unequal treatment between Mexican banks and non-Mexican banks. There is an absolute protection of workers' rights which means workers have an absolute priority with respect to claims for unpaid wages, substantive severance payments, vacation pay, and mandatory bonuses. There is a significant disparity between the secured financing laws of Mexico and their counterparts in the United States and Canada. The outcomes in bankruptcy proceedings are simply unpredictable, particularly in times of crisis. Nevertheless, there is a tremendous growth in the number of secured transactions with leading companies in the export sector of Mexico's economy, and we expect that trend to continue.

There will be continued revisions to Mexican law. This creates an opportunity to revise some of the civil state codes, to change local registration requirements, and to provide a more effective procedural system. Unfortunately, there seems to be more reluctance to modernize the federal codes, and commerce is a federal matter under the Mexican constitution.¹² It should be possible to implement some significant changes fairly rapidly, but federal authorities are more concerned with political reform. In May 1996, there were reforms that streamlined procedural law.¹³ This is welcome news. The negative side is that under the strange transitory article,¹⁴ these new streamlined procedures will only become

12. "CONSTITUCIÓN POLITICA DE LOS ESTADOS UNIDOS MEXICANOS," 5 de febrero de 1917, as amended, at art. 73.

13. "Amendments to the Código de Procedimientos Civiles para el Distrito Federal," D.O., 23 de mayo de 1996.

14. *Id.*

available with respect to contracts executed after May 1996. Many delaying tactics will continue to be available to litigators.

On a more positive note, this author's opinion is that the industrial sector has a very strong and proven track record for keeping out of the courts and for reaching very successful debt restructurings. In 1982, when Mexico experienced its first massive post World War II debt crisis, the Mexican government simply ran out of foreign currency. There was approximately fourteen billion dollars worth of maturing private sector debt and approximately five to six hundred million dollars of that debt ended up in litigation. The bulk of the debt was successfully restructured within the context of creditors' committees. All in all, a very excellent success story.

A U.S. PERSPECTIVE

Martha T. Collins: The following is a review of the highlights of a typical bank's secured financing of equipment in the United States. Assume that a U.S. bank is considering financing equipment for a Mexican telecommunications company and is advising the company about the terms that the borrower could expect in the United States. Then compare and contrast that with what they can expect in Mexico. Our hypothetical Mexican telecommunications company is located in Mexico City. The amount of the loan requested is \$6,000,000, and the interest rate will be a floating rate tied to LIBOR, the London Interbank Offered Rate, plus five percentage points. If a default occurs, the interest rate will increase by four percentage points, which is LIBOR plus nine. The term of the loan will be four years, and this will be a term loan so amounts borrowed cannot be repaid. Multiple advances under this credit facility will be available with minimum fundings of \$500,000 pursuant to the equipment schedule. The borrower can request advances under this credit facility through December 31, 1997. Each funding will be evidenced by a separate promissory note. This loan will be structured so that all loan proceeds will be advanced in U.S. dollars to the borrower's account, which account will be required to be in the United States. The payments by the borrower are also to be made in U.S. dollars in the United States. There will be the typical requirement for the borrower to get insurance. In the loan documentation, the borrower will be required to make all payments without a set-off or reduction for withholding taxes or otherwise. Also, the borrower will agree to indemnify the lender against all taxes and third-party liability claims, and to pay a late charge on any payments not received when due, in addition to the default interest rate. The loan will be amortized over the term in equal monthly installments of principal. The purpose of the loan is to purchase equipment. Therefore, in the United States, the lender's lien would constitute a purchase money security interest. The equipment will be located in Mexico at the borrower's place of business and no more than 5% of the loan proceeds may be used for installation costs. The other 95% will be used for purchasing the equipment. No part of the loan proceeds may be for household, personal

or consumer uses. This is intended to be a business loan in the United States. Optional prepayments will be permitted without penalty or premium although any amounts prepaid cannot be reborrowed. The collateral will be the equipment that is purchased with the loan proceeds, together with the presently owned or hereafter acquired attachments, accessions, or additions. The lender expects to get a first priority lien on the collateral. The governing law will be New York, and borrower will pay all the transaction costs.

In the United States, this would be a very straightforward transaction. The lender would file a financing statement, usually with the Secretary of State of the state where the equipment is located. But if the equipment is mobile equipment, such as construction equipment or railroad rolling stock, then the filing would be with the Secretary of State of the state where the debtor is located. If it is equipment used in farming operations, an additional filing might be required in the county where the equipment is located. Once a security agreement is signed, value has been given by the lender, the debtor has acquired rights in the collateral, and the necessary filings have been made, the secured party has a perfected security interest. The costs are minimal, under \$20 to file a financing statement with most Secretaries of State. If it is necessary to file in a Pennsylvania county, the cost could be as much as \$175 if a standard form is not used. In a multi-state transaction, there are going to be additional fees. But because most of the U.S. states provide for state-wide filing, only the one filing with the Secretary of State will be required no matter where in the state the equipment is located.

With that overview of how this financing would work in the United States, we would like to compare and contrast it with Mexico and what would happen to the creditor there.

Heather: The first step is to consult a lawyer.

Collins: With most of the security devices in Mexico, one of the problems is that they require that the creditor take possession. However, there are at least five techniques that would not require possession: the trust device, the installation credit, the industrial mortgage, the conditional sales contract and the financial lease. Those would seem to be viable alternatives for equipment financing. Which of those would work the best for our proposed equipment financing?

Heather: Probably the *crédito refaccionario* [installation credit], simply because the term sheet indicates that there is a very specific purpose of the loan, that is, to purchase the equipment and go on from there. There is one problem with this: the equipment is to be purchased at different stages in time, and the *crédito refaccionario* does not cover after-acquired equipment. So you may have to incur expenses, in creating the security interest, more than one time. An alternative is the use of a conditional sales arrangement. The transaction could be set up as a lease. However, you have to take a look at the actual cost, whether or not you trigger some value-added-tax or withholding taxes. So it depends; I think typically you are looking at a *refaccionario*. An industrial mortgage may be an option. But in the Federal District, the Public Registrar may say that

the mortgage may not be granted in favor of a foreign lender. So I think the best prospect is a *crédito refaccionario*.

In fact, you should look at whether there are other alternatives such as the use of standby letters of credit. In the telecommunications industry, where large investments are being made vis-a-vis the receivables generated from the handling of incoming telephone calls, the collateral may be repackaged and set aside to guarantee these types of facilities.

A guarantor also may be required. A guarantor is an individual who is a principal of the borrower. This should be documented with promissory notes. With promissory notes, the lender has access to the *acción ejecutiva mercantil*, the executive action. Although the executive action or summary proceeding may be available if the creditor has an instrument that qualifies as a *título de crédito*, a negotiable instrument under Mexican law, getting to the actual payment phase may be a problem. However, if an individual has signed an unconditional guarantee, on a promissory note, the creditor may obtain an immediate attachment of assets of the borrower, should there be a problem, by means of an executive action. The parties can then negotiate from there. If there is a suspension of payments, all those attachments are worthless. They all go into the bankruptcy court and you end up where you were. But at least if you have an individual, you can attach assets and you can presume that the assets are there. A strong litigator can attach the personal assets of the individual guarantor. This is a tactic used to pressure people to come to the table and negotiate. The problem is that most individuals are not going to give you a guarantee unless it is a very small operation. In conclusion, the best way to structure this type of financing is by using the *crédito refaccionario*. The Federal District filing fees will cost about \$1,000. In the Federal District there is a table of notarial fees, but that is very much negotiable. The notary will not be doing the work because it is typically a New York agreement, and you will have Mexican counsel. Therefore, the notarial fee, on a \$6,000,000 loan, could be as little as \$50,000. But he would be entitled to more. As the notaries say, "The bigger the frog, the bigger the rock." The Mexican legal fees may be about \$5,000. A total of \$56,000 to \$60,000 in fees for Mexican legal, notarial, and registration services.

Collins: What about the currency issues? One thing that a U.S. bank would be very concerned about is that they do not want to take the currency risk and the risk of devaluation. The transaction is structured so that the loan proceeds would be both advanced in U.S. dollars and repaid in U.S. dollars. If the lender actually advances the loan in pesos and then requires that the loan be repaid in U.S. dollars, is that enforceable in Mexico?

Heather: The governing law is the monetary law which must be strictly observed. What the monetary law says is that payment obligations, which are contracted by a Mexican entity and are to be performed outside Mexico, where the debtor actually received the foreign currency, may only be discharged in the contracted currency at the place of payment outside of Mexico. I believe that a U.S. dollar loan by a U.S. bank and

payable in the United States, under the monetary law,¹⁵ would create a payment obligation in U.S. dollars. If you transform the payment obligation, the result may be different. Let us suppose you go through litigation and you have a Mexican judgment expressed in dollars. The debtor may satisfy the judgment in the equivalent pesos at the rate of exchange on the date of payment. The payment obligation is now the result of the judgment payable in Mexico by virtue of the court determination.

Collins: If the debtor goes into suspension of payments, does not that change the timing of when you can fix the exchange?

Heather: What the courts have done systematically in these cases is to say, monetary law notwithstanding, in interpreting the bankruptcy law, we will change that dollar obligation into Mexican currency because otherwise it would be unfair to the bulk of the other creditors who have their obligations in Mexican currency.

QUESTIONS AND COMMENTS BY INSTITUTE MEMBERS

Institute Member: Can we assume for a minute that the U.S. bank, the lender, has formed a *financiera* in Mexico, and compare and contrast the benefits of using a lease finance vehicle as opposed to the *crédito refaccionario*? Please discuss the securitization vehicles, enforcement, and other important considerations.

Heather: Your question is changing the scenario. Basically the issue is that the U.S. bank could have a fixed asset financing agreement to make it qualify for purposes of registration and translation, etc. if a Mexican lender is involved, a leasing company or a bank, we have a different situation. A Mexican leasing company, which is an auxiliary credit institution, would be leasing the equipment to the Mexican telecommunications company. Many of the issues caused by a bankruptcy will present themselves, because the statute is so out of date and we have little sophistication in the some of the judiciary. There are some advantages to a Mexican vehicle, such as a leasing company or a bank, because it can actually create a security interest on after-acquired property by handling invoices, inserting annotations among itself and it could discount its portfolio with other institutions within the market. But again it is a different scenario. In the event of a Mexican vehicle, such as a leasing company or a bank, it would access to *acción separatoria*, to separate from the bankruptcy estate that equipment. Again, be aware that the workers put a hold on that one, too.

Institute Member: I have a general question in terms of the status of equipment leases in the face of the super priority issue. You mentioned that there would have to be a separatory action, I believe, in order to excise the title retained equipment from the *suspension de pagos* proceeding. To what degree would super priority claims, such as labor claims,

15. "Ley Monetaria de los Estados Unidos Mexicanos," D.O., 27 de julio de 1931, as amended.

impinge on the interests of the owner of the equipment in the event of that type of an action? Would there be any sort of a deduction or charge against the retained title equipment as a condition to its repatriation, say, from Mexico back to the United States?

Heather: I think the repatriation aspect is much more of a secondary concern. The main concern is that the workers see the failed company as a negotiable whole, their livelihood and source of work, and they are not forced to distinguish whether the equipment is owned technically by a subsidiary, a parent, or others. Once you get labor involved, you have to look at the possibility of entering into some sort of negotiation if you want to recoup the equipment. This might be possible perhaps by forming a creditors' committee and convincing it to recognize subordination by contractual arrangement. But let us suppose all of that is not available. You will have to go through the *acción separatoria* [action for separation], and you will have to put any possible third party on notice that the equipment is yours, perhaps through publications in the dailies. Without proper notice, a third party could take the equipment as a buyer in good faith. If that happens, you would have to get into a second litigation, at which time I would suggest that you forget about your equipment.

Institute Member: In your term sheet where you put New York as the governing law, if you have a situation where you have to resort to the courts, would you recommend a bank to sue in New York and then enforce a judgment, or to commence an *acción mercantile* [commercial action] first and then under the contract? What would you suggest to the bank in that case?

Heather: It really depends on the facts. I suggest you go where the assets are. To the extent you have assets in Mexico, you should consider the possibility of an *acción separatoria* because, you can attach the assets and put some pressure on the company to come and negotiate. If it is a multinational company, that has assets all over the world, New York may make sense.

Institute Member: Let us suppose our company has gone bankrupt. What would happen if the person in the company who made the collateral guaranty also goes into bankruptcy?

Heather: Well, probably checkmate. One of the things that is important here is the inconsistency in the retroactive period that is being handled by the Mexican court. In other words, under Mexican bankruptcy law, the court has the power to determine at what time the company became insolvent. Any transactions occurring during this so-called "suspicious period" and any security interest created, will be annulled, and will not be recognized. And suspiciously, this suspicious period is getting longer and longer. I was very surprised recently by a case in which a company called McGregor went into a suspension of payments in 1993, published on the 14th of August, 1996, and the court made a determination to have retroactive effects to the 23rd of April, 1993. You should always obtain some sort of representations and warranties before you proceed.

Make sure your debtor gives you adequate financial statements so you can avoid transactions that occur during the suspicious period.

But addressing your point, suppose your company goes into bankruptcy and you go against the principal. The principal has the possibility, as an individual, to also request the court's ruling for a personal bankruptcy proceeding. What you will find in Mexico more and more as the general rule is that individuals do not have too many assets in their own name. So if you are lending to a small or medium-sized company, you had better check out the spouse, and depending on the state you may need them to both sign. Also, be sure to get authorization for them to sign. They could both declare bankruptcy, but most do not. Even in the medium and small-sized companies and even in the tremendous recession that we experienced last year with a decrease of GDP of almost eight percent which is phenomenal, there were not that many bankruptcies and suspensions of payments. They are growing in the aftermath of the crisis, and I think there is a very strong element in the Mexican entrepreneurial of the personal pride factor that makes bankruptcy a last resort. But if they do go into bankruptcy, you are better off to try to sell your loan in the secondary market and forget about your equipment.

Institute Member: I want to know if, in your analysis of the different vehicles for creating a security interest, you could discuss the pros and cons of using a trust, which was not emphasized in your listing. Also, if you could address one particular risk, some of these pieces of equipment and machinery are rather sizable and some are bolted into the ground. This raises the issue of these things becoming fixtures and no longer being movables. Are there some recommendations you could make to a lender regarding the kind of due diligence required to come up with the conclusion that the item is a movable and not an immovable?

Heather: First, very briefly, I will address the trust as a security device for this type of transaction. You have the possibility of creating a *fideicomiso* with a Mexican bank if the assets are in Mexico. You have to negotiate fees. The banks have schedules that are approved as a ceiling by the banking and securities commission, but you can negotiate a lesser fee. The lender and the borrower must determine the extent to which the trust is obligated to participate or not participate in the administration of the collateral and whether or not to eliminate some of the risk by forming a technical committee, a group of people that would have a say in instructing the trustee how to address the property that is being transferred to the trust. Pitfalls: In addition to procedural pitfalls, you have to make sure that the trust is not categorized as a business trust. A business trust could be a taxable entity subject to double taxation.

Let us suppose that the tax issue can be properly addressed, and you have your assets within the trust. You have to be careful in stipulating the procedure pursuant to which those assets may be auctioned, sold, repossessed, etc., with the principle of keeping very much in mind the right of due process. The right of due process, which is the equivalent of the Mexican bill of rights within the Mexican constitution is frequently being invoked by debtor groups who insist that any type of self-help

remedial action would be a violation of due process. One problem with that interpretation is what happens with arbitration? The court's point of view, as expressed in the *López Estolano* opinion,¹⁶ is very literal indeed. So you may have a *fideicomiso*, you may be paying \$25,000 to \$30,000 a year for a \$6,000,000 loan, you have a technical committee, you have to register the agreement for purposes of making sure you have that separatory action if the equipment becomes bolted down and really becomes part of the industrial process, which is usually the case. Although I think that there are other court precedents that do allow the credit institution to come in and try to exercise a separatory action, there are many cases that say a *fideicomisos* [a trustee] may exercise rights of repossession and may therefore claim an *acción separatoria* even though the agreement is not registered. While this may seem to be a favorable ruling, you would then have to bring an *acción separatoria* and that would take a long time.

16. "Amparo en Revisión 1613/94," *supra* note 8.

