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A Case Study of Three Opportunities to Improve the Private Financial Infrastructure of Mexico: Secured Financing of Inventory; Accounts Receivable and Equipment; The Securitization of Assets; The Laws of Bankruptcy and Insolvency: A Panel Discussion

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OWEN: We owe a debt of gratitude to John Stephenson, the chairman of U.S-Mexico Institute, who could not be here today. I am honored to have been asked by him to substitute for him as moderator of this panel.

I want to briefly discuss the organization of our panel discussions. This case study, developed for us by John Stephenson is located at the end of this article (Annex 1). The format for this case study seeks to focus on the questions found at the end of the study, with one important exception: this panel will identify and analyze the types of credit that may be of value to Empresas Bonas; identify the types of security that might be available; analyze the advantages of the different types of lending institutions mentioned in the case study; and identify the types of changes that would be beneficial to the Mexican securities laws. Additionally, this

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panel will examine some bankruptcy laws potentially helpful in providing the types of securities that would benefit organizations like Empresas Bonas.

SHORT-TERM FINANCING.

First we will identify the types of credit Empresas Bonas needs. For me the most urgent type of credit seems to be working capital: they seem to have some rather stringent impending needs. I think it is also obvious there is a need to recommend long-term debt. That represents 70% of the outstanding financing on the equipment.

LUBRANO: Before getting into the specific financing needs, an important fact to keep in mind is that 65% of this company's revenue comes from export sales. This may provide the company access to international capital markets or dollar denominated loans. Additionally, the company's facilities are now operating at production capacity. It needs to buy another facility or another plant to grow. Clearly it has an opportunity to grow and it is probably going to need long-term financing for that purpose.

OWEN: So there are three types of credit needs this company has. One, very urgently, a form of working capital. Two, it needs to refinance its existing long-term debt and arguably also its high-priced short-term Mexican peso debt, which was also borrowed to finance the purchase of some of its equipment. Three, it has tremendous growth potential but has run out of capacity, so it needs to improve upon its operating structure. Let us first address the working capital needs of this company.

LUBRANO: I would like to point out, especially in today's market, the fortunate situation that this company is in, which many companies in Mexico do not share. In times of crisis this is the kind of company that is much more attractive to foreign financial institutions. It has export sales which comprise 65% of its revenues and the clients to which the company exports may even be AA or AAA credit rated companies. A bridge loan or mid-term financing in foreign currency, probably dollar-denominated, would at least allow the company some breathing room in the form of working capital. From a timing and cost point of view this would be quite efficient. That is, an export-backed financing designed to be restructured for a securitization transaction would be, depending on circumstances, more cost efficient for the company.

For the short term needs of the company, an export-backed financing which is collateralized by export receivables payable outside of Mexico in dollars would have two effects. First, it would isolate the transaction from Mexico and the concept of Mexico risk. Second, it would isolate the transaction from currency risk and therefore reduce the cost of funds to the company in moments like this.

OWEN: What types of creditors might provide this? As the receivables comprise the most prevalent and most liquid assets of the company, compare how it should be structured in terms of categorizing those receivables as an off-shore risk, as opposed to attempting to obtain a security interest in the receivables under Mexican law.

OWEN: Is a lender going to be willing to lend on those receivables, if those receivables are due Empresas Bonas? Or are the lenders going to want to get those receivables off shore so they can protect them under the laws, say, of the United States?

NADER: We have two alternatives. If balance sheet effects are not important, perhaps the ideal solution would be for the company to create a pledge on those receivables. The pledge would cover both present and future receivables. To be exercised, notice would have to be served to the obligors, as opposed to the assignment where notice must be served to the obligors before the assignment is to be perfected. So, for the short term I would explore perhaps the possibility of creating a pledge, which would not attain the effect of moving the assets outside of Mexico. From an efficiency and cost standpoint, that is the preferable alternative.

The pledge would have to be notarized to protect a creditor in an insolvency scenario so it could have the standing of a secured creditor, since the pledge can not be registered in any public record or there is no UCC filing.[1] The protection for the lender derives from the date of the pledge. I would advocate using those export receivables for short-term financing.

OWEN: Would this lender be a Mexican bank? Or do you believe that there are off-shore banks or dollar-based banks out there that would be willing to lend within the structure that you have just described?

NADER: I would look towards foreign lenders, primarily into the U.S. market. I would look into the U.S. market because I believe there are funds available for this type of project. As a general rule, U.S. lenders would enjoy a lower withholding tax rate than some European or Asian lenders. When I say 'withholding rate,' I mean interest payable to foreign lenders is subject to withholding taxes, usually at a rate that would range anywhere from 4.9-15%. In the case of U.S. banks the rate will be 4.9% in most cases.

AIZA: Mexican banks can also lend in dollars and they are willing to do so with a sound Mexican sound company with some exports. You can also try to get a Bancomex supported credit which are normally for seven years or so, which is beneficial in this case. I would not rule out that possibility at all.

OWEN: Before we move on to the long-term financing, let me just mention one scenario with which I am sure a number of you are familiar. On occasion there has been considerable reluctance by off-shore asset-based lenders or off-shore banks to lend against accounts receivable in Mexico. They feel that the legal system is very cumbersome should lenders have to enforce the pledge or the assignment. They seek some mechanism to get the receivables off shore. One scenario has been to set up a U.S. marketing arm of the Mexican company and have their sales made through the U.S. marketing arm. They then perfect their security interest in the receivables then owned by the U.S. marketing sub under the U.C.C. in the U.S. What problems do you see from a Mexican perspective with that structure?

LUBRANO: I think if Empresas Bonas has a direct or indirect subsidiary in the United States through which it actually sells the products to the U.S. customers, there are a couple of elements that would need to be present. The first one is that the obligors under these receivables be U.S. residents, or non-Mexican residents. Secondly, the receivables are of course denominated in dollars or other hard currency and not Mexican pesos.

1. Manuel Garcia Barragan, *Highlights of Mexican Law Concerning Contracts and Procedural Formalities*, IN DOING BUSINESS IN MEXICO, pt. III, §1.03 (Michael W. Gordon, ed. 1992).

We can actually make the receivable payable outside of Mexico, perhaps through a lock-box account or similar account in the United States, through a United States bank. This requires U.S. or foreign obligors to actually make payments into that account. They should perhaps create some sort of collateral security, whether it is a perfected collateral security pursuant to the laws of the local jurisdiction or through an escrow or trustee arrangement where the monies can only be distributed based on certain reserve or general requirements that relate to satisfaction of financing covenants and obligations under financing. Without having to take any further steps, this would isolate the asset from Mexican perfection requirements and foreclosure.

The second point is that the marketing subsidiary also isolates various risks relating to potential third party claims against the Mexican resident. By creating this interim level U.S. subsidiary for the Mexican company, that would technically own the receivables, thereby creating a security interest in some way in those receivables completely outside of Mexico, and without having to have access to the Mexican court system to enforce or foreclose.

AIZA: To summarize, the issue is whether to move the assets into another corporate layer that is a marketing subsidiary where the marketing subsidiary disposes of the assets to the benefit of the lenders, or disposition is made directly by the company to the lenders. Regardless of means, there is ultimately going to be a Mexican contact, which is the company that originally conceived the receivable. More so in long term projects than in short term the tendency is to move the receivable into the ownership of a U.S. bank or an off-shore bank rather than keep it in Mexico. To use a U.S. marketing company, it becomes necessary to consult Mexican and U.S. tax experts as well as considering transfer pricing issues that may not solve the urgent need for short-term financing. I advocate avoiding the use of a marketing arm in the United States for short-term loans.

LONG-TERM FINANCING.

OWEN: We have identified two different types of long-term financing. Should there be one type of loan or one type of financing to cover both needs, or are there reasons, especially under Mexican law, favoring a division into two different types of financing? Already identified is both the means to support existing long-term financing and financing needs related to infrastructure augmentation.

LUBRANO: One of the types of investors that John identified was private investment funds. The case study, however, requires that private investment be restricted to debt, not to equity. What the case study references, then, is mezzanine financing. That is, expensive venture capital debt financing. My assumption is that Empresas Bonas will double the size of its operation; Empresas Bonas will encounter an injection of equity either from the existing holders, or separately, but both private equity money and high yield debt are expensive options.

Venture capital is especially expensive in Mexico due in part to pervasive confusion in the bankruptcy law. It becomes particularly confusing for a company with long-standing operations. For example, contingent liabilities for unpaid severance benefits are difficult to estimate. In Mexico there is a double risk. Venture capital often expects that three out of four of the investments will fail, but not that necessarily all failed investments will result in a total loss. In Mexico failed investments often see absolutely no return. In such scenarios equity is eliminated, the senior debt is paid off, and little is left. We know that we will probably never see a dime, within the lifetime, certainly, of the investment officer who made the loan. Assuming a debt investment that complements an equity increase, the principal obstacle for the venture capitalist is the bankruptcy law.

OWEN: How would the long-term financing seen here be secured?

BERDEJA: Assuming a paucity of funds, the best option is equity. I assume that Empresas Bonas is large, well-funded and prosperous. Empresas Bonas might be subject to anti-trust considerations and even the possibility of a merger or a direct investment from their clients.

OWEN: Injection of equity is beyond our scope. Is equity attractive because of structural inability to provide needed long-term financing?

BERDEJA: Once accounts receivable are assigned or pledged, there remains little in which banks are interested. Another option is supplier financing; still, that is short-term. Equity sometimes becomes the sole answer.

LUBRANO: The bankruptcy law converts the mezzanine financing that would support equity into an equity-type risk, so it must be priced like equity. What Agustin is saying is, "Well then, you are stuck with that," because of some of the things we have worked on and because of a tension between equity and long-term subordinated debt. The risk is priced the same if there is ultimately no difference in rights.

OWEN: A common type of collateral in the United States is equipment. Empresas Bonas bought state of the art equipment. Also, their inventory is a hot item, obviously valuable. Are equipment and inventory readily available options?

LUBRANO: Equipment can always be leased. Mexican leasing companies are currently in a difficult position, particularly those that were unaffiliated with banks. Large equipment can be financed that way. Of comfort to creditors is where equipment is removable from the real estate; then it can be repossessed in a reasonable time.

BERDEJA: Many major Mexican non-bank banks continue to finance equipment purchases, like General Electric.[2] That option is not always attractive to borrowers though. Equipment is a major asset and to lose equipment is to lose an entire operation. Equipment leasing is available on a limited basis from foreign creditors.

OWEN: How are their security interest being secured?

BERDEJA: A recent deal involved a large piece of Russian, tailor-made manufacturing equipment for a group in Monterrey. Its cost from scratch was $40 million and $20 million financing was obtained when it arrived in Mexico. A relatively straightforward trust agreement was created. There the major problem was the cost of registering the mortgage. This was problematic due to existing valuation systems in the State of Nuevo Leon. In other words, the price of the duty is based on a percentage of the value of the collateral. Nonetheless, though problematical, that kind of collateral is acceptable in Mexico.

2. See generally Howard Ruda, *Inventory Financing*, *in* PRACTICING LAW INSTITUTE COMMERCIAL LAW AND PRACTICE COURSE HANDBOOK 769 PLI/Comm. Order No. A4-4541 (April, 1988).

LUBRANO: Concerning the pricing issue, what is obtained in the security interest? You say it is a unique piece of equipment, it is tailor-made. So that means if I repossess it there is little I can do with it, it was made for you. To me, it is probably not worth anywhere near what it is to you. But it may mean that I still get a very valuable right. I can make your life absolutely miserable, so I will become a preferred creditor in that sense.

In Mexico a mortgage on real property is distinctive in that it is not quickly recoverable. The annoyance value is the largest portion of the value of the creditor's rights. That I can prevent you from selling it renders it better than an unsecured loan. What is the true value of repossession in a piece of secured property?

BERDEJA: In this regard, General Electric studied its possibilities involving enforcement where they could sell the tailor-made equipment. The pricing of the deal was expensive. Finally, there was expected bridge financing and the near-term debt perhaps encouraged General Electric in this case to proceed. They knew they were being replaced, within the next six months.

Of course, in this trust agreement, it was assured that the equipment was owned by the trustee and not by the company. It was also assured that in the context of bankruptcy proceedings, the equipment would not be considered part of the bankrupt estate. That was part of the deal.

NADER: There are potentially four categories of assets. First are export receivables; second are local receivables which comprise a good source of financing; third are equipment and inventory; and fourth is real estate property.

First it is advisable to allocate the right value to each of these assets. Long-term financing should be placed with dollar receivables which are either financed or secured. Second, particularly with Mexican banks, mid-term financing or short-term financing with local receivables is advisable. Third, with regard to the real estate and the equipment, it could either be financed through a mortgage or a sale-leaseback, or we could finance the equipment through a pledge. As mentioned, the leasing sector is in a difficult cash crunch. A number of the leasing companies have been taken over by the large banks to boost their capitalization levels. There are a number of solid group leasing companies (a number of them are affiliates of foreign financial institutions) that lease back equipment. Fewer companies would consider leasing back real estate. As to real estate, the options are limited to mortgage financing.

BERDEJA: One of the key items in the case study concerns the four family member-owners who want to get rid of their personal liability. There is a viable alternative for those individuals. Instead of incurring personal liability, they could ensure that their exposure is limited to real estate. That option may be acceptable to banks, which would provide relief to the four family member-owners.

OWEN: Traditionally the bankers, in particular the Mexican bankers, look either to personal guarantees or real estate security. Given the constraints of this case study, it is assumed that there is real estate available here. The assets referred to in the case study do not include real estate. Assuming then that there is real estate here, is there a way to finance this and obtain the guarantees relieved? Are Mexican banks, with their benefit of an industrial mortgage, an alternative? Could a Mexican bank tie up all of these assets, including future assets? Would they be willing to lend dollars using their industrial mortgage, thereby disposing of the personal guarantees?

BERDEJA: It is possible, but I am not sure that is most beneficial for the debtor. Normally it is advisable to divide risk as a borrower into drawers. I do not think that it is wise to tie up all assets with the Mexican bank and then have to access the bank for waivers if more financing becomes needed. That would be both overkill and an inefficient way of financing the needs of Empresas Bonas.

LUBRANO: Is it possible to do that from the beginning? For instance, can there be a floating charge loan but you exclude receivables at the outset? The floating charge exists and the real property mortgage exists, but the receivables are not pledged. You do that at the beginning, so you do not have to go back to the original lenders for a waiver. Or are they just not flexible enough to do that?

BERDEJA: I do not see any objection from a strictly legal point of view, but I am not sure a Mexican bank would say that was a great idea.

OWEN: One last question before we turn to the subject of substantive changes to the law. We have been discussing potential lenders. Are clients available who are willing in today's market to do the type of lending that we have just shown Empresas Bonas to need? Please address the working capital solution first. Are there, in fact, off-shore lenders willing to extend the type of working capital described above?

AIZA: Two different historical points can describe that. 1998 is one, 1995 was another. That was a good example even though the fundamentals and general conditions have changed since then. The issue of Mexican currency risk certainly persists. 1995 was a good example of foreign banks coming to Mexico and looking to fund exporters of all kinds and sizes. I personally witnessed many deals in 1995 directed specifically to large Mexican companies whose export sales were a little less than 65% of revenue. I think the case study provides a good example of what many bankers under today's circumstances would be looking to fund. This is simply because the collateral is isolated to an important extent from currency risk and Mexican risk. So I think the answer to the question is yes, specifically because I think this company has a very valuable asset in its export receivables.

I would like to briefly step back and touch on two points. One that is extremely important is the one-stop shopping point, which we addressed in the context of a Mexican bank but not a foreign bank. A second point, key to this analysis is that the export receivables of this company are not a frozen asset at this point in time. Rather, I think a banker would be looking toward the future ability of this company to generate additional export receivables which would allow the company to assume additional indebtedness from that bank, syndicated banks, or other lenders in the future.

To summarize the discussion thus far, first we talked about the working capital issue. That is, bridge financing secured only in the simplest way possible, through export receivables. Then regarding the longer-term prospect, a larger financing through a syndicated loan or an asset securitization in which the bankers would be looking for a package deal.

Additionally we have examined the types of assets this company has, its existing and future export receivables (the latter of which are the most valuable asset of the company), local receivables, equipment and other movable assets of the company, and finally real estate. Because the case study referenced Empresas Bonas' existing plant and expansions and potential additional plants, I assume that the company had real estate. Assuming that Empresas Bonas owns its real estate, it is appropriate to discuss the packaging of a long-term deal. One important point that comes to mind is the concept of a guarantee trust.

Bankruptcy is one issue that has been mentioned. Bankruptcy and enforceability and the attendant timing and cost issues are certainly of concern. It is important to isolate the assets from the bankruptcy estate of the company, first by transferring title to the greatest extent possible to the export receivables both present and future through a vehicle outside of Mexico. This is similar to what is done in an asset securitization when future flows are sold to a vehicle. Separate the Mexican assets into a guarantee or security trust agreement, whereby Empresas Bonas and potentially the principals are going to be released from personal obligations by transferring some personal assets. This would serve the purpose of actually transferring title to those assets into a trustee pursuant to a guarantee trust arrangement, thereby effectively segregating trustee-held assets from the bankrupt estate of the company in the event it did go bankrupt. Isolating the assets provides the ability to foreclose on those assets and the ability to sell those assets to a foreclosure transferee, without having to go through the Mexican court system and having to suffer the timing and cost issues typically arising in a court proceeding in Mexico.

Long-term package deals are best accomplished with one agent, through a financial advisor in a syndicated loan where the whole set of assets is one single collateral package. Then, it is important to generate future flows for the company, which may increase its ability to incur additional indebtedness in the future.

FIDEICOMISO

OWEN: I would like to address the issue of foreclosing without ending up in court. Because that is a fundamental issue in dealing with foreign lenders in the context of a fideicomiso (a trust), I would like our Mexican lawyer friends to address that issue. The central question here is whether this is going to keep me out of the court system. What is the answer?

BERDEJA: There is not only one correct answer. The fideicomiso must be structured in the right way: beyond just a correct description of the assets and the names of the participants. Due process considerations must be examined as well as various kinds of defenses provided for the borrower. There is no question that the borrower can take you to court, there is no way to prevent that from happening. There are decisions in which the court has found that the fideicomiso structure was correct from a due process analysis and that the steps taken to enforce were consistent with what is provided for in the fideicomiso agreement.

NADER: My opinion is not the prevailing opinion in the bar. I have a number of reservations in using trust arrangements, especially where there are other statutory security arrangements that are specifically governed by law. I have two concerns, one deals with time and the second deals with an insolvency issue. As to timing, there are multiple cases. There are at least two Supreme Court cases confirming that foreclosure through a trust mechanism, where due process is subserved and the borrower is given the right to appear and prove its case, has been held to fall within constitutional rules and therefore cannot be voided for lack of due process. That is a fundamental reason I do not like to use the trust. Because if I am trying to use the trust to stay out of court and there are myriad cases where the courts are consistently confirming that a well structured trust does not violate due process, at the end of the day I am not sure that I am attaining my goal.

Second, if I am going to be in court, I would rather be in court pursuant to a mechanism that is spelled out in the law, than under a contractual mechanism for foreclosure. Not every type of security arrangement has a specific foreclosure procedure in the law. There is one for mortgages which has been tested over the years and I think it works. On the other hand, there is one for pledges which has been tested over the years and it is questionable whether it works in the manner written by the law, or whether it is necessary to make contractual enhancements. That is the second reason. The third reason is that from a bankruptcy perspective, traditionally where an asset is conveyed to a trust, the asset leaves the estate of the settlor and becomes ownership of the trustee.

A distinction must be drawn between two types of assets, assets that are used solely as collateral as opposed to assets used to actually repay the loan. Where the asset is going to be used to repay the loan, there are grounds to say it has left the estate of the settlor. The structure and the fate of the transaction does not entail the asset returning to the settlor. However, where the asset is only used as collateral and once the loan is repaid, the asset is bound to return to the settlor. No matter what we call it, that is only a collateral arrangement. It does not imply disposition of the asset. The big risk is not in the commercial case; the big risk is in an insolvency scenario where there would be many creditors competing for few assets. As I said this is not the prevailing view, it might very well be the minority view but we have already had one case in which we succeeded with this argument.

BERDEJA: I agree with your assessment of what occurs if the perfection of the collateral is not done the right way. What has been done is a transfer of property to the trustee. We give them the invoice or invoices and say the property has been transferred. The idea of isolating the asset in the context of bankruptcy proceedings was, as far as I know, first discussed by Mr. Pasquel in a very old article in 1951. He asserted the view that if the collateral is perfected it in the right way, it is isolated, even in the context of insolvency proceedings.

Second, Don Rodolfo Batista who in my view is Mexico's foremost trust expert, has said in that he considers that the assets are being separated from the borrower's assets while the trust is in place, for purposes of bankruptcy concerns as well. So there are opinions of two authorities that would confirm both Carlos' views and mine.

THE NEED FOR CHANGE

OWEN: Views on fideicomiso are absolutely clear as mud! It is a wonderful vehicle, but not the be-all and end-all. It causes some foreign lenders concern in that there remains a lack of clarity on its benefits.

The discussion of the fideicomiso as a vehicle to secure assets in Mexico is a natural seque into our final topic, which is the need for substantive changes to the Mexican legal system in this area. We would all agree that the primary function of a fideicomiso is to avoid having to go to court to foreclose on the assets. This is particularly so because fideicomisos are very expensive in Mexico and lenders think twice about opting for a fideicomiso rather than for a standard pledge agreement or whatever else might apply to the type of collateral in mind. There is fear on the part of lenders of getting bogged down in the Mexican court system. Why is that, Fernando?

MONTES: I have examined this issue mostly from the side of the banking sector. The rate at which a bank can shrink in size depends a lot on the legal infrastructure that it faces. I have examined the fundamental questions that probably reflect my own ignorance of the topic and not being a lawyer. When a lender sells money to a borrower in exchange for a promise of future repayment against his or her expected future cash flow, the lender is taking a commercial risk. It is giving cash today against a promise of future payment that might not happen. In order to mitigate those risks, the lender goes to the question of guarantees: how can I improve the quality of my loan, or how can I reduce the risk in giving money today against an expectation of money tomorrow?

So what are the characteristics of those guarantees? What should be in a guarantee? What would be the ideal guarantee? And I came up with some answers. It should be as independent as possible and unrelated to, the original source of repayment, to free up another uncorrelated flow of funds that could provide protection.

Second, a third party to the transaction, a borrower, or a bank, must have a clear legally recognized interest in the assets pledged, collateral is acceptable provided that the entity pledging the collateral can do so and has the right title to it. That collateral must remain in effect until the loan is fully repaid, although it may decline *pari passu* with reductions in the outstanding obligation. It could be a self-liquidating type of guarantee. It must be easily enforceable, fast, at low cost and ideally, within and across political jurisdictions. Legal issues become important in Mexico if federal or state issues arise.

Another important point is that the collateral must retain its value, in real terms, until the original obligation is extinguished. That is why I have so much reluctance to accept movable property as collateral.

It must also have a right or a value that is not eroded through additional pledges created after the assets are received as collateral. Also, from an economic perspective it should not lead to gross inefficiencies, such as the freezing of assets that could be deployed into more productive use. This is a generic kind of consideration, not to have the assets removed from the productive cycle just to be guarantees and be frozen.

The guarantee should provide fair protection to the interests of both borrowers and lenders. It should be transferable with the sale of the underlying transaction. It should be transparent. The public should know, in order to reduce fraud to good-faith third parties, if there have been multiple pledges. And it should be simple to constitute and register. There might be other items that could be considered. Nevertheless, to meet some of these conditions is very difficult. Many societies have struggled with these issues for a long time. Any weaknesses inherent in those conditions of what I call the ideal guarantee will make the loans more expensive and increase the risk for the lender.

So banks face a substantial predicament because they have to select good risks and avoid bad bets in an environment where the information is very poor, the risks are very high, and there is a lot of uncertainty in many areas. This includes not only poor accounting, but also issues of asset repossession. That is, it is not the same to repossess an asset in Texas as in Mexico. Markets are thinner, a number of shocks may be experienced that are not present in more developed economies, and the registries do not work well. The legal system is deficient and there is often no other way to recover the assets but to go to court.

From a banking perspective, even the best type of guarantees are not always very good. Bankers have indicated that to repossess a mortgage takes about five years, and about 50% of the credit and interest is recovered after deducting all the costs. That is pretty worrisome. Even the best kind of guarantees can be eroded rapidly. This leads to a concern that very few banks will be willing to accept guarantees that are not real estate, giving some, but not full protection. In the end, the borrower has to pay the bill. If this is the cost of doing business, there will be tremendous spreads between the deposit rates and lending rates, and the banks will have no profit. My article includes an interesting quote from Corrigan that says, "High rates and spreads are a reflection of the need to cover very high credit costs as an integral part of the cost of doing business. Indeed, it is high credit costs that explain the apparent anomaly of high spreads and low profits," for the banks.[3] Certainly that is a main issue.

There are also other concerns. For example, many groups will be excluded from access to credit if the preferred guarantee is real estate. Very productive groups will be excluded because they just cannot offer the type of guarantee preferred by the bank.

In a study done for Argentina, 25% of the farmers were completely out of the market for bank credit because they did not have any real estate, any land. Additionally, 50% were out because they did not have enough land. So the fact is that 3/4 of the farmers were out of the credit market. That cannot lead to growth, creation of employment, or an efficient sector.

OWEN: The irony here, of course, is that the Mexican government has asserted that one of its most urgent needs is to provide credit to small and medium sized borrowers, yet the laws are not structured to allow that. A clear example of that irony is found in reading Fernando's article.

To accept that small and medium sized borrowers do not have the real estate and that their personal guarantees are not attractive requires us to look to the types of assets that they might have in their businesses, such as inventories, accounts receivable, equipment, the traditional types of assets that small and medium borrowers have. If a lender takes those as collateral without using a fideicomiso, and instead uses traditional methods of obtaining security interests in these types of collateral, how long will it take the lender to realize foreclosure on these assets in Mexico today?

AIZA: Depending on such variables as defense and having a good lawyer, foreclosure on mortgages take anywhere between 1-1/2 and five years.

OWEN: In the meantime the borrower has possession of that asset.

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3. Montes-Negret, supra note 3, quoting E. Gerald Corrigan, *Building Effective Banking Systems in Latin America and the Caribbean: Tactics and Strategy*, IDB, Social Programs and Sustainable Development Department, Washington D.C., May, 1977.

NADER: In small and medium sized loans where the asset is used as premises and is not an asset, per se, it would generate cash flow. Accordingly, it is difficult to control the asset.

I would like to digress here. A number of collateral arrangements on real estate, equipment, inventory can be created. One of the problems with Mexican banks is that even assuming the presence of reasonable forms to document consumer loans and medium sized loans, implementation of those forms is not properly managed. By doing so much volume, they cannot follow all details. What must be kept in mind is a wide range of time necessities, 1-1/2 to five years depending on the procedural defenses, the quality of the litigators, and how well documented the loan is. For example, two loan documents could be made by the same bank, literally on the same day. One of them will be immaculate and the other will be fairly deficient. So in focussing on the setbacks of the system, it is necessary to understand that volume in institutional lenders has not been properly handled.

OWEN: Another question concerns two critical issues. One critical issue is the ability to foreclose and realize on value of the collateral. The second issue is the ready ability to create the security interest in a cost-effective manner as the registration fees are quite expensive. Those two issues are critically important to lenders. What changes realistically deal with those two problems? It is my understanding right now that there are no ready mechanisms to deal with the secured transaction lending law. There are mechanisms in place to deal with bankruptcy.[4]

BERDEJA: I am not aware of anything in the legislative powers that could be taken seriously. The court system has helped a bit with the cost of registering collateral.[5] We have at least one decision where the courts say that what is charged to a government entity that is registering collateral must have a reasonable link to the actual cost of the service provided and may not be a percentage of the value of the collateral. That has yet to make it to all states, and many states continue to have the old system in which it is very expensive to register collateral.

Another aspect is corruption. There was a case recently in one of the states where a certificate of non-encumbrance for a property was requested and received, but my doubts persisted. A local *notario publico* investigated it for me. He called me and said, "They opened a new folio, or registry number, for the guarantee that is there." That is just one example that corruption is still a problem.

Third, there is no uniform system of registration which requires state-by-state analysis. You want to register in Leon, maybe Coahuila, maybe Mexico. It is really an exercise of common sense. The system is not there to create and perfect security in an efficient way.

OWEN: What changes, if any, are realistically possible to deal with these problems?

NADER: Within the last four years, there have been a couple of attempts to create a new law. One was headed by the Ministry of Commerce. It went nowhere. The other was headed by the PAN and also went nowhere. When the Ministry of

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4. see, eg., Brian Kozolchyk, *What To Do About Mexico's Antiquated Secured Financing Law*, 12 AZ. J. Int'l. Comp. L 253 (Fall, 1995).

5. see, e.g., Todd C. Nelson, *Receivables Financing To Mexican Borrowers: Perfection of Article 9 Security Interests in Cross-Border Accounts*, 29 U. Miami Inter-Am. L. Rev. 525 (Spring-Summer 1998).

Commerce invited practitioners to talk about the subject, I made what I thought could be a very simple first step, not necessarily dealing with the whole system. Regrettably either it was not a good idea or no one paid any attention to it.

A suggestion that could be implemented at a relatively low cost concerns the current process in which a significant number of economic activities are being privatized. Telecommunications has been privatized in the last eight years. While all being privatized, railroads, petrochemicals or secondary petrochemicals still continue to be highly regulated industries. Through a 1995 telecommunications law, telecommunications was privatized.[6] The telecommunications law provides for a telecommunications registry although other benefits were obscured. These could have created an additional section in this registry that would permit registration of collateral arrangements on personal and real property solely for companies that would enjoy either a telecommunications concession or license. This is a very small world, but an important one.

The same could have been done for railroads. There is a railroad registry.[7] No one, however, focused on the subject despite the fact that the government was educated of its potential benefits in eliminating overlap between the federation and the states. Unfortunately, there remains quite a bit of struggle when it comes to controlling public registries. There is a reasonable attempt to cover a limited number of industries. If it were to work, it could be an example to further develop collateral arrangements and registration systems. What I suggest does not require a change (which is much needed) to the commercial code or the banking law or the insolvency laws; I merely suggest creation of a parallel public registry of a federal nature for companies engaged in licensed activities.

OWEN: Any other points?

LUBRANO: I have one. One thing we have not touched on is the product markets. Mexico has privatized a number of its important industries, but many remain oligopolistic at best. If there is little competition in the product markets, those companies are able to extract excessive profits and become the only ones who can borrow because they can out-compete. This is a drastic over-simplification, but Canada had a similar situation in the 1970's. In fact, because of oligopolistic behavior Canada had an exceptional number of billionaires like Mexico has today. The prospects in those days for corporate and commercial law reform were very limited, because, "If we are the only group you can lend to, make it work. But the money will not flow to other people if we do not make these reforms. If we make the reforms, maybe it will flow to small and medium industries, and that is not us."

So until there is greater competition in the product market which might require more aggressive enforcement of the anti-monopoly laws, there will not be political pressure from the entities with the money to accomplish the reforms that are needed to lend to small and medium companies.

OWEN: Self-help is one critical element in the ability to foreclose on an asset and realize its value. That is the system that we have both in the U.S. and in Canada. In Mexico there is a constitutional prohibition against self-help. What are

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6. Federal Telecommunications Law, Diario Oficial de la Federacion, 7 de junio de 1995.
7. See, eg., Michael Downey Rice, *Railroad Equipment Financing Redux*, 21 Transp. L. J. 359 (1993).

some approaches to deal with this issue? Is there a way in Mexico whereby a creditor can quickly realize on its collateral?

BERDEJA: That is a very delicate question. We could, if there existed the political will. For that to happen it is necessary to consider whether to change the system, which is a state system and not a federal system. Some federal arm twisting may be needed. This has been evident in other areas in which the federal government was committed to an idea and committed the funds for the idea, while the states seek to account for lost revenues because it is possible to make a lot of money with this dispersed and inefficient system. Another issue is funding to create the system. It requires political will, commitment on the part of the federal government, and, finally, money to make up for lost revenues and money to create the system.

We have succeeded in other areas because of attempts to arrive at solutions under our own system of law. Efforts to "Americanize" or find an American solution to this, I think, will fail. Even if an American-type law is passed in this respect, if it does not respect our traditions, constitutional and otherwise, it will not work. That is important to keep in mind. There are many efforts to help Mexico with that. Some of them, though, are just trying to create a U.C.C. type of thing in Mexico. The idea of change, in and of itself, is not necessarily bad if Mexico's old and well-established principles of law are dealt with in a proper way.

MONTES: There is a need for a wholesale upgrading of the system. One obstacle is that it is necessary to reform the Constitution. Some articles of the constitution might need to be changed, at least that is what I have been told. What is puzzling is that all the emphasis has been on improving supervision and regulation. The World Bank has advocated this. This is necessary but not sufficient. After the crisis, the banks are still operating with the same legal system as before the crisis. We question why there has not been sufficient attention paid to reforming the legal infrastructure. That is probably my question to the whole panel - why has there not been a fundamental change that will make the legal system in Mexico more efficient, and deal with problems in the judicial system and in enforcement?

LUBRANO: Let me make the question even more pointed. The U.S. in the 1950s wasn't much better off than Mexico is today, in terms of our laws concerning secured transactions. It was a mess; it was not efficient. The Uniform Commercial Code revolutionized the granting of security interests in the U.S. and revolutionized the granting of credit to small and medium sized business. The legal profession, in the form of the National Conference of Commissioners on Uniform State Laws and the American Law Institute, developed, drafted, and convinced the legislatures in all 50 states to adopt the U.C.C.[8]

AIZA: I do not see how any politician in Congress would take on the task of modifying commercial laws in order to facilitate the perfection and foreclosure of security interests. Even though the majority of us here, the legal profession, and the banking or financial community generally all understand that such reform would bring an enormous benefit to the country in making consumer loans more accessible to large, middle-sized, small companies. Politically, in a country with a

8. See PRENTICE-HALL ENCYCLOPEDIC DICTIONARY OF BUSINESS LAW 570 (4th ed. 1966).

demographic structure such as Mexico's, it is difficult for any politician to exercise the courage and true vision of embarking on that responsibility. That would carry a very high political cost. I know of no politician who is willing to give up his or her career in order to make things better, so I guess until that happens it will be a slow process. I hope we get there at some point, but in my personal opinion that is the major problem; that is the heart of the problem right now.

LUBRANO: One need only look at what happened to bankruptcy reform. What SECOFI did in 1994 was at least ready to be considered. Unfortunately, it came to light on the heels of the banking crisis when the bankers were demonized and scapegoated.

NADER: In all fairness, the new law was brought about at the wrong moment like many things we do in our country. Politically if it could have emerged just one year before 1995, it might not have been adopted but I think it would have worked. It is necessary to draw a distinction, self-help is many years away. Though I have no answers, I think the emphasis should be placed on creating a more predictable, more user-friendly filing system and a layer of adequate collaterals that a reasonable person could understand. There is going to be a gap between that enhancement and self-help but movement toward a more modern registration system would be significant progress.

Mike touched on an important point in mentioning the monopolistic position that pre-eminent companies have in Mexico. I would add that financing is most needed at the middle of the layer. To look at our system, the largest 100 companies, one way or another already, have access to international capital. The people who are buying their appliances and their bedspreads and tables also have access to financing, at an astronomic rate, from commercial companies. The void is in the middle and that will only change if we move towards a more reasonable system.

BERDEJA: I agree with what Michell and Carlos just said. I would add that any attempt to come up with a new bankruptcy code, if it parallels the way that the Ministry of Trade dealt with it (ie. ". . . as between friends and we will just let the people know once we are ready to pass it"), is going to fail. It will fail unless consensus is achieved and the rights and situation of creditors and borrowers are considered. There is no reason why any group of five people, however smart and experienced they are, should be able to rule on this for the country.

OWEN: We will now open the floor to questions.

JIMMIE REYNA, Stewart & Stewart, Washington, D.C.: I just came from Santiago, Chile, where there was a meeting of the Coalition of Service Industries discussing the impact of electronic commerce on trade and services, and banking was one of the big areas. With respect to this discussion, I was wondering what the role of electronic commerce and advances in information technology have in improving Mexico's financial infrastructure?

LUBRANO: That question can be addressed in the context of one of the important items we were discussing, the registration system. Agustin had mentioned improving the registration system in both real estate assets and movable assets. A concept similar to that of the U.C.C. filing in the United States would improve the information available for lenders in the Mexican market. That is an issue of asset securitization.

New technology can be used to improve efficiencies in the creation and perfection of security interests. I do not think it can be used to enforce rights or remedies generally, but at least to perfect it and make it more accessible. There have been some important improvements in the past few years in connection with real property registries in several jurisdictions in Mexico. This not only impacts real estate but also the creation and true implementation of a U.C.C.-equivalent filing system in Mexico to create the concept of blanket liens, which as such does not exist except for the industrial mortgage to which Agustin referred. Improving access to true updated information and consumer lending will improve the financial services generally. It will also improve the bottom line cost for the borrowers, from the top companies to small consumer loans.

AIZA: My view of this is that as long as the decision-making process within Mexican banks does not change, all these improvements, while very important, are not going to mean much. Let me give you two examples.

In one recent case, one client had bad credit reports about a potential borrower. While we were discussing that, a more senior credit officer said, "This company is owned by Mr. X, who is a major shareholder of this bank." So the information was there. Everyone knew that, at least from the point of view of the borrower's morals and payment history, he was not a good candidate for credit. Because he was a major shareholder, he got the loan.

A second instance emphasizes the need for better credit analysis. Even though there was a bad credit report on a company, the credit officer authorizing the transaction said, "I like the collateral. I am comfortable with the collateral." So it is important; information matters. While it is going to improve the system, it is still necessary to change the way decisions within the banks are made.

JOHN ROGERS, Carlsmith Ball, Mexico City: I find it highly ironic that on the one hand in Mexico today, the banks and the bankers are being demonized for all kinds of failings, and at the same time the banks as institutions have all kinds of privileges. It seems to me that one small step in the direction of improving the system would be to take the industrial mortgage and make it available to institutions or creditors other than banks, including foreign institutions. We have seen the industrial mortgage has a number of advantages in terms of establishing a floating lien on all kinds of assets including inventory and receivables, which are the most liquid kind of assets. It seems to me that would create a greater, more reliable security interest than some of the alternatives. It would also put competitive pressure on the banks to be more efficient, exercise better credit judgment, and emulate some of the competitors that they would have to be dealing with. I am wondering what the views of the panel are on that.

BERDEJA: I agree with you in general, John. I do not see why only Mexican banks should have access to that kind of collateral. I also like the idea of fostering competition by making it available to other institutions. Those who would price their loans in a better way and maybe be more reasonable in the general terms of the loan would get the client.

MONTES: To a certain extent that would address the problem that it is sometimes a great challenge for Mexican lawyers to create a good security interest in movable assets, especially liquid assets because we do not have the concept of the floating or blanket lien. I would not want to lose those challenges. If it does address the issue of perfecting the security interest, enforcement can be emphasized. It is a very challenging problem because it has political implications and constitutional issues, which require a lot of time, a lot of political will and work to get done. I think that is an easy change with which to begin. It should not be a problem. Take advantage of technology to create the system, and then amend a couple of articles in a couple of statutes to get that done.

LUBRANO: I agree with that too. However, there are a lot of good reasons for banks to be treated differently than non-bank financial institutions, but there are no good reasons for bank shareholders to be treated differently than shareholders of non-bank financial institutions concerning government policy. What we have seen in Mexico is disparity in treatment between bank and non-bank financial institutions, both of which suffered from the same problems of non-payment of their loans. If non-bank institutions were not affiliated with a bank, the Mexican government let them go the way of the market, and their shareholders were completely wiped out. Meanwhile, if you go to the annual meeting of the Mexican Bankers Association, you will see the same faces every year. Their shareholders did not get wiped out. Sure they got hurt, but they should have suffered complete losses in the same way as the non-banks. Until you beat that, every time you have a cyclical problem the banks are going to have a competitive advantage.

OWEN: We will end on that. I want to thank John Stephenson for putting together a very astute hypothetical, and the rest of our distinguished panel for gleaning out the issues and giving us a very good discussion.

ANNEX 1

CASE STUDY

FACTS: Empresas Bonas, S.A. de C.V., a Mexican company (the "Company") manufactures several products in Mexico for sale to the Mexican and foreign markets. The Company's customers outside Mexico are major international companies, most of which could be considered to have a AA or AAA credit rating. The Company's export sales make up 65% of its total sales. Mexican customers of the Company are large, well funded and prosperous. But because of rapid growth, the Company has insufficient working capital and, if it continues to grow as rapidly as it has during the last year, could be unable to pay its suppliers and its lenders as the Company's debts become due. In addition, the costs of the materials used in the manufacturing process and in producing its inventory are increasing at a rate faster than the rate of increase of the prices of its products. Moreover, the Company has some short-term, high interest rate Mexican peso debt that it would like to replace with lower priced debt.

The Company has purchased equipment that is state of the art for its business. It financed this equipment partially (30%) with Mexican peso loans that are secured by the equipment, and partially with some of the long term debt that is unsecured. The loans are all guaranteed by four of the members of the family that controls about 60% of the shares of the Company.

The Company's competitive advantages include low labor costs, low energy costs, access to the large U.S. market, an improving position in the South American market, and high growth industries in Mexico and the U.S. that need the Company's products.

The two primary suppliers of materials to the Company, which have been providing 90 day credit to the Company on purchases made by the Company, have both decided that they will not sell to the Company unless the Company pays at least one-half of the purchase price upon delivery of materials and the other one-half within 30 days after delivery.

The market for sales of the Company's products requires the Company to sell on credit to its customers, and the Company must give net 90 day terms to its customers outside Mexico and net 110 day terms to its Mexican customers. The products of the Company are in demand because of a shortage on the world market, although competition internationally is strong. The Company intends to double its sales in the next three years.

NEEDS: The Company needs additional working capital, needs to refinance its high rate Mexican peso short term debt, and also needs to refinance its existing long-term debt, which is coming due over the next five years in amounts each year that are projected to be more than projected annual cash flow, considering the working capital deficit, capital needs and increasing costs, unless the increase in sales changes the projections (The Company has not projected in its financial projections that it will increase its sales by doubling them in three years, even if that is the Company's goal). The four family members desire to be relieved of their personal liability on Company debt. The Company needs to upgrade its existing facilities or build a new manufacturing facility if it desires to continue its growth, because its existing facilities are running at close to maximum capacity in their present configuration.

PANEL RESPONSIBILITY:

The panel represents the lenders and/or investment bankers that have been approached by the Company for financing. Several different types of lenders have been approached: Mexican banks, U.S. banks, Spanish banks, U.S. asset based lenders, U.S. insurance companies, U.S. pension plans (exempt from income taxation in the U.S., some of which are registered as foreign financial institutions under Mexican law), both government and private, private investment funds that have raised money to invest in Mexico, and European institutions that combine both investment banking and banking functions.

Based upon the limited information available in this case study, the panel is to discuss alternative methods of financing the growth of the Company, considering that the existing creditors of the Company are becoming increasingly more anxious about the financial viability of the Company. The panel should focus upon working capital and short term financing, structured financing possibilities and other methods of financing the Company's operations. Where additional assumptions are necessary, the panel should state these assumptions as part of their comments.

What are the alternatives available for financing the Company's operations (other than through the equity market) and the legal issues involved in financing the Company using inventory, receivables and/or equipment of the Company as collateral.

Which financial institutions are the best suited to provide financing for the Company? Why? Contrast the approaches of the various financing entities? What advantages do Mexican banks have, if any? Do foreign financial institutions have any advantages in the competitive market?

What Mexican laws could be changed that would make it easier for the Company to obtain financing from foreign lenders if collateral consists of inventory, receivables and/or equipment? What specific changes could be made? What other collateral would be viable for a foreign lender? Attached is a copy of the proposed law dealing with Mexican secured financing—is it or some alternative a viable approach for Mexico?

How would one approach the securitization of assets of the Company, so that it could receive dollar loan or sale proceeds that could be financed by dollar receivables to be created over the next five years?

What bankruptcy issues must be considered by legal counsel for the lenders in structuring financing to be made available to the Company? What liability concerns face the directors of the Company if the Company must file for *suspension de pagos*? Are there standards the directors must meet in arranging for financing, in case the Company is not able to meet its payment obligations even after the financing is obtained? How difficult are the bankruptcy issues to overcome?

What are the most difficult legal issues that must be addressed in developing a financing plan that will enable the Company to grow its business in business circumstances that are basically positive? How are these problems being solved presently? Are there alternative approaches that are successful even though the approaches are different?