3-1-1997

General Goods: A Case Involving Security Interests in Inventory and Accounts in the United States, Canada, and Mexico

John E. Rogers
Carlos de la Garza-Santos

Follow this and additional works at: http://digitalrepository.unm.edu/usmexlj

Part of the International Law Commons, International Trade Law Commons, and the Jurisprudence Commons

Recommended Citation
Available at: http://digitalrepository.unm.edu/usmexlj/vol5/iss1/4
GENERAL GOODS: A CASE INVOLVING SECURITY INTERESTS IN INVENTORY AND ACCOUNTS IN THE UNITED STATES, CANADA, AND MEXICO

JOHN E. ROGERS* and CARLOS de la GARZA-SANTOS**

INTRODUCTION

One useful way to understand the differences between the laws of different countries is to work through those differences in a hypothetical case involving both or all of such countries. Following is a suggested case involving the secured transactions laws of the United States, Canada and Mexico, insofar as they relate to inventory and accounts receivable. This hypothetical case is based upon a real case in which the parties decided not to rely on collateral security in Mexico because of the uncertainties in Mexican commercial law.

FINANCING THE NEEDS OF GENERAL GOODS CORPORATION

General Goods Corporation (GGC) is a Delaware corporation¹ engaged in the business of manufacturing and distributing a variety of products, the most significant of which are parts for farm equipment and vehicles. GGC's headquarters and main manufacturing plant are located in Topeka, Kansas, but it has sales offices in ten states in the United States. Its operations in the United States have resulted in sales of approximately US$500 million per year in the last two years.

GGC began a few years ago to establish foreign operations; it formed a Canadian subsidiary, General Goods of Canada, Limited (GG Canada), based in Saskatoon, Saskatchewan, in 1991 and a Mexican subsidiary called General Goods de México, S.A. de C.V. (GG Mexico), domiciled in San Luis Potosí, S.L.P., in 1993. Both GG Canada and GG Mexico have manufacturing plants for producing GG brand products. GG Canada’s plant and chief executive office are located in Saskatoon but it has sales offices in Alberta, British Columbia, Manitoba and Ontario. GG Mexico’s manufacturing facility and chief executive office are located in San Luis Potosí but it also has sales offices in the States of Aguascalientes, Guanajuato, Jalisco and Nuevo León and in Mexico City, Federal District.

---

* John E. Rogers received a B.A. from Harvard University and a J.D. from the Columbia University. He was admitted to the New York State Bar in 1971 and is currently the resident partner in Mexico City of Carlsmith Ball Wichman Case & Ichiki.

** Carlos de la Garza-Santos is a partner of Santos-Elizondo-Cantú Rivera-García-González-de la Garza, S.C. a Law Firm of Monterrey, N.L., Mexico.

¹ And largely the product of the authors' imagination.
GGC has decided to expand its manufacturing and sales operations in dramatic fashion over the next three years, and in that connection it has determined to replace a variety of existing working capital loans with a single three-year US$300 million secured credit facility to be offered by Large City Bank, N.A. (Bank), based in New York City.

The Bank has asked its New York counsel to prepare a Secured Revolving Credit Agreement (Credit Agreement) between the Bank and the three GGC entities as borrowers (collectively, the Borrowers); and each Borrower will guarantee the obligations of the other Borrowers, subject (in the case of GG Canada and GG Mexico) to certain limitations related to their net worth. The Credit Agreement will be governed by New York law, and the Borrowers will each submit to the jurisdiction of the New York State and Federal courts in connection with any legal actions that may be brought by the Bank against any of them with respect to their obligations under the Agreement.

Borrowings under the Credit Agreement by GGC will be used to finance its operations in the United States, and the borrowings by GG Canada and GG Mexico are to be used to finance their operations in Canada and Mexico, respectively. Of the US$300 million to be available for borrowing under the Credit Agreement, up to US$60 million will be available to GG Canada and up to US$50 million will be available to GG Mexico. However, in any case, borrowings by any Borrower may not exceed its Borrowing Base, as defined in the Credit Agreement to mean 80% of the current book value of the respective Borrower’s inventory and accounts receivable.

One of the conditions precedent to borrowing under the Credit Agreement is that the Bank obtain evidence satisfactory to it that a “first priority security interest” in favor of the Bank has been created and perfected, under the applicable laws of the United States, Canada and Mexico, with respect to all of the inventory and accounts receivable of GGC, GG Canada and GG Mexico. The Bank’s New York counsel is familiar with the provisions of Article 9 of the Uniform Commercial Code in the United States but has been asked by the Bank to also determine what the requirements for creating and perfecting such security interests are under the laws of Canada and Mexico as well. Legal opinions will be required on such matters, among others, as an additional condition precedent to borrowing under the Credit Agreement.

I. SECURITY INTERESTS IN INVENTORY AND ACCOUNTS IN THE UNITED STATES

In the United States, state law governs the creation and perfection of security interests in personal property such as inventory and accounts receivable (sometimes called “accounts”). Each state in the United States has adopted its own version of the Uniform Commercial Code (U.C.C.), Article 9 which governs secured transactions affecting personal property.2

---

2. U.C.C. § 9 (1972) The most recent version of the U.C.C. Article 9 is the 1972 Official
Despite some variations from state to state, each State's version of Article 9 provides for a relatively simple method of creating and perfecting security interests in inventory and accounts receivable.

Article 9 permits a security interest to be created in favor of a creditor or "secured party" with respect to various types of personal property, without necessarily requiring the secured party to have possession of the property in order for the security interest to be perfected. A non-possessory security interest can be created with respect to property of a general type—such as "all inventory and accounts receivable of the debtor"—without having to identify the individual items of property that fall within the general category, and need not be limited to the property of the specified category which is currently owned by the debtor but may also include property which is subsequently acquired by it. It is not necessary to separately perfect security interests in the later acquired property (so long as the financing statement specifies that it covers after-acquired property)—because, in effect, a "floating lien" attaches automatically to the after-acquired property at the moment of acquisition. Nor is it necessary to effect subsequent perfections to ensure that the security interest secures subsequent loans or extensions of credit, sometimes called "future advances".

A non-possessory security interest in inventory or accounts receivable of a debtor is created through an appropriate "security agreement" between the debtor and the secured party which adequately describes the obligation to be secured and the property items or types to which the security interest is to apply. The security interest is perfected by the filing of a "financing statement" in the appropriate filing office of the state where the inventory is located or (with respect to accounts receivable) where the chief executive office of the debtor is located.

The financing statement is a simple form which must contain the names and addresses of the debtor and secured party, a description of the items or types of property covered and whether products or proceeds of the collateral are also covered, and in most cases must be signed by the debtor and secured party. The financing statement must be filed, in the

Text which has been adopted by all 50 States. However, the Permanent Editorial Board for the U.C.C., established by the National Conference of Commissioners on Uniform State Laws and the American Law Institute, created a Study Committee to consider possible revisions to Article 9, and the Study Committee released its report as of December 1, 1992. A Drafting Committee has been working on the recommendations since 1993, and presented discussion drafts at the National Conference's annual meetings in the summers of 1995 and 1996. Unless otherwise indicated, references herein to the U.C.C. shall be deemed to refer to the 1972 Official Text. See RICHARD F. DUNCAN & WILLIAM H. LYONS, THE LAW AND PRACTICE OF SECURED TRANSACTIONS: WORKING WITH ARTICLE 9, at 1-4 to 1-8 (1996).

3. U.C.C. § 1-201(37) ("An interest in personal property or fixtures which secures payment or performance of an obligation.").
5. U.C.C. § 9-204(1).
6. U.C.C. § 9-204(3).
7. U.C.C. §§ 9-203(1)(a), 9-302(1).
case of inventory and accounts receivable, with the office of the Secretary of State of the relevant state and, where required in a particular State, in the applicable county recording office.10

In this case, based on representations and warranties that are to be made by GGC in the Credit Agreement, New York counsel for the Bank has determined that inventory of GGC is located in Kansas and nine other states in the United States, and that the chief place of business of GGC is in Kansas.11 Consequently, financing statements are prepared, using the forms prescribed by the ten states in question, describing the property to be covered thereby as “All inventory and accounts receivable of the debtor, whether now owned or hereafter acquired.” The financing statements all list the debtor’s address as its chief place of business in Kansas. A filing fee must be paid to each filing officer, which in most cases does not exceed US$15.00 per financing statement. Once filed, the financing statement generally remains effective for a period of five years from the date of filing.

In order for the Bank to be assured that it has a “first priority security interest” in GGC’s inventory and accounts receivable, i.e., that no other security interests have been perfected against the inventory or accounts receivable of GGC, the Bank will obtain, prior to closing of the initial borrowing under the Credit Agreement, but normally after the filing of the Bank’s financing statement, a search certificate or information statement from the filing office in each state where financing statements were filed by the Bank against GGC’s inventory and accounts receivable. The filing office of each state will certify as to all financing statements on file against GGC with such filing office as of the date of the certificate. If such certificate or statement shows the filing of the financing statement of the Bank and no other financing statement with respect to the inventory or accounts receivable of GGC, the Bank can be reasonably certain that it has a first priority security interest in such property (including any thereof which is after-acquired), to secure the obligations of GGC, including those with respect to future advances, under the Credit Agreement, subject to certain exceptions which are beyond the scope of this discussion.12

The foregoing roughly indicates what the Bank’s counsel will have to verify before he can be assured that the Bank has a perfected first priority security interest in GGC’s inventory and accounts receivable in the United States.13 But there is still the question of how such perfection is to be

11. A sample Financing Statement is included as Appendix A to this Article.
12. The legal opinions to be delivered at the closing as to the U.C.C. filings will contain certain rather standard qualifications, which will probably not prevent the Bank from concluding that it is adequately protected as a secured party. Attached as Appendix B is a possible form of legal opinion to be required from the Bank’s “special Uniform Commercial Code counsel” in one of the states in question.
13. The question of priority is one that is difficult for counsel to cover in a legal opinion, because of the possibility that mechanic’s liens and other unrecorded liens exist with respect to the
achieved in Canada and Mexico. If comparable perfection cannot be achieved with respect to the inventory and accounts receivable of GG Canada and GG Mexico, those companies will not be able to borrow under the Credit Agreement. In this connection, the Bank’s counsel contacts his colleagues in Toronto and Mexico City. What he learns from them is set forth below.

II. SECURITY INTERESTS IN INVENTORY AND ACCOUNTS IN CANADA

In Canada, as in the United States, the creation and perfection of security interests in personal property is a matter of local rather than Federal law. The seven most populous Anglophone Provinces in Canada, as well as the Yukon Territory, have adopted the Personal Property Security Act\textsuperscript{14} [P.P.S.A.], under which a non-possessor security interest in inventory and accounts receivable may be created by a written security agreement and perfected by the registration of a financing statement with a Provincial registration office. Registration is subject to the payment of a nominal flat registration fee, and registration may be for a period of one to twenty-five years (or forever, against payment of a slightly higher fee).\textsuperscript{15}

As under the U.C.C., it is not necessary to register a copy of the security agreement together with the financing statement. In some provinces, the registration of the financing statement may be made electronically, through on-line connections with the registration office. Registration as to inventory must be in the Province where the inventory is located, and registration as to accounts receivable must be in the province where the chief executive office of the debtor is located.\textsuperscript{16}

Most of the key concepts relevant to the creation and perfection of security interests in inventory and accounts receivable under the P.P.S.A. are similar to those contained in the U.C.C. A financing statement with respect to inventory and accounts receivable may cover after-acquired property and future advances. The description of property may be of general types rather than of specific items.\textsuperscript{17}
Based on the foregoing, the Bank’s New York counsel arranges with his colleagues in a Toronto law firm to have financing statements prepared to cover GG Canada’s inventory and accounts receivable, for registration with the Provincial Personal Property Registries in Alberta, Manitoba, Ontario and Saskatchewan, the Provinces where GG Canada has indicated its inventory is located and (in the case of Saskatchewan) where its chief executive office is located. Canadian counsel is to review the GG Canada security agreement to ensure that it satisfies the requirements of the P.P.S.A. in all of the applicable provinces.

After the financing statements are registered in the four Provinces, the Bank will file a request for a report on all existing financing statements registered with the applicable Registries. After consultation with Canadian counsel on the issue, the Bank’s New York counsel expects that, if such reports show the registration of the Bank’s financing statements, and no others, against the inventory and accounts receivable of GG Canada, the Bank will have a perfected first priority security interest against the inventory and accounts receivable of GG Canada, including those acquired subsequently, to secure the obligations of GG Canada, including future advances, under the Credit Agreement.18

III. SECURITY INTERESTS IN INVENTORY AND ACCOUNTS IN MEXICO

Upon contacting counsel in Monterrey, Nuevo Leon, Mexico, the Bank’s New York counsel learned that the Mexican laws related to secured transactions were not as similar to the U.C.C. as were the Canadian laws embodied in the P.P.S.A. in various provinces of Canada. For one thing, it appeared that there was no single unified law governing such transactions. The first challenge appeared to be to decide which approach to creating a security interest would be best for this transaction.

There seemed to be at least six possibilities: (1) a “commercial pledge” of the inventory and accounts receivable [prenda mercantil]; (2) a “chattel mortgage” with respect to the inventory and accounts receivable [hipoteca] (in Mexico, there are no qualifying terms to distinguish the mortgage of personal property and the mortgage of real property); (3) a “guaranty trust” covering the inventory and accounts receivable [fideicomiso de garantía]; (4) a special financing device called the “production credit” [crédito de habilitación o avío]; (5) another special device called the “installation credit” [crédito refaccionario]; and (6) an “industrial mortgage” [hipoteca industrial] covering virtually all of the debtor’s property, including its inventory and accounts receivable. Each possibility needed to be analyzed to determine which would be the most appropriate for this transaction. Some of the approaches involved non-possessory security interests and floating liens such as those available under the U.C.C. and

18. As in the case of the closing opinion or opinions on the U.C.C. filings, the Canadian closing opinion will contain certain qualifications which are not expected to be overly troubling to the Bank.
the P.P.S.A., but others did not. At the outset, this meant that the Mexican part of the transaction would be more complicated than the U.S. and Canadian portions had been, at least insofar as collateral security was concerned.

A. THE COMMERCIAL PLEDGE

Mexican counsel advised that inventory and accounts receivable could both be the subject of a commercial pledge \([\text{prenda mercantil}]\) under Article 334 of the General Law of Credit Instruments and Transactions \([\text{Ley General de Títulos y Operaciones de Crédito}]\). However, the procedure seemed to be rather cumbersome, and in each case required specific collateral to be delivered to the creditor. If the accounts receivable were not negotiable by endorsement, the pledge could be constituted only by delivery to the creditor of the invoices or other documents evidencing the accounts receivable, and notification of the account debtor had to be effected either through a public deed executed before a notary public, or before two witnesses.

A commercial pledge of the inventory was theoretically possible, but required that the inventory be either delivered to the creditor, to a third party designated by the parties and answerable to the creditor, or to places subject to the control of the creditor (to which it has the keys) even though owned by, or located within the premises of, the debtor. There is a common practice, in order to comply with Section IV of Article 334 of the L.T.O.C., which is to appoint an employee of the debtor as depository of the goods. In this way, if the goods are sold without the consent of the creditor, the depository may be subject to criminal sanction. Under such a threat, he will normally act diligently. Furthermore, if the collateral remains in the possession of the debtor, a filing before the Public Registry where the debtor is incorporated is required (in this example, the State of San Luis Potosí). In such case, the lien created under the pledge will remain effective as to any purchaser. This is of course very inconvenient for the ordinary operation of the business. There are still some questions about the legal validity of such an arrangement related to whether such an appointment falls within the spirit of Section IV of Article 334. The whole idea behind this section is to have someone representing the interests of the creditor, and an

---

19. A civil pledge, or pledge under the provisions of the applicable Civil Code, did not seem possible, since both the debtor and creditor are commercial companies, and the transaction in question is an "act of commerce" governed by the General Law of Credit Instruments and Transactions.
21. Pursuant to the other provisions of article 334 of the L.T.O.C., the pledge is constituted: I) By delivery to the creditor of the goods or credit instruments, if such instruments are issued to the bearer. II) By the endorsement of the credit instruments on behalf of the creditors, if such instruments are nominative . . . . [i.e., issued in their name].
employee of the debtor is likely to have his first allegiance to the interests of the debtor.

The practical consequences of the delivery or possession requirement would be numerous: the operations of GG Mexico would be disrupted by requiring it to deliver its property to the Bank and then to seek releases when the property had to be disposed of in the ordinary course of business; the commercial pledge could not represent a "floating lien" on all of the debtor's inventory and accounts receivable existing from time to time, but rather each newly acquired item would have to be the subject of a new pledge by delivery to the creditor or agent for its disposition; and the creditor's consent would have to be obtained before any items of collateral could be released from the pledge and disposed of by the debtor. As for the accounts receivable, there was the troublesome requirement of notification of account debtors.

These limitations on the use of a commercial pledge appeared to make it impossible for this transaction, so the Bank's New York counsel asked his Mexican counterpart to describe the other devices.

B. THE CHATTEL MORTGAGE

The next approach to be considered was the mortgage [hipoteca] as it applied to personal property or chattels. The mortgage concept has long been identified solely with real property, and it appeared that a mortgage has rarely been used with personal property such as inventory and accounts receivable. The mortgage is a device governed by the Civil Code, even when (as here) it secures a commercial transaction. Unlike the commercial pledge, the chattel mortgage is a non-possessory device, and therefore it might not be as disruptive of GG Mexico's operations as the commercial pledge would be (at least insofar as physical possession of the property was concerned). In case of default, the creditor secured by a first mortgage has the right to be paid out of the value of the assets covered, except in the case of the bankruptcy of the debtor, in which case, the order provided in the Bankruptcy Laws must be followed. However, perfection of the chattel mortgage requires recordation of a notarial deed with the Public Registry for Property and Commerce in each of the States of Mexico in which the property is located, at least when the amount secured exceeds a relatively modest threshold level. The public deed must identify the individual accounts receivable and items of inventory with specificity; a general reference to "all inventory

---

23. L.T.O.C. art. 335 (permits the pledge to cover after-acquired "fungible" goods, but it is not clear that GG Mexico's products would be treated as fungible).
26. The Public Registry for Property and Commerce [Registro Público].
27. C.C.D.F. art. 2917.
and accounts receivable, whether now owned or hereafter acquired" is not sufficient.\textsuperscript{28}

The lack of a floating lien feature means that the chattel mortgage presented the additional problem of having to separately record supplemental mortgages against newly acquired items and to record releases of items that the debtor wished to dispose of. This would involve not only the legal expense of preparing the supplemental deeds and release documents, but also the payment of additional filing fees, which could be substantial. The Bank's counsel was also concerned with what appeared to be a difficult problem with performing searches as to existing liens. The Public Registries in certain places in Mexico did not seem to be very reliable, and at the very least seemed difficult to utilize. As in the United States with respect to the inventory and accounts receivable of GGC, to determine whether other chattel mortgages had been recorded against the property of GG Mexico would require performing a search in the Public Registry of each state in which GG Mexico had operations. However, unlike in the United States, the search of the records of a Public Registry in Mexico which focused on GG Mexico's name would not necessarily show all recordations with respect to its property, because some of such recordations might have to be located by reference to the locations thereof rather than by reference to the debtor's name.

After reviewing the elements of a chattel mortgage on inventory and accounts receivable, the Bank's New York counsel concluded that it presented at least as many problems as the commercial pledge. As a consequence, the Bank's counsel turned to the next possibility on his list, using a guaranty trust.

C. \textit{THE GUARANTY TRUST}

Using a trust mechanism offered one possible advantage over all of the other approaches: by the debtor transferring title to the subject property to a trust created for the purpose of serving as collateral security or a guaranty \textit{[fideicomiso de garantía]}, which would return the property to the debtor or its designee only upon payment of the debt, the Bank might obtain a stronger position in the event of the debtor's bankruptcy or insolvency.\textsuperscript{29} With title to the property in the name of the trust, other creditors of the debtor might be prevented from requiring that the property be treated as part of the debtor's estate in a bankruptcy or insolvency proceeding.

It appeared, however, that a price would have to be paid for such an advantage. For one thing, as with most other approaches, a notarial deed or at least a ratification of signatures by the notary would have to be required, in this case to document the trust agreement between the settlor/debtor \textit{[fideicomitente]} and the trustee \textit{[fiduciario]}, although the deed would not have to be recorded with the appropriate Public Registry.
unless it also covered real property. The trust agreement would have to be carefully prepared and negotiated, to ensure that the creditor/beneficiary would have a clear right to require the trustee, in case of any default under the Credit Agreement, to transfer title to the property to the creditor.

In addition, it was not clear that a floating lien could be created through a guaranty trust, and periodic transfers and releases of the inventory and accounts receivable might complicate the business operations of GG Mexico.

The Bank’s counsel, still holding out a hope that he might find a Mexican security device with fewer potential pitfalls and complications, turned his attention to the next approach on Mexican counsel’s list.

D. THE PRODUCTION CREDIT

The production credit [crédito de habilitación o avío] is a device under the L.T.O.C. for collateralizing credits that can be said to finance the direct and immediate costs of production by a debtor. Under this approach, the production credit is secured by the raw materials and equipment acquired with the proceeds of the credit, whether present or future. Thus, this is a security device that seems at first impression to have the characteristics of a floating lien, distinguishing it from the commercial pledge, the chattel mortgage and the guaranty trust. However, this is not the case. Article 326, Section II, of the L.T.O.C. requires that the assets to be given as collateral must be very particularly described, thus precluding the use of a general reference to after-acquired property as permitted in the United States and Canada. In addition, like the chattel mortgage and guaranty trust, the production credit must be evidenced at least by a notarial ratification of the signatures of the parties and recorded with the Public Registry for the place where the property is located.

The Bank’s counsel wondered if this device would really be appropriate given the structure of the Bank’s transaction with the three Borrowers. The production credit would have to be subject to its own credit agreement, which might require substantial modifications of the Credit Agreement already prepared for the overall financing for the General Goods group, and there would still not be a floating lien on the subject property.

Also, consideration would have to be given to how well the borrowing base requirement, the cross-guarantee aspect and other elements of the Credit Agreement could be incorporated into a separate credit agreement with GG Mexico.

Any proceeds of a production credit, which are not used to acquire the specific types of property required under the L.T.O.C. to be covered

32. L.T.O.C. art. 326, IV.
thereby, run the risk of not being secured by the lien created by the device. This made the Bank’s New York counsel somewhat nervous.\footnote{33. Article 321 of the L.T.O.C. defines this type of transaction as an agreement by which the debtor is obligated to invest the amount of the loan in the acquisition of raw materials, payment of salaries and direct expenses that are necessary to carry out the purposes of the company. In our hypothetical case, the purpose of the credit is to finance working capital and therefore falls precisely within the scope of the above definition. The importance of this type of instrument is that pursuant to article 322, the Habilitacion or Avio credits as a matter of law are secured by the raw materials purchased and the products acquired with the credit. The question here, is whether the finished product, in other words, the inventory, falls within the scope of the definition. It would make little sense to interpret the law in a very narrow way thereby excluding finished products produced from the raw materials. In many situations, raw materials are converted to finished products in just a few days. To place finished products outside the scope of the definition, would diminish the value of the guarantee. Unfortunately, the law is not clear on this point and there are no court decisions which give us further guidance.}

Before making a decision, the Bank’s counsel turned to the next device on the list.

\textbf{E. THE INSTALLATION CREDIT}

The installation credit [crédito refaccionario] is similar to the production credit in the sense that it does not create a floating lien on the subject property. It also involves similar documentation, embodied in a document duly ratified by a notary and recorded with the relevant Public Registry for the place where the property was located.\footnote{34. \textit{Id.}} Another similarity is that the installation credit must satisfy specific purpose requirements. Unlike the production credit, the installation credit must be for the purpose of financing preparation for production, through, for example, the acquisition of production equipment or the preparation of land for farming. It appeared that the collateral secured by an installation credit would be primarily the debtor’s fixed assets, equipment and improvements, and the proceeds obtained by the debtor. There is still a question as to whether or not “proceeds” means the inventory and accounts receivable of the debtor.

As in the case of the production credit, the use of any portion of an installation credit for the acquisition of property, other than those types specified under the L.T.O.C. to be covered, would run the risk of not being covered by the lien created by this device.

The limitations related to the purpose of the credit and the uncertainties about the assets to be subject thereto, together with the lack of a floating lien feature, led the Bank’s counsel to turn eagerly, perhaps desperately, to the next and last item on his list, the industrial mortgage.

\textbf{F. THE INDUSTRIAL MORTGAGE}

At first blush, the industrial mortgage [hipoteca industrial]\footnote{35. \textit{Ley de Instituciones de Crédito,” D.O., 18 de julio de 1990, as amended art. 67.}} appeared to be just what the Bank needed: it could cover inventory and accounts receivables; it had the floating lien aspect lacking in the other devices; it did not require a difficult analysis as to whether a purpose requirement...
would be satisfied; there would not be any third parties (such as trustees) to have to negotiate with; and the cost of preparation and recordation of the industrial mortgage at least appeared to be no greater than in the other approaches.

It was true that the industrial mortgage would cover more than just the inventory and accounts receivable of the debtor, but in this case GG Mexico seemed prepared to grant an industrial mortgage if that would satisfy the Bank's collateral requirement under the Credit Agreement.

Alas, it turned out that the Bank could not take an industrial mortgage in Mexico. Under the Credit Institutions Law, under which the device is established, only Mexican-incorporated credit institutions (banks) are entitled to be mortgagees under industrial mortgages. Given this news, the Bank's counsel turned back to the other five approaches on his list and, based on what he has learned about them from Mexican counsel, tried to formulate some advice to the Bank as to how to proceed with respect to GG Mexico.

G. HOW TO DECIDE?

Based on the foregoing, how should the Bank's New York counsel advise the Bank as to whether a first priority security interest can be created and perfected in favor of the Bank in the inventory and accounts receivable of GG Mexico?

It seems clear that such a security interest can be created, using any of a variety of devices. However, none of these devices resembles a U.C.C.-style security interest: (i) the commercial pledge, the chattel mortgage, the guaranty trust and the production and installation credits all lack the floating lien feature; (ii) the guaranty trust approach requires negotiating with a third party over the fees it will receive for its services and the documentation that will govern the relationship with it; (iii) the Bank is ineligible to take an industrial mortgage; and (iv) the production credit and installation credit present potentially difficult questions as to whether their respective purpose requirements can be satisfied and whether the proceeds from the sale of inventory and accounts receivable are part of the guaranty.

In light of these problems, the Bank's counsel was forced to conclude that it would not be possible for the Bank to obtain and perfect a "U.C.C.-style" security interest in the inventory and accounts receivable of GG Mexico. However, he expected that the Bank would ask him for practical advice as to which of the various devices would most closely resemble a U.C.C.-style security interest. In this connection, it appeared to him that the first question to resolve would be as to how important it was for the security interest to have the "floating lien" feature and be non-possessory in nature.

36. Id. A Credit Institution in Mexico is a bank incorporated under the laws of Mexico, whereas, in our hypothetical, the Bank was incorporated under the laws of the United States.
This was largely a business issue which, in the absence of a floating/non-possessory device, would depend on: (i) the ability of GG Mexico to accommodate its business operations to the need to periodically obtain releases of pledged property from the applicable lien or guaranty trust, and subject new property to the lien or trust arrangement through refilings with the Public Registry or additional transfers to the trustee; (ii) the ability of the Bank to administer a mechanism which would involve periodic releases and refilings with the Public Registry or additional transfers to the trustee; and (iii) the willingness of GG Mexico to pay the costs of the periodic releases and refilings or transfers, which appeared to be substantial.

Perhaps the most troubling overall conclusion the Bank's counsel arrived at was that the possibility of creating a guaranty trust in inventory and accounts receivable without recording it in the applicable Public Registry meant that even the most diligent search of such Registries would not necessarily reveal the existence of a guaranty trust created in favor of another creditor. This would make it virtually impossible to determine, through searches of such Registries, whether a non-possessory security interest in favor of the Bank was the first to be perfected. This seemed to mean that the only reliable security interest in inventory and accounts receivable would be a possessory one, which appeared impracticable from a business point of view.

After considering the above, and discussing it at length with officers of the Bank, the Bank's New York counsel senses that the Bank's credit officers will in the end despair of a solution and conclude that the inclusion of the inventory and accounts receivable of GG Mexico in the Borrowing Base under the Credit Agreement is not possible, because of the differences between Mexican law and the U.C.C. This will mean either that the closing under the Credit Agreement will not occur or that GGC will have to acquiesce in an amendment or modification to the Credit Agreement that will in effect eliminate the inventory and accounts receivable of GG Mexico from the calculation of the Borrowing Base. This will, perhaps, require GG Mexico to depend mainly on more expensive financing sources to satisfy most of its borrowing needs for the foreseeable future.

IV. CONCLUSION

This case should serve to illustrate the considerable differences between the secured transactions laws of the United States and Canada, on the one hand, and of Mexico on the other. These differences appear to make transactions like the hypothetical one with General Goods very difficult to carry out, at least insofar as the Mexican portion is concerned. They also constitute an obstacle to a variety of other types of transactions. Banks and other financial institutions in the United States and Canada that are accustomed to granting credit secured by inventory and accounts receivable will be reluctant to grant such credits to Mexican borrowers so long as these differences exist.
The awareness of such difficulties has led the National Law Center for Inter-American Free Trade (NLCIFT), in a recent study, to recommend sweeping legislative changes in Mexico that would tend to "harmonize" the secured transactions laws of Mexico with those of its NAFTA trading partners.\(^{37}\) In response to such recommendations, we have been informed that notarial organizations in Mexico have prepared draft amendments to the Commercial Code, the L.T.O.C. and other laws that would address some of the concerns cited by the NLCIFT study.\(^{38}\)

Representatives of the NLCIFT and the private sector have also met with representatives of the Mexican Government to discuss the prospects for legislative change. Currently the Mexican Bankers’ Association is working on proposed legislation that may go beyond the notaries’ proposals. It is to be hoped that legislation will be enacted soon in Mexico that will make a transaction like the one with General Goods less hypothetical and problematical.

**QUESTIONS AND COMMENTS BY INSTITUTE MEMBERS**

*Institute Member*: I’m a Mexican lawyer from Ciudad Juarez and a notary public. I should like to clarify something. I think that you have said things about the costs, and that you are afraid of notaries. I am going to tell you what the fees are in my state, Chihuahua. Notarial fees for one contract are about 0.3% of the amount of the contract. That is the maximum, not the minimum. Furthermore, there is always a way to negotiate and reach an agreement with the client. In Nuevo Leon they do not have a limit; in Chihuahua we have a limit. For the banks the limit is 7,500 pesos; that is about $1,000 for banks. For particular individuals, the limit is 3,500 pesos, so that is about $500. Thus, there is nothing to be afraid of in Chihuahua.

*John E. Rogers*: That is, of course, a little bit more than the $15 average U.C.C. filing fee in the United States.

*Institute Member*: Well, of course you have to take into account again the responsibility that the notary public in Mexico has. We are personally responsible for the legal content of the document, for the taxes that any case might cause, and for the payment to the federal or state offices.

*ROGERS*: That is a good point; there is no U.S. person in this transaction that plays the same role as a notary. However, the U.S. law firm has to give the legal opinion and may be held liable for its accuracy.

---

38. *Id.*
# A CASE INVOLVING SECURITY INTERESTS

## APPENDIX A

**FINANCING STATEMENT — FOLLOW INSTRUCTIONS CAREFULLY**

This Financing statement is presented for filing pursuant to the Uniform Commercial Code and will remain effective, with certain exceptions, for 5 years from date of filing:

<table>
<thead>
<tr>
<th>A. NAME &amp; TEL. # OF CONTACT AT FILER (optional)</th>
<th>B. FILING OFFICE ACCT. # (optional)</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>C. RETURN COPY TO: (Name and Mailing Address)</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>D. OPTIONAL DESIGNATION (applicable)</th>
</tr>
</thead>
<tbody>
<tr>
<td>LESSOR/LESSOR</td>
</tr>
<tr>
<td>-------------</td>
</tr>
<tr>
<td></td>
</tr>
</tbody>
</table>

1. DEBTOR'S EXACT FULL LEGAL NAME - insert only one debtor name (1a or 1b)

<table>
<thead>
<tr>
<th>1a. ENTITY NAME</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>1b. INDIVIDUAL'S LAST NAME</th>
<th>FIRST NAME</th>
<th>MIDDLE NAME</th>
<th>SUFFIX</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>1c. MAILING ADDRESS</th>
</tr>
</thead>
<tbody>
<tr>
<td>CITY</td>
</tr>
<tr>
<td>STATE</td>
</tr>
<tr>
<td>COUNTRY</td>
</tr>
<tr>
<td>ZIP CODE</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>1d. S.S. OR I.N. #</th>
<th>OPTIONAL ADDITIONAL INFO</th>
<th>1e. TYPE OF ENTITY OR COUNTRY OF ORGANIZATION</th>
<th>1f. ENTITY'S ORGANIZATIONAL ID. OR any other identifying number</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

2. ADDITIONAL DEBTOR'S EXACT FULL LEGAL NAME - insert only one debtor name (2a or 2b)

<table>
<thead>
<tr>
<th>2a. ENTITY NAME</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>2b. INDIVIDUAL'S LAST NAME</th>
<th>FIRST NAME</th>
<th>MIDDLE NAME</th>
<th>SUFFIX</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>2c. MAILING ADDRESS</th>
</tr>
</thead>
<tbody>
<tr>
<td>CITY</td>
</tr>
<tr>
<td>STATE</td>
</tr>
<tr>
<td>COUNTRY</td>
</tr>
<tr>
<td>ZIP CODE</td>
</tr>
</tbody>
</table>

3. SECURED PARTY (ORIGINAL, SUB or TOTAL ASSIGNED) EXACT FULL LEGAL NAME - Insert only one secured party name (3a or 3b)

<table>
<thead>
<tr>
<th>3a. ENTITY NAME</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>3b. INDIVIDUAL'S LAST NAME</th>
<th>FIRST NAME</th>
<th>MIDDLE NAME</th>
<th>SUFFIX</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>3c. MAILING ADDRESS</th>
</tr>
</thead>
<tbody>
<tr>
<td>CITY</td>
</tr>
<tr>
<td>STATE</td>
</tr>
<tr>
<td>COUNTRY</td>
</tr>
<tr>
<td>ZIP CODE</td>
</tr>
</tbody>
</table>

4. The FINANCING STATEMENT covers the following types or items of property:

5. CHECK BOX J if the FINANCING STATEMENT is signed by the Secured Party instead of the Debtor to perfect a security interest already subject to a security interest in another jurisdiction where it was brought into the State, or if the property covered by the document has been removed from another State, or if the security interest was changed in another State, or if the security interest has been perfected in another State, or if the additional data may be required:

6. REQUIRED SIGNATURE(S)

<p>| | | | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
</table>

7. FILLED IN HANDS (check one)

   [ ] Documentary
   [ ] Documentary Sample
   [ ] Sample
   [ ] Sample Non-Recalculable

8. The FINANCING STATEMENT is to be filed (or record) (or recorded) in the REAL ESTATE RECORDS

   [ ] If applicable

<p>| | | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
</table>

9. Check to REQUEST SEARCH CERTIFICATE(S) on Debtor(s) (Additional Fee (optional) $300)

   [ ] Debtor 1
   [ ] Debtor 2

(S) SECURED PARTY COPY — NATIONAL FINANCING STATEMENT (FORM UCC1) (TRANS.) (REV. 12/18/95)
APPENDIX B

[Letterhead of the Bank's UCC Counsel in the State of ]

[Date]

Large City Bank, N.A.
1000 Wall Street
New York, New York 10000

Re: General Goods Corporation; Credit Agreement

Gentlemen:

We have acted as your special Uniform Commercial Code counsel in the State of __________ in connection with the Credit Agreement dated as of __________, 199 (the "Credit Agreement") between Large City Bank (the "Bank"), General Goods Corporation ("GGC"), General Goods of Canada, Limited ("GG Canada") and General Goods de México, S.A. de C.V. ("GG Mexico" and, together with GGC and GG Canada, the "Borrowers"), pursuant to which the Bank agreed to lend up to U.S.$300,000,000 to the Borrowers, and that certain Security Agreement dated as of __________, 199 (the "Security Agreement") between GGC and the Bank. All terms used herein and defined in the Credit Agreement shall have the respective meanings ascribed to them in the Credit Agreement.

In rendering this opinion, we have examined copies of the following documents which you have transmitted to us by telecopy, and which we have assumed, with your permission, to be true and correct copies of the originals:

(i) The Credit Agreement;
(ii) The Security Agreement;
(iii) Uniform Commercial Code financing statements in the form of Exhibit to the Security Agreement (the "Financing Statements").

We have not acted for GGC or the other Borrowers and are not familiar with the affairs of any of them. We have not undertaken any independent investigation or review to determine the authenticity of the above documents or the accuracy of any statement contained therein, and no inference as to our knowledge of any matters bearing on the authenticity of the above documents or the accuracy of any statement contained therein should be drawn from the fact of our delivery of this opinion letter.

For the purpose of rendering opinions as to the obligations of GGC, we have, with your permission, relied solely and exclusively and without
independent inquiry on the opinion of GGC's Kansas and Delaware counsel both as to due authorization, execution and delivery by GCG of the Loan Documents to which it is a party, and as to the matters set forth in paragraph ___________of such opinion.

We have assumed that GGC is duly organized, validly existing and in good standing under the laws of the State of Delaware and in that connection we have, with your permission, relied exclusively and without independent inquiry on the opinion of GGC's Delaware counsel, _____ , Esq., regarding such matters. We have no knowledge that such opinion is erroneous and we believe it can be reasonably relied upon.

In rendering the opinion in paragraph 2, we have, with your permission, made the following assumptions, as to which we have not made any investigation: (i) that GGC has "rights" (as that term is used in Section 9-203 of the Uniform Commercial Code of the State of _________(the "UCC") in all of the Collateral (as that term is defined in the Security Agreement); (ii) that GGC has duly executed and delivered the Security Agreement and the Security Agreement describes the Collateral; (iii) that value (as that term is used in Section 9-203 of the UCC) has been given by the Bank to GGC; (iv) that there has been no agreement postponing the attachment of any security interest created pursuant to the Security Agreement; and (v) that the principal place of business and chief executive offices of GGC are located in Topeka, Kansas, and all assets which are part of the Collateral in the State of _________are located in the counties specified in the Security Agreement. Please be advised that if GGC changes its name or corporate structure or the place where its principal place of business or chief executive office is located, or the place where any of the Collateral is located in the State of _______, new financing statements may have to be filed, and continuation statements will also have to be filed at the appropriate time as set forth in the UCC in order to continue any such perfected status. In the case of property which becomes personal property collateral after the date hereof, please be advised that Section 552 of the Federal Bankruptcy code limits the extent to which property acquired by a debtor after the commencement of a case under the Federal Bankruptcy Code may be subject to a security interest arising from a security agreement entered into by the debtor before the commencement of such case. In addition, the continuation of a security interest in proceeds is subject to the provisions of Section 9-306 of the UCC. In addition, the opinion in paragraph 5 only relates to items which are of the type referenced to in Section 9-102(a)(1) of the UCC.

We have not made any investigation of the state of title to the Properties, Improvements, Equipment or other Assets of GGC, as such terms are defined in the Security Agreement. We are not rendering any opinion as to the state of title to the Properties, Improvements, Equipment or other Assets of Borrower, as to the priority of the Liens created by the Security Agreement, or as to due recordation or filing of such document.

Based upon and subject to the foregoing and to the matters set forth below, we are of the opinion that:
1. The Financing Statements are in appropriate form for filing with the Secretary of State of ___________ and the County Recorders of ______ and ___________ Counties.

2. With respect to those categories of assets listed on Exhibit "A" attached hereto, upon the filing of the Financing Statements duly executed on Form UCC-1 with the Secretary of State of the State of ______ and the ________ of ______ or __________ Counties, and to the extent any such assets are fixtures (as that term is defined in the UCC) with the [Recorder of Deeds] of the counties in which such fixtures are located, the Bank will have a duly created and perfected security interest in those assets. To the extent the Collateral includes money, or "instruments" (as such term is defined in Article 9 of the UCC), not constituting part of "chattel paper" (as such term is defined in Article 9 of the UCC), such as certificates representing shares of corporate stock, a duly created security interest is perfected by having possession thereof in accordance with the provisions of Article 9 of the UCC.

We point out to you that to the extent a tenant’s interest in leases for real property is not considered personal property (as that term is used in the UCC), a validly created lien thereon may be obtained by the recording of a leasehold mortgage in the Office of the [Recorder of Deeds] of the county in the State of where the property subject to the leasehold is located.

We express no opinion on any matter covered by Sections 9-104 or 9-302(c) of the UCC, or any portion of the Collateral covered by a certificate of title or which are mobile goods, consumer goods, farm products, crops, timber or minerals and the like (including oil and gas) or rights therein or accounts arising therefrom, or beneficial interest in a trust’s or a decedent’s estate, licenses, permits or other governmental authorizations, or any instruments or documents or goods covered by documents (except for certificates representing shares of corporate stock), or any category of assets other than those referred to in paragraph 2, or the priority of any lien or security interest in, or title to, any of the Collateral whether created and preserved by the Security Agreement or by any other agreement.

We express no opinion as to whether financing statements have been duly filed in the State of ___________. We also express no opinion as to state or federal securities laws.

We have assumed for the purposes of issuing the opinions set forth above that all documents, materials and information which we have received and reviewed in rendering this opinion are genuine, and are what they purport to be, and that each copy of any document is a true and complete copy of the document it purports to copy. With respect to all legal opinions we have received from other counsel upon which we are relying in rendering this opinion, we assume that all such opinions

39. Or other applicable county recorder.
correctly set forth the state of the law as described, interpreted, or referred to therein and that counsel rendering such opinions are competent to do so.

The opinions expressed above are subject to the following additional qualifications:

(i) The effect of bankruptcy, insolvency, reorganization, moratorium or other similar laws now or hereafter in effect affecting generally the enforcement of creditor's rights; and

(ii) As to the enforceability of certain remedies authorized or contained in the Security Agreement, the effect of rules of law governing specific performance, injunctive relief and other equitable remedies, but the inclusion of such remedies does not, in our opinion, affect the validity of the Security Agreement or of the security interests created pursuant thereto under the UCC, and there are available adequate remedies for the practical realization of the benefits and security contemplated by the Security Agreement.

We are qualified to practice law in the State of and we do not purport to be experts on, or to express any opinion herein concerning, any law other than the laws other than the laws of the State of ____________

This opinion is directed solely to you and may not be relied upon by any other party other than the Bank and its counsel in connection with the Credit Agreement and the Security Agreement. It is based on the state of the law of the State of and the facts as of the date hereof and we are under no obligation to advise you of any changes therein after the date hereof.

Very truly yours,

[Signature]
List of Assets

1. Furniture.
2. Leases for Real Property (Tenant's Interest).
3. Accounts.
7. Inventory.