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# REFORMS OF THE LAW OF SECURED TRANSACTIONS IN MEXICO AND THE UNITED STATES

MICHAEL L. OWEN, ESQ.\*

This essay will address several issues related to the guaranty trust and the reform of the *Ley de Garantías*<sup>1</sup> that would be of most interest. It will also provide a brief overview of the most recent revisions to Article 9 of the Uniform Commercial Code, which became effective in the United States on July 1, 2001.

First, I will discuss briefly the origin of the guaranty trust. Gringo lawyers are often accused of being extremely inventive in our approach to things. However, one of the most inventive legal devices ever created is the guaranty trust, which was developed by Mexican lawyers. The original vehicle for the guaranty trust was the statutory trust agreement, which was created by statute in the 1960s to allow foreigners to own land in the forbidden zone. But within ten years, Mexican lawyers recognized deficiencies in the enforceability of security interests in Mexico, and began to convert the original concept of the statutory trust agreement into the guaranty trust. The guaranty trust was not codified or located in any statute. Ironically, it was working quite wonderfully until legislators got their hands on it.

When the Mexican legislature began reworking the laws governing security interests,<sup>2</sup> Boris Kozolchyk, from the University of Arizona<sup>3</sup>, and his group actually played a considerable role in the early drafting of the law. At a program last year in Dallas, Mr. Kozolchyk was in the audience while one of his colleagues was giving a presentation on the guaranty laws. His colleague failed to mention the fact that both of the two forms are non-recourse, which I thought was quite remarkable. And so my very first question was, "Yes, but... it's non-recourse." When I looked over at Mr. Kozolchyk, he almost literally fell out of his seat. He came running up to me after the program and said, "I can't believe that the non-recourse provision was stuck in there, because I met with Angel Gurria and I came away certain that I had convinced him that he could not insert the non-recourse provision because it would destroy the law. And, lo and behold, it was in there."

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1. Amendments to Secured Financing Laws (Decreto Reforman Ley General de Títulos de Créditos del Código Comercial y de la Ley de Instituciones de Crédito), Diario Oficial de la Federación, May 23, 2000.

2. See the preceding article by Lic. Carlos Aiza.

3. A renowned expert on bankruptcy laws and on secured transactions lending laws around the world.

From other sources, I heard that the non-recourse provision was included at the behest of the PRD after the Barzon<sup>4</sup> group, which believes that lenders should not be able to foreclose on their collateral and enforce their debts, allied with PRD. The non-recourse provision had to be included in order to get the support of the PRD in the legislature. But later, when I was talking with a very high official in Hacienda during the former administration, and relayed all of this to him, he vehemently disagreed. He said they had to include the non-recourse provision because one of the factions of PAN said that party would not support the reform unless it contained a non-recourse provision. It is fascinating to see how blame is shifted all around. However, there is no doubt that the non-recourse provision completely undermined the original purposes of the reforms to the laws governing security interests.

### RECENT REFORMS TO UCC ARTICLE 9

Now, the essay will turn to the revised Article 9 of the Uniform Commercial Code in the United States.<sup>5</sup>

One of the aspects of the statutory legal system in the United States that works well is our law relating to the granting of security interests in personal property. The history and origins of Article 9 are important. In 1950, before the adoption of Article 9 of the UCC, the U.S. focus on secured transaction lending was not much different, in a practical sense, from what exists in Mexico today. There were isolated laws for various types of particular security interests, some of which were federally created and some of which were created by the states. These laws were extremely inconsistent and cumbersome. Recognizing that the system was a mess, a group of prestigious lawyers from the American Law Institute decided that the legal profession should take the lead and try to come up with a complete reform in order to create a coordinated system of secured transaction lending law.

Once the American Law Institute comes up with a reform to the Uniform Commercial Code, then that version of the UCC is presented to the legislature of each of the fifty states. Remarkably, the individual states adopt these reforms as law with very few changes. Therefore, Article 9 really is quite uniform among all fifty states. There have not been many reforms to Article 9 since its adoption, and the reform that took effect on July 1, 2001 was the first since 1972.

The 2001 revisions are intended to bring about greater certainty to financial transactions and to reduce the costs of incurring credit. This objective relates back to one of the original reasons for the creation of Article 9 back in the 1960s: the critical need to improve the ability of small and medium-sized businesses to obtain credit. This should also be the primary motivation for the reforms to the laws governing security interests in Mexico. If the procedures are expensive, credit is simply not going to be made available.

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4. See DALLAS MORNING NEWS, June 5, 1999. The Barzonistas are a "debtors union", which now represents over 1 million small debtors. This popular movement sprang up during the Mexican Financial crisis of 1995 to protest the foreclosure of small loans because interest rates climbed so high that debtors could not pay the interest. Interest rate climbed to as high as 110% from 18%, and inflation reached 52% after Mexico devalued its currency.

5. Uniform Commercial Code (hereinafter U.C.C.), Art. 9 (2000).

The new reforms to Article 9 became effective as of July 1, 2001.<sup>6</sup> In general, Article 9 covers the creation of security interests by contract, regardless of the form. It also now covers agricultural liens, consignments and outright sales of accounts, chattel paper, promissory notes, and payment intangibles. The extension to sales of accounts, chattel paper, promissory notes, and payment intangibles is primarily designed to facilitate securitization activity in the United States, which is now an important foundation for the availability of financing.

In addition to broadening of the scope of Article 9, the reforms have facilitated the use of deposit accounts as collateral.<sup>7</sup> Prior to the revision, deposit accounts could generally be used as security only if perfected by a common law pledge. California was the only state where a security interest in deposit accounts could be created under Article 9. Under reformed Article 9, a security interest in deposit accounts is available in all fifty states.

The original concepts of Article 9 have remained basically the same under these reforms. Creation of the security interest between the borrower and the creditor is through attachment.<sup>8</sup> Value must be given, the debtor must have rights in the collateral, and there must be a security agreement. Proceeds are covered by automatic attachment and by, for the first time, supporting obligations.<sup>9</sup> Supporting obligations are for example guaranties or standby letters of credit, that secure the fulfillment of the collateral used as security interest. If the creditor has a receivable from the debtor as collateral and that receivable is secured by a guaranty or by a standby letter of credit, then there is automatic attachment to those supporting obligations.

Once a security interest has been created, perfection is the next step. If there is a valid security interest between the debtor and the creditor, it must be perfected so it will stand up against attack by a lien creditor or some other third party. Moreover, only perfected security interests can survive a debtor's bankruptcy.

There are several recognized methods for perfecting a security interest in collateral. One, of course, is possession of the collateral by the secured party.<sup>10</sup> Possession is the key method of perfection in nearly all civil law countries and, in some instances, may be the most favorable method under Article 9 in the United States.

Another method of perfection is control of the collateral, which is an important, but relatively new method under revised Article 9. Control first crept into the Uniform Commercial Code through the development of a security interest in investment property, such as brokerage accounts. This concept has been extended under the new reforms to cover deposit accounts, letter of credit rights, and electronic chattel paper.<sup>11</sup> In fact, certain types of collateral, such as deposit accounts and cash, *must* be perfected by control and cannot be perfected by any

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6. References are to Revised Article 9, Uniform Commercial Code as promulgated by the National Conference on Uniform State Laws, effective July 1, 2001.

7. U.C.C., Art. 9, §109 (2000).

8. U.C.C., Art. 9, §203 (2000).

9. U.C.C., Art. 9, §203(f) (2000).

10. U.C.C., Art. 9, §313 (2000).

11. U.C.C., Art. 9, §314 (2000).

other means.<sup>12</sup> Therefore, it is important to define what exactly “control” means. The easiest example is the deposit account. Control requires a three-way agreement between the debtor, who is the depositor, the secured party, and a bank, which is holding the deposit. In that three-way agreement the bank commits to honor instructions from the secured party. In the meantime, the debtor might be able to continue to draw money out of the account. However, if the debtor defaults on its indebtedness, the secured party can send a notification to the bank and say, “Enough is enough, don’t allow any more money to come out, and furthermore I want you to pay the balance in that account over to me.” The creditor is considered to have control even if its acquisition of the collateral is dependent on a future default by the debtor.

In addition to possession and control, there are some forms of automatic perfection. For example, the sale of payment intangibles and the sale of promissory notes now are automatically perfected.<sup>13</sup>

Despite the availability of alternate methods, perfection is most commonly achieved by filing.<sup>14</sup> Filing pursuant to Article 9 notifies third parties that a security interest in the collateral has been granted. The revisions to Article 9 significantly expanded the types of collateral that can be perfected by filing. For example, a security interest instrument such as promissory notes and bonds may now be perfected by filing whereas, previously, they could only be perfected by possession.

However, filing might not necessarily be the best way to perfect. For example, in the case of instruments, if perfection is by filing and the debtor then fraudulently pledges those instruments to somebody else who perfects a security interest by possession, that secured party takes priority over the secured party who perfected by filing. This occurs even though the secured party with possession perfected later in time. Therefore, if perfection can be attained either by filing or by possession or control, the recommendation is to perfect by control or possession. This is because with control or possession the creditor will come out ahead against another creditor who may have filed a prior financing statement.<sup>15</sup>

The biggest and most noticeable difference under the revisions to Article 9 is where to file. Again, the whole premise of the UCC system is filing rather than possession. Therefore, where and how to file is critical. Previously, the touchstone for where to file was, in overly simplistic terms, the location of the collateral. The reforms have changed this entirely. Under the reforms, the key is the location of the debtor, which is a term of art.<sup>16</sup> If the debtor is a corporation or, for example, a limited liability partnership or any form of entity that requires recordation in order to be created, then where that entity was created is the place to file. For example, if the debtor is a Delaware corporation, then the secured creditor must file in Delaware. Even if the collateral is located in North Dakota, Delaware is the place to file. If the debtor is a non-registered organization, such as a general partnership, the secured creditor must look to the place of business of the debtor. If he or she has more than one place of business, then look to where the chief executive office

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12. U.C.C., Art. 9, §312(b)(1) (2000).

13. U.C.C., Art. 9, §309 (2000).

14. U.C.C., Art. 9, §310 (2000).

15. U.C.C., Art. 9, §317-339 (2000).

16. U.C.C., Art. 9, §307 (2000).

is located. Finally, if the debtor is an individual, file in the state of his or her residence.

The new rules for where to file have important implications where the debtor is not a U.S. entity. If, for example, there is a Mexican company with assets in the U.S. but without an office or anything like that in the U.S., where should the financing statement be filed? The old laws lent considerable confusion. The new law requires the secured creditor to look to the country where the debtor is located or organized. If the laws of that country do not have a general recordation requirement in order to perfect a security interest in non-possessory liens, then the creditor should file the financing statement in the District of Columbia. This caused considerable panic in the District of Columbia because their recordation system is a bit antiquated.

The real question now is whether Mexico has this general recordation requirement. Japan, for example, has no system for recordation of personal property security interests. So, clearly if the borrower is Japanese, the District of Columbia is where to record. My counsel would be to file in the District of Columbia when the debtor is Mexican even though Mexico's new law requires recordation for *prendas sin posesión de transmisión*. In Mexico, however, the type of collateral dictates where to record and whether recordation is necessary. Therefore, perfection in both Mexico and the District of Columbia would be preferable, especially since there could be certain types of guaranty trusts that are not recorded and since it is inexpensive to do so.

In addition to changes in where to file, the revisions to Article 9 have altered the requirements for what to file. The financing statement is a simple form, and under the new reforms, one can simply list "all assets" or "all personal property" as the collateral. This will not work for the security agreement. The description of the collateral in the security agreement can be by type or category when dealing with equipment or inventory. The security agreement does require an indication of the different types or categories of goods or assets that will be covered by the security interest, but the financing statement can be quite general so long as it is accurate.<sup>17</sup> Furthermore, under the new revised system, the debtor's signature is not required on a financing statement. However, an authorization for the creditor to file a financing statement is required, although the execution of a security agreement is deemed sufficient.

The key requirement under the new filing system is that the debtor's name must be absolutely correct.<sup>18</sup> This is important because the state filing system is computerized. The name of the debtor will be run through the system for recording financing statements and it only lists the exact name of the debtor. If the correct name of the debtor is not filed, then there is no way of knowing if there are existing security interests with the debtor. So, the person filing must be certain the debtor's name is correct.

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17. U.C.C., Art. 9, §§108,502, 504 (2000).

18. U.C.C., Art. 9, §503 (2000).

## COLLECTION EFFORTS AGAINST THIRD PARTIES

The recent reforms did not change a secured creditor's collection rights under Article 9. However, it is in this area that one of the most fundamental differences between the system in the U.S. and the system in Mexico is seen. The U.S. does not have a constitutional prohibition against self-help collection<sup>19</sup> whereas the Mexican constitution basically prohibits it. In the U.S., there is rarely the need to go to court and get a court order to permit foreclosure on a security interest. However, in the U.S., if self-help will cause a breach of the peace, the collector must cease his or her collection efforts and get a court order. This may be almost identical to the way the law is written in Mexico, but the practical application is different in the two countries.

One of the reasons self-help collection works in the U.S. is that every step in the self-help process is subject to a standard of commercial reasonableness.<sup>20</sup> If property is foreclosed, as long as it is done in a manner recognized in a market or the price obtained is current in the recognized market or is otherwise in conformity with reasonable commercial practices among dealers in that type of property, the foreclosure is deemed commercially reasonable.

The law does provide some parameters for self-help collection, which are especially important in the context of a sale of the repossessed collateral. The new reform discusses the differences between a private and public sale and specifically addresses what occurs if there is a purchase by a secured party, which is allowed only at a public sale. A private sale is only allowed if there is a recognized market for the collateral with a standard price.<sup>21</sup> Article 9 contains specific requirements for disposition and, in particular, notice of disposition.<sup>22</sup> The new reform is much stricter on notice requirements. Notice must be given to the debtor, to other creditors that have requested notice or to other creditors who file.

Retention of the collateral by the secured party after a foreclosure is also addressed in Article 9.<sup>23</sup> If a secured party wants to retain the collateral in full or partial satisfaction of the debt, he or she must give notice to everybody. If any one creditor or the borrower objects, then the secured party must dispose of the collateral through the other mechanisms, such as a public or private sale, and follow commercially reasonable standards. For a determination of a deficiency or surplus judgment, there are special provisions in the reforms that come into play if the collateral is acquired by the creditor or a related party.<sup>24</sup>

This essay was just a quick review of the main elements in the Article 9 revisions. The Mexican lawyers may wonder how well it works, since the borrower's signature is not even required on the financing statement. Additionally, there are many protections built into the Mexican legal system that the U.S. system ignores. Basically, there are fewer formalities required in the U.S. system. What is to prevent somebody from filing a completely false financing statement and lousing

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19. U.C.C., Art. 9, §610 (2000).

20. U.C.C., Art. 9, §610(b) (2000).

21. U.C.C., Art. 9, §610(c) (2000).

22. U.C.C., Art. 9, §§611-614 (2000).

23. U.C.C., Art. 9, §§620-622 (2000).

24. U.C.C., Art. 9, §615 (2000).

up the credit taking potential of a debtor? It just almost never happens and there are provisions that allow for an injunction and immediate relief, with penalties, for anyone who abuses the process.<sup>25</sup> Regardless, it is a very important development in the U.S. that is focused on trying to drive down the cost of credit and making credit more available, especially to small and medium-sized businesses.

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25. U.C.C., Art. 9, §625 (2000).



