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Mexico's Attempt to Reform the Guaranty Trust Agreement and to Create the Floating Lien Pledge

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This article will discuss recent amendments to the laws related to secured transactions in Mexico. Specifically, it will set forth the provisions related to an entirely new form of security interest known as the floating lien pledge, or prenda sin transmisión de posesión, and the amendments to an existing form of security interest called the guaranty trust agreement, or fideicomiso de garantía. Although the guaranty trust agreement existed prior to the reforms and worked very efficiently, the form has been altered in a way that is quite unfortunate. Finally, the article will conclude with a discussion of the practical effects of this reform, which have been overwhelmingly disappointing.

ORIGIN OF THE AMENDMENTS

The reform was originally intended as an entirely new statute on secured transactions. However, it ultimately turned into a series of amendments to the existing statutes governing secured transactions. The amendments to the Commercial Code, the General Law of Negotiable Instruments and Credit Transactions and the Mexican Law of Banking Institutions were originally intended and sold to the public as the basic, albeit political, solution to the banking crisis and the credit crunch that Mexico suffered after the 1994 devaluation of the peso.

In April of 1999, the President of Mexico presented to Congress an initiative to create an entirely new statute that would be specifically related to secured transactions. The statute created, among other things, a new form of security interest known as a floating lien pledge, or a prenda sin transmisión de posesión. At the same time, the guaranty trust agreement, which has existed for many years and was widely used, was to be modified. Six or seven months later, members of three important political parties in Mexico, the PRI, the PAN and the Verde Ecologista, presented a bill to Congress that essentially did exactly the same thing that the initiative from the President intended to do. However, the bill proposed by these legislators was merely an amendment to the existing statutes, rather than an entirely new statute. Ultimately, Congress decided to use these amendments in lieu of a completely new law on secured transactions. While the differences in substance were minimal, it is important to highlight that the law was changed by the legislators and not by an initiative of the President, as was originally intended.

The Mexican press discussed this issue for months. Lay people generally understood the regulations as a real solution to the Mexican credit crunch crisis, and assumed they would solve all the problems caused by the unavailability of credit in
Mexico. Today, however, the regulations have not solved, nor is it clear that they will solve, the problem of credit availability in Mexico.

The Exposición de Motivos', or legislative history, set forth with great clarity the objectives of the amendments. The primary purpose of the reform was to reactivate credit and give protection to creditors in Mexico. Creditors desired more certainty and security with regard to their rights in the context of both the creation and perfection of security interests and the enforcement of those security interests. The second purpose was to create these two allegedly new forms of security interests that essentially were just one new form (the floating lien pledge) and changes to the second one (the guaranty trust agreement). Finally, the amendments were intended to make the foreclosure of security interests more efficient, specifically in the context of a judicial foreclosure.

After a discussion of the floating lien pledge and the guaranty trust agreement, these three objectives will be evaluated to ascertain whether they accomplished their stated goals or whether the exact opposite occurred.

THE FLOATING LIEN PLEDGE

The floating lien pledge is an entirely new concept for the creation and perfection of security interests in Mexico with respect to movable property. The general rule in Mexico before this amendment, as it is in many other civil law jurisdictions, was the dispossession of the secured property. In order for a secured lender to hold a perfected security interest in movable property, with a few exceptions, the debtor could not be in possession of the pledged assets, physical or otherwise. In practice, this led to varied and complicated consequences.

The amendment allowed for an important exception to this general rule by allowing the debtor to retain possession of the pledged assets. This revision is similar to the situation in equipment financing or vendor financing where the floating lien pledge or security interest is created and perfected with respect to assets that come in and out of the estate of the debtor in the ordinary course of business. This is especially important when the debtor needs the assets to conduct business.

The second important change effected by the amendment is that the debtor can sell assets in the ordinary course of business, even if the assets are subject to a lien. That was a foreign concept in the context of the old pledge. Since there was no possession on the part of the debtor, it was legally and practically impossible for the debtor to sell without the consent of a secured lender. Again, the amendment creates a floating lien concept where the borrower can now use and dispose of assets that are used in the ordinary course of business. This becomes extremely important when dealing with assets such as inventory and those types of assets that, by definition, must be sold by the debtor in order to generate sufficient funds to service the financing.

The next change, which is important from a practical point of view, deals with the description of assets. The old commercial pledge required a detailed description of the pledged assets for purposes of creation and perfection. This requirement was

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unreasonable in the context of, for example, financing of a hotel, where every television and towel in every room would need to be specifically described in attachments to the pledge agreement in order to create a perfected security interest. Under this new floating lien concept of a pledge, there is no need for specific description of those assets. Unless otherwise agreed, assets that are used and/or owned by the debtor and used in the ordinary course of business are deemed covered by the security interest. Therefore, the concept of model numbers, serial numbers, even colors that used to be necessary to distinguish one asset from another is no longer needed.

Another change is related to the concept of foreclosure procedures for the commercial pledge. The amendments to the Commerce Code intend, but possibly only state as an intention, to allow for a more expedited and efficient foreclosure procedure, specifically for the floating lien pledge. This has the potential of being a dramatic departure from the typical judicial foreclosure procedures for the old, ordinary commercial pledge.

Although these changes may appear to have made the floating lien pledge a desirable method for creating and perfecting a security interest, in practice, the floating lien pledge has been rendered basically inoperative by the inclusion of a most unfortunate mandatory non-recourse concept. Unless the transaction is for a limited purpose, such as non-recourse financing in the context of project finance, or the loan is secured with all of the assets of the pledgee, it will clearly not be used as broadly as intended. Balanced against the stated purposes of more efficient forms of security interests and greater availability of credit, the actual practical consequences of the amendment may turn out to be exactly the opposite.

This non-recourse concept provides that if the debtor's obligations are secured with a floating lien pledge, then the lender will have recourse only against the pledged assets. To the extent the proceeds from the sale of such assets are insufficient to cover the amount of the loan, the lender will be unable to pursue payment of the deficiency from the borrower. By express provision in the statute, this cannot be validly waived.

The non-recourse provision applies to both the floating lien pledge and the guaranty trust agreement, which will be discussed below. From the legislative history, it appears that the rationale (or lack thereof) for the inclusion of this provision was to make debtors and creditors share in the expenses or costs of a financial crisis. Regardless of that justification, little can be done to draft around the non-recourse concept, meaning that the practical use of the floating lien pledge is extremely limited. The floating lien pledge or guaranty trust agreement must incorporate non-recourse language into the agreement. Additionally, the non-recourse nature of the obligation is binding because the parties agreed to use these forms of security interest; any provision to the contrary will be deemed null and void.

**THE GUARANTY TRUST AGREEMENT, OR FIDEICOMISO DE GARANTÍA**

Many interesting issues arise in the context of the guaranty trust agreement. The concept of a trust has existed in Mexico for a very long time and has been widely used, even though the concept of the trust is quite foreign to most civil law jurisdictions. It is difficult to imagine how innovative this concept was when first
created and how it managed to survive in the Mexican legal system. Regardless, the
trust works quite well, especially as people increasingly came to understand it. It
is used for many different things, from estate planning to investments and most
widely used as a form of security interest — the guaranty trust agreement.

The basic advantage of the guaranty trust agreement was, and will probably
continue to be, the concept of the transfer of title of the debtor’s assets to the
trustee. This is a fundamental and essential element of the Mexican fideicomiso;
otherwise there is doubt as to whether there is in fact a fideicomiso. Conceptually,
the assets are transferred from the estate of the debtor to the trustee, where they
form an independent estate that is under the responsibility and management of the
institution that acts as a trustee.

Obviously the basic benefit from a collateral point of view is that the assets, first,
would not be consolidated into the estate of the debtor in the event that it went
insolvent. Second, because of the nature of the trust, upon the occurrence of
default, the trustee would simply sell the assets that it received and apply the
proceeds of that sale toward payment of the secured obligation. Thus, the case was
clean-cut and the court system would not intervene in a foreclosure. The settlor of
the trust, who was typically the debtor, instructed the trustee what to do in the event
of a default. Even though there could be discussion as to whether or not a default
had occurred, it was generally quite efficient for the trustee to dispose of the
collateral.

The reforms changed quite a few things. First, the concept that was originally
introduced in 1996 was that a trustee could also act as the beneficiary of the trust.
In other words, the same bank — typically the trustees in Mexico are banks, though
insurance companies and other regulated entities can act as trustees — could be both
the trustee under the guaranty trust agreement and the secured lender and the
beneficial owner of the trust. The statute says that if there is a conflict of interest,
the parties agree to appoint a different trustee. The general opinion is that the
conflict of interest arises on day one. The standard of care of a trustee is in Mexico
is that of a good pater familae. It is difficult to be a good father to the settlor, or to
the beneficiary, when you have a specific preference for yourself because you have
an interest in the trust. This is the first problem.

The second problem is that by incorporating an extrajudicial option, the concept
of the foreclosure sale of the trust is contaminated, as is the case in a commercial
pledge. Again, this concept is incorporated into the Mexico Commercial Code,
where the trustee can sell the assets without accessing the court system only to the
extent that the debtor does not oppose either the delivery of the assets, or the actual
amount of the indebtedness. So, if the debtor decides to oppose any of the
extrajudicial options, then sale must be judicial.

The Mexico banking law, however, was amended to maintain the concept of the
ability of the parties to agree on an extrajudicial foreclosure procedure. Although
this is subject to discussion, it is clear that the extrajudicial foreclosure option
continues to be available to the extent the trustee under a guaranty trust agreement
is a Mexican commercial bank.

The concept of the non-recourse obligation continues to be the most important
obstacle to the use of the guaranty trust agreement as a security interest. It worked
fine before the inclusion of the non-recourse provision. The Supreme Court
confirmed quite a few times that the assets were not consolidated into the estate of
the bankrupt entity. Extrajudicial foreclosure was constitutional and it was valid, and now these recent amendments contaminated the form of security interest in such a way that people simply do not want to deal with it.

In conclusion, it is my personal opinion that the Legislature accomplished exactly the opposite of the three objectives they set forth with regard to this reform. Essentially, the new floating lien pledge is not being used as intended and use of the guaranty trust agreement has been substantially limited. In effect, all the amendments achieved was a specific regulation of what the guaranty trust agreement is, how it works and what the rights of the parties are without giving the parties the opportunity to freely negotiate the agreement. Additionally, the legislature imposed a series of provisions that the parties cannot waive. Consequently, the trend is to go back to the mortgage and to the old commercial pledge. Of five transactions presently at our firm, all are going through the old forms of security interest because there are so many problems with the new ones.

Lastly, there is an initiative on the part of the Mexican Banking Association and other groups, and possibly a group of lawyers, to push legislators to reconsider what they have done. Hopefully the legislators will understand that the reform is simply not working and that the objectives were not met. Perhaps in the near future there will be an additional revision to the statute to fix what some consider serious problems.