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FINANCING MEXICAN INFRASTRUCTURE DEVELOPMENT: INCENTIVIZING FINANCE PROJECTS

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I am going to describe what I believe are the manners of creating incentives for finance projects in Mexico, basically through the guarantee trust, the pledger-in-possession pledge, and insolvency law and bankruptcy remoteness. The difficulties arise first from the rules for collateral in Mexico, and also from the fact that foreign security interests and Uniform Commercial Code (UCC) filings are not adequate incentives for encouraging finance projects in comparison to countries which offer collateral in rem. Finally, I will just touch briefly on the telecommunications lien.

INTRODUCTION

In order to incentivize the granting of credit backed by assets within the Mexican territory, the Mexican Congress passed Amendments (the Amendments) that deal with the creation of liens to secure contractual obligations. The Amendments now make desirable the use of two important security devices: the guarantee trust (fideicomiso de garantía) and the pledger-in-possession pledge (prenda sin transmisión de posesión), both of which were introduced to the Mexican legal system in mid-2000 but were originally burdened by a number of debtor protection provisions that made them unappealing to creditors.

Following the introduction of these security devices in 2000, they were stalemated by the "Barzón Clause," which made both the guarantee trust and the pledger-in-possession pledge unappealing to creditors. These devices were unappealing because they amounted to a mandatory deficiency waiver provision that made them next to useless for recourse financing, and completely out of the question in any financing where other security interests would have had to coexist (such as a foreign parent guarantee). Before the implementation of the Amendments, by accepting to have an obligation secured by means of a guarantee trust, the obligee

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2. Id. Chapter V, articles 395-414.
3. Id. Chapter IV, Sections 346-380.
was irrevocably deemed to have waived the right it may have had to recover, on account of the secured obligation, any monies or assets beyond the proceeds of the collateral. Thus, as far as project financing was concerned, the new devices could be used only in deals where the entirety of the project could be made subject to the single security interest created by the guarantee trust or pledger-in-possession pledge (a rather complicated proposition where multiple concessions and EPC contracts were involved), and the lenders did not rely at all on guarantees of foreign third parties.

Therefore, due to their complexity and difficulty, investors basically did not like these devices. Then these security devices went out of use for a few years, but now Amendments to the laws have made it feasible to move away from the complex, multi-layered, inflexible Mexican project finance structures of the past and towards simpler security packages. These newer and simpler packages may in fact out perform the legacy structures while allowing a more straightforward approach to cash-flow management and taxation. The recent overhaul of the Mexican Insolvency Laws, including the Statutory Confirmation of Bankruptcy Remoteness of ordinary Mexican trusts, when used as Special Purpose Vehicles (SPVs), has improved the outlook for the legal aspects of financing infrastructure development in Mexico. As we see rating agencies look with kinder eyes on Mexican SPVs and Mexican pensions, the insurance sector continues to amass disposable cash. The issuance of asset-backed securities as a means of financing infrastructure projects therefore becomes more and more appealing.

Overall, there is now a sturdy and flexible platform that may perhaps allow structuring efforts to focus more intensely on the operational detail of financed projects and on value-added enhancements, as opposed to focusing almost entirely on achieving collateral safety.

**BACKGROUND**

*Law Applicable to the Creation of Security Interests*

One of the key conditions for a Mexican court to enforce a foreign judgment is that the judgment not stem from the exercise of a right *in rem*, that is to say a right with respect to an asset as opposed to a right with respect to a person. Therefore, for purposes of the Mexican law governing insolvency and priority in payment, true ownership and security interests are *in rem* in nature. Therefore, the safest course with regard to collateral located within the Mexican territory is a security package that follows requirements of Mexican law and is designed for bringing suit directly in Mexico.

This has obviously brought a lot of controversy among colleagues worldwide. Certainly the colleagues in the United States and institutions in general are saying, “Are the Mexican courts safe enough to do this?” On the one hand, there is case history, for instance, with regard to foreclosure of mortgages, in which case we see that our courts are more efficient than not. There is a tradition of enforcing and foreclosing mortgages. Therefore, it is less cumbersome to deal in that area, but then is it sure enough to do across the board? And that is really what the Amendments are about. This is also a good reason not to rely solely on a foreign
security interest, such as a UCC filing, as a means to achieve priority on collateral that is located in Mexico or otherwise subject to Mexican law.

**Origin of the Guarantee Trust and the Pledger-in-Possession Pledge and Downsides of their Original Versions**

On May 24, 2000, the General Law of Credit Instruments and Credit Transactions (Spanish acronym "LNICT") was amended to introduce a new type of trust formally called a "guarantee trust" (fideicomiso de garantía) as opposed to the general type of trust that used to be informally referred to as a "guarantee trust," and a new type of pledge called a "pledger-in-possession pledge" (prenda sin transmisión de posesión). These two devices had been long anticipated and were expected to revolutionize the security interest panorama in Mexico. It was rumored at the time that both would perfect the means of registration in a federal registry and would allow the security interest to be "floating," thus opening the doors to U.S.-style inventory and receivables financing. Finally, the new devices were intended to wrest the monopoly on blanket liens away from licensed Mexican banks.

These expectations turned out to be true. Unfortunately, due to last-minute tampering by Congress due to intense pressure from then powerful pro-debtor groups, the original versions of the guarantee trust and the pledger-in-possession pledge included a mandatory deficiency waiver provision (The Barzón Clause, or la clausula de barzón). This deficiency waiver provision made the original versions of the guarantee trust and the pledger-in-possession pledge next to useless for recourse financing and completely out of the question in any financing where other security interests would have had to coexist.

Before the implementation of the Amendments, by agreeing to have an obligation secured by means of a guaranteed trust, the obligee was irrevocably deemed to have waived the right it may have had to recover, on account of the secured obligation, any monies or assets beyond the proceeds of the collateral. Therefore, the Amendments basically did away with the deficiency waiver.

Thus, as far as project finances were concerned, the new devices could be used only in deals where the entirety of the project could be made subject to the single security interest created by the guarantee trust or pledger-in-possession pledge, a rather complicated proposition, where multiple concessions and UCC contracts were involved and the lenders did not all rely on guarantees of foreign third-parties.

**Life without the Amendments**

Before the Amendments, there were three major challenges that had to be overcome when developing infrastructure security packages. First, was the creation of security interests or comparable isolation and foreclosure devices with respect to receivables, UCC and management contract rights, and other non-IP intangibles. The second major challenge was the creation of a security interest or comparable isolation and foreclosure devices with respect to future/after-acquired assets including inventory. Finally, there was a substantial challenge in the creation of a security interest or comparable isolation and foreclosure device with respect to public service concessions, licenses, and permits. Over time, heavily structured, multi-layered solutions were favored. These complex solutions often hinged on a
transfer of ownership of intangibles into non-guarantee trusts and constant automatic sweeps of cash flows into offshore vehicles.

While it was clear that there was no fraudulent conveyance issue regarding the transfer of ownership of project assets to an intermediate Mexican trust,\(^5\) the tax and accounting analysis of these intermediate vehicles, while ultimately satisfactory, was usually very cumbersome.

The varying opinions of legal counsel created a situation in which no single collateral structure was ever identical to the next. We always had tailor-made collateral provisions that were very difficult to implement. Real estate and sometimes inventory were made subject to a mortgage. Why? Since the tradition in the court was to enforce or to foreclose mortgages, it was easier to advise our clients as to the type of guarantee that they could have with a fair amount of security within the Mexican judiciary. Inventory machinery and equipment were often made subject to an ordinary commercial pledge. Ordinary commercial pledges, if you read the law, are a nightmare because they basically cannot do any kind of a floating lien. They always have to be under the care of a depository, which requires that a depository be appointed. Shares of stock were endorsed and physically delivered—sometimes to the lenders, sometimes to yet another trust that controlled voting. It was common to see between four and seven Mexican devices working in tandem, some of them statutory, some of them *ad hoc*.

Now, after the Amendments, the only remaining challenge in some sectors of infrastructure is the creation of a suitable security interest or comparable isolation and foreclosure device on the relevant public service concessions, licenses, or permits.

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\(^5\) Author's note: This point is resolved by a simple test, which I will call the “fairness test.” Basically, the insolvency court may unwind a transfer made by a debtor only if (i) it occurs after the commencement of the period ("Preference Period") going back 270 days (or more, at the discretion of the insolvency court, up to the moment in time when the debtor in question actually became insolvent) prior to commencement of insolvency and (ii) the debtor did not receive, prior to commencement of insolvency, consideration ("Fair Consideration") that was the higher of (1) market consideration for the transferred asset or (2) consideration reasonably commensurate in value as compared to the transferred asset. Both form and substance are essential in the Mexican legal framework. Requirements, categorizations and distinctions based on form are primary tools utilized by Mexican law to protect substantive goals. Bear in mind that the entirety of Mexican law originates as written, grammar-based logical constructs given the force of law by an act of Congress (whether or not there was any popular tradition existing prior to such act to support it), with only a few exceptions where binding jurisprudence is created by court precedent (that is itself based on the interpretation of written, grammar-based logical constructs). Mexican courts are therefore not required to match facts to precedent, but to match facts to structured logical constructs. Evidentiary tests and the like are very strict. The Mexican legal system implicitly acknowledges that Mexican tradition and the type of sources from which Mexican laws stem does not make it appropriate to place on Mexican courts the responsibility, or authority, to interpret the will of the parties to a commercial contract when the sense of their written agreement is clear from a grammatical standpoint and from the standpoint of the internal logic of the agreement, regardless of matters like “reasonableness,” prudence, or tradition. Certainly, Mexican law is not so superficial as to place too much reliance on labels (e.g., the name chosen by the parties to label an agreement). But Mexican law will not attempt, and forbids courts, to change the rights and obligations of the parties as written in a commercial agreement (there is no general authority of courts to re-write or re-characterize commercial transactions other than in exceptional cases where there is a statutory provision that expressly requires it). Thus, form-based tests (where, for example, the nature of an agreement is determined by whether a key element was expressly agreed to or not by the parties) are in fact intimately related to substance.
The Amendments

After the Amendments became effective on June 14, 2003, one of the key results was the elimination of the statutory deficiency waiver provisions—the Barzón Clauses—that previously applied mandatorily, both with respect to the pledger-in-possession pledge and the guarantee trust. Pursuant to the mandatory deficiency waiver, a creditor secured by means of a pledger-in-possession pledge or a guarantee trust would not have recourse to recover the balance of the outstanding secured obligations, as noted above, against the debtor or any guarantor. In contrast, under the Amendments, creditors secured by means of a pledger-in-possession pledge and the guarantee trust now enjoy full recourse to the debtor and all guarantors to recover the balance of the outstanding secured obligations, after application of the proceeds of the sale of the collateral upon foreclosure.

Another important feature of the Amendments is that they allow the creditor and the debtor, or a guarantor posting collateral under a guarantee trust, to contractually establish their own tailor-made rules of foreclosure. Such tailor-made rules may sometimes include out-of-court foreclosure, subject to the requirements of reasonable process. This is really not something that is as easy in the pledger-in-possession pledge.

Guarantee Trust

Pursuant to a guarantee trust arrangement, in order to secure an obligation, the original owner of the collateral, as settlor of the trust, conveys ownership of the collateral to the trustee for the purpose of liquidating such assets through special judicial foreclosure proceedings upon default (or through tailor-made out-of-court foreclosure proceedings). As a general rule, the trustee must be the trust division of a licensed Mexican bank. We still have that limitation in Mexican law. The collateral may be tangible or intangible. The collateral may be present and future after-acquired collateral. In either case, the transfer of ownership of the collateral by the settlor to the trustee is deemed to occur on the date on which the guarantee trust agreement is entered into or such other later date as may be agreed by the parties. With few statutory exceptions and such others as may be agreed upon by the parties, the collateral subject to a guarantee trust extends to things, receivables, and proceeds that result or are received from the transformation, exploitation, or other disposition of the assets originally constituting the collateral. The parties to a guarantee trust may agree to allow the settlor the use of the collateral under such conditions and for such period of time as they may likewise agree. Upon satisfaction in full of the secured obligations, the ownership of remaining assets or proceeds subject to the guarantee trust reverts to the settlor. The guarantee trust arrangement is perfected by means of registration in the Public Registry of Commerce regardless of whether or not the collateral remains in possession of the trustee in whole or in part. The trustee is to be acknowledged as the owner of the collateral for all purposes, including from and after the time of declaration of insolvency or bankruptcy of the settlor. If foreclosure is sought through the courts, the statutory foreclosure proceedings are designed to be faster and less expensive than others previously available, including mortgage foreclosure proceedings. The
parties may contractually supplement, and in some cases override, non-essential statutory provisions governing the guarantee trust.

Pledger-in-Possession Pledge

The pledger-in-possession pledge agreement to secure an obligation means that the owner of the collateral creates a pledge of a security interest in the collateral for the purpose of liquidating such assets through special judicial foreclosure proceedings upon the secured obligation being defaulted or through tailor-made out-of-court foreclosure proceedings. The pledger-in-possession pledge is perfected by means of registration in the Public Registry of Commerce. The collateral may be tangible or intangible. With few statutory exceptions and such others as may be agreed by the parties, the collateral subject to a pledger-in-possession pledge extends to things, receivables, and proceeds that result or are received from the transformation, exploitation, or other disposition of the assets originally constituting the collateral. The main difference in this new pledge is that the pledger retains physical possession of the collateral, but is bound to deliver it to the pledgee upon default for purposes of liquidation through the courts. The statutory proceedings leading to that foreclosure are designed to be faster and less expensive than others previously available, including mortgage foreclosure proceedings. The parties may contractually supplement and, in some instances, override, non-essential statutory provisions governing the pledger in the possession pledge.

Telecommunications Lien

Something that is useful for project finance in telecommunications is the Telecommunications Lien. In transactions where the borrower holds a concession to provide telecommunication services, Mexican law allows for the creation of blanket liens irrespective of whether the mortgagee is a Mexican bank or not. Then we have a certain chapter and verse of the Law of General Means of Communications\(^6\) whereby a mortgage may be granted in all or a portion of the assets, rights, privileges, and interests of the concessionaire. Unless otherwise agreed to, the mortgage will include: (1) the concession; (2) the means of communication, the means of transportation or the communication systems that are the subject of such concession (collectively, the “Subject Matter of the Concession”), all construction and works built in connection with the installation and operation of the Subject Matter of the Concession and, in general, all other accessories and other property pertaining to or otherwise built or affixed for the operation thereof; (3) all of the fixed and movable property and equipment acquired by the mortgagor relating to the construction, exploitation, repair, renewal and maintenance of the Subject Matter of the Concession, including all machinery, equipment, furnishing, fixtures and vehicles; (4) all accounts receivable and other forms of intangible assets, owned, acquired or belonging to the mortgagor; and (5) all moneys already paid, due or to become due to the mortgagor under all contracts for the sale of goods or the performance of services or both by the mortgagor.

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You can see the utility of establishing this kind of a floating lien on a very specific and important field of endeavor in Mexico. Hopefully it will work if there is a resurgence in that market.

OUTLOOK

In addition to the simpler but equally or better performing collateral structures than the ones available prior to the Amendments, Mexican infrastructure projects are also starting to benefit from other common financing techniques such as the issuance of asset-backed securities, whether privately or publicly, and domestically or cross-border.

Most cross-border securitizations and asset-backed transactions, until recently, had employed U.S. or offshore vehicles. Following the mid-2000 overhaul of the Mexican Insolvency Laws and more exposure by rating agencies to domestic transactions, greater familiarity now exists with ordinary Mexican trusts, and these are being increased in use as cross-border, special purpose, asset-backed issuers. The artful use of derivatives and credit insurance is broadening the possibilities as assets are more effectively disassociated from specific currency risks and specific credit risks.

Finally, for some time now, Mexican federal and state governmental agencies have been exploring the monetization of alternate resources, such as tax assets and existing public service fees to finance new infrastructure projects.

I have given an overview of what I think is the status of some very hopeful Amendments to the laws that enhance Mexico’s chances of expanding project financing across the board.