Mexico Upgrades Laws on Security Interests: "Non-possessory Pledges are now Legal in Mexico"

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On May 23, 2000, the Mexican Law of Negotiable Instruments and Credit Transactions ("LNICT") was significantly amended.

As of May 24, 2000 it is possible for debtors to pledge goods such as personal property ("goods") in Mexico without transmitting possession of such goods to creditors allowing creditors to still perfect a security interest on such collateral. Thus, for the first time in Mexico an in rem right such as the pledge does not have to be deposited with a creditor or a third party, but rather it may remain in the possession of the debtor allowing it to continue with the use of the collateral for its operations.

The amendments begin by stating that a pledge without transferring possession is an in rem right over movable goods, which are also commonly known as personal property. Its main objective is to guarantee the compliance of an obligation and to establish its ranking priority, by allowing the pledgor (debtor) to keep actual possession of the collateral and, even more important, use it in the normal course of its operations. Importantly, the pledge can be placed on all of debtor's existing personal property, without the requirement of specific identification, only a general description will be required. This new development changes Mexico's old and obsolete process of perfecting a security interest on personal property only by specific identification of each item, and provided the debtor is not in possession of the collateral. Debtors will now have the ability to use such collateral for their operations in the ordinary course of business which means that the lien will be a floating lien without the need to renew and amend the pledge or make additional filings with the Public Registry of Commerce. The debtor's personal property (i.e. inventory) will remain subject to the lien from the time debtor acquires it until sold to third parties, and new inventory coming in will automatically be subject to the lien.

The scope of the term "goods" used in this reform is quite broad and it also includes "rights" such as accounts receivable. Trademarks and commercial names are also included within those rights and goods. The pledge may also include those goods of a similar nature that are acquired by the debtor after the granting of the pledge. This means that a floating lien can be created on all inventory. Also included in the definition are goods either pending or already obtained from the original pledged goods and those goods resulting from the manufacturing and transformation process of those goods already covered by the pledge. Finally the definition refers to those goods that the debtor is entitled to receive as payment from sales to third parties of any such goods which were already pledged.

Debtor's rights under the non-possessory pledge include: (i) ability to use the goods as well as to combine them with others and employ them in the manufacturing of other goods, with the understanding that their value should not decrease and the finished product will become subject to the pledge; (ii) ability to obtain and use the products of the pledged goods; (iii) ability to transfer the pledged goods in the normal course of business, in which case the effects of the pledge would cease as well as any enforcement rights against third parties who

acquire them in good faith. Such goods would be automatically substituted with new goods received by the debtor or with the payment itself of any such goods.

If the debtor defaults under the main obligation (i.e. payment of a loan) then the debtor's right to sell or transfer the collateral in the ordinary course of business will terminate by notice that the enforcement procedures have been initiated against the debtor. If such goods represent 80% of the total assets of the debtor, a court order is required to sell or transfer any such goods.

Debtor and creditor must agree on the following: (i) the location in which the collateral will remain; (ii) the minimum price that the debtor is entitled to receive as a result of the sale of the collateral; (iii) the specifications, categories or characteristics that will allow the identification of the person or persons specifically authorized to deal with in any such sale; (iv) the destination of the proceeds obtained therefrom (such as money, goods or rights received as payment); (v) the information that the debtor must deliver to the creditor about the transformation, sale or transfer of any such goods.

Notwithstanding that the debtor may give as collateral all of its goods used for conducting its main activities, the debtor will still be able to pledge to other creditors the goods that are acquired from funds loaned by these new creditors. In such case, the original creditor will retain its priority for the payment of the obligation on all goods that constitute the pledge, and thus ahead of any other creditor. Exception is made to those goods acquired by the debtor with the funds provided by the new creditor. The new goods shall constitute the collateral for this new creditor and will give him priority even ahead of the original creditor. This exception to the rule is only permitted when the goods can be identified with great detail and can be distinguished from the rest of the goods that the debtor has used as collateral with the original creditor.

Future obligations may also be subject to a non-possessory pledge. However, the collateral cannot be foreclosed on, or adjudicated to the creditor if the main obligation does not become enforceable.

The pledge agreement may provide for the collateral to be insured and the insurance company selection can be made by the debtor, but the beneficiary under the policy must be the creditor. The guaranteed obligation will be reduced by the payment that the creditor receives from the insurance company. Should there be any additional insurance proceeds, those shall be returned to the debtor.

The debtor is obligated to keep and maintain the goods subject to the non possessory pledge, and is liable for any damages, deterioration and losses suffered by his own fault or negligence. The debtor is also prohibited from using the collateral for a different purpose than the one agreed to with the creditor. The debtor is also responsible for any maintenance, repair, recovery or management costs of any such goods. If the pledged goods are lost or deteriorated in excess of a specified mutually agreed upon value, creditors are entitled to demand another pledge or the payment of the debt before it becomes due.

The creditor will be entitled to inspect the goods in order to determine their weight amount and their general appearance and status. The scope of the inspection is to be determined by the parties. The parties may also agree in the pledge agreement that if the value of the collateral decreases to the extent that it fails to cover the principal as well as interest and other amounts, the debtor may add additional goods to replace the original amount. Otherwise, the payment of the main obligation can be accelerated in which case the creditor must notify the debtor either through court or a notary public.

The parties will also include in the pledge agreement the terms under which an expert will be appointed for purposes of rendering a report, after having heard both parties, regarding the acceleration due to the loss of market value or due to damage.

When the principal, interest and other amounts owed under the main obligation are fully paid, the creditor must release all goods from the pledge following the same formalities and procedures as for the creation of the pledge.

Any non-possessory pledge has to be in writing and if it involves goods that are valued at the equivalent in Mexican Pesos of 250,000 UDIS (investment units) currently at $1.00 peso per 2.7 UDIS, which is approximately $9,800.00 US, then the signatures of all parties must be ratified before a notary public. The effective date for purposes of third party notice starts on the date that the non-possessory pledge is recorded with the Public Registry of Commerce.

Priority is granted to non-possessory pledge creditors above all other creditors except for the ones resulting from labor claims. However, if the goods that are subject to the pledge have been acquired from proceeds arising from a loan guaranteed with the collateral, then the priority remains on those goods even ahead of those resulting from labor claims. Such priority begins only when the pledge is recorded with the Public Registry of Commerce. The security interest created by a non-possessory pledge will have priority over a mortgage, a trust guarantee or a specific type of bank loan for capital goods, provided that the non possessory pledge is recorded prior to the goods being attached to the real estate property that is subject to those other types of guarantees.

If the non-possessory pledge is not recorded then the chronological order of the agreements shall determine such priority. In all cases a non-possessory pledge will rank above negotiable instruments, non registered liens on real estate, or pre existing court orders which have not been recorded.

The debtor is required to obtain authorization from the creditor to sell the collateral to any of the following: (i) individuals or companies who hold more than 5% of the capital stock of the debtor; (ii) members of the Board of Directors of the debtor and their replacements; (iii) spouses and family relatives within the second degree of kinship or if they have a civil relationship with the individuals referred to in sections i) and ii). If a sale is made to any of the above-mentioned individuals, the same will be null and void and the rights of the non-possessory creditor will not be affected. Further, the modifications specifically provide for the possible acceptance by both parties of an acceleration clause should any of these events occur.

The creditor's rights under a non possessory pledge have a statute of limitations of three (3) years which begins when the main obligation becomes due and payable.

Non possessory pledge agreements, their amendments, assignments, terminations, as well as any court orders concerning their cancellations must be recorded in the Public Registry of Commerce located where the debtor's address is located or if applicable, in any special registers, if available (such as the case of airplanes and ships).

Another important provision under these amendments is that non possessory pledges will be recorded even if the amount being guaranteed or secured is not determined at the time of registration but keeping in mind that the enforcement (i.e., foreclosure) will not take place until the amount has been determined. The office of the

registry is ordered to conduct the registration even if the maximum amount to be guaranteed by the collateral is not specifically determined at the time of registration.

Another important provision, that will be the subject of much criticism by lenders, is that debtors and creditors will have to determine in the pledge agreement that in the event the collateral is foreclosed, then even if the proceeds from such sale are not enough to cover the total amount of the guaranteed obligations such as principal, interest and other amounts, the debtor will be released from any deficiency resulting and therefore the creditor's rights to claim such deficiency will be extinguished. This provision cannot be waived.

It is important to note that the amendments also include penalties ranging from the payment of a monetary fee all the way to imprisonment, a development that is rarely seen in a commercial law but rather left to the criminal codes in Mexico. The penalty provisions state that if the debtor has the physical possession of the collateral that has been pledged or even if it's the creditor, and if such person or entity transfers, other than as provided by the amendments, imposes a lien or affects the possession or the ownership of such goods, removes such or abuses them or for any reason intentionally decreases the value of such, then such person will be subject to such sanctions.

These amendments are long awaited by Mexican companies seeking more flexible ways of obtaining financing as well as by foreign banks and other lending institutions who, prior to the amendments, were reluctant to provide financing in Mexico because of the lack of regulations and collateral mechanisms of the modern world. Although the practice of creating non-possessory pledges in Mexico is not necessarily new, Mexican banks were the only type of creditors allowed to obtain such through refraccionarios or avios. The lack of regulations such as the one being implemented now, created many uncertainties for creditors. Hopefully, with these amendments, Mexican companies will receive much needed financing in order to compete in today's economy and creditors will have the comfort of obtaining a perfectly legal and flexible, security interest on collateral.

This publication is designed to provide information regarding the subject matter covered and is not to be considered as legal advise by the authors.

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