

IDENTIFYING AND MITIGATING CREDIT RISK IN CROSS-BORDER FINANCING TRANSACTIONS

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1. THE MOST IMPORTANT CHALLENGE FACED BY US LENDERS IN MEXICO

Unless one is dealing with a publicly-held company, determining the creditworthiness of the borrower can be difficult. Information on privately-owned companies is not readily available, and the lender should begin a thorough fact-finding process well in advance of the desired closing date. The time required to complete a transaction in Mexico can also be longer than what foreign lenders normally expect; this is occasionally a source of frustration.

The importance of a thorough legal and financial due diligence cannot be overstated, therefore, the first step should be to locate reliable local resources: Mexican counsel and a reputable accounting firm, as well as financial advisors, if required. These specialists will guide the lender through the due diligence and negotiation process. They can also point out any risks or difficulties posed by a specific borrower, as well as market conditions.

In some instances, governmental agencies may need to be involved. This is to be expected when the recipient of the loan benefits from guarantees provided by the Mexican government for certain sectors, such as the construction of homes or agriculture. In these cases, it will be necessary to obtain the consent of the corresponding agency prior to execution of all or some of the transaction documents. If the deal has been properly structured, the consent will usually be granted; the parties should, however, be prepared to wait the necessary time for the authority to complete the review process. The lender may be required to provide information in connection with the authorization that has been requested. My recommendation is to join the borrower in all meetings with the government officers who will be responsible for granting the authorization. Mexican counsel to the lender should attend any such meetings, along with the representatives of the borrower.

It is important to inquire about any regulations that may be applicable to the borrower, or to Mexican guarantors. Certain types of companies, particularly within the financial sector, are prohibited from guaranteeing obligations of third parties (including their parent companies). We have come across cases where these limitations made it necessary to change the structure originally contemplated by the parties, with the corresponding inefficiencies in cost and time. In order to avoid this scenario, the regulatory analysis should be done as early as possible.

In the case of publicly-held companies, information will be available and can be obtained through customary channels, such as the company's website and the stock exchange. This type of borrower will be familiar with the due diligence process, and will have information readily available for review by the lender and its advisors. It is also possible that these companies may have obtained a public or private rating by a recognized rating agency, which will constitute an independent opinion regarding the creditworthiness of the borrower.

2. PERFORMING A CREDIT CHECK REGARDING A MEXICAN BORROWER

There is no source for financial data of Mexican private companies, and the process of finding the relevant information is more complex than in other countries. Nevertheless, a thorough legal and financial due diligence will bring forth the relevant information.

The most important sources are the Public Registries of Property and Commerce. The Property Registry keeps files of all properties within a city or municipality, indicating current ownership, liens or attachments and the chain of title. The Registry of Commerce keeps records of all companies which have their domicile within a city or municipality, indicating the date of incorporation, changes to the company's bylaws, liens on corporate assets which are subject to registration, and the appointment of directors or legal representatives. Mergers, spin-offs and dissolutions are also reflected in these files. Some important transactions, such as share transfers and certain types of liens, are not subject to registration. The review of registry information is therefore an essential part of the due diligence process, but it will not provide a complete picture: a lot of the information must be requested directly from the borrower.

One disadvantage is that these are local registries; without knowing the location of a property, or the domicile of a company, it is not possible to locate the corresponding file. It is necessary to physically visit the office of the registry in order to file a request, and to pick up the documents containing the information requested. Information is not provided free of cost, although the fees are not substantial. Currently, a system is being developed which will eventually make it possible to obtain registry data by electronic means, anywhere in Mexico.

Mexican banks rely on credit information companies to provide a credit history of potential clients. Unfortunately, these companies are only permitted to disclose information to the users authorized in the applicable law: Mexican financial institutions, companies which sell on credit, and individuals who request a copy of their own credit reports. In absence of other sources, lenders need to rely on the financial information provided by the borrower and, frequently, on the services of private agencies that carry out independent research.

The situation is different with publicly-held companies. Their relevant financial information can be reviewed via internet at the company's web site, and the site of the Mexican Stock Exchange. Bloomberg is another possible resource of data regarding large companies. Shares of the largest Mexican corporations are publicly traded in foreign stock exchanges, such as the NYSE, and therefore, these corporations are bound to comply with the applicable disclosure requirements.

3. ASSUMPTIONS OF AMERICAN BUSINESS LAWYERS THAT ARE INAPPLICABLE IN MEXICO

The belief that "the more familiar laws are always better," is widespread. Frequently, contracts are subject to the laws of the lender's domicile, under the assumption that this is the best way to protect the interests of the client. This is true when the borrower has an

important connection to the US, or where no other option would be practical, given the number and nationality of the parties; however, it is not the best option in every case.

With this assumption, come two more: first that submission to US courts or to arbitration is always best, and second, that it is most convenient to create security interests in accordance with US law. Neither of these statements are universally true: the choice of law and forum (or submission to arbitration), is a decision which must be made taking into account many factors, specific to each case.

I am partial to choosing the law of the place where we will seek to enforce our client's rights, whenever possible. Mexican courts have the authority to apply foreign law, but the process can be long and complex, particularly in light of the differences between our civil legal tradition and the common law system. Ultimately, the issue is how to obtain a fair judicial or arbitral decision that will be easier to enforce against the borrower, at the place where the majority of its assets are located. If the assets of the borrower are located in Mexico, it is appropriate to create a contract governed by Mexican law, and subject to the jurisdiction of Mexican courts or to arbitration. This will result in a less complex enforcement process. Choosing the courts of a country where neither one of the parties has its domicile is not advisable, as the resulting judicial decision will not be enforceable in Mexico.

Mexican courts do not enforce foreign judgments or arbitral awards regarding *in rem* rights, such as pledges or mortgages. A U.C.C. filing made in the US will have no impact on assets located south of the border. Because of this limitation, contracts creating a security interest on assets located permanently in Mexico must be governed by Mexican law, even if the loan agreement is subject to the laws of New York. This also true for security interests on vessels and aircraft.

Another common belief is that the creation of a valid and enforceable security interest in accordance with Mexican law will help to avoid the hassles of litigation. Mexican law does not acknowledge "self-help repossession", and therefore, unless the borrower willingly transfers possession and title of the collateral, it will be necessary to resort to the competent courts in order to enforce the rights of the lender.

Finally, it is important to note that shareholders and members of the board of Mexican companies do not necessarily have authority to individually execute loan agreements, promissory notes or contracts creating liens on corporate assets. Such authority must be granted in the form of powers of attorney, or in the company's bylaws. A thorough review of the corporate charter, as well as the deeds containing the relevant powers, is essential to ensure the validity of all transaction documents. No officer's certificate can eliminate the need for this review.

4. MAIN TAX CONSIDERATIONS FOR US LENDERS

When interest is paid by a Mexican tax resident or by a non-resident with a permanent establishment in Mexico, such interest is considered to be Mexican-source income for the lender. The tax rates applicable to this income are determined by the Income Tax Law and the treaties to which Mexico is a party. The following rates will usually apply:

(a) A 4.9% rate will be applied on interest paid to foreign banks which are tax residents in a country that has a treaty with Mexico, including the US.

(b) A rate of 10% is applied to interest payments made to banks which are tax residents in countries which have not entered into a tax treaty with Mexico, upon compliance with specific requirements before the Mexican tax authorities.

(c) 21% withholding tax is applied to interest payments made by Mexican credit institutions to lenders different from those contemplated in (a) and (b) above, or when credit is granted by a foreign supplier for the purchase of equipment or machinery.

(d) The general rate of 28% withholding tax is applied in all other cases.

Specific rates will be applicable in the case of reinsurance companies, financial entities in whose capital the Mexican government has an interest, instruments traded in the stock exchange and transactions indexed to the Mexican Interbank Equilibrium Rate.

Interest paid in connection with the following loans is exempted from this tax: loans made to the Mexican government, loans granted for terms exceeding three years which are guaranteed by foreign financial institutions and dedicated to the promotion of exports (when the guarantor is an institution registered with the Ministry of Finance), and loans to entities authorized to receive deductible donations.

Usually, the rates contemplated in the tax treaties are lower than those set forth in the Law: the general rate as per the Income Tax Law is 28%, while the rate set forth in tax treaties is generally 15%. There are even cases where treaties provide that interest is not subject to withholding, given the specific characteristics of the lender. It should be borne in mind, however, that in the case of non-US banks which are residents in a country that has entered into a tax treaty with Mexico, the rate of 4.9% stated in the Law is the most favourable. Please note that this rate is contemplated in a transitory article of the Law, and is subject to yearly review. In the case of US lenders, this annual review is not relevant, given that the rate of 4.9% is set forth in the tax treaty with Mexico. This is the only treaty that provides for application of this withholding rate.

It is common for loan agreements to provide that the borrower shall bear all taxes imposed by the borrower's home country, and pay to the lender the total principal and interest agreed, free of any withholding. Nevertheless, Mexican law provides that the lender will be jointly liable with the borrower for taxes that are not properly withheld and paid. The lender must ensure that the appropriate rate has been applied, and that the payment of the corresponding tax has been made. It is therefore advisable to request from the borrower copies of the documents which prove the proper withholding and payment of taxes on interest.

5. MITIGATION TOOLS THAT ARE ESPECIALLY USEFUL IN MEXICO

One option is credit insurance. It is also possible to obtain guarantees from US entities such as Eximbank and OPIC (to name only two examples). Independently from these

forms of protection, it is customary to request from the borrower one or more of the following:

(a) *Pagaré*

A promissory note drafted in accordance with Mexican law, called a “*pagaré*” gives the holder access to a simplified collection proceeding. This judicial process is faster than an ordinary collection trial, and allows for the preventive attachment of assets of the borrower, which are immobilized until the court issues a decision regarding payment of the amount owed under the note. The legal costs for issuance of a promissory note are minimal. Our recommendation is that all loans be documented in a promissory note, even if additional securities are obtained.

(b) *Aval: guaranty of payment of a promissory note*

Payment of sums due under a promissory note may be guaranteed by including the signature of the guarantor on the note itself. The guarantor will then be responsible for payment of the note on the same terms as the maker.

(c) *Guarantee*

A guaranty may be included in the loan agreement or formalized in a separate contract. As a general rule, the guarantor will only have an obligation to pay the guaranteed amount after said amount has been claimed unsuccessfully from the borrower. It is advisable that the guarantor expressly waive the rights known as “*beneficios de orden y excusión*”, which will eliminate the requirement of proceeding against the borrower.

It is possible to provide that a third party will be jointly liable for obligations of the borrower, rather than a mere guarantor. By signing a contract which expressly contemplates this type of liability, the joint obligor becomes bound in the same terms as the borrower.

(d) *Pledge*

Creation of a pledge requires different formalities, depending on whether the lien is created on tangible or intangible assets, and whether possession of the pledged goods is delivered to the lender. In the case of a pledge with transfer of possession to the lender, any of the following formalities should be observed for the perfection of the pledge:

- (i) delivery to the lender of the goods or negotiable instruments being pledged;
- (ii) endorsement of the negotiable instruments being pledged, in favour of the lender;
- (iii) delivery to the lender of the non-negotiable instruments pledged and recording of the lien in any applicable registries;
- (iv) deposit of the goods or bearer instruments at disposal of the lender in a place to which the lender has the keys;
- (v) deposit of the goods or bearer instruments with a person appointed by the lender and the borrower. In light of the rather formalistic regulation of pledges with transfer of possession, it is advisable to consult with local counsel in order to confirm compliance with all applicable requirements.

Pledges may also be created without transfer of possession to the lender. These “pledges without transfer of possession” are ideal in the case of liens on accounts receivable, or on assets which are used by the borrower in the ordinary course of its business. Under this form, it is also possible to create a lien on the total assets of the borrower.

(e) Mortgage

In Mexico, the term “mortgage” is used in cases where a lien is created on real estate, aircraft or vessels. In all other cases, the term “pledge” is employed. The mortgage extends to any new buildings constructed on the property after creation of the lien, and to any improvements to mortgaged buildings. Mortgages are formalized before a notary public, and must be registered at the Public Registry of Property of the place where the mortgaged property is located.

Prior to creation of a mortgage, it is important to check the deed of ownership, as well and the file of the property kept at the local Public Registry in order to ensure that there are no prior liens.

(f) Trusts

Assets may be transferred unto a Mexican trust for the duration of the secured obligation. In Mexico, only banks and other financial entities may act as trustees, and they charge fees both for the creation of the trust and for its management. Trust agreements require careful drafting, and the cost and time involved can be substantial.

Independently of the type of security created, it is always advisable to take the following precautions, in order to ensure the validity and enforceability of all documents:

- Companies may only act as guarantors, or encumber corporate assets to secure obligations of third parties, when their bylaws expressly permit them to do so. Review the bylaws of the borrower and all Mexican guarantors, in order to ensure that creation of the guarantee or security interest are permitted;
- Request copies of the file kept at the Public Registry of Commerce for the borrower and for any Mexican guarantors. The copies should not be more than 30 days old at the time of closing;
- Ensure that the person signing documents on behalf of a company has sufficient authority to do so, in accordance with Mexican law; and
- Keep in mind that only original documents are valid for purposes of enforcement in Mexico. All deeds or instruments formalizing the securities mentioned above should be safeguarded carefully.

6. PRIORITY OF CREDITORS

According to the Constitution and the Federal Labour Law, employees (including managerial employees) have priority over all secured and unsecured creditors of a company, for the collection of salaries and severance payments accrued within the last two years. This priority is a matter of public policy, and therefore, the parties to a loan agreement have no power to contract against it. Tax authorities have priority over other creditors, except for employees, and except for those creditors who have a prior mortgage or pledge created in accordance with Mexican law.

Among creditors whose rights have been secured by a mortgage, priority will depend on compliance with one specific formality: registration before the Public Registry of Property. Priority will be given to the party whose mortgage was first filed for registration before the Public Registry, disregarding the date of creation of each mortgage. We recommend that, as soon as the parties agree on the terms of the mortgage, a notary public be instructed to notify the registry of their agreement; the registry will then reject any requests for registration of liens by other parties, for a term of 30 days.

These rules regarding priority show the importance of complying with all formalities for the creation of a valid security interest. Mortgages must be formalized before a notary public and registered; the same requirement applies to pledges when the borrower is allowed to keep possession of the pledged goods. Notarization and registration not only ensure the enforceability of the lien, but are also essential to establish priority with regard to other creditors, including tax authorities.

Banks and other lenders have the possibility of creating a lien on the total assets of a company, in the form of a “pledge without transfer of possession”. Before accepting one or more assets as collateral, it is essential to review the borrower’s file at the Public Registry of Commerce, in order to ensure that no such pledge exists.

As an effective way to protect the rights of the lender, it is possible to transfer assets of the borrower to a Mexican trust, or *fideicomiso*. Once this transfer is effected, the assets will be deemed to be owned by the trust, and not by the borrower. They will then be excluded from possible claims by all creditors of the borrower, including its employees. Another advantage of the trust is its flexibility: it allows for the creation of rather complex structures, including constant substitutions of the assets placed in trust, and the distribution of sums of cash to one of the parties, or to both of them, on a periodic basis. This is particularly useful in cases where the *corpus* of the trust are accounts receivable, and the borrower requires access to proceeds from these accounts in order to carry on with its business.

If a sale on credit is made to a Mexican company, neither the seller nor the party who financed the purchase will have any lien or priority with regard to the merchandise that has been sold. If the goods are easy to locate and identify, it is possible to effect a sale with reservation of title, which will protect the goods from any potential claims by other creditors of the purchaser. The reservation of title must be formalized in accordance with Mexican law, in order to be registered and thus enforceable against third parties.

7. THE MOST IMPORTANT ADVICE FROM A MEXICAN LAWYER TO US LENDERS

The success of the transaction, and its timing, will depend to a large extent on local counsel. My most important advice is to choose your Mexican firm carefully. Your expectations of Mexican counsel, regarding the quality of the service provided, should be the same as those that would be applicable to US firms.

It is often assumed that Mexican counsel needs to be located in a specific area of the country. Most of the laws applicable to an international financing transaction are federal statutes, and the work can be done from one of the larger urban areas, where it is easier to find firms with experience on the subject.

Whenever possible, plan ahead of time and give local counsel notice of the transaction as early as possible process. This may make it possible to begin the work of requesting information from public registries (with minimal cost) and reviewing corporate documents of the borrower, saving time later in the process. One of our clients consistently closes transactions during the Easter holiday, when public registries and notaries are closed. By giving us a few weeks advance notice of the possible closings, this client allows us to get the information we need well before these critical days.

Provide local counsel with as much information as possible regarding the loan and any related operations, even if the Mexican firm will not be involved in every aspect of the deal. Understanding the transaction in its entirety avoids inefficiencies, and ensures that no important issues will be overlooked. Rest assured that Mexican lawyers are bound by strict confidentiality obligations.

Be prepared for things to take longer than they might in the US: exercise a high degree of patience. Mexican business lawyers will go to the same lengths as their American colleagues to get a deal closed on time, but the formalities involved in most transactions can cause delays, no matter how hard everyone tries to get things done on time.

It is the cultural and technical differences that make international work fun and rewarding: they also constitute the largest challenge in every transaction, by forcing us to leave aside our assumptions, and to understand systems that may differ radically from our own.

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