WHAT TO DO ABOUT MEXICO'S ANTIQUATED SECURED FINANCING LAW*

by Boris Kozolchyk**

I. THE UNAVAILABILITY OF COMMERCIAL CREDIT AT REASONABLE RATES

Massive distribution of goods and services requires that manufacturers, producers, wholesalers, retailers, and consumers obtain credit at reasonable rates of interest. Yet reasonable rates of interest require that the risk of debtor default be minimized while affording the debtor the ability to generate the income necessary to repay his debt. A system of secured credit preserves the ability of debtors to use their business assets to their fullest income generating extent while also enabling creditors to repossess those assets quickly and inexpensively in the event of debtor default.

In furtherance of the secured creditors' rights, major financial centers in Canada and the United States record hundreds, if not thousands, of security interests each day. In contrast, the recordings of personal property transactions in Mexico City, one of the world's largest cities, do not exceed a handful per week.[1] And, while Mexican law provides for various types of secured transactions including conditional sales[2] and pledges without debtor dispossession,[3] they are

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1. Interviews with officials of the Public Registry of Property and Commerce (including the director and assistant director) for the Federal District of Mexico, Mexico City, Mexico (Aug. 1993).

2. Mexico, Codigo Civil para el Distrito Federal [Civil Code for the Federal District, hereinafter "C.C.D.F."], art. 2310 (II). These conditional sales contracts usually include a *"clausula resolutoria"* whereby upon debtor default on the agreed payment schedule, the contract is rescinded and the goods revert to the creditor. *Id.* So

seldom used to secure the acquisition of a merchant's inventory or his accounts receivable.[4] Not surprisingly then, the average cost of commercial and consumer loans in Mexico is often three times higher than in Canada or the United States.[5]

The impact of this credit cost differential on NAFTA's ability to succeed and on Mexico's ability to develop its internal and external markets is quite significant. First of all, how can a Mexican merchant (especially if his business is small or medium sized) compete with Canadian or United States merchants who pay much less for their commercial credit? And, if commercial credit is prohibitively expensive, and thus unavailable, to the small and medium sized Mexican merchant, what kind of credit can he make available to his consumers? Furthermore, how can a credit-dependent Canadian or United States investor open up a manufacturing plant or a distribution business in Mexico if, as a result of

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that third parties may be put on notice of this lien on property, this contract must be filed at the Public Registry of Property and Commerce. *Id.*

3. *Id.* arts. 2858, 2859. Article 2858 requires that the lender be in possession of all pledged goods. However, this same article provides that possession on behalf of the lender can take two forms: *real* or *judicial*. *Id.* As in the traditional Roman pledge, the former requires that the debtor transfer actual possession of the goods to the lender. However, under *judicial* transfer of possession, article 2859 permits the debtor to retain possession of the pledged goods. Furthermore, to provide notice of the lien to third parties, this same article requires filing at the Public Registry of Property and Commerce. *Id. See also,* José María Abascal Zamora, *Consideraciones Acerca de la Posesión de los Bienes Muebles en la Prenda* [Considerations of the Possession of Pledged Personal Property], 14 (NS) 40 Boletin Mexicano de Derecho Comparado, UNAM Instituto de Investigaciones Juridicas 1981, at 26. A practitioner will see that the rules of registration are not always clear, and there is some ambiguity as to the correct place for filing liens on personal property. *Id. See also,* Sánchez Medal Ramón, De Los Contratos Civiles [Of Civil Contracts] 412 (1978); Lozano Noriega Francisco, *Contratos* [Contracts] 652 (Asociación Nacional del Notariado Mexicano, 2d ed. 1970).

4. Todd C. Nelson & Ron C.C. Cuming, Harmonization of Secured Financing Laws of the NAFTA Partners: Focus on Mexico, (National Law Center for Inter-American Free Trade) (1995). Both of these devices are found in the civil code and are civil, as opposed to commercial, in nature. It is sometimes difficult to differentiate between civil and commercial transactions. Although for simplicity sake, we can think of civil transactions as those between non-commercial parties, or a commercial party and consumer. These transactions would be regulated by the C.C.D.F, or the Civil Code of the state in which the transaction took place. On the other hand, commercial transactions would be those that embody "acts of commerce," and would be governed by the various federal commercial regulations, since all commercial activity is federal subject matter.

5. Interviews with Mexican banking officials at BANAMEX, BANCOMER, and Banca SERFIN, Mexico (August 1994 - January 1995).

the legal uncertainties of Mexico's secured transactions law, his home country secured credit is unavailable once he crosses the Mexican border?

II. WHY MEXICO'S SECURED COMMERCIAL CREDIT SYSTEM IS LARGELY INOPERATIVE

A. Cultural Attitudes

Commerce, and especially money lending, were not among imperial Spain's and colonial Mexico's favorite occupations.[6] Mercantile and intellectual endeavors were regarded in imperial Spain and colonial Mexico as usurious transactions.[7] While popular suspicions toward merchants and moneylenders still abound, many of the imperial and colonial prohibitions and restrictions disappeared once Mexico gained its independence and especially after it enacted its 1917 Constitution.[8] Moreover, for generations, central banking law has encouraged the extension of commercial and consumer credit through a highly complex system of banking and financial institutions. NAFTA has now opened this system to foreign banks.[9]

B. Inappropriate Legal Models

1. The Self Liquidating Transaction—UCC Model

While official Mexican attitudes toward commerce and credit have changed, the legal institutions chosen to implement the central banking policy of making credit more easily available have failed to fulfill their mission. To understand this failure, it is necessary to be aware of the function of legal institutions such as

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6. Ernesto Lobato López, El Crédito en Mexico: Ebozo histórico hasta 1925 [Credit in Mexico: historical perspective through 1925], 9 (1963); *see also* Boris Kozolchyk, *Law and the Credit Structure in Latin America,* 7 Va. L. Rev. 1 (1967).

7. Lobato López, *supra* note 6, at 27-28; *see also,* Boris Kozolchyk, *Transfer of Personal Property by a Nonowner: Its Future in Light of Its Past,* 61 Tul. L. Rev. 1453, 1477-1478 (1987).

8. Constitución Política de los Estados Unidos Mexicanos (1917) art. 27 (v), officially permitting Mexican banks to engage in lending activity, and art. 28, abrogating all monopolies including credit monopolies.

9. *See* North American Free Trade Agreement [Tratado de Libre Comercio de America del Norte], Ch. 14, Dec. 17, 1992, Can.-Mex.-U.S., 32 I.L.M. 289 (1993).

conditional sales and pledges without debtors' dispossession of the collateral, as well as of the public registries which record these transactions. [10]

Mexico's central banking policy with respect to commercial bank lending is the same as first introduced by the 18th century Bank of England.[11] This policy draws a sharp line between real estate and commercial lending. Real estate loans usually are associated with long term loans and are secured by the value of identifiable "immovable" property, i.e., the borrower's land, building, or both.[12] Commercial loans tend to have shorter terms and be secured by "moveable" and "self liquidating" type of collateral, which is a not always easily identifiable, i.e., a collateral that, while constantly changing shape and hands, still provides the means with which to repay the loan.

This Bank of England distinction deeply influenced United States central banking policy, especially that of the Federal Reserve Act at the beginning of this century. Commercial law implementation of this policy in the United States was carried out first by a series of uniform and non-uniform state laws and eventually by the enactment of the Uniform Commercial Code (hereinafter U.C.C.), a decade or so after the conclusion of the Second World War. This code has made possible the development of the world's largest and most active commercial and consumer credit market. It did so by shaping rules inspired by key principles of the contemporary commercial lending marketplace. Among these principles are the following:

1. Any asset can become the collateral of a secured transaction, if buyers or lenders are willing to give money for it, or a marketplace value to it;[13]

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10. In order to understand the secured financing system in Mexico, it is also necessary to study commercial devices such as the commercial pledge, General Law of Credit Instruments and Operations [hereinafter "GLCIO"], art. 334; the *avio* and *refaccionario* credits, GLCIO art. 321; the Industrial Mortgage, Law of Credit Institutions [hereinafter "LCI"], art. 67; and the commercial banking pledge, LIC art. 69.

11. Boris Kozolchyk, *supra* note 7, at 1492-1495.

12. Joaquin Rodriguez Rodriguez, Derecho Mercantil [Commercial Law] 270 (2d ed. 1988). Real property mortgages have been historically considered of civil nature, and continue to be regulated by the Civil Code even though the mortgage contract might be executed to secure a commercial obligation. *Id. See also,* C.C.F.D., *supra* note 2, art. 2893.

13. *See* U.C.C. § 9-102. The general scope of Article 9 of the U.C.C. encompasses security interests created in goods, U.C.C. § 9-103; (including consumer goods, U.C.C. § 9-109(1); equipment, U.C.C. § 9-109 (2); farm products, U.C.C. § 9-109(3); and inventory, U.C.C. § 9-109(4), documents, U.C.C § 9-105(1)(e);

2. The collateral need not exist at the time of the loan,[14] nor does it have to be tangible.[15] Nor does the debtor have to be the owner or have title to the collateral.[16] All that the debtor is required to have is possessory rights to the collateral;

3. Even if the original collateral is fraudulently sold or repledged by the debtor in possession of such collateral, or is consumed by the debtor's or a third party's use, or disappears, a creditor's secured rights can continue to be enforceable against the original collateral's replacement or its "proceeds":[17]

4. Secured rights in the same collateral may be held by different creditors concurrently or at different times as long as these rights are assigned different priorities;[18]

5. The acquisition of creditors' rights over collateral, and the enforceability of such rights, depends on notice of such rights being given to other creditors and purchasers by means of a public filing. Notice can be given, in some instances, by the creditors' possession of the collateral[19] or by a recording of the security interest, an inexpensive, easily obtainable, and accessible process;[20]

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instruments, U.C.C. § 9-105(1)(g); general intangibles, U.C.C. § 9-106; chattel paper, U.C.C. § 9-105(1)(b); and accounts, U.C.C. § 9-106).

14. *Id.* § 9-204 (1) provides for security interests in after-acquired property. Subsection 1 of this article expressly provides that a security interest arising by virtue of an after-acquired property clause has the same status as a security interest in collateral presently owned by the debtor. *Id.* Official Comment 1. The after-acquired property feature is particularly important in inventory financing and the creation of a floating lien.

15. *Id.* § 9-106

16. *Id.* § 9-202.

17. *Id.* § 9-306.

18. *Id.* § 9-312 establishes the rules for competing creditor's interests in the same collateral. The basic priority rule is first in time, first in right. Under this system, the creditor who filed his security agreement first, will have priority over subsequent competing creditors. *See* James J. White & Robert S. Summers, Uniform Commercial Code 1131-1137 (3d ed. 1988). U.C.C. § 9-301 establishes rules whereby unperfected secured creditors are subordinated to competing claims with an interest in the same collateral.

19. U.C.C. § 9-305 establishes rules and types of collateral for which the creditor can perfect by taking possession. *Id.* § 9-302 establishes that filing will not be required in some instances.

20. U.C.C. §§ 9-401 to 9-408 govern filing of security interests. Filing takes place by executing and delivering what is commonly known as a UCC-1 at the proper location. The information in this form will not typically contain a detailed

6. The type of registry best suited for personal property secured transactions is not a registry of collateral but a registry of debtors. Only when the individual item is highly valuable and subject to serial number identification does a registry of collateral make sense.[21]

7. The realization of the secured creditors' rights in the event of debtors' default should be as quick and inexpensive as possible.[22] This includes the peaceful use of creditor self-help repossession.[23]

2. The Mexican Real Estate Financing Law Model

Mexican secured financing legal institutions failed in their mission because they ignored the above enumerated principles. They ignored these principles in favor of the principles that govern real estate secured financing in Mexico, allowing to govern personal (or "moveable") property secured transactions as well.

One of these principles assumes that real property is the most valuable form of property and that any other form of property is accessory or subsidiary.[24] Accordingly, the accessory, personal property and fixtures, follows the fate of the

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description of the collateral, the amount of the loan, the interest rate or terms of repayment, or the duration of the agreement. In fact, from the information contained on the UCC-1, one cannot even be sure that a loan has been made. This is because the U.C.C. calls only for "notice filing"; a type of filing which is intended only to put third parties on notice that a further inquiry must be conducted. *See* Richard E. Spidel et al., Sales and Secured Transactions §§ 3-4, at 141-73 (5th ed. 1993).

21. Federal law currently requires special collateral filings for ships, Ship Mortgage Act of 1920, 41 Stat. 1000, 46 U.S.C.A. §§ 911-984 (1987 Supp.); railroad rolling stock, Interstate Commerce Act of 1887, ch. 104, as added 1952, ch. 881, 66 Stat. 724, 49 U.S.C.A. § 30(c) (1979 Supp.); and all civil aircraft, Act of 1958, Pub. L. No. 85-726, 72 Stat. 772, 49 U.S.C.A. § 1403 (1976). To this effect, article nine defers to any statute of the United States where such statute governs the rights of parties affected by transactions in particular types of property. U.C.C. § 9-104 (a).

22. White and Summers, *supra* note 18, at 1195-1209.

23. U.C.C. § 9-503. In case of default, article nine allows the secured party to retake possession of the collateral through extra-judicial means, if this can be done "without a breach of the peace." *Id.*

24. C.C.D.F., *supra* note 2, arts. 750, 751.

principal real property.[25] Thus, a real property filing involving the same personal property or fixtures as a personal property filing will have priority, regardless of time of filing.[26] *Mutatis mutandis*, a security interest (as an accessory transaction) can only be filed once the underlying loan (the principal transaction) has been completed.[27]

Another principle inspired by real property law assumes that the most protective, and therefore most sought after, right of purchasers and of creditors is that of ownership. Several sub-principles flow from the supremacy of ownership rights. The first is that the law is much more protective of a purchaser or creditor who is able to exhibit a formal "title" to the collateral, such as public or private deed of sale or mortgage or trust (fideicomiso). The second is that possessory rights are protected only when the purchaser or the creditor can prove his adverse possession by means of an exhaustive legal procedure.

Third, one who does not have ownership rights, or who cannot prove that he acquired his rights to the collateral as a debtor or creditor from someone who is an owner, cannot be a party to a secured transaction. Unlike a U.C.C. rule which states that "title to the collateral is immaterial,"[28] title to Mexican collateral is material and must be proven in a historical or chronological fashion.

The implications of this principle for the operations of a commercial or personal property security registry are very significant. To implement this principle, a registry must be able to provide historical information on the chain of title of the collateral in question, even though this collateral may be as changing, as ephemeral or untraceable as a department store's inventory, a magazine's accounts receivable, or money on deposit in a checking account.

In addition, the registry must be able to identify in detail the collateral in question, much as it does in real property filings with Blackacre's metes and bounds.[29] Finally, the right to follow or pursue the creditor's right in the value of the collateral or in those goods or proceeds that replace it in value, is lost as a result of the present system's ineffectiveness in proving a continuous chain of title leading to the new collateral or proceeds. In short, the registry inspired by the real property law principles must per force be a registry of collateral, regardless of the difficulties in tracing title or in identifying the collateral.

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25. *Id. See also* C.C.D.F., *supra* note 2, art. 2896 (III) (establishing that a mortgage on real property ("principal") will extend to any personal property incorporated to this land).

26. *See id.*, tit. XV, ch. I.

27. *Id.*

28. *See* discussion *supra* note 14.

29. *See, e.g.*, Ley No. 143, art. 81, *Catastral y Registral del Estado de Sonora* [Registry and Assessor Law for the State of Sonora].

III. WHAT TO DO?

The financing of commercial and consumer transactions is done by parties who, according to the principles of Mexican real property law, are not "true" owners. Imagine, for example, a transaction which is likely to become typical of the NAFTA trade: Mexican producers manufacture small refrigerators but their raw materials and parts are subject to a pledge conveyed by the Mexican manufacturer to their bank in Mexico. Imagine next, that once manufactured, the refrigerators become collateral for another bank that has financed the manufacturer's inventory of refrigerators in Mexico. At that point, the Mexican manufacturer sells these refrigerators to a United States distributor on credit. The United States distributor obtains financing for the purchase of the refrigerators from his local bank in the United States. This bank issues a letter of credit naming as beneficiary the Mexican manufacturer of the refrigerators. The United States bank requires a security interest from the dealer while the refrigerators are still in transit. The distributor-importer obliges by having the manufacturer endorse a negotiable bill of lading obtained from the ocean carrier of the refrigerators. While the goods are in transit, fifty refrigerators are sold to a retailer who makes a down payment and identifies the fifty refrigerators he purchased. The refrigerators arrive at the United States port and the importer-distributor does not have the money to pay either the ocean carrier's freight or the bank's loan. Who owns the fifty refrigerators? And, regardless of who owns the refrigerators, who can claim possession of these refrigerators from the carrier whose freight remains unpaid?

The answer is that if real property law standards were to apply, it would be very difficult to say who truly owns the refrigerators. From a possessory standpoint, however, each person in the above chain has, including the captain of the vessel whose freight remains unpaid, a right to the useful retention or use of the collateral or to the realization of its market value. For the law of commercial secured loans to succeed, each one of these rights must be acknowledged, and be allowed to provide the most effective notice to other actual or potential creditors and purchasers and be assigned priorities based upon what kind of credit is the most desirable.

President Zedillo, while still a candidate, noted the importance of transforming the real property lending mentality to a commercial lending mentality. In a speech to Durango entrepreneurs, he pointed to the need to promote "changes in the commercial bank mechanisms that facilitate loans to small and medium firms." He added that such loans must be evaluated in light of their commercial feasibility and intrinsic value and not on the basis of the "real

property mortgages that the owner of the firm was able to provide . . . ."[30] This is a correct characterization of the problem and a helpful enunciation of policy.

The implementation of this policy requires the enactment of a law that provides for the creation, perfection (notice), and priority of security interests likely to attract the widest range of commercial loans at interest rates comparable to those that prevail in Canada and the United States. Once these security interests have been selected, it will be necessary to identify their common elements. If common elements are not identified and a common criterion for perfection and priority is not adopted, the law of secured transactions would face the very difficult task of ranking the proverbial apples as if they were oranges. This would be the case, for example, if the law attempts to set forth a rule for the perfection and priority of a security interest based on the creditor's ownership, as in a financial lease, and apply it to a possessory type of interest as in a pledge without the debtor's dispossession of the collateral. It is not difficult to predict that those creditors who regard themselves as actual or putative owners will soon claim to be immune, as owners, to any claims by those who merely claim possessory rights.

As proven by the Canadian and United States experience, a unitary security interest which contains the common denominator of the creditor's and debtor's right of possession, is a much more workable approach than that of security interests predicated upon ownership or a mixture of ownership and possessory rights. Accordingly, the right conveyed to the secured creditor is best characterized as one to the possession of the collateral based on the terms and conditions specified in the security agreement or in the law of secured transactions.

As a consequence of the conveyance of a right to the possession of the collateral at any stipulated time, whether by the parties or by the law, the creditor will be able to repossess the collateral, either by peaceful, extra-judicial means or judicially, by means of a truly summary action. Such a creditor will not need to: a) prove the effectiveness of the loan-pledge agreement in court; b) file an action for the recision of the security agreement; and c) undergo the procedure for the execution of judgments or of highly liquid rights ("execution" procedures or procedimientos de ejecucion). Predicated upon a valid filing, endorsement of a document of title or acquisition of physical control over the collateral, his action should be possessory in nature, and as such, resemble that of the "possessory interdict" procedures. These are procedures common in civil law countries for the quick preservation or recovery of possession.

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30. Mexican Presidential Candidate Ernesto Zedillo Ponce de León, Address at a conference for entrepreneurs, in Gomez-Palacio, Durango, Mexico (May 24, 1994), *in* El Norte, May 25, 1994, at 1.

Finally, this system should be harmonized with those in effect in Canada and the United States as well as those in other countries entering into free trade agreements with NAFTA countries. Harmonization will require not only changes in the respective countries' substantive law but also in their recording systems, which hopefully will provide for an electronic network that will allow a bank, say in British Columbia, Canada, to check its computer for recordings in the registries of Guadalajara or Monterrey, Mexico prior to considering the extension of a loan to borrowers in those cities. Thanks in large measure to the work of Professor Ronald Cuming of the University of Saskatchewan, Director of the Secured Financing Project at the National Law Center for Inter-American Free Trade, Canada has become the world's leader in electronic commercial registries. Present legislative efforts to modernize secured transactions law in the United States are moving in the direction of Canada's model. Hopefully, Mexico as well as other Latin American countries will soon join that network.