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Summary of Amendments to Mexico's General Law on Negotiable Instruments and Credit Transactions Allowing the Creation of a "Non-Possessory" Pledge

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On May 23, 2000, Mexico amended its General Law on Negotiable Instruments and Credit Transactions (LGTOC) to allow for the creation of a "non-possessory" pledge or lien (*prenda sin transmisión de posesión*) over any type of personal property. The amendments, which became effective on May 24, 2000, significantly changed and improved Mexico's secured transactions system. In the past, the system generally required actual or constructive (through a third-party depository) delivery of the collateral or pledged assets to the creditor, and specific identification of the same in order to perfect a security interest over such collateral.

Now, a debtor in Mexico may perfect a pledge or lien over any of its personal property to secure any obligation, without having to give up physical possession of that property, thus allowing the debtor to continue using the collateral in its regular course of business. In addition, if the creditor is granted a "blanket" security interest (covering all of the debtor's assets used in its business), then only a general identification of the collateral is required.

The amendments grant to a registered "non-possessory" pledge priority over any unsecured debts, unregistered security interests, unregistered judicial liens, and subsequently registered secured interests. The amendments prohibit the debtor from granting any other pledge or security interest over property already subject to a "non-possessory" pledge, but allow for the creation of a purchase money security interest to new creditors over after-acquired property, provided that such property is specifically identified. The amendments allow the debtor and creditor to agree on and use voluntary extra-judicial procedures for the foreclosure of the collateral, provided that no disputes arise regarding the credit. They also establish a new procedure for the judicial enforcement of a "non-possessory" pledge and foreclosure of the collateral when the matter is contested by the debtor.

Virtually any type of property other than real estate may be subject to this new pledge, including intangibles such as accounts receivable, trademarks, and commercial names. This new pledge may also cover "after-acquired" property and allows for the creation of a "floating lien" over inventory or other collateral, which means that there would be no need to renew or amend the pledge or make additional filings with the Public Registry of Commerce as inventory enters or exits the debtor's facilities. The debtor's personal property such as inventory, transferred by the debtor in its regular course of business, remains subject to the pledge from the time the debtor acquires it until sold to third parties, and new inventory coming in will be subject automatically to the pledge.

To create a "non-possessory" pledge, the debtor and creditor must agree on the following: (1) the location, if applicable, of where the collateral will remain; (2) the minimum price that the debtor is entitled to receive as a result of the sale of the collateral; (3) information allowing the specific identification of the person or persons to which the debtor is authorized to sell or transfer the collateral; (4) the destination of the proceeds obtained from such sale or transfer; and (5) the information that the debtor must deliver to the creditor regarding the transformation, sale, or transfer of the collateral.

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 require the debtor to insure the collateral with an insurance company of its own choice, but the beneficiary under the policy must be the creditor. The secured obligation would then be reduced by the payment that the creditor receives from the insurance company. Any remaining insurance proceeds must be returned to the debtor.

The debtor must keep the property subject to the "non-possessory" pledge in good condition, and is liable for any damages, deterioration, or losses suffered by the property as a result of the debtor's fault or negligence. The debtor is prohibited from using the collateral for a purpose different from the one agreed to with the creditor. The debtor is also responsible for any maintenance, repair, recovery, or management costs of the pledged property. If the collateral is lost or deteriorated by more than a specified value agreed to between the parties, the creditor is entitled to demand an additional pledge or acceleration of the main obligation.

The creditor is entitled to inspect the property to determine its weight, quantity, general appearance, and condition. 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 no longer covers the principal as well as interest and certain costs, then the debtor may add additional collateral to replace the original amount. Otherwise, the payment of the main obligation may be accelerated upon judicial or notarial notice by the creditor.

The parties may also include in the pledge agreement a procedure allowing for an expert appointed by the parties to issue a binding report regarding the acceleration due to the loss of market value or damage to the collateral. Once 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.

A "non-possessory" pledge must be created in writing, and if it involves property valued at the equivalent in Mexican Pesos of 250,000 Investment Units (UDIS), currently valued at 2.7 UDIS per Peso, which is approximately U.S.$9,800, then the signatures of all parties must be ratified before a notary public. The pledge does not become effective with respect to third parties until it is recorded with the Public Registry of Commerce.

From the moment of its registration with the Public Registry of Commerce, a "non-possessory" pledge is granted first priority above all other unregistered or subsequently registered liens, except for those derived from labor claims. However, the priority remains on the collateral even ahead of liens derived from labor claims in those cases where the collateral was acquired by the debtor with secured credit (e.g., in the case of a purchase money security interest). A "non-possessory" pledge even has priority over a mortgage, a trust guarantee, or a specific type of guarantee in a certain type of bank loan for the acquisition of capital goods ("*garantía refaccionaria*"), provided that it is recorded prior to the goods being attached to the real estate property that is subject to those other types of guarantees.

The debtor is required to obtain authorization from the creditor to sell the collateral, even in the ordinary course of business, to any of the following: (1) individuals or companies who hold more than 5 percent of the capital stock of the debtor; (2) members of the board of directors of the debtor or their replacements; and (3) spouses and family relatives (including in-laws) within the second degree of kinship with the individuals referred to in sections (1) and (2). An unauthorized sale to any of the above-mentioned individuals is null and void without affecting the rights of the creditor. The statute of limitations for a creditor to enforce its rights under a "non-possessory" pledge is three years from the date on which the main obligation becomes due and payable.

Another important provision under the amendments is that a "non-possessory" pledge will be recorded even if the amount being guaranteed or secured is not determined at the time of registration, provided that enforcement (i.e., foreclosure) cannot take place until that amount has been determined. The office of the Public Registry of Commerce must effect the registration even if the maximum amount to be guaranteed by the collateral is not specifically determined at the time of registration.

A provision that has been subject to strong criticism by lenders is that requiring the pledge agreement to provide that the secured obligation is extinguished, and the debtor released with respect to any deficiency upon foreclosure of the collateral, even if the proceeds from the sale are not enough to cover the total amount of the guaranteed obligations such as principal, interest, and costs. This provision cannot be waived. For this reason, creditors should ensure that the collateral is of sufficient value to cover the entire amount of the secured debt.

Under the amendments, if the party having physical possession of the collateral transfers (other than as provided in the LGTOC) grants a lien or affects the possession or the ownership of such collateral, removes or damages it (other than as a result of normal wear and tear), or for any reason intentionally decreases its value, then such party is subject to severe sanctions, including fines and imprisonment.

Finally, the amendments provide for new procedures for enforcement of the pledge and foreclosure of the collateral, and contain specific time frames and limit the number of defenses that may be raised by the debtor. However, such procedures still do not allow for extra-judicial repossession or foreclosure of the collateral without the debtor's consent. It remains to be seen whether in practice the new procedures for the enforcement of the pledge will serve to expedite the collection of a secured credit in Mexico. The amendments, though, are definitely an improvement over Mexico's previous secured transactions system.