The One-Edged Sword: The High Risks of Commercial Transactions in Mexico (Denominated in Either Pesos or Other Currency) Created by Mexico's Monetary Law and Frequent Peso Devaluations

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I. Introduction.***

Mexican monetary law can have ruinous results for the unwary that enter into commercial transactions in Mexico.1 The instability of the Mexican peso presents the economic side of the dilemma, whereas Mexico’s monetary law creates the legal side. Together they provide the proverbial final nail in the coffin to the unwary. The cyclical ups and downs of Mexican markets, especially the historical and present rapid devaluations of the peso,

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1 "Ley Monetaria de Los Estados Unidos Mexicanos (Legislación Bancaria)," D.O. 27 de julio de 1931 [hereinafter Fourth Transitory Article]. Modificada en 1935. Modificada por última vez por decreto publicado el 8 de diciembre de 1992. This monetary law is a federal law and applies to transactions in Mexico, whether the transaction took place in the State of Jalisco, Monterrey, Quintana Roo, the Federal District, or any other location in the Republic of Mexico.
make this article particularly timely for those who have already or will enter into almost any type of commercial transaction in Mexico. Unfortunately, contracting parties usually give little thought to the consequences and terms of repayment obligations under a particular contract entered into in Mexico or to the effect of legal provisions such as the Fourth and Ninth Transitory Articles of the Monetary Law of Mexico, other than providing that payment will be made at a particular time, using a particular currency, and at a fixed or variable rate or amount.

A. STATEMENT OF THE PROBLEM.

The general rule under Mexico's monetary law provides that all payment obligations acquired within or outside of Mexico that are payable within Mexico shall be paid in Mexican pesos at the exchange rate applicable at the time and place where payment is made. However, in some types of transactions under Mexico's monetary law, debtors are entitled to refund, repay, or reimburse pesos to the other contractual party using the exchange rate at the time the amounts were originally received instead of the exchange rate at the time when the amounts are reimbursed. This is the result even if the contract expressly states that such refund or reimbursement will be paid in dollars, or other non-peso currency, at the rate of exchange existing at the time of the reimbursement.

This article discusses the exception to the general rule, where the result is that the debtor can receive an economic windfall if the peso devalues since payment can legally be made in pesos at the rate of exchange that exists at the time the debtor reimburses the creditor, notwithstanding written terms of a contract to the contrary. The differing results under the general rule and the exception (which is the discussion of this article) are due to a timing difference the debtor can legally use to determine the currency rate of exchange applicable to the transaction.

By way of illustration, assume a U.S. corporation, as a buyer, enters into a real estate purchase contract to buy a tract of commercial real estate in the State of Jalisco from a Mexican seller. The contract provides that the buyer will make a one-million-dollar down payment.

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2 Throughout this article, the fourth transitory article of Mexico's Monetary Law is referred to as the "Fourth Transitory Article," and was adopted in 1931 along with the new monetary law. The Ninth Transitory Article was adopted in the 1935 amendments to the monetary law and is almost identical in language, except for a minor difference relating to the timing of when the applicable exchange rate should be determined. See infra notes 9 and 12. Both the Fourth Transitory Article and the Ninth Transitory Article are transitory articles. This article refers to the Fourth Transitory Article throughout, and the authors mean to also include the minor revisions that were made by the Ninth Transitory Article each time reference is made to the Fourth Transitory Article.


4 This rule is set forth in Article 8 of the Monetary Law (Artículo 8º de la Ley Monetaria) and is not a transitory provision of law. See Artículo 8º de la Ley Monetaria, D.O., 8 de enero de 1986.

5 The application of the Fourth Transitory Article normally applies equally to contracts for personal use and contracts for commercial use. The Fourth Transitory Article would apparently apply equally to a real estate purchase of a personal home as it would to a purchase of commercial property.
payment payable in either pesos or dollars. Assume the rate of exchange on the date the down payment was made was N $3.4 to the dollar, and that the buyer paid the down payment in pesos totaling N $3,400,000. If certain conditions precedent are not met, the contract expressly requires that seller or escrow agent "shall return the one million dollar (US $1,000,000) down payment to Buyer payable in U.S. dollars, payable either within the U.S. or within Mexico."

Next, assume the conditions precedent are never satisfied under the contract, therefore, the seller (or the escrow agent) is contractually required to return the US $1,000,000 down payment to the buyer. However, in the interim, assume the peso has devalued so the exchange rate is now N $7.6 to the dollar, making the US $1,000,000 down payment now worth N $7,600,000.

Herein lies the dilemma. After consulting Article Eight and the Fourth Transitory Article of Mexico's monetary law, the seller or escrow agent tells the U.S. buyer that instead of repaying the US $1,000,000 in dollars (remember the contract expressly requires the return of the down payment "payable in U.S. dollars"), the seller will only pay pesos at the pre-devaluation rate in a total amount of N $3,400,000. The law in Mexico provides that under these circumstances the U.S. buyer has a legal right to receive only N $3,400,000 from the seller, or escrow agent, leaving the buyer with an economic loss of US $552,632 ((N $7,600,000 – N $3,400,000 = N $4,200,000)/N $7.6).

The end result is the U.S. buyer loses over half of the initial payment (US $552,632) of the "refundable" deposit (the US $1,000,000) because of the decline in the Mexican peso and the effect of the application of the Fourth Transitory Article of Mexico's monetary laws, notwithstanding the express terms of the contract. In addition, the buyer has no legal right to the real estate. In this scenario there is only bad news for the U.S. buyer, but the good news is that if the transaction had been structured properly, the buyer could have avoided the draconian effects of the Fourth Transitory Article of Mexico's monetary laws.

II. Purpose of this Article.

The purpose of this article is three-fold. First, it will discuss the scope of the Fourth Transitory Article of Mexico's monetary law and its effects. Second, this article will describe some typical commercial transactions that can be adversely affected by the application of the Fourth Transitory Article. Finally, the article will discuss what steps can be taken and how transactions can be structured so as to avoid the damaging effects of the Fourth Transitory Article.

The Fourth Transitory Article could apply to an almost infinite number of transactions and therefore these hypothetical transactions are only provided for purposes of illustrating the application and consequences of the Fourth Transitory Article. Any party to a commercial transaction in Mexico that requires (1) contractual performance in Mexico and (2) some type of payment, reimbursement, refund, or other similar consideration, which must be complied within Mexico, should be wary of the potential application of the Fourth Transitory Article (regardless of the nationality of the creditor).
III. Brief Historical Background.

In order to better understand the logic (or lack thereof) of the Fourth Transitory Article, it is important to have a brief understanding of the historical roots of this provision of law in Mexico. In 1918, during the last stage of the Mexican Revolution, President Venustiano Carranza issued a presidential decree granting legal effect (curso legal) to foreign currency, which at the time usually had intrinsic value apart from the governmental political unit that issued the currency. In those days, coins usually were made wholly or partially from precious metals such as gold and silver. Therefore, there was no reason to prohibit the circulation of foreign currency that held intrinsic value, since an ounce of gold had the same value worldwide, regardless of the political state that manufactured the currency.

This presidential decree was effective only until Mexico adopted a new monetary law in 1931 that allowed the manufacture of coins and notes that had nominal physical value and did not contain precious metals. At that time, the strength of a nation's economy determined the value of its currency. Since the currency no longer had intrinsic value, contracting parties needed to know what currency and exchange rates would be allowed or required by law in various commercial transactions.

The new law contained, as is common practice in Mexico every time a new law is enacted, transitory provisions that allowed it to become effective without disrupting transactions entered into prior to its enactment. The transitory provisions of the Monetary Law of 1931 provide the exception to the general rule contemplated in Article Eight for cases where the debtor can demonstrate that it received Mexican currency. It grants a debtor the controversial right to reimburse the obligation in Mexican currency at the later date.

Initially, jurists interpreted these provisions in different ways. Some thought that if a contract provided that payment must be made in either a non-peso currency or at a predetermined rate, then the terms of that contract should control, and payment must be made as reflected in the contract. The reasoning was that the exception contained in the Fourth Transitory Article would apply, based on its transitory nature, only to specific cases occurring prior to, or continuing up through 1931 in order to protect individuals that received Mexican currency at any time before the Monetary Law was adopted.

In contrast, others took the view that has been upheld by the Supreme Court of Mexico. This school of thought assumed that this rule had no place among the transitory provisions, and assumed the legislature meant to place this provision among the permanent provisions and not as a transitory provision.

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7 Presidential Decree for the recognition of legal effect to foreign currency, D.O., 17 de mayo de 1918.
8 The third article of the presidential decree established legal effect for currencies made of gold at the equivalency of one Mexican gold peso to three-quarters of a gram of pure gold. See id.
9 This law was then modified in 1935, amending Article 8, changing the date upon which the value of the currencies was to be determined in relation to the repayment date. Originally, the 1931 law provided that the value of the currencies was to be fixed as of the date the contractual obligation arose between the parties, whereas the 1935 amendments (which adopted transitory article 9, see supra note 2) provided that the value of the currencies can be fixed as to the date at which the contractual obligation was acquired or if not determinable, then at the date at which repayment is actually made. The Fourth Transitory Article only referred to the date when the money was initially received (which is not necessarily the same date at which the contractual obligation arose) or if this date was not determinable, then at the rate determined by the competent authorities. However, since 1935 the government has never fixed such a rate.
Of course, these provisions and their legal interpretation and effect would have no real importance from an economic perspective if the Mexican currency were to remain relatively stable in comparison with other foreign currencies. This has not been the case in Mexico in the twentieth century. These provisions were not seriously considered and analyzed by jurists, business people, or their lawyers until some of the more recent major peso devaluations. As the Mexican peso has suffered sequential devaluations over the years, deteriorating in value against stable currencies such as the U.S. dollar, both Article Eight and the Fourth Transitory Article of the Monetary Law have been used as a shield by debtors to avoid making payments in a non-peso currency, providing debtors with a windfall if the peso devalues between the time the contract was entered into and the date of payment.

The most recent overnight devaluation occurred on December 20, 1994, when the peso went from N $3.4662 to the dollar to N $4.8875 in a short period of time, which is a devaluation of forty-one percent. The peso continued to decline throughout 1995, and at one point the exchange rate exceeded N $8 to the dollar. The peso further declined in 1998 and at one point the exchange rate exceeded N $10.69.

In times of currency devaluations, the Fourth Transitory Article and its interpretation becomes extremely important. The above differing interpretations of the Fourth Transitory Article were settled by the Mexican Supreme Court in its opinions discussed in more detail below.

### Principle Peso Devaluations in Mexico During the 20th Century:

<table>
<thead>
<tr>
<th>Year</th>
<th>Percentage Devaluation</th>
<th>Change in Value</th>
<th>President in Office</th>
</tr>
</thead>
<tbody>
<tr>
<td>1902</td>
<td>13.3</td>
<td>2.11 to 2.39</td>
<td>Porfirio Diaz</td>
</tr>
<tr>
<td>1913</td>
<td>35.1</td>
<td>2.08 to 2.81</td>
<td>Francisco I. Madero</td>
</tr>
<tr>
<td>1914</td>
<td>17.4</td>
<td>2.81 to 3.30</td>
<td>Victoriano Huerta</td>
</tr>
<tr>
<td>1915</td>
<td>237.9</td>
<td>3.30 to 11.15</td>
<td>Eulalio Gutierrez</td>
</tr>
<tr>
<td>1916</td>
<td>113.7</td>
<td>11.15 to 23.83</td>
<td>F. Lagos Chazaro</td>
</tr>
<tr>
<td>1931</td>
<td>17.3</td>
<td>2.65 to 3.16</td>
<td>Ortiz Rubio</td>
</tr>
<tr>
<td>1932</td>
<td>19.2</td>
<td>3.16 to 3.50</td>
<td>A.L. Rodriguez</td>
</tr>
<tr>
<td>1933</td>
<td>10.8</td>
<td>3.16 to 3.60</td>
<td>A.L. Rodriguez</td>
</tr>
<tr>
<td>1938</td>
<td>25.6</td>
<td>3.60 to 4.52</td>
<td>Lazaro Cardenas</td>
</tr>
<tr>
<td>1939</td>
<td>14.8</td>
<td>4.52 to 5.19</td>
<td>Lazaro Cardenas</td>
</tr>
<tr>
<td>1948</td>
<td>18.4</td>
<td>4.85 to 5.74</td>
<td>Miguel Aleman</td>
</tr>
<tr>
<td>1949</td>
<td>39.5</td>
<td>5.74 to 8.01</td>
<td>Miguel Aleman</td>
</tr>
<tr>
<td>1954</td>
<td>44.5</td>
<td>8.65 to 12.50</td>
<td>A. Ruiz Cortinez</td>
</tr>
<tr>
<td>1976</td>
<td>22.9</td>
<td>12.50 to 15.36</td>
<td>L. Echeverria</td>
</tr>
<tr>
<td>1977</td>
<td>46.9</td>
<td>15.36 to 22.56</td>
<td>J. Lopez Portillo</td>
</tr>
<tr>
<td>1982</td>
<td>257.9</td>
<td>24.48 to 87.62</td>
<td>J. Lopez Portillo</td>
</tr>
<tr>
<td>1983</td>
<td>71.5</td>
<td>87.62 to 150.30</td>
<td>M. De la Madrid</td>
</tr>
<tr>
<td>1984</td>
<td>23.3</td>
<td>150.30 to 185.27</td>
<td>M. De la Madrid</td>
</tr>
<tr>
<td>1985</td>
<td>69.3</td>
<td>185.27 to 313.73</td>
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<td>1986</td>
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</tr>
<tr>
<td>1987</td>
<td>120.2</td>
<td>637.63 to 1404.02</td>
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<tr>
<td>1988</td>
<td>63.2</td>
<td>1404.02 to 2291.24</td>
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</tr>
<tr>
<td>1990</td>
<td>14.4</td>
<td>2481.08 to 2837.13</td>
<td>Carlos Salinas</td>
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</table>

La Carreta Purpura, No. 179, Jan. 6, 1995, at 8.

See id.
IV. Law, Source of Law, and Analysis.

In the Mexican civil law statutory system, the statutes, regulations, codes, and laws (leyes) are normally accompanied by "transitory provisions" (disposiciones transitorias). These transitory provisions are used so that a piece of legislation may become effective while taking into consideration special circumstances that may require different treatment. For example, the Mexican Federal Law of Civil Aviation, enacted as of May 12, 1995, provides in its Third Transitory Article that all violations incurred before the enactment of the law will be sanctioned in accordance with the provisions of laws effective at the time of their occurrence.

Provisions of this sort, by their nature, are necessarily of limited application during a limited period of time. Their sole purpose is to provide a solution to particular cases that normally pertain to a particular period of time when the exact application of a statute may be in doubt, or when special circumstances need to be taken into consideration to permit the new law to become effective. In some rare cases, however, transitory provisions of law in Mexico are continuing in nature and can permanently become part of the statute, losing their "transitory nature." Such has been the case of the Fourth Transitory Article of the Monetary Law (Ley Monetaria) which, as translated into English, provides:

Payment obligations in foreign currency [i.e., other than in Mexican pesos] which are acquired within Mexico and which are to be complied with in Mexico, shall be paid as provided in accordance with Article Eight of the Monetary Law, unless the debtor demonstrates, with respect to loan or credit operations, the currency initially received from the creditor was national currency of any sort, or that with respect to other operations the currency in which the operation was originally contracted, was national currency of any kind; in these cases the referenced obligations shall be resolved and payable in national currencies [i.e., Mexican pesos] in accordance with Articles Four and Five of this Law, at the exchange rate applicable at the time the obligation was initially incurred, or if not possible, at the legal rate.12

The above provision was a transitory provision adopted when the Monetary Law was originally enacted in 1931. Many legal scholars thought the Fourth Transitory Article should only apply to obligations acquired prior to the enactment of the 1931 law.

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12 The literal text in Spanish of the Fourth Transitory Article provides in part as follows: Las obligaciones de pago en moneda extranjera contraídas dentro de la República para ser cumplidas en ésta, se solventarán en los términos del artículo 8° de esta ley, a menos que el deudor demuestre, tratándose de operaciones de préstamos, que la moneda recibida del acreedor fuera moneda nacional de cualquier clase, o que tratándose de otras operaciones, la moneda en que se contrajo originalmente la operación, fue moneda nacional de cualquier clase; en estos casos las obligaciones de referencia se solventarán en monedas nacionales, en los términos de los artículos 4° y 5° de esta ley, respectivamente, al tipo que se hubiere tomado en cuenta al efectuarse la operación para hacer la conversión de la moneda nacional recibida a la moneda extranjera, o si no es posible fijar este tipo, a la paridad legal. [Artículo 9 substituye la frase "... a la paridad legal" por lo siguiente "... al que haya regido el día en que se contrajo la obligación.]
For some reason, these scholars were apparently ignored by the Supreme Court of Mexico, who changed the transitory nature of this article by treating it as a permanent provision of the Monetary Law. In doing so, the Mexican Supreme Court ruled in favor of the debtors, apparently ignoring the provisions of President Carranza's Decree of 1918.13 Had this decree been considered, the Fourth Transitory Article might have indeed been treated as transitory instead of as a permanent provision of law.14

Consequently, during times of peso devaluations, many Mexican debtors of non-peso currency can legally refuse to pay the non-peso currency and instead pay in "devalued" pesos. This law has given rise to numerous, long-lasting disputes, and the recent peso devaluations of 1994, 1995, and 1998 will undoubtedly spawn even more.

Herein lies the "one-edged" sword. Based upon the express language of the Fourth Transitory Article, only the debtor can benefit economically from a change in currency value, i.e., a peso devaluation.15 Under no circumstances does the creditor have the legal power to economically benefit from the Fourth Transitory Article. The language of the Fourth Transitory Article says that "the exchange rate applicable at the time the obligation was initially incurred . . ." will be applied "if the debtor demonstrates . . . the currency initially received . . . was national currency . . . ."16 In this sense, the force of the Fourth

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13 (a) Semanario Judicial de la Federación. Época 7a: Tomos 151-56, Pág. 221; Tomos 163-68, Pág. 103; Tomos 109-14, Pág. 121; Tomos 139-144, Pág. 85; Tomos 151-56, Pág. 222; Tomos 193-98, Pág. 94. Época 8a: Amparo Directo 2063/87 Pérez Avella y otra; Amparo Directo 478/86 Valencia Caballero. Informe de la Suprema Corte de Justicia de la Nación.


15 The Fourth Transitory Article requires the debtor to "demonstrate" that payment was originally made in pesos, thereby placing the initial burden of proof on the shoulders of the debtor before any reimbursement can be made in devalued pesos.

16 "Ley Moneteria de Los Estados Unidos Mexicanos (Legislación Bancaria)", D.O., 27 de julio de 1931.
Transitory Article is solely within the power of the debtor since only the debtor can "demonstrate" that payment was made in pesos. If the creditor were to try to "demonstrate" the form of payment, the creditor's activities would arguably not fall within the scope of the Fourth Transitory Article.

If the peso were to strengthen in value, the creditor would only be entitled to receive the non-peso currency equivalent of the earlier weaker value of the peso. Thus, under the unlikely circumstance that the peso would increase in value (or where the peso remains the same value vis-à-vis other foreign currencies and the U.S. dollar devalues vis-à-vis other foreign currencies such as the yen or pound), the debtor could pay the creditor in non-peso currency at an economically cheaper exchange rate, i.e., at the rate of exchange that exists at the time of payment and not at the rate applicable at the time the obligation was initially incurred.

These provisions and interpretations of Mexico's Monetary Law can be a trap to those unaware of it and the general legal environment in Mexico. Fortunately, precautionary measures can be taken to protect creditors from the onerous provisions of the Fourth Transitory Article.

17 For example, assume the rate of exchange that exists at the time payment is due is N $6.5 to the dollar, and the rate applicable at the time the obligation was initially incurred was N $7.5 to the dollar. If the creditor originally paid the debtor N $750,000, then the debtor would only pay dollars in the equivalent amount of N $650,000 as the reimbursement payment, and of course would have no incentive to "demonstrate" that payment was initially made in pesos.

18 Before the authors explain how transactions can be structured to avoid the draconian effects of the Fourth Transitory Article, there are two important statutory provisions that should be considered. First, if a transfer of funds in non-pesos is made outside of Mexico to a payee/trustee, or other holder (with a right to later receive the monies), then the payor/creditor has a right to a return of those monies in the currency originally paid. See Articulo 80 de la Ley Monetaria, D.O., 8 de enero de 1986. The payee/trustee cannot return the amounts in pesos at the "old and devalued" exchange rate. In the above example of the real estate purchase contract, assume the contract provided the initial one million dollar (US $1,000,000) down payment shall be made by the buyer within the United States in an account established by the seller with a U.S. bank. Assuming the buyer paid the peso equivalent of N $3,400,000 at the time of the deposit, the buyer will nonetheless be entitled to the full US $1,000,000 at the time of the reimbursement (even if the peso equivalent now requires 7.6 million pesos to equal one million dollars). Under this scenario, the buyer will have a right to one million dollars or 7.6 million pesos and will not suffer an economic loss of US $552,632. Secondly, if a deposit is made with a Mexican bank, and this fact is determined by a competent authority, the depositor has an unconditional right to a return of the exact kind of funds (even though banks become more than mere trustees of the deposit under Mexican law). See id. para. 4. The Civil Code of Mexico provides that any deposit by its nature should be returned or restored in the same kind. If dollars are deposited in an account then dollars in the same amount must be returned to the depositor (and the same would apply to any other form of deposit). For instance, if a person or company deposits US $100,000 with a bank at a time when the peso was valued at N $3.4, the bank cannot return only N $340,000 to the depositor at a time when the peso has devalued to N $7. The depositor is entitled to US $100,000. This provision does not mean that a depositor would have a right to receive more than N $340,000 if the deposit was originally made in pesos (even if the non-peso currency equivalent is worth much more).

19 Companies should also be aware of the special U.S. income tax consequences of these type of transactions, of the gains or losses relating to the currency (whether amounts are actually paid in a foreign currency or not, including certain payments when the amounts are based upon a
V. Hypothetical Risky Transactions.

The scope and application of the Fourth Transitory Article can be surprisingly broad. These provisions of law can apply to almost any commercial transaction in Mexico where some form of payment, initially made in pesos, must be reimbursed. There is no requirement that one of the parties is foreign to Mexico, and the same results can apply between two Mexican contracting parties. The types of transactions to which this provision could apply are unlimited in number. The following factual scenarios help demonstrate the various applications of the Fourth Transitory Article. The authors will then discuss various steps and protections to assist a client to avoid the adverse results of the Fourth Transitory Article.

A. REAL ESTATE PURCHASE CONTRACT WITH DEPOSIT.

The first example is where a U.S. buyer makes a US $1,000,000 “refundable deposit” in pesos to purchase real estate located in Mexico. The result of this type of transaction was previously described in this paper.

B. PURCHASE AND SALE OF GOODS - WITH A LETTER OF CREDIT.

The second example is where a U.S. buyer enters into a contract to purchase twenty thousand (20,000) Mexican widgets from a Mexican manufacturer (MEX.S.A.) for the equivalent of “US $30 per widget payable either in Mexican pesos or in U.S. dollars.” Mexican widgets are used in personal computers and the rapid changes in technology can make them obsolete. Therefore, the terms of the purchase contract negotiated by the U.S. buyer grants an “unconditional contractual right to return any or all of the Mexican widgets within forty-five (45) days from receipt, in the event there is a material technological development that makes the Mexican widgets obsolete.” The terms of the contract further provide that, upon the return of any or all of the Mexican widgets, MEX.S.A. will pay directly to the U.S. buyer the

reference to a foreign currency) apart from the separate tax consequences of the underlying transaction. The tax results and treatment of exchange gains and losses (their timing, amount, source, and character) can be enormously different depending upon whether the U.S. dollar, the Mexican peso, or other foreign currency is the “functional currency” of the taxpayer under section 985 of the United States Tax Code. I.R.C. §§ 985-89 (West 1999). These foreign currency transactions are taxed differently (plus there may be different book and record keeping requirements, as well as required accounting methods) depending upon a number of factors including whether the U.S. entity is a corporation, partnership, trust, estate, or “qualified business unit” (QBU). Certain debt obligations are expressly included under the foreign currency transactions of Section 988. I.R.C. § 988(c)(1)(B)(i); Treas. Reg. § 1.988-1(a)(2)(i). Plus, the accrual of certain expenses or gross income or receipts that are to be paid or received after the date on which the transaction was originally accrued are normally included as a Section 988 currency transaction. I.R.C. § 988(c)(1)(B)(ii); Treas. Reg. § 1.988-1(a)(2)(ii). However, certain contracts for the purchase or sale of goods in the future are not Section 988 transactions even if the underlying contract is denominated in a foreign currency or determined in reference to the foreign currency (non-functional currency). See Treas. Reg. § 1.988-1(a)(6). A detailed discussion of the foreign currency tax rules under I.R.C. Sections 985-89 is beyond the scope of this article, but foreign currency exchange gains and losses should be planned for and considered in these type of transactions.
The transaction is financed using an irrevocable letter of credit confirmed by the Mexican bank for MEX.S.A. Assume the initial sale goes smoothly and the U.S. buyer's bank draws from the U.S. account to pay the full purchase price of US $600,000 to an account for the benefit of MEX.S.A. However, as provided in the agreement, instead of paying MEX.S.A. US $600,000, the bank pays the then peso equivalent of N $2,040,000 (N $3.4 to the dollar). After the U.S. buyer has used only 1,000 of the widgets and within forty-five (45) days after receiving the Mexican widgets, technology makes them obsolete. Under the express terms of the contract the U.S. buyer can return the remaining 19,000 widgets and receive US $30 per widget (19,000 x US $30 = $570,000). During this time the peso has devalued from N $3.2 to N $7.6.

In the above scenario, applying the Fourth Transitory Article, the U.S. buyer is only entitled to receive a reimbursement of US $255,000 (US $570,000 x 3.4 = N $1,938,000/7.6 = US $255,000).21

C. LEASING OF MANUFACTURING EQUIPMENT BY MAQUILADORA.

The final example applies to a Mexican corporation (MAQUIL) operating as a maquiladora. MAQUIL enters into a five-year finance lease agreement to lease manufacturing equipment from another unrelated manufacturing corporation (LESSOR). MAQUIL has an affiliated U.S. corporation operating in the United States (USCORP) that markets and distributes all of the products manufactured by MAQUIL. USCORP often finances various operations and financial needs of MAQUIL directly or indirectly through U.S. banks because the cost of money is usually cheaper and more stable in the United States (including the financial requirements under the lease).

20 Interestingly, this type of transaction would probably be governed by the United Nations Convention on Contracts for the International Sale of Goods, opened for signature Apr. 11, 1980, U.N. Doc. A/CONF.97/18, Annex I, 19 I.L.M. 668 [hereinafter CONVENTION]. Article 1 of this Convention provides that it shall apply “to contracts of sale of goods between parties whose places of business are in different States: (a) when the States are Contracting States . . . .” Id. art. 1. In this case, both Mexico and the United States are contracting states of the Convention and the places of business are in each of the two states, respectively.

21 This result also seems to hold true when applying the United Nations Convention, see supra note 20, even though the Convention normally respects the will of the parties and their intent as expressed in various writings, words, and acts (see for example Article 6, which provides that the “parties may exclude the application of this Convention or, subject to article 12, derogate from or vary the effect of any of its provisions”). Id. art. 6. The Convention does not determine the choice of law that is to apply to a particular transaction. For example, Article 54 of the Convention provides that “The buyer’s obligation to pay the price includes taking such steps and complying with such formalities as may be required under the contract or any laws and regulations to enable payment to be made.” Id. art. 54. In this case, the Fourth Transitory Article would arguably be one of the laws that would be applicable (assuming Mexican law would apply) since it is a formality under Mexican law.
The finance lease of manufacturing equipment requires MAQUIL to make a refundable "initial rental payment" of US $500,000 (payable in either dollars or pesos at the current exchange rate) to LESSOR. This US $500,000 is refundable to MAQUIL over the life of the contract if certain maintenance standards, units of production, and insurance requirements are maintained. The terms of the lease contract require that these "repayments shall be made and payable to MAQUIL in U.S. dollars." Separately, MAQUIL makes monthly lease payments of N $350,000 under the contract, with adjustment factors that reflect inflation, interest rate risks, and an adjustment for Mexico's value added tax.

Assume further that USCORP obtains the initial financing for the lease from U.S. banks, and then USCORP loans U.S. dollars to MAQUIL in order for it to meet its payment obligations under the lease (including the US $500,000 "initial rental payment"). MAQUIL generally uses pesos to pay its obligations arising in Mexico and, therefore pays LESSOR the "initial rental payment" in pesos at a time when the rate of exchange is N $3.4 to the dollar, making a total "initial rental payment" of N $1,700,000. During the five-year life of the contract, MAQUIL satisfies all maintenance standards, units of production, and insurance requirements under the contract so that it is entitled to the return of the US $500,000 "initial rental payment" at the end of the five years. Finally, in the interim, the rate of exchange went from N $3.4 to the dollar to N $7.6.

MAQUIL will not receive the US $500,000 as required under the express terms of the contract. Instead LESSOR is only obligated under the Fourth Transitory Article to pay at the earlier exchange rate (N $3.4) and therefore must only pay US $223,684 ((US $500,000 x N $3.4)/N $7.6). This results in MAQUIL suffering a significant unexpected economic loss, and in turn, its affiliated company USCORP if MAQUIL cannot make its payments to USCORP, since USCORP is obligated to pay the full loan amounts to the U.S. banks in U.S. dollars.

VI. Protective Steps.

In each of the above examples, the transactions were structured in a manner that caused the creditor to suffer significant economic losses because of the application of the Fourth Transitory Article. Fortunately, protective steps could have been taken to avoid these disastrous results.

Probably the most important point to make is that parties can not protect themselves by contractually waiving the requirements of the Fourth Transitory Article. The Mexican Supreme Court has made it clear that the Fourth Transitory Article takes precedence over the intent of the parties. For instance, there would have been no legal effect to a contractual provision negotiated by the maquiladora lessee (MAQUIL) that stated "notwithstanding any Mexican law to the contrary, the return of the US $500,000 initial rental payment shall be payable in U.S. dollars or its equivalent at the rate of exchange existing at the time payment is due under the contract." In this case, the express intent of the contracting parties will not be honored by a Mexican court when the debtor refuses to pay the US $276,316 of the total US $500,000 called for in the contract. The Mexican Supreme Court has made it very clear that the intent of the parties in this case will be ineffective.
A. PROTECTIVE STEPS WHEN INITIALLY STRUCTURING THE TRANSACTION.

Fortunately, fairly simple steps can be taken to protect contracting parties. First, and most importantly, creditors need to make sure the initial payment is made in U.S. dollars (or the foreign currency of choice) instead of Mexican pesos. This automatically brings this type of transaction within the realm of Article Eight, thereby requiring payments to be made in non-peso currency or Mexican pesos at the rate of exchange existing at the date of payment (not at the date the monies were initially received).

This is the best and most protective step that can be taken. In the above examples, the purchaser simply needed to pay the US $1,000,000 refundable deposit in dollars; the widget purchase price in U.S. dollars; and the refundable US $500,000 lease deposit in dollars. Most Mexican businesspersons are more than willing to receive U.S. dollars as the form of payment. As an evidentiary matter, a company should make sure that it receives a signed receipt from the payee at the time payment is made in non-peso currency and that the receipt clearly reflects that payment was made in a currency other than pesos.

A second step that a company might want to take, if the financial costs of the transaction are great enough, is to use a third party to the transaction such as a financial institution or escrow entity. With a third party, the creditor company can pay the amounts due under the contract to the third party in U.S. dollars or other non-peso foreign currency. The underlying transaction documents could provide that any reimbursements due to the creditor would be made by the third party financial institution, instead of the debtor, and, that in the event the debtor brings an action against the creditor under the Fourth Transitory Article, the underlying transaction documents will require the financial institution to indemnify the creditor for any such damages. The third-party would directly pay the "debtor company" in any form of currency it chooses, thereby effectively shifting the commercial risk under the Fourth Transitory Article to the third party financial institution who presumably can better assess the legal risks of doing business in Mexico, pertinent changes in the law, and foreign and domestic currency risks. Of course, this type of scenario will increase the costs of the transaction, yet effectively provides a protective layer to the creditor company.

23 Companies can take precautionary measures to make sure that payments of these sorts are made in U.S. dollars (or non-peso currency) by establishing internal accounting and payment controls requiring approval from management or legal personnel before such payments are made.

24 Any party to a contract, where performance is to take place in Mexico, has the legal right to pay pesos (although without necessarily obtaining an economic windfall if the Fourth Transitory Article does not apply), even in transactions where the parties contractually agree to make payments in some other currency such as dollars. See Artículo 8º de la Ley Monetaria, D.O., 8 de enero de 1986. Additionally, in certain transactions, for instance, residential real estate leases, Mexican law is even more strict and specifically forbids parties to enter into lease agreements where payment is to be made in a currency other than pesos. See Código Civil para el Distrito Federal, art. 24480 [Federal Civil Code of Mexico].
If a bank is a party to a transaction, the creditor needs to make sure that any exchange of monies with a bank is bifurcated from any transfers of funds between the contracting parties. In other words, if a bank loans the creditor pesos, the creditor should make sure the relationship between it and the bank does not allow the bank’s actions to be imputed to the creditor as its agent. The creditor should expressly hold the bank liable (and require indemnification from the bank) in the event the bank pays pesos to the debtor. The authors recommend that this approach normally be used when transactions are large and the economic risks of peso devaluations are high.

A creditor can also protect itself by making sure the payment obligations are contractually required to be made physically outside of Mexico, and that payments are indeed made outside of Mexico, thereby causing the transaction to fall outside the scope of the Fourth Transitory Article of Mexico’s Monetary Law. For example, in the leasing problem above, USCORP should have contractually required that the initial refundable payment of US $500,000 be financed in such a way that payment is made to LESSOR in a U.S. bank account or any other bank account physically located outside of Mexico, which would protect the transaction from the draconian effects of the Fourth Transitory Provision.

Another protection method would require that some or all of the obligations, other than payment obligations, under the contract be performed outside of Mexico. Remember that the Fourth Transitory Article only applies when “performance of those obligations is to take place within the United Mexican States.” If all of the performance occurs outside of Mexico, then this law might not apply to the transaction when determining what choice of law should apply. Nevertheless, if a Mexican debtor brings an action against a foreign creditor in a Mexican court, the Mexican court might well apply Mexican law and the provisions of the Fourth Transitory Article. Because of questions relating to the meaning of the Fourth Transitory Article, this protective measure is not as certain as the others are.

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24 For purposes of illustrating the above real estate purchase contract hypothetical, assume the contract provided that the initial one million dollar (US $1,000,000) down payment shall be made by the buyer within the United States in an account established by the seller with a U.S. bank. Assuming the buyer paid the peso equivalent of N $3,400,000 at the time of the deposit to the U.S. bank account, the buyer will be entitled to the full US $1,000,000 at the time of the reimbursement (even if the peso equivalent now requires 7.6 million pesos to equal one million dollars).
At this point, it is unclear whether this statute applies to the entire contract and its payments (or only a portion), when only part of the contractual obligations are performed outside of Mexico. Perhaps a court would make some type of allocation under the Fourth Transitory Article where only a portion of the payments may be subject to the Fourth Transitory Article. Because of the uncertainties surrounding this question, the authors think that this protective step is generally unadvisable (especially in light of the high probability that a Mexican debtor would have an incentive to bring an action in a Mexican court for purposes of applying the Fourth Transitory Article to the detriment of the creditor who may be from a foreign jurisdiction).

B. PROTECTIVE STEPS TO TAKE AFTER ENTERING INTO A TRANSACTION.

The aforementioned protective steps are only effective when taken before a transaction has been negotiated and entered into. Those protective steps allow a party to structure a transaction to avoid the consequences of the Fourth Transitory Article. But what if a transaction has already been negotiated and one of the parties realizes they could suffer a severe economic loss if there is another peso devaluation? What steps can be taken at this point?

Although it is advisable to initially structure a transaction in a manner that protects against the draconian effects of the Fourth Transitory Article, a party can take certain post-transaction steps for protective proposes before a peso devaluation has occurred; however, once peso devaluation occurs, there is very little the creditor can do to avoid economic loss.

In each of the above examples (the real estate purchase contract, the sale of widgets, and the equipment lease by the maquiladora), the creditor could negotiate with the debtor to return the initial payment of pesos in exchange for a dollar payment in an amount equivalent to the pesos at that point in time. If the other party is accommodating and agrees to a reimbursement in pesos and a repayment in dollars (or other non-peso currency), the creditor should make sure the form of payment is adequately documented and that the debtor expressly agrees to such transactions. This scenario, however, would be equivalent to entering into a new or supplemental contractual relationship and would inevitably require the other party to agree to such an arrangement. Alternatively, the creditor could negotiate an early termination of the contract (thereby having a right to receive pesos before they become devalued) and then renegotiate a new contract. The economic benefits of renegotiating an entire transaction might well be worth the time and underlying transaction costs, considering the potential losses that could be suffered by applying the Fourth Transitory Article. Both of these approaches require the consent of the debtor.25

25 Careful planning of "exit strategies" out of a business relationship in Mexico and early termination provisions of a contract are probably of greater importance in commercial transactions in Mexico than in the United States since there are greater economic swings and, thus, potentially greater financial risks related to peso devaluations, hyper-inflation, etc.
VII. Conclusion.

Mexico's Monetary Law, specifically its Fourth Transitory Article, can have disastrous consequences to a creditor who originally makes a payment in pesos and then believes the terms of the contract and the intent of the parties will be honored under Mexican law. As the examples in this analysis demonstrate, this assumption would be erroneous and can create highly unintended consequences. Fortunately, advanced planning of any commercial transaction in Mexico that requires some type of payment, reimbursement, refund, or other similar consideration, can avoid the application of the Fourth Transitory Article.

The constantly changing economic environment in Mexico requires that a business participant from outside of Mexico not only be aware of the mechanisms at its disposal to limit risks, but also to be able to adequately plan for long term transactions. Although the economic environment in Mexico can carry many risks, these same risks can bring with them many economic advantages to the foreign businessperson if appropriate legal steps and business precautions are taken.

Businesses can avoid some of the economic risks associated with Mexico's historic and persistent peso devaluations by having an appreciation of the legal environment in Mexico in general, and specifically, the Fourth Transitory Article of Mexico's Monetary Law.