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**"MEXICO: AN 8<sup>TH</sup> ANNIVERSARY REVIEW OF NON-  
POSSESSORY PLEDGE AGREEMENTS"**

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This article is not intended to be comprehensive or to provide specific legal advice. It only enunciates the main issues arising in connection with the subject matter hereof.

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**INTRODUCTION**

In its endeavors to foster credit growth, a Decree which aimed to expedite the enforcement of creditors' rights was published in Mexico's Federal Register (Diario Oficial de la Federación) on June 13, 2003 (the "Decree"). The Decree became effective on June 14, 2003 and its provisions did not apply retroactively.<sup>1/</sup> The Decree amended 30 and derogated 8 articles of the General Law of Negotiable Instruments and Credit Transactions (Ley General de Títulos y Operaciones de Crédito) ("LTOC").

The Decree also amended various articles of the (i) Commercial Code (Código de Comercio) ("Commercial Code"); (ii) Credit Institutions Law (Ley de Instituciones de Crédito) ("Banking Law"); (iii) Securities Market Law (Ley del Mercado de Valores) ("LMV"); (iv) General Law of Insurance Institutions and Mutual Companies (Ley General de Instituciones y Sociedades Mutualistas de Seguros); (v) Bonding Companies Law (Ley Federal de Instituciones de Fianzas); and (vi) Auxiliary Credit Organizations and Activities Law (Ley General de Organizaciones y Actividades Auxiliares del Crédito).

Concretely, the Decree sought to facilitate enforcement of collateral such as the non-possessory pledge and the guaranty trust. This article describes the main features of the non-possessory pledge, with an emphasis on its regulation under the LTOC.

Sections I and II of this article explain the principal amendments to the LTOC and the Commercial Code, respectively. Section III includes a brief comparison between the Organization of American States ("OAS")'s Model

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<sup>1/</sup> See the Sole Transitory Article.

Interamerican Law on Secured Transactions (the "Model Law") and the LTOC, whereas section IV elaborates on the importance of proper perfection of commercial transactions (before an insolvency proceeding takes place). Finally, section V describes the ranking and priority of non-possessory pledge agreements in the context of Mexican insolvency proceedings.

#### **GENERAL BACKGROUND AND OVERVIEW**

Clearly, the Decree was the result of the powerful bank lobby. While the enforcement of creditors' rights became generally more expeditious as a result of the Decree, some of its provisions were not properly drafted so that clever litigators may find ways to circumvent their purpose. In addition, some of its provisions raised important constitutional and/or legal issues.<sup>2/</sup>

On the structural side of the financing industry, the Decree included no provision that resulted in higher credit-risk analysis or due diligence standards being required of lenders. In sum, it seems that more in substance could have been accomplished had proper care been taken in the preparation of the Decree.<sup>3/</sup>

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<sup>2/</sup> For example, in a most unfortunate change the Decree provides the trust beneficiary upon a loss or deterioration of the value of the trust assets with the right either to (i) demand from the settlor a delivery of additional assets, or (ii) accelerate the credit. The validity of the creditor's right to immediately accelerate the credit will be undoubtedly challenged in court, at least in the context of debtors who are not in arrears regarding compliance with their (underlying) credit payment obligations. See article 400, final para. of the LTOC.

Another example. The Decree expressly sets forth that industrial mortgages "must comprehend the [debtor's] applicable concession or authorization". See article 67 of the Banking Law. Only case law will confirm the validity of this provision in an enforcement context as the regulation of permits and concessions is subject to public order statutes.

<sup>3/</sup> It is noteworthy that the Decree amended most of the provisions of the May 23, 2000 Decree (the "2000 Decree"), which had amended the LTOC, the Commercial Code and the Banking Law. The 2000 Decree quickly demonstrated fundamental flaws which the Decree aimed to cure.

**I. AMENDMENTS TO THE LTOC**

**I.1 Structure of the Decree**

The 2000 Decree had created a regulatory category for the non-possessory pledge, separate from the general pledge. The Decree expressly incorporated the first as a sub-category of the second.<sup>4/</sup>

**I.2 Possession of Assets**

Under the 2000 Decree, the debtor and "exceptionally" the creditor could remain in possession of the pledged assets. Under the Decree, the pledged assets must remain in the possession of the debtor or a third-party expert, but not the creditor.<sup>5/</sup>

**I.3 Value of Assets in a Non-possessory Pledge**

Under the 2000 Decree the amount guaranteed by a non-possessory pledge had to be determined upon creation of the pledge or be determinable for its execution. Under the Decree, the guaranteed amount can be determined or determinable upon creation of the pledge, provided that it can be determined for its execution.<sup>6/</sup>

**I.4 Flexibility to Transfer Possession of Assets**

As a novelty, the debtor in possession may now transfer possession of the assets if so agreed with the creditor.<sup>7/</sup> The 2000 Decree did not allow for this flexibility.

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<sup>4/</sup> See article 346, 2<sup>nd</sup> para. of the LTOC. This is true also of the guaranty trust which became a statutory sub-category of the general trust. See, e.g., *id.* article 407. The guaranty trust shares some of the non-possessory pledge's key features. The scope of this article, however, is limited to the latter.

<sup>5/</sup> *Id.* article 346, 1<sup>st</sup> para.

<sup>6/</sup> *Id.* article 348.

<sup>7/</sup> *Id.* article 361.

### **I.5 What Constitutes Bad Faith?**

Under the 2000 Decree, bad faith was presumed to exist where the acquirer of the assets (i) was aware of the existence of the non-possessory pledge; and (ii) the terms and conditions of the purchase and sale transaction departed "in a significant manner" from market conditions prevailing at the time of the execution thereof, from the debtor's general sales policies or from "healthy" commercial usages and practices. (The Decree has eliminated this latter concept). Of course, no bad faith could exist where the creditor's prior consent had been obtained. Under the Decree, bad faith is presumed to exist where the acquirer, being aware of the existence of the non-possessory pledge, effects the purchase without the creditor's prior consent.<sup>8/</sup>

### **I.6 What can be Pledged?**

Since the 2000 Decree, all kinds of rights and movable assets could be pledged. The Decree added an (obvious) express exception: not those of a strictly personal nature.<sup>9/</sup>

### **I.7 Recovery of Losses and Damages**

Under the 2000 Decree, sales made without the creditor's consent were declared to be null and void and the creditor became entitled to recover the assets vis-à-vis the acquirer thereof. Under the Decree the creditor became entitled to pursue the assets vis-à-vis any acquirer in bad faith. The Decree further incorporated in the LTOC the creditor's right to also recover losses and damages from the debtor, a right creditors already had under the civil code of each state.<sup>10/</sup>

### **I.8 Statute of Limitations to Enforce**

Since the 2000 Decree, the statute of limitations to enforce a non-possessory pledge is 3 years from the time the

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<sup>8/</sup> *Id.* article 373.

<sup>9/</sup> *Id.* article 353.

<sup>10/</sup> *Id.* article 374, 3<sup>rd</sup> para.

guaranteed obligation became due and payable.<sup>11/</sup> In addition, upon the expiry of such term the creditor's right to demand payment of the guaranteed obligation would cease to exist. This second concept was eliminated by the Decree and therefore the creditor remains able to sue for payment of its credit through other judicial alternatives.<sup>12/</sup>

### **I.9 Deficiency Waiver: Eliminated**

The 2000 Decree created the "deficiency waiver" concept pursuant to which the creditor was obligated to relinquish its right to collect on the remainder of its credit where, in the event of enforcement of the non-possessory pledge, the proceeds of the sale of the pledged assets were insufficient to pay for the whole amount of the credit. This provision could not be waived by the parties.<sup>13/</sup> This concept also applied to guaranty trust agreements.<sup>14/</sup> The use of non-possessory agreements had come to an almost complete halt because of the "deficiency waiver" concept. Fortunately, this concept was derogated by the Decree.

## **II. AMENDMENTS TO THE COMMERCIAL CODE**

### **II.1 Suppletory Application of State Procedural Codes**

Traditionally, state procedural codes would apply to any proceedings commenced under the Commercial Code, which is federal in scope. Thus, for example, the Federal District's Code of Civil Procedure (Código de Procedimientos Civiles para el Distrito Federal) would apply to proceedings brought in Mexico City. Under the Decree, the Federal Code of Civil Procedure (Código Federal de Procedimientos Civiles), as opposed to each state's procedural code, must apply to all proceedings commenced under the Commercial Code, regardless of the jurisdiction. Case law has confirmed the constitutionality of this change, which was obviously designed to bring uniformity to procedural matters

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<sup>11/</sup> *Id.* article 375.

<sup>12/</sup> *Id.*

<sup>13/</sup> *Id.* article 379.

<sup>14/</sup> *Id.* article 412.

throughout the country.<sup>15/</sup>

## **II.2 Availability of Various Actions**

Confirming case law, the Decree expressly provides that creditors would have simultaneous recourse to pursue payment of a credit under various statutes and for varying causes of action and remedies, without losing the legal ranking applicable to each type of guaranty.<sup>16/</sup>

## **II.3 Service of Notice**

The Commercial Code was amended to facilitate service of notice on debtors, some of whom have escaped the court system by hiding. (Under the Mexican legal system, defendants must be served personally for court proceedings to be validly undertaken). The Decree created a procedure for creditors to get information on the whereabouts of debtors to be provided to the court by any competent government authority. The judge was empowered to order service of notice at any address it deems appropriate. In addition, the Decree confirms the validity of notifications made in "contractual domiciles", *i.e.* those which are set forth in a contract, whether the contractual domicile is still in existence or not at the time of enforcement.<sup>17/</sup>

## **II.4 Payment of Legal Expenses**

The Decree created the concept that any respondent who unsuccessfully defends a claim must pay for plaintiff's legal fees and expenses.<sup>18/</sup> Only case law will confirm the constitutionality of this concept, which is obviously designed to discourage dilatory or frivolous defenses but the application of which may give rise to plain injustice for debtors in some cases.<sup>19/</sup>

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<sup>15/</sup> See articles 1054, 1063 of the Commercial Code.

<sup>16/</sup> *Id.* article 1055 Bis.

<sup>17/</sup> *Id.* article 1070. (Only case law will confirm the constitutionality of this change).

<sup>18/</sup> *Id.* article 1376-Bis.

<sup>19/</sup> *Id.*

**III. A BRIEF COMPARISON BETWEEN THE OAS' MODEL LAW<sup>20/</sup>  
AND THE LTOC**

**III.1 The Illusion of a Uniform Registration System**

Article 1, 3<sup>rd</sup> para. of the Model Law establishes that any "State adopting this law shall create a unitary and uniform registration system". Under the 2000 Decree, "the automated operation of the Public Registry of Commerce [in the various states of the Mexican Republic] shall be in place no later than November 30, 2000...".<sup>21/</sup> As of the effectiveness of the 2000 Decree and pursuant to the Commercial Code, such (new) operation was going to include a central database, "interconnected with the databases of the various states of the Mexican Republic".<sup>22/</sup>

Mexican law does contemplate the existence of a section in the federal Public Registry of Commerce (Registro Público de Comercio) where recordation of security over movable property may be effected.<sup>23/</sup> Unfortunately, however, cooperation between the federal government and the state governments has been far from exemplary. Thus, an element that would be key for the proper existence and management of a "unitary and uniform registration system", is missing. Due to this, among other reasons, the use of non-possessory pledge agreements remains scarce.

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<sup>20/</sup> The Sixth Inter-American Specialized Conference on Private International Law (CIDIP-VI) was convoked by the General Assembly of the OAS at its twenty-sixth regular session, through resolution AG/RES. 1393 (XXVI-O/96). The OAS approved the Model Law in February, 2002.

<sup>21/</sup> See Transitory Article Third of the Commercial Code.

<sup>22/</sup> See Book First, Title Second, Chapter II of the Commercial Code, with a specific focus on article 20. Compare with Articles 43 (providing for the existence of an entity designated by each State that will operate and administrate the Registry), 44 (providing for the existence of a central database constituted by the registration records of the security interests inscribed in the State) and 45 (according to which for the registration and searches of information, the Registry will authorize remote and electronic access to users who so request) of the Model Law.

<sup>23/</sup> See articles 30-35 the Regulations of the Public Registry of Commerce (Reglamento del Registro Público de Comercio), which is a federal statute.

### **III.2 Concepts that are not included in the LTOC**

Certain concepts are expressly contemplated by the Model Law to try to facilitate the creation and perfection of collateral over movable property. The LTOC takes a different approach and leaves many of these concepts for the parties to any given transaction to agree on. This results in more contractual flexibility allowed under Mexican law, although it demands more care from the drafters of non-possessory pledge agreements. Examples of this are the right of a holder of a security interest in a collateral "as well as to receive the product of an insurance policy or certificate that covers the value of such property".<sup>24/</sup> The LTOC does not include such products automatically, although nothing prevents the parties from agreeing otherwise.

Another example concerns the scope of secured obligations. Under the Model Law, secured obligations include "reasonable expenses incurred by the secured creditor for the maintenance and custody of the secured property".<sup>25/</sup> The LTOC is silent on this issue, but nothing prevents the parties from agreeing otherwise.

Finally, it is noteworthy that the Model Law sets out a long, detailed list of concepts that govern the application of proceeds of the sale or auction of collateral.<sup>26/</sup> Conversely, the LTOC and the Commercial Code are silent on this issue, but nothing prevents the parties from reaching a specific agreement thereupon, either in the non-possessory pledge agreement, an intercreditor agreement or otherwise.<sup>27/</sup> Actually, it is a common practice in the Mexican market to set out how proceeds of a sale or auction of collateral will be applied.

### **III.3 Intellectual Property Rights**

Under the Model Law, "a security interest in

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<sup>24/</sup> See Article 3-V, 2<sup>nd</sup> para. of the Model Law.

<sup>25/</sup> *Id.* Article 4-III.

<sup>26/</sup> *Id.* Article 60.

<sup>27/</sup> Compare with article 1414 bis 17 of the Commercial Code.

intellectual property rights, such as patents, trademarks, trade-names, goodwill, royalties and other attributable movable property derived therefrom, is governed by this Law...".<sup>28/</sup> In Mexico, perfection of security interest in intellectual property rights requires compliance with a separate statute<sup>29/</sup> and the involvement of a different agency.<sup>30/</sup>

#### **III.4 Designation of an Appraisal**

Under the Model Law,

"the collateral may be sold privately, or taken in payment against the debt, provided that it has been previously appraised by a single qualified appraiser designated by the secured creditor, for the price of the appraisal...".<sup>31/</sup>

The possibility that one of the parties to a contract or transaction will have sole authority to comply or not with an obligation is in direct violation of Mexican principles of contract law.<sup>32/</sup> Accordingly, the parties to a non-possessory pledge agreement are required to appoint an expert appraiser or to agree on how the expert appraiser will be appointed from the execution thereof.<sup>33/</sup>

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<sup>28/</sup> Article 32 of the Model Law.

<sup>29/</sup> See article 62 of the Industrial Property Law (Ley de la Propiedad Industrial).

<sup>30/</sup> The Mexican Institute of Industrial Property (Instituto Mexicano de la Propiedad Industrial), known as "IMPI". Perfection of security over industrial property rights in Mexico must be made complying with various formal requirements which because of the scope of this article, are not being explored herein.

<sup>31/</sup> Article 59-IV of the Model Law.

<sup>32/</sup> See, e.g., article 1797 of the Federal Civil Code (Código Civil Federal) ("CCF").

<sup>33/</sup> See, e.g., article 363 of the LTOC.

**IV. THE IMPORTANCE OF PROPER PERFECTION OF COMMERCIAL TRANSACTIONS (BEFORE AN INSOLVENCY PROCEEDING TAKES PLACE)**

Creditors have to be especially diligent in complying with the legal formalities that give certainty to their commercial transactions, before an insolvency proceeding takes place. Mexican law is very formalistic and failure to meet such formalities may hamper a creditor's efforts to be recognized as a privileged creditor or have its assets qualify for separation from the insolvency estate (masa).

Some transactions whereby proper evidence of title is essential to qualify under one of the above-mentioned creditor categories, or for an asset to be eligible for exclusion from the insolvency estate, are the following:

**IV.1 Mortgages (Security in Real Property)**

The mortgage is the most common form of security involving real property. Real property is used to secure many types of transactions in Mexico. Certain documentary and recording requirements must be met to ensure perfection of mortgage financing.

The value of the mortgaged property dictates the type of documentation required to perfect it.<sup>34/</sup> In most cases, acquisitions of real property the value of which exceed approximately \$18,000.00 Mex. Cy. must be evidenced by a public deed.<sup>35/</sup> Mortgaged real property valued at less than \$18,000.00 Mex. Cy. can be secured by private contract, executed before 2 (two) witnesses whose signatures are ratified before a notary

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<sup>34/</sup> See articles 2917 of the CCF and the Civil Code for the Federal District (Código Civil para el Distrito Federal) ("CCDF"), respectively. They state that the formalities established in articles 2317 and 2320 must be observed for mortgage financing.

<sup>35/</sup> See articles 2317, 2320 and 2917 of the CCF and the CCDF, respectively. As of December, 2007, Mexico City's minimum daily wage (salario mínimo general diario vigente en el Distrito Federal) is \$52.59 Mex. Cy. The exchange rate of the Mexican peso is approximately \$11.00 Mex. Cy. per \$1.00 U.S. dollar.

public (notario público).<sup>36/</sup>

Further, a mortgage shall be registered before the corresponding Public Registry of Property and Commerce (Registro Público de la Propiedad y de Comercio) ("RPPC") or Public Registry of Property (Registro Público de la Propiedad), as applicable in each state, to ensure its perfection against third parties.<sup>37/</sup> Only a mortgage with its "preventive registration" at the RPPC<sup>38/</sup> will be effective against third parties. This registration will take effect retroactively if confirmed within the statutory period.<sup>39/</sup>

#### IV.1.1 Industrial Mortgages

By means of an industrial mortgage, a debtor grants in favor of a creditor a floating lien over all its assets, including its real estate property, while keeping possession and use of such assets. This type of security is available for certain creditors such as Mexican credit institutions<sup>40/</sup> and multi-purpose financial companies (sociedades financieras de objeto múltiple), known as "SOFOM's".<sup>41/</sup> Creating and perfecting an industrial mortgage requires compliance with certain formalities, including registration of it before the RPPC where the assets are located.<sup>42/</sup>

The creditor must allow ordinary use of assets by the borrower. The creditor has a statutory right to oppose partially or totally the sale or transfer of assets as well as any merger

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<sup>36/</sup> *Id.*

<sup>37/</sup> *Id.* article 2919. Each state of the Mexican Republic, as well as the Federal District, has its own RPPC, sometimes divided in two offices: the Public Registry of Commerce (Registro Público de Comercio) and the Public Registry of Property.

<sup>38/</sup> *Id.* articles 2919, 3015 and 3044.

<sup>39/</sup> See articles 3017 of the CCF and the CCDF, respectively.

<sup>40/</sup> See article 67 of the Banking Law.

<sup>41/</sup> See article 87-G of the Auxiliary Credit Organizations and Activities Law (Ley General de Organizaciones y Actividades Auxiliares del Crédito).

<sup>42/</sup> See article 67 of the Banking Law.

which may create a risk for the repayment of the secured credit.<sup>43/</sup>

#### **IV.2 Pledge (Possessory Security)**

Pledges are the most common form of security on personal property. Pledges can be either civil or commercial in nature.<sup>44/</sup> Thus, they are regulated by different codes. Civil pledges are regulated by the civil code of each state, while commercial pledges are regulated by the LTOC.

Civil pledges require that goods be delivered either physically or constructively to the creditor.<sup>45/</sup> Where goods are delivered constructively, the pledge is subject to further requirements to ensure its perfection vis-à-vis third parties.<sup>46/</sup> A civil pledge agreement for constructive delivery must be evidenced by either a written contract executed in 2 (two) counterparts, one for each party, a public deed, or some other authenticated documents.<sup>47/</sup> Civil pledge agreements which are formalized before a notary public are effective against third parties only when registered at the RPPC.<sup>48/</sup> In contrast, civil pledge agreements initially evidenced by a private contract are only effective against third parties once recorded at the RPPC.<sup>49/</sup>

Commercial pledges are broadly defined as those pledges involving "acts of commerce".<sup>50/</sup> In order to perfect a commercial pledge, the pledged goods or credit instruments must be physically delivered to the creditor.<sup>51/</sup> The rules governing

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<sup>43/</sup> *Id.*

<sup>44/</sup> See articles 2856 of the CCF and the CCDF, respectively, and article 334 of the LTOC.

<sup>45/</sup> See articles 2858 of the CCF and the CCDF, respectively.

<sup>46/</sup> *Id.* articles 2859.

<sup>47/</sup> *Id.* articles 2860.

<sup>48/</sup> *Id.* articles 2859.

<sup>49/</sup> *Id.* articles 2859 and 2860.

<sup>50/</sup> See articles 75 of the Commercial Code and 1 of the LTOC.

<sup>51/</sup> See article 334 of the LTOC.

how to perfect a commercial pledge and its effectiveness against third parties vary depending upon the nature of the collateral.<sup>52/</sup> For instance, a commercial pledge involving a contract for equipment, operating, or financing credit can be perfected before two witnesses and ratified before an officer of the RPPC prior to the commercial pledge's registration at the RPPC.<sup>53/</sup>

### **IV.3 Non-Possessory Security Interests**

Other types of structures are used to secure credits. The non-possessory pledge (prenda sin transmisión de posesión), trust, guaranty trust (fideicomiso de garantía), purchase finance agreement and the installment sales contract (contrato de compraventa a plazos), are some of the most common ones in Mexico.<sup>54/</sup> The bailment agreement and the accommodation agreement (convenio de espera) are also used.

#### **IV.3.1 Non-possessory Pledge**

In the event of the debtor's insolvency, credits guaranteed by means of a non-possessory pledge shall become due and payable and ordinary interest shall continue to accrue, up

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<sup>52/</sup> As regards commercial contracts, however, articles 77-79 of the Commercial Code establish the principle that commercial agreements bind the parties thereto without the need for formalities or other requirements, except as otherwise expressly provided for in the law.

<sup>53/</sup> See articles 326 and 334-VII of the LTOC.

<sup>54/</sup> There are other non-possessory security mechanisms available. For example, a securities pledge (prenda bursátil) is a security mechanism where the debtor uses listed securities to guarantee its obligations to the creditor. If the debtor defaults on any obligation, the securities pledge enables its beneficiary (usually the creditor) to instruct a pre-appointed trustee to sell the pledged securities and to deliver the proceeds thereof to the pledgee. The effectiveness of the securities pledges has not yet been tested in court. Its sale procedure raises certain due process questions under the Political Constitution of the United Mexican States (Constitución Política de los Estados Unidos Mexicanos). Overall, however, securities pledges seem to offer a sensible and cost-efficient alternative to other financing mechanisms that entail lengthy court proceedings. See article 204 of the LMV. Another form of non-possessory security interest may be created through a title retention contract (contrato de compraventa con reserva de dominio). See articles 2312 of the CCF and the CCDF, respectively.

to the value of the pledge.<sup>55/</sup> Furthermore, foreclosure of this type of pledge can be requested from the bankruptcy court and the bankruptcy court must order the foreclosure "without any further proceedings".<sup>56/</sup>

The pledged assets must be identified, except in the case where the debtor provides a non-possessory pledge on all of the movables that it uses to carry out "its main activities", in which case such movables may be identified "generically".<sup>57/</sup>

Unless otherwise agreed to between the parties to a non-possessory pledge, the debtor in possession shall remain entitled to (i) use the pledged assets to manufacture goods, provided that their value is not impaired and the goods produced therewith become a part of the pledge; (ii) utilize the pledged assets and receive the products and benefits thereof; and (iii) sell the pledged assets "in the ordinary course of its business", whereupon the pledge over such assets shall expire vis-à-vis bona fide third parties, although this right shall cease upon commencement of any enforcement proceedings against the debtor under the Commercial Code.<sup>58/</sup>

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<sup>55/</sup> See article 350 of the LTOC.

<sup>56/</sup> *Id.* article 351.

<sup>57/</sup> *Id.* article 354.

<sup>58/</sup> *Id.* article 356. Conversely, bad faith shall be presumed to exist whenever the acquirer of the assets shall be aware of the existence of the non-possessory pledge. Of course, no bad faith shall exist where the creditor's prior consent shall have been obtained. See *id.* article 373. Furthermore, the creditor's prior written consent is required for the debtor to sell assets subject to a non-possessory pledge to any of the following individuals: (i) holders of the shares representing 5% or more of the debtor's capital stock; (ii) regular and alternate members of the debtor's Board of Directors; (iii) the spouse and relatives by blood or affinity up to the second degree, or in-laws, of any of the above-mentioned individuals or of the debtor's should the debtor be an individual; and (iv) the debtor's employees, officers and creditors. Failure by the creditor to respond within 10 (ten) days to a request by the debtor as described above shall be construed as its acceptance thereto. Sales made without the creditor's consent shall be null and void and the creditor shall be entitled to recover the assets vis-à-vis the acquirer thereof. Moreover, the creditor may accelerate the credit in these cases if so agreed with the debtor. See *id.* article 374.

The parties must designate a third-party expert (perito) who shall be responsible for assessing the value of the pledge for purposes of articles 361 and 362 of the Commercial Code.<sup>59/</sup> Whenever a warehousing company (almacén general de depósito) shall be designated as the expert, it may also be entrusted with the custody of the pledged assets.<sup>60/</sup>

The pledge contract must be in writing and formalized before a commercial public registrar (corredor público) or a notary public whenever the value of the pledged assets shall be equal to or higher than the equivalent in pesos of 250,000 investment units (unidades de inversión) ("UDI's").<sup>61/</sup>

The creditor under a non-possessory pledge has priority over (i) unsecured credits; (ii) unrecorded secured credits; and (iii) unrecorded pre-existing judicial liens.<sup>62/</sup> Unrecorded non-possessory pledges shall be ranked based on the date of execution of each contract.<sup>63/</sup>

**V. RANKING AND PRIORITY OF NON-POSSESSORY PLEDGE AGREEMENTS IN MEXICAN INSOLVENCY PROCEEDINGS**

Creditors often secure transactions with collateral over personal or real property. Frequently, title, possession or administration of such property remains with the debtor. Sometimes the debtor becomes insolvent and is subject to an insolvency proceeding. Consequently, it is essential to know the nature of each type of collateral as well as its destiny, assuming its proper perfection, in the context of insolvency proceedings.

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<sup>59/</sup> *Id.* article 363.

<sup>60/</sup> *Id.*

<sup>61/</sup> *Id.* article 365. As of the date of this article the value of one UDI is approximately \$4.00 Mex. Cy. Assuming an exchange rate of \$11.00 Mex. Cy. per U.S.\$1.00, 250,000 UDI's are the equivalent of approximately U.S.\$90,000.00.

<sup>62/</sup> *Id.* article 371.

<sup>63/</sup> *Id.* article 370.

### **V.1 Priority of Claims and Separation of Assets from the Insolvency Estate in General**

Pre-petition claims will rank according to their category. The Commercial Insolvency Law (Ley de Concursos Mercantiles) ("LCM"),<sup>64/</sup> the Federal Labor Law (Ley Federal del Trabajo) ("LFT")<sup>65/</sup> and the Fiscal Code of the Federation (Código Fiscal de la Federación) ("CFF")<sup>66/</sup> establish 5 (five) categories of creditor rankings. Other statutes also include their own set of rankings and priorities,<sup>67/</sup> although the provisions of the LCM, which is the special statute, prevail in case of a discrepancy.<sup>68/</sup> Under the LCM, the general rankings of claims are listed in descending order of preference.

First, "exclusively privileged creditors" (acreedores singularmente privilegiados) include, in connection with individuals, creditors for burial expenses of the debtor as well as expenses related to the disease that caused the death of the debtor where the insolvency proceedings shall have commenced, after his death.<sup>69/</sup>

Second, "secured creditors" (acreedores con garantía real) include creditors under mortgage (hipoteca), pledge (prenda), and purchase finance agreements (créditos de habilitación o avío y créditos refaccionarios), that can recover their debt from the proceeds of the secured property sale.<sup>70/</sup> If there is more than one security interest in a property, creditors recover their debts according to the date on which

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<sup>64/</sup> See articles 217-222 of the LCM.

<sup>65/</sup> See articles 113-114 of the LFT.

<sup>66/</sup> See article 149 of the CFF.

<sup>67/</sup> See, e.g., article 288 of the Social Security Law (Ley del Seguro Social).

<sup>68/</sup> See Tesis Aislada. Registro No. 918,803. Séptima Época. Tercera Sala. Apéndice 2000, Tomo VII. pág. 262. Tesis: 298. Materia: Civil. See also Tesis Aislada. Registro No. 227,087. Octava Época. Tribunales Colegiados de Circuito. Semanario Judicial de la Federación, Tomo IV, Julio a Diciembre de 1989. pág. 315. Materia: Penal.

<sup>69/</sup> See article 218 of the LCM.

<sup>70/</sup> *Id.* article 219; see also article 328 of the LTOC.

their respective security was recorded.<sup>71/</sup> In practice, any excess amount of the sale proceeds shall become part of the debtor's assets and be made available for the unsecured creditors. If the sale proceeds are insufficient to satisfy a creditor's secured claim, the creditor will be treated as an unsecured creditor for the deficiency.

Third, the federal tax authority (fisco federal). The Ministry of Finance and Public Credit (Secretaría de Hacienda y Crédito Público) via the Tax Administration Service (Servicio de Administración Tributaria) ("SAT") acts as the creditor for so-called "social claims", namely, unpaid federal taxes.<sup>72/</sup> Certain labor claims rank pari passu with tax claims.<sup>73/</sup>

Fourth, "creditors with special privilege" (acreedores con privilegio especial)<sup>74/</sup> comprise all those creditors that, under the Commercial Code or related statutes, have a special privilege or right of retention. This category of creditors includes commission agents,<sup>75/</sup> merchandise vendors,<sup>76/</sup> and carriers.<sup>77/</sup>

Fifth, "common creditors" (acreedores comunes).<sup>78/</sup> All other creditors holding claims not falling within any of the above categories are treated as non-priority (general) unsecured creditors.

Creditor ranking (graduación) and creditor priority or "degree" (grados) within each ranking (prelación), as provided

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<sup>71/</sup> See article 219 of the LCM.

<sup>72/</sup> See article 221 of the LCM; see also articles 2, 4 and 149 of the CFF. It is noteworthy that amounts withheld, transferred or collected by the debtor for taxes can be separated from the estate under article 71-VI of the LCM. Also, under article 146-B of the CFF, a debtor may request from SAT a partial reduction of the amount of its social claims.

<sup>73/</sup> See article 221 of the LCM.

<sup>74/</sup> *Id.* article 220.

<sup>75/</sup> See article 306 of the Commercial Code.

<sup>76/</sup> *Id.* article 386.

<sup>77/</sup> See articles 2662 of the CCF and the CCDF, respectively.

<sup>78/</sup> See article 222 of the LCM.

by the law, determine payment order. Generally, creditors of the first through fourth priority categories have the highest probability of being paid in full. When assets are insufficient, first priority creditors are paid in full before second priority creditors are paid and so forth. Fifth priority creditors are paid a pro-rata reduced amount.<sup>79/</sup>

The fees of the insolvency examiner, the mediator, the trustee (síndico) and other specialists involved in the estate's preservation and administration, are payable as ordinary operating expenses.<sup>80/</sup>

Debtor in possession or "DIP" financing agreements are considered to create claims against the insolvency estate.<sup>81/</sup> Certain labor claims for wages and other benefits have superpriority, and thus must be paid before any of the debtor's creditors.<sup>82/</sup> The reorganization agreement<sup>83/</sup> must include the payment terms for claims against the insolvency estate, including post-petition claims based on DIP financing agreements.<sup>84/</sup>

## **V.2 Property Excluded from the Insolvency Estate**

The LCM allows third parties to, prior compliance with certain requirements, institute legal actions to separate identifiable assets that have not been definitively transferred to the debtor.<sup>85/</sup> Non-definitive transfers include situations

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<sup>79/</sup> *Id.*

<sup>80/</sup> *Id.* articles 333 and 75. Prior to the December 27, 2007 amendments to the LCM that became effective the following day, said fees were treated as credits against the estate. The LCM seems to create a gray area concerning "normal expenses" relating to the "...replacement, conservation and administration" of the estate's assets, which are treated as credits against the estate under article 224-III. Compare with the text of article 75, which refers to "ordinary operations including expenses that are essential therefor".

<sup>81/</sup> *Id.* article 224-II.

<sup>82/</sup> *See id.* articles 224 and 225.

<sup>83/</sup> *Id.* Title Fifth, Sole Chapter.

<sup>84/</sup> *Id.* article 153.

<sup>85/</sup> *Id.* articles 70 and 73.

involving:

- (i) personal or real property that can be repossessed in accordance with the law;<sup>86/</sup>
- (ii) real property that was sold to the debtor if the sale was not duly recorded and the debtor did not pay for the real property;<sup>87/</sup>
- (iii) personal property which the debtor has not fully paid for;<sup>88/</sup>
- (iv) personal or real property purchased on credit, where failure to pay was stipulated and publicly recorded as an event of default;<sup>89/</sup>
- (v) in certain cases, negotiable instruments issued or endorsed in favor of the debtor in payment of third-party credits;<sup>90/</sup>
- (vi) taxes collected or withheld by the debtor for the benefit of the tax authorities.<sup>91/</sup>

Finally, non-definitive transfers can also arise where the debtor holds assets, for example, in deposit, usufruct, trust (fideicomiso), administration, consignment, purchase or sale commission, or in transit, for delivery to, or collection on behalf of, a third party.<sup>92/</sup>

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<sup>86/</sup> *Id.* article 71-I.

<sup>87/</sup> *Id.* article 71-II.

<sup>88/</sup> *Id.* article 71-III.

<sup>89/</sup> *Id.* article 71-IV.

<sup>90/</sup> *Id.* article 71-V.

<sup>91/</sup> *Id.* article 71-VI.

<sup>92/</sup> *Id.* article 71-VII. This happens for example, with the bailment agreement (contrato de depósito)