AVOIDING THE PITFALLS OF CROSS-BORDER SECURED LENDING IN the US and Mexico

Panelists:

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Trans-Pacific Partnership (TPP) (12) 11 countries?
Comprehensive Economic and Trade Agreement (CETA)
29 countries

CANADA
Austria + Italy
Belgium Latvia
Bulgaria Lithuania
Croatia Luxembourg
Cyprus Malta
Czech Rep. Netherlands
Denmark Poland
Estonia Portugal
Finland Romania
France Slovakia
Germany Slovenia
Greece Spain
Hungary Sweden
Ireland UK
Cross-border financing opportunities

Key industries:
• Agri-Food
• Pulp & Paper
• Mining
• Fisheries
• R&D
• Life Sciences

• Chemicals
• Metals
• Plastics
• Automotive
• Retail
• Service Industries
TOPICS TO BE COVERED

• Jurisdictions discussed in this presentation:
  • Canada
  • US
  • Mexico

• Taking security and enforcement

• Risk areas for lenders

• Practical considerations: Recommendations and best practices
WHAT IS DIFFERENT ABOUT CROSS-BORDER LENDING?

- Familiar Canadian concepts may not be recognized in some countries
- Common law vs. civil law jurisdictions
- Robustness of foreign secured lending laws
- Possible unpredictable enforcement process and timeline
- Different cultural priorities
WHAT IS DIFFERENT ABOUT CROSS-BORDER LENDING?

• Credibility of foreign judiciary
• Different registration regimes: greater due diligence
• Perfecting liens over future assets
• Waiver of prohibition to pledge or assign A/R
• Notice to account-debtor may be essential
WHAT IS DIFFERENT ABOUT CROSS-BORDER LENDING?

• Domestic protection of unpaid suppliers
• Financial assistance restrictions
• Withholding tax
• Stamp duty & notarial fees
• Opinion of local counsel
• Recognition of Canadian judgments & arbitration awards
CROSS-BORDER LENDING ISSUES

• Cross-border lending opportunities & international trade agreements
• Harmonization of conflict of laws rules
• STA and control agreements
• Cash collateral and control agreements
• Lenders’ concern about foreign borrowing base
• Withholding tax & access to foreign capital
• Loan documentation drafting issues
• Personal liability of directors
Corporate structure of the Borrower and Guarantors

Canadian Holding Corporation

US subsidiary

Mexican subsidiary
CROSS-BORDER LOAN STRUCTURE

• Lenders lend to Canadian borrower with subsidiaries in US & Mexico
• Quebec law credit agreement
• Canadian Borrower charges its personal property located in Canada
• Canadian Borrower pledges its equity interest in the subsidiaries
• Each Subsidiary guarantees obligations of Canadian Borrower
• Each Guarantee is supported by security over Subsidiaries’ property
• All personal property of each guarantor is located in home jurisdiction
SECURITY AND ENFORCEMENT

• Know Your Customer (KYC)
• Applicable Law
• Perfection Rules
• Control Agreements
• Limitations on Assignability
• Priority Rules
• Foreclosure and Enforcement
• Recognition of Foreign Judgments
Know Your Customer (KYC)

• Anti-Money Laundering Laws (AML)
  • Verification of customer identity.

• Office of Foreign Assets Control Laws (OFAC)
  • Targets counterparty risk.
  • US persons may not engage in transactions with persons, governments and countries subject to US sanctions.
Applicable Law

• The law of several states may govern
  • Article 9 of the UCC is state law that governs the creation, perfection and priority of security interests and includes certain rights and remedies on enforcement.
  • Article 9 covers most types of collateral but excludes, among other things, statutory liens, liens governed by other law (i.e., certificates of title and registered intellectual property), and pledges of real property.
  • The security agreement is governed by the state law determined by the parties to the agreement.
Applicable Law (cont’d)

Perfection, Priority and Remedies

Example:

• Guarantor is organized in Delaware
• Collateral includes bank account in Pennsylvania
• Security agreement and guarantee are governed by the laws of New York
• Credit agreement is governed by the laws of Quebec.
Applicable Law (cont’d)

Perfection, Priority and Remedies

• The law of the jurisdiction of the guarantor (Delaware) governs perfection, the effect of perfection or non-perfection and priority.

• While collateral (bank account) is located in a jurisdiction (Pennsylvania), the local law of that jurisdiction governs perfection, the effect of perfection or non-perfection and priority.

• The obligation to pay under the guarantee, whether a security interest has been created and the rights and remedies of the parties under the security agreement (including process and standards for foreclosure) are governed by the laws of New York.
Perfection Rules

Determined by the category of collateral

- **Perfection by filing**
  - most personal property including goods, account receivables and payment rights and other general intangibles
  - excludes deposit accounts, money and letters of credit
  - file in the “location” of the debtor, the location of the chief executive office if not registered or Washington, DC if a foreign entity
Perfection Rules (cont’d)

Determined by the category of collateral

- Perfection by possession
  - tangible chattel paper, instruments, goods, negotiable documents and money
  - an agent may take possession on behalf of the secured party
Perfection Rules (cont’d)

Determined by the category of collateral

- **Perfection by control**
  - investment property and deposit accounts
  - control agreements
Control Agreements

• Highly standardized, banks do not like to negotiate

• Key provisions
  • springing versus hard
  • account access by the borrower
  • bank’s right of setoff
  • indemnification of the depository bank by the secured party
Priority Rules

• First to file or perfect.
• Control/possession of investment property trumps filing.
• Purchase-money security interests trump blanket liens.
• Ordinary course buyer for value takes free of liens.
• Transferee of funds from a deposit account takes free of liens unless in collusion with the debtor to violate the rights of the secured party.
• Commingled goods and identifiable proceeds.
Foreclosure and Enforcement

Under Section 9-610, after default, a secured party may sell, lease, license or otherwise dispose of any or all of the collateral, and every aspect thereof must be *commercially reasonable*. 
Foreclosure and Enforcement (cont’d)

• The secured party may:
  • use self help and take possession of collateral
  • notify an account debtor to render payment or performance to the security party
  • take proceeds to which it is entitled
  • enforce collection of accounts
  • exercise of rights under a control agreement and apply the balance to amounts due

• The secured party may NOT:
  • vary by contract its obligations relating to good faith, diligence, reasonableness and care
Recognition of Foreign Judgments

• Governed by Civil Practice Law and Rules 5301 through 5309
• If a foreign judgment for a sum of money is final, conclusive and enforceable where rendered, it is enforceable in New York
• A few grounds for non-recognition:
  • rendered under a system that does not have impartial tribunals or procedures are incompatible with the due process of law
  • foreign court did not have personal jurisdiction over the defendant
  • judgment was obtained by fraud
  • judgment obtained is contrary to public policy of the State of New York
  • enforcement of judgment would be unconstitutional
RISK AREAS FOR LENDERS

• Tax Issues
  • withholding taxes
  • deemed dividends

• Fraudulent Conveyances
Tax Issues

• Withholding Tax on Interest and Tax on Certain Fees
  • avoiding US federal net taxation on US-source income
  • rely on portfolio interest exemption or tax treaty
  • if lender is engaged in US trade or business, it may be subject to tax and required to file a US federal income tax return
    • purchase in secondary transactions, season and sell, limit number of loans
    • no US establishment
• **Deemed Dividends under Section 956 of the Code**
  • if a controlled foreign corporation provides credit support to its US parent, its earnings and profits will be deemed to have been distributed to the parent and will be subject to US income tax
  • limit support to pledge of less than 66 2/3% of subsidiary’s stock
Fraudulent Conveyances

• Avoidance of a transfer of property made within 2 years of filing for bankruptcy protection, if at the time of transfer the debtor was insolvent or became insolvent as a consequence of the transfer, and the debtor received less than reasonably equivalent value for such transfer.
  • how to define insolvent?
  • what is reasonably equivalent value?
Fraudulent Conveyances (cont’d)

• Arises with upstream and cross-stream guarantees.
• Savings/support clauses limit the guarantee to the maximum amount permitted without rendering the guarantor insolvent, but In re Tousa, Inc. has called enforceability of these provisions into question.
  • contribution agreements
  • solvency opinions
RECOMMENDATIONS AND BEST PRACTICES

• Tax structuring is key in cross-border transactions
• Reduce enforcement risk by structuring a transaction that will hold up in a bankruptcy
• Coordinate: don’t forget to have local counsel review the reps, warranties and covenants for their loan parties
SECURITY AND ENFORCEMENT

• Guarantee
  • An *aval* is a personal guarantee granted by a third party and is a promise to pay a negotiable instrument in case of default by the obligor.
  • Under an *aval*, a guarantor is considered jointly and severally liable with the obligor and the creditor may collect payment directly without exercising rights against the obligor.
  • Consider both Quebec law guarantee and *aval* to ensure ease and flexibility of enforcement.
    • *Aval* may provide expedited remedies. Can be enforced directly without having to obtain foreign judgment.
Overview of Legislation

Overview of Secured Transaction Legislation

• Many of the security instruments in Mexico are relatively new, arising out of changes in secured transactions law since 2000

• No comprehensive law covering securing transactions and no single concept of a “security interest” in personal property but rather a number of different instruments and mechanisms.
  • Commercial Code
  • General Law of Credit Instruments and Transactions (Ley General de Titulos y Operaciones de Credito)
  • Civil Codes of Mexican States
Overview of Legislation

Overview of Secured Transaction Legislation (cont.)

- In 2000, amendments to Commercial Code and General Law of Credit Instruments created the mechanisms of the “guaranty trust” and “nonpossessory pledge”.
  - Prior to these reforms, security interests could only be created by listing specific items of collateral, e.g. specific accounts receivable.
  - Permitted pledge of property not yet in existence and subsequently acquired property.
- In 2009, establishment of central electronic registry for most types of personal property security interests.
- In 2014, reforms aimed at strengthening legal framework for secured loans and enforcement of collateral
  - Allowed extra-judicial enforcement for certain collateral.
  - Clarified and codified measures for enforcement of collateral, increasing efficiency and certainty in collection of collateral.
  - Enhanced role, and thus use, of electronic registry.
Types of Security

• General considerations:
  • Which structure or security vehicle should be used requires analysis on a case-by-case basis.
  • Take into account assets being secured, size of financing. Certain security vehicles may come with significantly higher costs.
  • Cost-benefit analysis is important. Thus importance of having competent local counsel.
  • Security interests must be created in writing and, except in limited circumstances, will need to be notarized.
  • Single national registry for personal property collateral *(Registro Único de Garantías Mobiliarias (RUG)), but special rules and registries exist for specialized collateral.*
Types of Security (cont’d)

• Mortgage
  • In the case of real property, registered with public register of property in state where assets located (*Registro Publico de la Propiedad*).
  • Must be registered in order for security interest to be valid against third parties.
  • Judicial foreclosure – public sale of secured assets through the Mexican courts.
Types of Security (cont’d)

• Industrial Mortgage
  • Floating lien over an entire business enterprise, including real estate, receivables, inventory, other personal property (in Canadian terms, an “all assets lien”)
  • Can only be granted to Mexican banks, not foreign banks.
  • Must be registered in appropriate public register office.
  • Title insurance available.
  • Requires judicial enforcement.
Possessory Pledge vs. Non-Possessory Pledge

• Possessory Pledge *(Prenda con Transmisión de Posesión)*
  • Must be specific moveable property and property has to be specifically identified.
  • Perfection requirements depend on assets pledged, but generally assets must be delivered to lender (or agent) for perfection.
    • Pledges on moveable assets that have a registry must be recorded (i.e. shareholders registry book, intellectual property).
  • Good for shares or other instruments.
  • Requires judicial enforcement.
Possessory Pledge vs. Non-Possessory Pledge (cont’d)

• Non-Possessory Pledge (*Prenda sin Transmisión de Posesión*)
  • Can be constituted as floating lien on all present and future moveable tangible or intangible property, identified generally.
  • Guarantor may continue to use collateral, including sale of inventory in its business.
    • Must be recorded before *Registro Único de Garantías Mobiliarias* (RUG).
  • Parties can elect non-judicial enforcement.
Guarantee Trust (Fideicomiso)

• One of the most popular and flexible security vehicles available under Mexican law.

• Commonly used in cross-border financing in Mexico.

• Title to collateral (any kind of real or personal property) transferred to trustee.
  • Obligor generally retains the right to make use of trust assets use and receive proceeds thereof (so usually not considered transfer for tax purposes).
  • Mexican law allows for the creation of security trusts to secure simultaneously or successively different obligations of the obligor with one or more creditors.
  • In addition, the grantor of the trust may designate one or more beneficiaries to receive the benefits of the trust simultaneously or successively. The proceeds derived from the foreclosure will be allocated to the beneficiaries in the priority of their designation as beneficiaries under the trust.
Guarantee Trust (*Fideicomiso*) (cont’d)

- Requires Mexican financial institution to serve as trustee, which means higher costs.

- Two big advantages:
  - Bankruptcy remote
  - Parties can elect non-judicial enforcement.
    - If a default occurs the lender (beneficiary of the trust) can foreclose over the trust assets.
    - Trustee should take care to establish compliance with due process. Should give debtor due notice of start of enforcement and opportunity to cure.
Guarantee Trust (Fideicomiso) (cont’d)

• With respect to a guarantee trust over real property, the trust must be recorded with the Public Registry of Property of the jurisdiction of the place where the assets are located.

• With respect to personal property or contractual rights, perfection requires vary on the underlying assets.
  • Guarantee trusts over receivables require notice to debtors unless consent is granted by other means.
  • If the trust assets contain shares or securities, endorsement in favor of trustee required.
Registro Único de Garantías Mobiliarias (RUG)

• In 2009, amendments to the Mexican Commercial Code established the RUG, a central electronic registry for most types of personal property security interests.
• Can be electronically searched.
• At first, the RUG was of little practical utility because guaranty trusts, industrial mortgages and other kinds of secured interests were not required to be recorded.
• In June 2014, amendments to the Mexican Commercial Code enhanced the role of RUG in Mexican secured transactions. Now all ordinary commercial pledges and guaranty trusts need to be registered.
• Greater assurances for secured creditors in search.
Workouts and Insolvency

• Concurso Mercantil. Obligor will have up to one year to develop a consensual plan with creditors subject to court approval.

• Liquidation, if reorganization isn’t attempted or achieved.
RISKS AREAS FOR LENDERS

• Withholding Tax
• Financial Assistance
• Priority Claims
Withholding Tax

• Withholding frequently an issue in cross-border deals in Latin America
• 4.9% withholding tax for registered foreign financial institutions from countries with double taxation treaties with Mexico (e.g. Canada).
• In other circumstances may be as high as 30%.
• Original lenders are almost always fully grossed up. Borrower will want to limit gross up for subsequent lenders/assignees to withholding applicable to assigning lender and not be liable for incremental withholding cost.
Financial Assistance

• Guarantees issued by a company to support parent’s obligations would be generally valid under Mexican law.
• Common in cross-border financing for Mexican subsidiaries to give upstream guarantees.
• Make sure that Mexican subsidiary allows for guarantee to be provided.
Financial Assistance (cont’d)

• Corporate benefit or fair consideration and arm’s length terms are issues to consider for tax reasons and for insolvency scenarios.

• Beware preferences:
  • Transactions entered into within a “suspicious period” of 270 days before date on which insolvency proceedings (concurso mercantil) is declared.
  • “Suspicious period” can be extended further back.
Priority Claims

• Wages and workers compensation for the year before insolvency decision.
• Expenses incurred in administration of estate and resulting from judicial or non-judicial procedures for the benefit of the estate.
• Fees of the bankruptcy auditor, conciliator and receiver.
• Employee or tax claims (other than wages).
RECOMMENDATIONS AND BEST PRACTICES

• Local counsel
• Due diligence
• Costs/timeline
Local counsel

• Mexican legal market is sophisticated.
• Find counsel that is experienced in assets/property involved in your transaction.
• Some firms have more experience, for example, with guarantee trust structures, or receivables financing, or energy sector financing.
Due diligence and Costs/timeline

• **Due diligence**
  • Always review power of attorneys to ensure due authorization of signatories.

• **Costs/timeline**
  • Registration, recording fees and notarial fees vary and registration duties in some states are based on value of secured assets.
  • Costs can be material.
  • Ongoing perfection requirement for non-tangible assets.
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