

FORECLOSING ON CROSS-BORDER LOANS IN MEXICO

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One of the main issues confronting the financial sector worldwide as a result of the economic and real estate market troubles is how to deal with developers and homeowners alike who, due to unfavorable financial and market conditions, are unable to timely repay loans.

This issue is particularly acute with respect to foreclosing on “cross-border loans” in Mexico, which is the subject matter of this article. A cross-border loan may be defined as either (a) a the loan originates in one country and is disbursed in another or (b) a loan that is executed under the laws of (or the lender is domiciled in) one country but secured by collateral located in another.

A. Foreclose or not to Foreclose, that is the Question

Financial institutions and private lenders who have made cross-border loans into Mexico are faced with the following options when confronted with a delinquent borrower:

- (i) grant the borrower either a **forbearance** or a **deferment**;
- (ii) **restructure** the loan, so that, for example, interest and/or principal payment obligations are reduced, the term is extended, balloon payments are deferred and/or the lender takes an equity interest in the project/property;
- (iii) threaten foreclosure and/or file for foreclosure then **negotiate a settlement** through which Borrower is given some sort of consideration for voluntarily “handing over the keys”;
- (iv) **foreclose**

Because of the well-known difficulties in foreclosing on loans and repossessing property in Mexico, and, in general, the perception that the Mexican judicial system is slow, unpredictable and vulnerable to corruption, most lenders are opting for restructuring the loan, deferment, forbearance or settlement.

Nevertheless, when confronted with a defaulting borrower in Mexico, it is advisable for lenders to look at all four options mentioned above and to weigh the pros and cons of each based on the specific circumstances. Indeed, the first step might be to grant a temporary forbearance, but if that does not work, then perhaps the parties will restructure the loan. And, only if both these attempts fail, might the lender decide to foreclose; and even then, he may end up settling by, for example, paying the debtor an agreed sum in exchange for voluntarily relinquishing his rights to the collateral.

In any case, before deciding on whether or at what point to foreclose, lenders are advised to consult with qualified Mexican legal counsel who can help them better understand (a) the type of Mexican security interest granted and the lender’s right to foreclose under Mexican law; (b) the likelihood of success; (c) the estimated time to obtain a final binding judgment and to enforce the judgment; and (d) the estimated costs involved.



The Foreclosure Process

Once the creditor ultimately decides to pursue foreclosure against a debtor in default, the first step will usually begin with a demand letter.

1. The Demand Letter

Mexican legal requirements for demanding payment under a promissory note or other debt instrument are much more formalistic than in the US, and to ensure the demand lender will hold up in court, it will likely be necessary to grant local counsel a formal power of attorney to serve the demand letter personally and in the presence of a Mexican notary public or officer of the court. This formal demand letter is referred to under Mexican law as an “*interpelacion*”. Although a demand letter usually will not be necessary if foreclosure is sought under a guaranty trust, it is often advisable to serve one regardless in case the matter ultimately ends up in court.

2. Mortgage v. Guaranty Trust

If the demand letter does not work, then the next step will depend on what type of security instrument is in place. The two most common ways of securing a loan with real property in Mexico are: (a) the mortgage; and (b) the guaranty trust.

A mortgage is an agreement whereby the debtor or a third party obligor grants the creditor the right to collect an amount due via the real property put up as collateral, which right may be exercised if the debtor breaches its obligations pursuant to the credit agreement or note. Mortgage agreements must be executed before a Mexican Notary Public and recorded in the Public Registry of Real Property. Once recorded, the “world is on notice” that the subject collateral has been encumbered to secure the payment of the debt referenced in the mortgage instrument.

On the other hand, a guaranty trust is an agreement whereby a debtor or third party obligor (trustor/*fideicomitente*) transfers title to collateral to a Mexican trust institution¹ (trustee/*fiduciario*) for the benefit of the creditor (beneficiary/*fideicomisario*). That is, instead of Debtor conserving title to the collateral and encumbering it in favor of Creditor, the Trustee holds the temporary title to the property in order to secure the debtor’s compliance of the debtor’s obligations.

3. Foreclosing under a Guaranty Trust

Guaranty trust agreements contemplate an administrative foreclosure process. This process is carried out by the trustee without the intervention of a judge and therefore is designed to be significantly more streamlined than foreclosing on a mortgage, which requires filing a lawsuit and obtaining a judgment. Every trust institution will have its own administrative foreclosure template to be included in the trust agreement. Nevertheless, lenders can negotiate the specific terms with the borrower, subject to approval of the trustee. For purposes of analysis, we have included below an example template, which establishes the following administrative foreclosure process:

1. The First (Guaranty) Beneficiary/Creditor (“Creditor”) notifies the Trustee in writing, (a) indicating that Trustor/Debtor (“Debtor”) has defaulted on one or more of the obligations guaranteed by the Trust, (b) specifying the events and causes of default and (c) requesting the sale of the properties to satisfy the debt.

¹ Almost all trustees in Mexico are banks, and they must be authorized as such by the Mexican Banking and Securities Commission.

2. The Trustee, upon receipt of the notice, shall within two working days thereafter proceed to notify the Trustor/Borrower that (a) he is in default and (b) he has ten working days to:
 - a) Submit the documents evidencing he has fully paid and/or complied with the guaranteed obligations;
 - b) Present any document evidencing an extension; or
 - c) Pay the total debt due.
3. If the Borrower/Trustor does not comply with the foregoing, the Trustee will initiate the foreclosure process by proceeding to sell the properties under the following terms:
 - a) The initial sale price of the properties will be the commercial value determined by an expert appraiser selected by the First Beneficiary/Creditor;
 - b) The Trustee will then, based on instructions from the First Beneficiary, either: (a) hire a realtor selected by the First Beneficiary to broker the sale of the properties at the appraised value; or (b) hold a public auction to sell the properties in the manner described below;
 - c) If the First Beneficiary chooses to hire a realtor, the realtor will promote the sale of the collateral for at least 90 days. If the properties are not sold at the appraised value during this time, the First Beneficiary may instruct the Trustee and/or the realtor (as the case may be) to: (i) continue promoting the sale for up to four additional 90 day-periods, in each instance decreasing the appraised amount by 10%; and/or (ii) proceed with the auction;
 - d) If the First Beneficiary elects to hold an auction (either from the outset or subsequently if selling through a realtor was unsuccessful) the auction shall stipulate a floor price of 80% of the appraised value;
 - e) Should the properties not sell in the first auction, a second auction shall be held, at a price equal to 20% less than the price of the first auction;
 - f) Should the properties not sell in the second auction, a third auction shall be held, at a price equal to 20% less than the price of the second auction;
 - g) Should the properties not sell in the third auction, the Trustee shall act upon First Beneficiary's [unilateral] instructions (which instructions could include, e.g., a request to transfer the property definitively to First Beneficiary or its assign in lieu of payment of the debt).

Despite the relatively quick and straight-forward process, “legal maneuvers” of recalcitrant borrowers can result in unforeseen delays and risks in the foreclosure process. One of the tactics most commonly employed by borrowers wishing to stall or avoid administrative foreclosure involves filing a lawsuit to enjoin the trustee from transferring title without a court order. Although in theory this should not be possible because the trust will stipulate that a court order is not necessary, in practice, trustees are very risk averse, so as soon as they are sued, then tend to “freeze up” and refuse to do anything further without a court order, thereby rendering the administrative foreclosure process inoperative. The legal argument of the borrower in these cases is often that the trustee transferring the property to a third party without the judge’s intervention is tantamount to depriving the Borrower of property rights without due process of law and is therefore unconstitutional.

These arguments, however, are not always successful and usually require that (a) the trustee has committed some sort of error in following the administrative foreclosure process outlined in the trust

agreement or (b) the trust agreement does not obligate the trustee to notify the borrower of the default and give him an opportunity to respond by showing he is not in default.

Moreover, borrowers considering “crossing the line” and refusing to abide by the agreement can be subject to a claim for damages, attorney’s fees and costs for filing a frivolous lawsuit or acting in bad faith. Indeed, although employing the tactics above (or others) will surely result in prolonging the foreclosure process, in almost all cases it will not change the ultimate outcome (i.e., all the borrower is doing is delaying the inevitable and incurring in expenses in the meantime). In the end, then, borrowers choosing to fight foreclosure are doing so only with the goal of improving their negotiating position with the creditor, often with an eye towards forcing the lender to consider restructuring the debt or granting an extension or forbearance.

Despite the practical risks associated with foreclosing, if the Borrower is willing to proceed in good faith and abide by the terms of the guaranty trust agreement, then indeed the process should be a quick and expeditious one. Accordingly, guaranty trusts have become quite the norm, particularly for cross-border lenders.

Six months to three years is a reasonable time-frame to achieve foreclosure under a guaranty trust, depending on whether and how much the borrower fights and how effectively the process is managed by the trustee and creditor.

4. Foreclosure of a Mortgage

If the creditor has a mortgage and debtor defaults, then to foreclose (assuming the mortgage has been properly granted before a Notary Public and recorded before the Public Registry of Real Estate Property) creditor must file a Special Mortgage Proceeding (Juicio *Especial Hipotecario*). Once creditor obtains a judgment, the collateral will be sold at a judicial auction pursuant to the procedure established in the applicable civil procedure code.

The special mortgage foreclosure proceeding (from filing until judicial sale is final) may take between one to five years to complete, depending on the actions or legal maneuvers employed by Borrower’s counsel.

B. The Pledge: an Additional Layer of Security

In addition to guarantee trusts and mortgages, many lenders are mandating that borrowers pledge their shares in the borrowing entity and/or the receivables/rents deriving from the collateral. The pledge may be the creditor, a third party, or the same trustee holding the collateral under the guaranty trust. If the later approach is taken, in the event of a default, not only can the creditor proceed to administratively foreclose on the real property collateral but also instruct the trustee to deliver the shares of the debtor company, thereby giving the creditor control over the debtor and preventing the previous decision-makers from challenging process.

In theory, the pledge guarantee offers the creditor significant additional security, but in practice, sometimes the creditor is faced with similar enforcement problems as those mentioned above (i.e., the borrower sues to enjoin the trustee from handing over the shares).

C. Eviction and Amparo²

² Under the Mexican Constitution and federal *amparo* law, a private party may bring two types of *amparo* suits to enjoin an official state act (or omission):

After the collateral has been sold or awarded to the judgment creditor – either pursuant to the terms of the guaranty trust or the mortgage – the party who was awarded title might still have to sue to evict a third party such as a lessee or laborers in possession.

Furthermore, in some instances, the debtor who has lost his property will file a federal injunction called an “*amparo indirecto*” to stay the enforcement of the new owner’s title that arose out of the foreclosure process. That is, oftentimes debtors will lose the property either administratively (guaranty trust) or judicially (foreclosure trial, followed by judicial auction), and then still fight the case via an *amparo*, which may be filed to enjoin any State action alleged to violate a party’s civil rights. For example, in the case of the guaranty trust, the debtor may claim that the administrative foreclosure violated his right to due process, thereby forcing the creditor to pursue judicial foreclosure notwithstanding the trust agreement. On the other hand, in the case of a mortgage where a default judgment has been rendered based on defendant’s failure to appear, the debtor may allege that he was not properly served, thereby nullifying the trial and requiring the Creditor to begin the process anew. In both instances, the *amparo* is typically filed when the creditor/new owner attempts to take possession.

D. Conclusions

Based on the foregoing, one can conclude that in theory Mexican law affords a relatively clear and expeditious foreclosure process, both under guaranty trust agreements and special mortgage foreclosure proceedings. However, in practice, a significant gap often exists between foreclosing in theory and in reality. Accordingly, the time and expense involved in foreclosure in Mexico will vary significantly from case-to-case and from debtor-to-debtor.

To help minimize the risks and unknowns associated with foreclosure in Mexico it is advisable to:

- a. Retain qualified Mexican legal counsel with experience not only in preparing cross-border loan documents, security instruments and guaranties, but also in enforcing them;
- b. Once the debtor has defaulted, consider all options before proceeding to foreclose, including restructuring the loan, granting Borrower a deferment or forbearance, or negotiating a settlement through which Borrower is given some sort of consideration for voluntarily “handing over the keys”;
- c. If foreclosure is inevitable, have a clearly mapped out legal strategy well in advance, taking into consideration possible moves by opposing counsel.

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- (1) an *amparo* appeal of a decision of a lower court (similar to a habeas corpus proceeding but not limited to cases in which the appellant is incarcerated or otherwise restrained of his liberty), which may be brought only after all other judicial or administrative remedies have been exhausted, called an *amparo directo*; or
 - (2) a claim brought at the federal trial court level to enjoin the activity of an individual or body acting under color of law claimed to have violated the plaintiff’s individual rights (akin to a civil rights claim to enjoin state action), called an *amparo indirecto*.