

To Trust or Not to Trust: Security Trusts in Mexican Commercial Reorganization Proceedings

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This article discusses the use of security trusts (*fideicomisos de garantía*) as a means for securing the payment of commercial obligations in Mexico, as well as the rights and risks associated with such trusts in the event of a commercial reorganization (*concurso mercantil*) of the debtor. We start with a brief overview of the types of instruments that creditors may use to create a security interest in a debtor's assets under Mexican commercial law and highlight how security trusts are distinct from other types of security interests. We then consider the impact of commercial reorganization proceedings on the property held by security trusts. We conclude the piece by examining the contradictory treatment of security trusts in recent court decisions in Mexico and summarize the practical implications for creditors who accept the use of security trusts as a form of security in commercial transactions.

Types of Instruments for Securing the Payment of Credits

Mexican law regulates several means for securing the payment of credits. The most common of these are mortgages, pledges and security trusts.

Mortgages: A mortgage grants a security interest to a creditor in the mortgaged property owned by the debtor. In the event of the debtor's bankruptcy, a mortgage gives the creditor the right to receive payment up to the value of the mortgaged property, in accordance with the priority ranking established by law.

Pledges: Similar to a mortgage, a pledge is a security interest created in disposable personal property of a debtor to secure compliance with an obligation to a creditor. In the event of the debtor's bankruptcy, the pledge permits the creditor to receive payment up to the value of the pledged property in accordance with the priority ranking established by law.

Security Trusts: In a security trust, a debtor (known as the "settlor"), which can be either a company or a natural person, transfers to a trustee (which may or may not be an affiliate of the settlor) the ownership of certain rights and/or assets for the purpose of securing compliance with any obligation to a beneficiary.

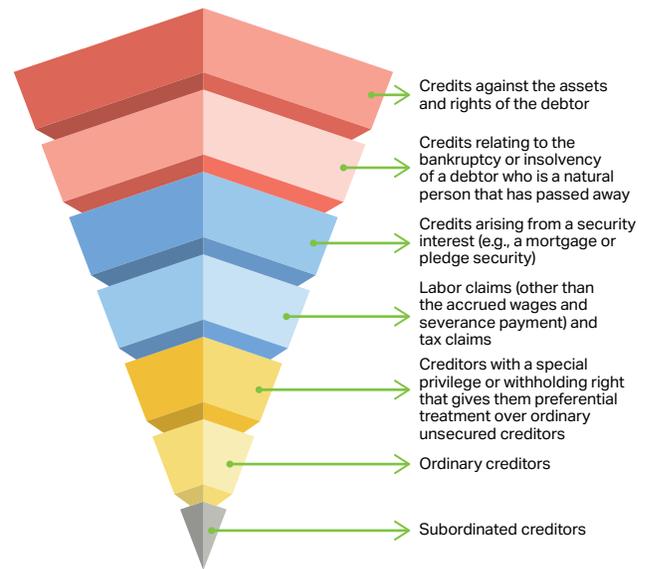
Classes of Creditors and Payment Priority

The Commercial Reorganization Law (*Ley de Concursos Mercantiles*) of Mexico aims to preserve the viability of financially distressed companies that have defaulted on their payment obligations and protect their business relationships with their partners. To achieve this, the Commercial Reorganization Law determines the character of the credits of the debtor and puts in place a priority scheme for the debtor's repayment of its debts. The law classifies credits into the following classes, each with a different priority ranking:

First, creditors with credits against the commercial reorganization property. These include:

- a. Credits related to accrued salaries or wages and for severance payments, considering the wages for the past year;
- b. Credits incurred during the commercial reorganization proceeding to manage the commercial reorganization property with authorization from the conciliator or receiver, as case may be;
- c. Credits incurred to maintain the ordinary operation of the debtor and to provide the liquidity required during the commercial reorganization process;

Priority of Payments



- d. Credits incurred to pay for ordinary expenses for securing the commercial reorganization property and for its repair, conservation and management; and
- e. Credits incurred in court proceedings or out-of-court for the benefit of the commercial reorganization property.

Second, certain creditors who incur credits relating to the bankruptcy or insolvency of a debtor who is a natural person that has passed away (e.g., the funeral expenses of such debtor or the medical expenses caused by the death of such debtor).

Third, creditors that hold a security interest. This category only includes creditors holding a mortgage or pledge security. Creditors who are beneficiaries of a security trust are not contemplated in this category and, as we will further discuss below, must file a separation action if their property or rights form part of the commercial reorganization property.

Fourth, creditors with labor claims other than the accrued wages and severance payments described above.

Fifth, tax claims by the federal or local treasury. Note that tax creditors holding a security interest will be deemed secured creditors (ranking *third* above) for up to the amount of their security, and the remainder of their claim will constitute a tax credit.

Sixth, creditors with special privilege. Those are creditors that, according to the Commercial Code (*Código de Comercio*) and other applicable laws, have a special privilege or withholding right that gives them a preferential treatment over ordinary unsecured creditors. There is no jurisprudence that defines



who those creditors are, but they have commonly included commission agents, personal property vendors, carriers and building contractors, to name a few. As we will discuss later on, beneficiaries of security trusts may also potentially constitute creditors with special privilege.

Seventh, ordinary creditors, consisting of creditors that do not fall within any of the aforementioned classifications.

Eighth, subordinated creditors. Those include:

- a. Creditors that agreed to the subordination of their rights with respect to ordinary credits; or
- b. Creditors that have unsecured credits and that constitute a “controlled person,” such as the manager, members of the board of directors or relevant employees of the debtor.

The priority between creditors of the same ranking shall be subject to the date of the credit, the registration date of the security or the relevant contractual provisions.

As mentioned above, the only secured credits of the debtor under the payment priority scheme are those that have a mortgage or pledge securing payment. The Commercial Reorganization Law does not recognize beneficiaries of a security trust as secured creditors of the debtor. Therefore, security trust beneficiaries with outstanding credits are treated as ordinary creditors.

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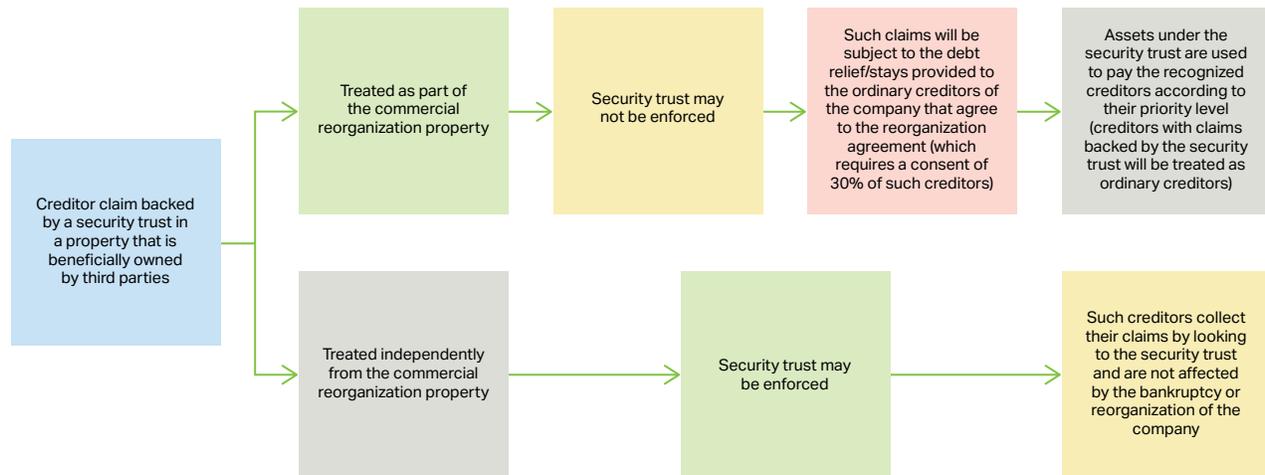
To facilitate enforcement against security trusts, the Commercial Reorganization Law expressly provides that property that is in the possession of the debtor but that is beneficially owned by third parties may be separated from the commercial reorganization property.

Impact of Commercial Reorganization on Security Trust Property That is Owned by a Third Party Trustee

As a general matter, from the moment when a decision is issued in a commercial reorganization proceeding until the conciliation stage ends, if the commercial reorganization agreement is approved or the bankruptcy of the debtor is declared by the court, no seizure or foreclosure order may be enforced against the property and rights of the debtor (other than labor-related seizures and foreclosures). As an exception to that general rule, a commonly held view is that commercial reorganization proceedings do not affect the validity of a security trust arrangement. Pursuant to the laws applicable to disposals of real and personal property, a commercial reorganization of the debtor does not affect the validity of prior disposals of property. Under this view, it would be possible to seize the security trust property and collect the proceeds to satisfy the related credits, in spite of the debtor having been declared in commercial reorganization. The bankruptcy of the debtor will not affect the creditor backed by a security trust, since the debtor will not be the party disposing of the trust property to pay the creditors. Some court decisions support this view and hold that the assets of a security trust cease to be part of the property of the debtor and therefore do not form part of the commercial reorganization property.

To facilitate enforcement against security trusts, the Commercial Reorganization Law expressly provides that property that is in the possession of the debtor but that is beneficially owned by third parties may be separated from the commercial reorganization property. The request for separation by the trust beneficiaries, and any opposition by the debtor, must be adjudicated through an ancillary proceeding in the commercial reorganization proceeding.

Potential Treatment of Security Trust Claims Over Commercial Reorganization Property



Contradictory Treatment of Security Trusts by Commercial Reorganization Judges

In contrast to the foregoing, some commercial reorganization judges have held that assets allocated by the debtor to security trusts continue to form part of the commercial reorganization property. This view is typically taken when the debtor continues to hold the title to the trust property and continues to enjoy rights to such property or when the trustee is not a third-party entity and is, instead, affiliated with the debtor (e.g., when the court found that the real property was allocated to a security trust while the debtor continued to hold possession of the property as a custodian, when the accounts receivable of the trust property were invoiced by the debtor or when the debtor received consideration for services provided by it in relation to the trust property).

If the court comes to a finding that the trust property in fact forms part of the commercial reorganization property, the beneficiaries' claims that are secured by the security trust will be subject to the payment ranking and priority that applies more generally to the commercial reorganization property and the security trust may not be enforced, despite the enforceability of the underlying secured obligation. Additionally, such claims—which will now be treated as part of the unsecured claims of the ordinary creditors—will be subject to the debt relief and/or stays assumed by the ordinary creditors of the debtor that execute the commercial reorganization agreement. Such reorganization agreement under the Commercial Reorganization Law only requires the consent of the holders of 30% of the amount of recognized claims of the ordinary creditors. Furthermore, the assets allocated to the security trust will be used to pay the creditors of the debtor in accordance with their class and priority ranking, which means the creditor holding claims that were backed by the security trust will now

get paid with the ordinary creditors and rank next-to-last in its priority of payment, coming ahead only of subordinated creditors.

Recent Court Cases Impacting the Treatment of Security Trusts in Reorganization Proceedings

On August 3, 2018, a court opinion issued on the treatment of security trusts was upheld by the Mexican Collegiate Circuit Courts.¹ The opinions issued by the lower court as well as the circuit court analyzed the nature of security trusts in commercial reorganization proceedings and the treatment to be accorded to them. Those opinions support the view that the property of the security trust is independent from the assets of the debtor that are subject to the commercial reorganization proceeding, despite any links that the trust property may have to the debtor. The main conclusions from both court opinions are as follows:

- Generally, security interests give creditors (i) priority on the sale price of the property that comprises the collateral, so the creditor may be paid with the price of the property before other creditors; and (ii) a right to pursue the property regardless of who its holder is, even if the property has changed ownership. The foregoing does not occur in security trusts. In a security trust, there are (i) no priority concerns, since there are no preferential rights of other creditors and no possibility of other creditors asserting a competing security interest (in other words, due to the effect of the trust itself, the property is removed from the debtor's property); and (ii) no need to pursue the property, since the property that comprises the trust cannot change ownership—it is allocated to the trust and it is the property of the trustee with no right to dispose of it.

— Therefore, property that is subject to a security trust may not be considered a security interest, since it is not the debtor's property. The fact that the trust is called a security trust does not mean that it is a security interest; it only means to denote that the property is subject to the payment of a debt and, in case of default in payment, the debt is satisfied with the enforcement of the security, without the risk of overlapping or competing claims by other creditors.

Further, the court held in those cases that if the trust property is in the possession of the debtor at the time of the commercial reorganization, the trustee may request its reversion, so the trust may hold it for the true legal owners. In addition, in the event of a precautionary measure (*providencia precautoria*) that suspends the enforcement of the security trust, the affected party (be it the beneficiary or the trustee) may challenge the suspension.

Although those two recent court decisions do not constitute binding precedents, they provide guidance for judges in commercial reorganizations and form part of the body of jurisprudence those judges must consider when adjudicating reorganization proceedings.

Inconsistencies in Treatment of Security Trusts to be Addressed by Mexican Federal Courts

Although the two court decisions discussed above address the independence of the security trust property from the commercial reorganization property, they do not address the class and priority ranking that the creditors backed by the security trust should be attributed when classifying their credits.

Acknowledging the independence of the security trust property does not sufficiently protect the beneficiaries of security trusts if the underlying credits held by them are classified as ordinary credits. If that is the case, the satisfaction of the credits secured by the trust property will be subject to the debt relief and/or stays agreed with the class of ordinary creditors under the commercial reorganization agreement, regardless of the amount that was originally secured by the trust property. In other words, the creditor/beneficiary would only be able to enforce against the trust property up to the amount that results from the debt relief and/or stays agreed with the other ordinary creditors.

On the basis of the foregoing, liabilities secured by a security trust could be recognized as credits with special privilege by having a special collection or withholding right against the trust property that comes ahead of ordinary unsecured creditors. Under the Commercial Reorganization Law, the commercial reorganization agreement must give priority to the payment of credits to creditors with special privilege that have not executed the reorganization agreement. In bankruptcy,

only the wages of the workers, the expenses of the litigation for the defense or recovery of the property subject to the security or on which the privilege lies, the necessary expenses for the conservation, maintenance and sale thereof and the guaranteed credits are paid before paying creditors with a special privilege.

The other possible negative effect on credits secured with trusts in the event of a commercial reorganization is the risk that the trust could be considered unenforceable. In an isolated court decision issued in 2015² (that is nonbinding on future court judgments), the court held that the predispositions of future income in favor of creditors for the purpose of paying their credits pursuant to a trust agreement or assignment of future rights agreement was ineffective. This precedent is questionable as it dismisses the intent of the parties to the trust agreement in favor of what it refers to as “the rules of public order that come into play” during a commercial reorganization—which is contrary to other jurisprudence on enforceability of contracts for the disposal of property. It is thus very likely that this precedent will come into direct conflict with future court decisions that will hold to the contrary. If so, the federal courts of Mexico will be required to issue mandatory jurisprudence on the subject matter and help remove the ambiguity currently surrounding the treatment of security trusts in reorganization proceedings. ■

1. *Amparo* under review 70/2018. Misiones de Casa Real, S.A. de C.V. May 30, 2018. Unanimous Vote. Reporting Judge: Abraham S. Marcos Valdés. Clerk: Patricia Villa Rodríguez.
2. *Amparo* under review 96/2015. Banco Invex S.A., Institución de Banca Múltiple, Invex Grupo Financiero. May 28, 2015. Unanimous Vote. Reporting Judge: Neófito López Ramos. Clerk: Samuel René Cruz Torres.



▼ **Everardo J. Espino** heads the litigation area of the firm and specializes in civil, commercial and administrative litigation. Before joining the firm, Mr. Espino had an outstanding career at Hegewish Abogados S.C. and Rocha & Ambrosi S.C. to then consolidate his own boutique Law Firm: Espino y Gutiérrez, founded in 2004. He is currently also a professor of the Postgraduate Course in Commercial Law of the Escuela Libre de Derecho.