MEXICAN PARTICIPATION IN THE MAQUILADORA INDUSTRY: LOAN THEM THE MONEY!!!

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I. INTRODUCTION

Increasing Mexican participation in the expanding maquiladora industry and the lucrative maquila suppliers market is a top priority of Mexico's President Ernesto Zedillo. The maquila industry has been one of the primary contributors to Mexico's economic recovery.

Maquilas play four fundamental roles in the Mexican economy: creating jobs; generating hard currency to pay Mexico's dollar-based international obligations; the transfer of technology; and redistributing political and economic power to the border states. Nevertheless, Mexican investors, along with suppliers of raw materials and intermediate goods, are not sharing in the benefits of this profitable sector.

The new Maquiladora Decree of October 1996, promotes the development of "sub-maquilas" which are essentially Mexican owned subcontractors for established maquilas. The hope is to increase the "value-added" services provided by Mexican owned companies.

Annually, maquilas purchase over $4 billion of raw materials and intermediate goods for use in their plants in Mexico. The vast majority of these inputs are purchased from U.S. or Asian suppliers, althout several Mexican companies have the expertise to serve as alternative suppliers. Increased Mexican participation in the maquila and suppliers industries would be advantageous for Mexico and, in the long run, beneficial for U.S. businesses. This Commentary will establish that, unfortunately, Mexican companies will not be able to participate in the growing maquila industry unless Mexico substantially reforms its lending laws.

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Cheap and accessible credit is the engine driving economic expansion in all developed economies. The inability under Mexican law to create and enforce security interests in most personal property effectively prevents small and mid-size businesses from obtaining credit to finance new sub-maquilas and suppliers in Mexico. The NAFTA allows U.S. and Canadian banks to participate in lending transactions in Mexico with the hope that foreign banks will infuse much needed capital to finance economic growth in Mexico. However, when personal property is located in Mexico, Mexican secured-lending laws control all efforts by U.S. banks to exercise their rights over the collateral. Mexican law will control even in situations where the parent of the maquila is a U.S. company, the loan is payable in U.S. dollars, and all other aspects of the transaction are controlled by U.S. law. Thus, U.S. lenders are constantly rejecting otherwise viable requests for loans from Mexican companies due to the banks' inability to create security interests in assets located in Mexico. Without significant reforms, Mexico will find itself at a severe disadvantage compared to its NAFTA partners that have more reliable lending laws and access to capital.

In Mexico, start-up monies for business are loaned on the basis of long-standing familial or personal relationships and not on the objective credit-worthiness of the borrower. As a result, access to capital from Mexican lending institutions has only been available to the privileged few who are part of Mexico's political and industrial elite. These practices have developed a system in which lenders have placed little importance on security interests in personal property. Thus, there has been no need for Mexican lending laws to evolve to allow for the use of reliable public registry systems or personal property (assets) as collateral.

II. MEXICO'S USE OF POSSESSORY SECURITY INTERESTS

The National Law Center for Inter-American Free Trade (NLC) has prepared a comparison of U.S. and Mexican lending practices that illustrates the antiquated nature of Mexico's asset-based lending laws. According to Todd Nelson, principle author of the NLC study, an asset-based transaction designed to provide financial support for a U.S. manufacturer would likely include a fixed-term loan amortized over a specified number of years. The transaction would probably include a renewable revolving line of credit. The line of credit is often secured by all assets the manufacturer currently owns or subsequently acquires through the use of a single security agreement. Under the security agreement, the purchase of any new inventory, equipment or creation of accounts receivable are added to the list of collateral that may be used to satisfy obligations owed to the lender.

Under normal circumstances in the U.S., a lender protects itself by filing a financing statement in the Secretary of State's office in the state where the manufacturing facility is located. Before the filing of the simple one page financing statement, the lender will carry out a lien search in the office of the Secretary of State to ensure that there are no creditors asserting an interest in the

collateral. U.S. law allows the parties to file an extremely broad description of the collateral which may include all current and subsequently acquired assets. Broad collateral descriptions give the lender guarantees that a wide array of assets can be used to satisfy the obligation and provide the borrower with a broad spectrum of personal property they can offer as collateral. The security agreement can also be structured in such a way that, in the event the loans are ever increased, all of the debt will automatically be secured by the original collateral with priority over other creditors, with the security interest relating back to the original filing date.

In stark contrast, Mexican secured lending laws favor actual physical possession of collateral, especially real estate, over asset-based lending mechanisms which permit the use of property such as inventory. Mexican possessory security interests involve the retention of the collateral's invoice or relinquishment of the good to insure repayment. For example, a lender traditionally retains possession of the borrower's invoice until full payment has been tendered. Invoice retention is used frequently when a bank wishes to keep a security interest in equipment. This is particularly damaging to Mexican sub-maquilas and suppliers as equipment is one of the most important assets they have to offer as collateral. Invoice retention was designed to prevent the debtor from pledging the same equipment to various creditors. While the invoice is in the possession of the first creditor, subsequent creditors contemplating the acceptance of the same collateral as security and who have conducted a search in all reasonable filing locations, would not learn of any competing interests. If the borrower should receive a second loan secured through already leveraged equipment, the second lender has no rights to the leveraged asset because the law favors the party in possession of the invoice.

In the event the borrower defaults on the loan, the party that performed a title search and properly filed would be unprotected under Mexican law against the lending institution that retained possession of the invoice. Banks are aware of the inadequacies of the Mexican filing system and of the practice of invoice retention. As a result, banks often insist on taking physical possession of the debtor's collateral which is frequently in the form of inventory. While actual physical possession of the collateral is an effective way of combating fraud, it is an overly restrictive restraint of trade that hinders the development of Mexico's export industry. Handing over physical possession of assets as collateral is disastrous for a sub-maquila or supplier in need of short term financing. This is because it forces the plant to relinquish possession of parts and components needed to fabricate goods called for under existing contracts.

III. MEXICO'S FILING SYSTEM

Mexico's filing system exacerbates the problems of creating a security interest. Identifying competing prior claims to assets offered as collateral is very difficult in Mexico. Almost without exception, a U.S. lender will perform a lien search in the corresponding filing office to ensure that there are no competing

prior claims to the offered collateral. The usefulness of a lien search is contingent on the reliability of government record keeping systems. Fortunately, most U.S. filing offices are easily accessible and maintain reliable information. In contrast, most Mexican filing systems are far below U.S. standards and create barriers to flexible and agile lending institutions. If lenders cannot quickly and cost-effectively determine their relative priority over third parties, they will simply look for more secure markets in which to loan their money. The most prohibitive aspect of the Mexican filing system is the daunting task of identifying the proper office in which to file and search for competing interests. Mexican regulations pertaining to the filing process are confusing and difficult to interpret. Consequently, security interests are often improperly filed and subsequent searches do not identify competing interest holders. As a general rule, banks do not lend money if they do not have minimum levels of certainty regarding their relative priority over collateral. Thus, the inadequacies of Mexican filing systems create substantial barriers for small and mid-size companies in need of start-up credit.

IV. ASSET BASED LENDING: FACILITATING ECONOMIC GROWTH

Asset-based lending reform is a necessary first step to increasing participation of Mexican lending institutions in the maquila industry. Asset-based lending is a system in which loans are secured by personal property instead of real property. Successful asset-based lending requires stringent underwriting policies, a comprehensive understanding of the collateral, and a strict system for collateral monitoring. This form of lending is very common in the U.S. and most developed economies. In contrast, Mexican law has not evolved to utilize such lending practices. In Mexico, it is difficult to create a security interest in equipment, inventory, and accounts receivable held by a sub-maquila or supplier. Mexican rules on collateral are highly dependent on the use of real property, and this has hindered manufacturers' ability to use personal property such as inventory and equipment to obtain loans.

Lending institutions provide resources that allow good market ideas to turn into viable business ventures. To ensure repayment of loans, lending institutions insist on guarantees from the borrower which are usually in the form of collateral. Before banks will accept collateral, they require proof that the same collateral has not been offered to another lending institution. This is accomplished in the U.S. through the use of reliable public registry systems that provide for a quick, inexpensive, and reliable means of establishing priority over collateral among creditors. The U.S. lending system has developed in such a fashion that borrowers have tremendous flexibility in the collateral they can offer, and banks are granted the security they need to ensure that collateral offered by the debtor has not been pledged to another lending institution. Unfortunately, Mexican banking laws do not offer the legal certainty and protection demanded by banks needed to give them the confidence to lend money to small start-up companies.

Creditors in the U.S. have unique rights that protect them in the event the debtor/manufacturer does not comply with the lending agreement. Often, when a manufacturer defaults on a loan in the U.S., the bank may seize the collateral without court intervention. It should be noted that such non-judicial remedies are only available in the absence of the debtor's objection. If an objection to the non-judicial seizure of the collateral is manifested, most states provide for expeditious pre-judgment remedies. Another attractive benefit afforded to U.S. secured creditors is their ability to collect the debtor's outstanding accounts receivable to satisfy the loan without judicial intervention. A simple notification by the secured creditor to the account debtor instructing them to remit payment directly to the bank is all that is required. The above protections have given lenders in the U.S. the security to readily grant credit for viable economic ventures.

The effectiveness of a security interest is measured by how quickly and inexpensively a creditor can enforce it. The problem with security interests in Mexico is that they are not expeditious in the procurement of collateral to remunerate a debt. Mexican lending laws do not allow creditors to confiscate the collateral and sell it to satisfy the debt without a lengthy judicial proceeding. Unnecessary delays create two significant risks that dissuade banks from loaning to Mexican companies. First, delays give the debtor time to move assets out of the creditor's reach. Second, during the course of a lengthy judicial process to attach collateral, assets can depreciate in value. In the U.S., the use of non-judicial remedies such as the right of self-help or pre-judgment provisional remedies allow the creditor to take control of the collateral and sell it to satisfy the loan while waiting for the court's final ruling. Non-judicial remedies such as those used in the U.S. are illegal under Mexican law. This is yet another barrier to Mexican participation in the maquila industry.

Mexican law has traditionally been distrustful of flexible, expeditious, and non-judicial mechanisms to attach collateral or to create security interests. Mexican law does not provide for the use of a single legal mechanism to create a security interest in inventory, equipment, and accounts receivable. A labyrinth of mechanisms exist in Mexico that must be used to create an enforceable security interest. It is often difficult to determine which legal document one must use to create a binding security agreement. For example, in order to finance a given project, a sub-maquila may be forced to use several of Mexico's varying security devices which include: pledges, installment sales contracts, and chattel mortgages or trusts. Each of these devices has its own system of filing and standards for granting priority interests over other creditors. The use of so many instruments for one single purpose makes filing very costly and creates uncertainty which further discourages lending. All of these factors have contributed to U.S. banks' hesitation to lend money in Mexico.

U.S. asset-based lenders are particularly concerned about their inability to use after-acquired-property clauses in Mexico. An after-acquired-property clause allows a U.S. creditor to maintain priority over other creditors for any assets acquired by the debtor after the signing of the security agreement. Such a clause is an absolute necessity for any secured transaction in the U.S. Currently, a U.S.

bank wanting to extend credit to a sub-maquila would have to execute and record a new security agreement or an amendment to the original agreement every time replacement inventory was acquired or new accounts receivable were generated by the Mexican company. Logically, such a cumbersome system is not commercially viable.

One of the most valuable assets held by a sub-maquila or supplier is its inventory. Maquilas often have large quantities of intermediate goods which are to be incorporated into the manufacturing process, as well as final products awaiting exportation to the U.S. However, these companies have great difficulty using inventory to secure loans. The need for a detailed description of collateral under Mexican law virtually destroys a sub-maquila's or supplier's ability to use fluctuating stocks of inventory as collateral. To provide adequate security and priority for the lender, the Mexican security agreement must describe the collateral in minute detail. On the other hand, U.S. law permits a lender to describe collateral very broadly. As a result, U.S. manufacturers often use inventory to secure loans to finance different points in the production cycle. It is important to note that U.S. law would recognize a description as broad as "all inventory," while in Mexico the same description would be considered invalid and leave the lender unprotected against third parties.

A revolving line of credit often provides a U.S. manufacturer with the flexibility to meet the demands of a changing marketplace. In contrast, Mexican law disdains such fluctuating indebtedness. An American revolving line of credit allows the debtor's obligation to fluctuate without affecting the validity of the underlying security agreement. In the U.S., the validity of a security interest is not tied to the existence of a specific amount of debt. Therefore, the quantity of the debtor's obligations to the bank are permitted to vary depending on market demands. A security interest is deemed an accessory to the underlying debt according to the Mexican lending laws. Therefore, Mexican law requires that the original security agreement specify the exact amount of the loan that must subsequently be paid down to zero before any new monies may be lent. Once the balance reaches zero, the original security interest must be canceled and, if the debtor needs more money, the parties must execute and file a new security agreement. Such repetitive filings are costly, time-consuming, and may cause a lender to lose priority vis-à-vis intermittent third party lenders. In turn, U.S. asset-based lenders are further reluctant to provide Mexican companies with revolving lines of credit necessary to respond to today's ever-changing global marketplace.

In order to facilitate Mexican participation in the profitable export market, a new center has been formed in Tijuana. The *Centro de Proveedores y Negocios para la Industria Mexicana de Exportación* will serve as a central clearinghouse for Mexican, U.S., Asian, and European companies interested in participating in Mexico's growing export market. Similar centers have played important roles in the development of thriving export economies in Japan and Taiwan.[1]

1. Interested companies should contact the projects director, Carlos de Orduña,

V. CONCLUSION

In summary, six major reforms must be undertaken to facilitate the proper investment climate in which U.S. lenders would contribute much needed start-up money for Mexican sub-maquilas and suppliers. First, a single security agreement must be developed which can be expeditiously, inexpensively, and securely filed. A single security agreement would lower costs associated with filing and provide certainty for lenders searching for competing interests. Second, Mexico's high dependence on real property based security interests must be changed so that Mexican sub-maquilas and suppliers can use accounts receivable in the U.S. and Mexico as collateral. Third, modern flexible devices must be developed which allow personal property such as machinery and inventory to be used as collateral, permitting Mexican companies to use one of their most valuable assets. Fourth, reforms must be instituted that permit the use of revolving lines of credit. Fifth, the Mexican system must move away from its excessive dependence on physical possession of collateral by creating a more reliable filing system. Finally, non-judicial procedures must be instituted to allow creditors to promptly attach collateral before it is moved or depreciates in value.

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