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Legal Update

Receivables Finance in Mexico

Summary. The Mexican receivables finance market has been growing in recent years due to the progressive development of policies that require electronic invoicing, as well as the implementation of the Sole Registry of Security Interests over Movable Assets known as the "RUG" in 2010. Nevertheless, the best practices in the field continue to evolve. In this article, I analyze the legal issues related to the design and implementation of cross-border receivables finance transactions and programs, as well as the best practices in Mexico, including devices to mitigate certain risks.

INTRODUCTION

Mexico is a mature market for financing or discounting of receivables due to the high levels of reported domestic invoices and companies exporting abroad. Receivables financing offers companies established in Mexico an efficient way to address their liquidity needs, while providing the financier with a bankruptcy remote scheme in case of insolvency of the entity or company assigning the receivables (hereinafter referred to as "**Seller**"). In other words, the main advantage of this scheme is that the financing is based on the risk of the receivables themselves rather than on the risk of the Seller.[1]

Although cross-border receivables financing has existed in Mexico for several years, best practices around it continue to evolve. As a result, this article aims to provide an analysis of the main legal, structural and due diligence issues regarding cross-border receivables finance in Mexico, as well as the best practices and mechanisms to mitigare certain risks.

A. OVERVIEW OF A TYPICAL RECEIVABLES FINANCE TRANSACTION

The structure for a cross-border receivables financing transaction in Mexico assumes the existence of an underlying transaction consisting of the sale of goods or services by the Seller, as a supplier (manufacturer, exporter, merchant, etc.) to its client (hereinafter, the "**Debtor**"), generating payment obligations with a determined maturity date. Receivables are typically documented via an invoice (hereinafter referred to as "**Receivables**"). Receivables are subject to assignment or factoring at a discount between the assignor (Seller) and the acquirer of the Receivables (hereinafter the "**Purchaser**"). Such assignment is instrumented through a Receivables Purchase Agreement or a Factoring Agreement (the "**RPA**").

For purposes of this article, I have assumed that the Seller is a company established in Mexico that exports products to the USA, the Purchaser is a non-Mexican financial entity (since from 2006 any person or entity may engage in factoring transactions in Mexico without the authorization of the Ministry of Finance and Public Credit), and the Receivables arise from a service contract or purchase order between the Seller (supplier-exporter) and the Debtor (Seller's client).

The purchase of the Receivables is usually at a discount, "without recourse" against the Seller, and based on a "true sale" from a contractual point of view. These characteristics typically follow New York Bankruptcy Law (or its equivalent in other countries), as well as accounting standards (Generally Accepted Accounting Principles or GAAP, and International Financial Reporting Standards or IFRS) to be able to extract the Receivables as a financial asset from the Seller's balance sheet and to avoid that US courts recharacterize the factoring transaction as a " loan" where the "collateral" are the Receivables, which would make the whole transaction a Seller-risk transaction.

B. EFFECTIVENESS OF THE ASSIGNMENT OF RECEIVABLES (FORMALITIES IN MEXICO)

In principle, all credit rights or Receivables may be transferred through a RPA, without the consent of the Debtor, unless the transfer is prohibited by law, not permitted by the nature of the right or the documents whereby the rights are created expressly state that they cannot be the subject of a factoring transaction.

When analyzing the legal effects of the transfer of the Receivables, the following three layers of legal relationships should be considered: **1.** Effects between the Seller and the Purchaser, between whom there is a transfer of ownership, **2.** Effects between the Purchaser and the Debtor, between who there is a debt relationship, and **3.** Effects of the assignment of the Receivables *vis-à-vis* third parties, including tax authorities and other creditors of the Seller, to whom the Purchaser has an interest in making his ownership over the Receivables opposable.[2] In other words, that no third party has a better title or right over those same Receivables.

1. EFFECTS BETWEEN THE SELLER AND THE PURCHASER

In accordance with Mexican law, the assignment of credit rights or Receivables through a RPA generates, after acceptance of the assignment offer by the Purchaser, the transmission of the ownership over the Receivables to the Purchaser. The Seller is, however, deemed, by law, to guarantee the existence and legitimacy of the Receivables at the time the RPA is executed. In turn, the Purchaser is obligated to pay the consideration (agreed price), which is usually the value of the Receivable established in the relevant invoice, less the discount and other concepts, as applicable.[3]

The analysis of the effectiveness of the assignment of the Receivables under Mexican law is usually *formalistic*, therefore Mexican courts usually respect the contractual intent expressly stated by the parties in the RPA (literal interpretation).[4]

When the RPA is subject to foreign law, from the Mexican law perspective, as long as the assignment of the Receivables under the law governing the RPA is effective, the Mexican courts would recognize such assignment.[5]

In other words, Mexican courts generally respect the choice of non-Mexican law, unless the Mexican law expressly prohibits it or the choice seeks to artificially avoid the fundamental principles of Mexican public policy. The choice of a non-Mexican jurisdiction would also be valid complying with certain requirements, and then a judgment granted by a New York court would be enforceable in Mexico provided that certain requirements are met (such as reciprocity between the enforcement of foreign judgments, due personal notification in order to ensure hearing rights, no *in-rem* claim is being exercied, among others).[6]

It is worth mentioning that it is a recurrent practice to provide in the RPA for provisions aimed at highlighting the true sale and, as a preventive measure, to provide for the granting of a fall-back

security interest over the Receivables in the event that a US court re-characterises the transaction as a secured loan.[7]

2. EFFECTS BETWEEN THE PURCHSER AND THE DEBTOR

Although the RPA would be subject to non-Mexican law, certain effects will not evade Mexican law, such as notification of the assignment of the Receivables to the Debtor and the filing with the RUG, which will be described below. The above, because the assignment of the Receivables itself does have certain effects in Mexico *vis-à-vis* the Debtor and the creditors of the Seller.

(a) Legal Effects of the Notification of Assignment

Unlike the New York regulatory framework, where notification to the Debtor may not be necessary, under Mexican law, as long as the Debtor has not been notified of the transfer of the Receivables, its payment obligation will be considered fulfilled if it is paid to the Seller (original creditor). As a matter of fact, once the Debtor has been notified of the assignment following certain formalities, its payment obligation will only be considered fulfilled if it pays the Purchaser. If for any reason, after notice of assignment, the Debtor pays the Seller instead of the Purchaser, the Debtor will not be considered released from the payment obligation and will continue to be obligated to pay the Purchaser.

(b) Payment Instructions Usually Included in the Notification to the Debtor

In most factorings where the Purchaser will be performing the collection, the notification to the Debtor usually includes irrevocable instructions for the Debtor to make payments of the Receivables directly to the Purchaser. However, as will be explained below, depending on the factoring business model, sometimes the Seller is entrusted by the Purchaser to continue with the collection of the Receivables.

Nevertheless, it is relevant to define in which account the payments will be received from the Debtor, since such account could be in the Seller's place of origin or in Mexico. In this last case it will be necessary to design the scheme that will allow the Seller to ultimately receive the product of the collection that enters the corresponding account in Mexico, as well as the issues related to the exchange risk, depending the currency of the Receivables and the currency of the funding under the RPA.

(c) Formalities of the Notification of Assignment under Mexican Law

The form of legal acts shall be governed by the law of the place in which they are held and the parties (including foreign parties) may be subject to the forms prescribed by Mexican law when the act shall have effect in Mexico regarding federal matters.[8] Due this reason, the notification of the assignment to the Debtor must be made according to one of the following modalities provided for factoring in article 427 of the LGTOC in order to be effective in Mexico: **(i)** delivery of the documents proving the existence and assignment of the Receivables together with an acknowledgement of receipt by the Debtor or any other unequivocal sign of its receipt; **(ii)** communication by certified mail with acknowledgement of receipt, telegram, or telefax, together with the proof of receipt by the Debtor; **(iii)** notification made by a public broker[9] or a notary public (in this case, a written acknowledgement of receipt by the Debtor would not be required); or **(iv)** by means of a "data message" sent under the conditions established in the Mexican Commercial Code. Notifications by electronic means will be explained in paragraph (d) below.

(d) Notification of the Assignment by Electronic Means is Usually Preferred by Foreign Purchasers

Although the practice in Mexico has been that the notification to the Debtor is done through a notary public or public broker to reduce risks, more recently it has favored the use of electronic communications, particularly when the Receivables are acquired using technological platforms or in

operations in which foreign Purchasers participate in establishing programs and electronic platforms of common and inverse factoring.

Pursuant to provisions of the Commercial Code, as the Debtor and the Purchaser do not normally have any contractual relationship, the sender and the recipient of the notification by digital means (data messages) have not established a system or means to receive them in a binding way.

However, if the Debtor established an e-mail address to receive any notification in the underlying agreement with the Seller, then there would be elements to argue that sending the assignment notification to the address of that Debtor established in the underlying agreement could qualify as an "information system" belonging to the recipient (in this case, the Debtor), pursuant to fraction III of Article 91 of the Commercial Code. If so, notification of the assignment by e-mail could be considered effective, provided that it can be shown that the data message "entered" the Debtor's information system. In any case, it is recommended to request a confirmation (acknowledgement of receipt) by e-mail when sending the corresponding notification by electronic means.

On the other hand, the lack of case law regarding these specific matters makes it still difficult to rely solely on e-mail notification. In practice, it is therefore preferable to require the recipient (the Debtor) to acknowledge receipt of the notification in writing or to effect it through a notary public or public broker.

In the case of Receivables acquired through the use of technologically managed platforms, notifications through the platform are effective and enforceable since the Debtor has expressly accepted the terms and conditions of the platform, for example, the clauses that establish that all notifications will be made by electronic means through the platform. The same occurs when the factoring scheme includes a legal instrument between the Debtor and the Purchaser where the former is obliged to pay the Receivables directly to the Purchaser (e.g., *acknowledgment deed*).

(e) A Single Initial Notification or Must Each Assignment Date Be Notified?

Depending on how the factoring is structured, the Purchaser may be entitled to acquire all or only some eligible Receivables. In the first case, it is clear that a single initial notification to the Debtor may be sufficient. However, when only some and not all Receivables are acquired, a conservative approach would suggest that the Debtor shall be notified of the assignment at each assignment date so that the Receivables assigned to it are properly identified.

To reduce the administrative burden of providing notification on each assignment date, periodic notifications (weekly or monthly) containing the batch of Receivables actually acquired during the given period may be used. Another alternative is to provide a single initial assignment notice indicating that a note will be added along with the associated invoice to the assigned Receivables indicating that the Receivables have been assigned to the Purchaser. In any case, acknowledgement of such initial notification by the Debtor or notification through a notary public or public broker would be necessary to achieve the effect of proper notification of the assignment of the acquired Receivables in progress.

(f) Cases in Which the Seller Performs Debt Collection

It is not strange that the Seller is designated as the administrative and collection agent of the Receivables that it originated, especially when the Debtors make payments to the Seller in Mexico. Even more so when it comes to Mexican companies that already have thousands of clients that ordinarily make payments in Mexico. In such cases, it will be deemed that the Seller will keep the product of the collection for the benefit of the Purchaser, with the obligation to transfer periodically

the product of the collection to the Purchaser. In order to make this possible, the Purchaser must commission the Seller for these purposes, normally in the RPA.

The main concerns in these cases are often "deviation" and "confusion." In the first case, the Seller uses the product of the collection for other purposes (by mistake or fraudulently), and in the second case, the product of the collection is confused with that of other receivables that were not acquired by the Purchaser, which makes it more difficult to separate them in case of bankruptcy of the Seller because money is the fungible good par excellence. The following section describes some techniques to mitigate those risks.

(g) Devices to Control Collection in Mexico and Deliver It to the Purchaser

In the case that the Seller continues with the collection task, the payments made by the Debtors normally enter an account that is usually under the name of the Seller in Mexico. It is common to implement the following structure in order to avoid that the Seller controls the resources of collection at his sole discretion, as well as to avoid the above mentioned problem of confusion.

The Seller opens a bank account in its own name at a financial institution in Mexico (a bank) (the "Collection Account") and then enters (as a principal) into an irrevocable commercial commission agreement with the same financial institution (as a commission agent). Such agreement will serve as an account control mechanism for the benefit of the Purchaser, who must also accept the stipulation in its favor made by the Purchaser. This means that the financial entity that receives the collection resources derived from the Receivables is obliged to transfer all those revenues to the Purchaser in an automatic and irrevocable manner.

However, if according to the RPA, the Purchaser does not acquire 100 percent of the Seller's Receivables, it is expected that the collection does not correspond entirely to the Seller. In this case, it is recommended to include in the irrevocable commercial commission agreement a "cascade" in which, as long as there has not been a breach under the RPA, the revenue of the collection will be settled periodically between the Seller and the Purchaser, and eventually the financial institution will periodically transfer to the Purchaser its share to the Seller the difference. In case of a default under the RPA, only the Purchaser will be entitled to give instructions to the corresponding financial institution. This type of commission agreements with financial institutions are usually managed by the trust departments of the corresponding bank and their costs are usually similar, but lesser than the constitution and management of a trust.

Should the Seller's account be in the US, then US law devices would need to be put in place to control the account and create a security interest over such account.

(i) What Happens if the Seller Becomes Insolvent?

I the Seller becomes bankrupt and the payments received in the Collection Account are confused with other resources, the Purchaser (even if he is the legitimate owner of the Receivables that he acquired) cannot separate the payments he receives from the bankruptcy estate of the Seller. The reason is that, according to the Bankruptcy Law, the identification of the good is an essential requirement to exercise the separating action. Therefore, a fungible good (such as money) cannot be separated unless it can be individually identified, which is a challenge most of the time.

One measure to protect the Purchaser in this case is to request the Seller to execute a non-possessory pledge on all its rights derived from or related to or associated with the Collection Account. After such pledge is duly formalized before a notary public or public broker and registered in the RUG, the

Purchaser will have at least a preferential lien on the aforementioned rights that he will try to oppose to the other creditors of the Seller, seeking a better rank in the corresponding bankruptcy proceeding.

(ii) In the Context of Securitizations

More often in the context of securitizations, it is common to executed a Trust in which the trust institution, as the holder of the Receivables, is the one which opens the Collection Account in its own name. This structure, although it tends to increase costs, allows the Collection Account and the income thereof to be -to a certain extent- remote to the bankruptcy or insolvency of the Seller.

3. EFFECTS BETWEEN THE PURCHASER AND THIRD PARTIES (E.G., OTHER CREDITORS, TAX AUTHORITIES, ETC.)

(a) UCC and the RUG

In the United States, the acquisition of Receivables requires the registration of a financial statement pursuant to the Uniform Commercial Code (UCC) by the Purchaser. In Mexico, the assignment of the Receivables, even if the RPA is subject to U.S. law, must be registered in the RUG by the Purchaser, because the Purchaser expects the assignment of the Receivables to be effective in Mexico, that is, to be enforceable against third parties in Mexico under Mexican law.[10]

Based on the aforementioned argument that the form of legal acts shall be governed by the law of the place where they are held and the parties (including foreign parties) may be governed by the forms established in Mexican law when the act is to have effects in Mexico in federal matters, it is expected that a Mexican court would not give priority to a third party creditor or secured creditor (or to the tax authority) that has registered its right or lien in the RUG after the Purchaser has done so with respect to the Receivables involved.

This is particularly important when: **(i)** the Seller is in bankruptcy proceedings where there will be other creditors opposing the Purchaser; **(ii)** the Seller has previously created a security interest (e.g., a non-possessory pledge) on the same Receivables in favor of another creditor, and the other creditor has registered the security interest before the RUG (prior to the Purchaser's registration); **(iii)** the Seller has disposed of the same Receivables to a third party that the Purchaser has acquired, and such third party has registered its acquisition in the RUG (prior to the Purchaser's registration); or **(iv)** a third party creditor obtains a lien in its favor on the Seller's Receivables and such third party is registered in the RUG (prior to the Purchaser's registration).

As we wonder how often notifications of assignment to the Debtor should be made, the same considerations apply to the convenience of the frequency of registrations of assignments in the RUG. The more timely and closer to the actual date of the assignment of the Receivables, the greater the protection for the Purchaser against creditors of the Seller who might oppose a specific unregistered assignment of Receivables.

(b) Due Diligence and Registration in the RUG

It is worth mentioning that prior to carrying out the acquisition of certain Receivables, a search must be made in the RUG of the Receivables to be acquired to confirm that they are free of any property lien and that they have not been transferred to a third party.

Also, when applying for registration in the RUG, the notary public or public broker must be asked to describe, in as much detail as possible, the Receivables to be acquired, including, for example, the

relevant invoice numbers, due date, amount, etc. It is common to "copy and paste" the information of the Receivables to be acquired in the "description of goods" field provided in the RUG.

F. SOME TAX ISSUES IN MEXICO

1. VALUE ADDED TAX

Article 9, section VII of the Value Added Tax Law (*Ley del Impuesto al Valor Agregado*) ("**LIVA**") exempts from Value Added Tax ("**VAT**") the transfer of Receivables. However, this does not mean that VAT issues do not arise in financial factoring. This is because Receivables themselves include VAT, especially at the time of collection. As a general rule, according to the first paragraph of article 1-C of the LIVA, the Seller that transmits the Receivables through a financial factoring operation has to consider that the price or the consideration, as well as the corresponding VAT, are received at the moment the transfer of the Receivables to the Purchaser takes place.

Alternatively, if several tax requirements included in the LIVA are fulfilled, the Seller can defer the moment in which the price or the consideration is considered to have been received and the VAT to be paid *until the time when the Debtor actually pays*. Such requirements include, among others, the exercise of the second alternative expressly foreseen in the RPA, the mention of the party that will receive the amounts of the Receivables, the emission of monthly statements of account (in case the Purchaser is in charge of the collection of the credits).

2. WITHHOLDING TAX

Pursuant to the Income Tax Law (*Ley del Impuesto sobre la Renta*) ("**LISR**"), the applicable income tax regime depends on the residence for tax purposes of the taxpayer in question. Non-residents are subject to income tax in Mexico depending on the origin of the income. Under international practice, Mexico's tax jurisdiction is based on a link to the activities that generated the relevant income. For purposes of this article, it has been assumed that the Purchaser **(a)** is not considered a resident of Mexico for tax purposes, and **(b)** does not have a permanent establishment in Mexico.

However, due to the fact that its income is considered to be of Mexican origin, the Purchaser will be subject to Mexican income tax. The tax regulations establish that the earnings obtained by such Purchaser, derived from the acquisition at a discount of accounts receivable from a Mexican resident or from a permanent establishment in Mexico, will be subject to Mexican income tax. The income will be considered as "interest" income for purposes of the Income Tax Law.

Such income ("interest") shall be determined by subtracting the face value of the Receivables (including any interest or yield of any kind) from the price paid by the Purchaser. In general terms, a 10-percent tax rate will be applied to such interest, and sometimes, depending on the nature of the parties to the transaction, a rate of 4.9 percent may be applied.

The person obliged to pay the tax is the Purchaser, however, since in the example we are dealing with, the Purchaser is not a resident in Mexico for tax purposes, the Seller will be responsible for collecting the tax and its payment to the tax authorities on behalf of the Purchaser, within 15 days after the assignment of the credit. This is the reason why the RPA must contain specific clauses regarding the payment of taxes (e.g., the "gross-up" clause) and the express obligation of the Seller to make the tax payments under the LISR.

G. NEW DEVELOPMENTS

Recognizing the advantages of financial factoring, there is a growing number of electronic platforms for electronic invoice discounting. One popular platform is the one of Nacional Financiera, S.N.C., known as "cadenas productivas," but there are other private platforms in several places in Mexico. Most of them are characterized by the fact that they seek to enable small producers to monetize their loans against large companies in order to obtain better financing for working capital, effectively transferring their credit risk to their high-quality clients. The technique used in this type of platform includes the "reverse factoring" scheme.

Another trend is to participate or securitize abroad the future flows derived from Factoring Agreements with Mexican or multi-jurisdictional Debtors. Under these schemes, the Purchaser, in turn, participates with other investors or assigns its rights to them or to a special purpose vehicle abroad which carries out the issuance of bonds at a certain term backed by the collection of present and future Receivables. This is a technique that allows the Purchaser, in turn, to monetize in the present the future flows of the factoring scheme implemented in Mexico.

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Endnotes

[1] Factoring is usually calculated using a formula to determine the value of the underlying assets, allowing for fast credit approval and disbursement. Depending on a well-developed technological infrastructure and on the laws of guarantees and regulation of electronic commerce that allow the agile electronic sale and transfer of Receivables, the credit provided by a creditor is not essentially linked to the general creditworthiness of the Seller who originated the Receivables.

[2] See section B.3.

[3] Articles 419 to 431 of the General Law of Securities and Credit Operations ("LGTOC"), Articles 389 to 391 of the Commercial Code, and Articles 2029 to 2050 of the Federal Civil Code ("FCC").

[4] Commercial Code. Article 78.- In commercial conventions, each one is bound in the manner and terms that appear to be bound, without the effectiveness of the commercial act depending on the observance of specific formalities or requirements.

[5] Article 13 of the FCC, section I, states that the legal situations properly created in the entities of the Republic or in a foreign State according to its law, must be recognized. Likewise, section V. provides that, except as provided in the preceding sections, the legal effects of acts and agreements shall be governed by the law of the place where they are to be executed, unless the parties have duly designated the enforceability of another law. Another article will deal with section III of Article 13 of the FCC, which provides that movable goods are governed by the law of the place where they are located.

[6] Article 571 of the Federal Code of Civil Procedures and Article 1347-A of the Commercial Code. It is worth mentioning specifically that the judicial notification in proceedings carried out abroad to a Mexican entity can be made to a prosecutor in the United States, for example if the Seller appoints and grants a power of attorney to a U.S. agent (judicial notification in Mexico is required to be personal). It is common for the Seller to appoint a process agent to avoid any challenge to the enforcement of the foreign judgment in Mexico.

[7] It is important to highlight that the creation of security interests as pledges on goods located in Mexican territory requires, for their proper perfection and execution, a pledge formalized under the laws of Mexico, an issue that would not be achieved with the mere provision of the pledge in the RPA.

[8] Article 13, Section IV of the FCC.

[9] In Mexico, a public broker is a lawyer that has been authorized by Ministry of Economy to support commerce in certain instances including acting as a mediator and to authenticate documents.

[10] Article 426 of the LGTOC. The RUG, established in 2010, is a department of the Public Registry of Commerce with a single nationwide database that serves to simplify the registration of security rights on movable property, as well as the assignment of certain rights (e.g., Receivables). Foreign entities are not entitled to make registrations directly in the RUG unless they first register with the Ministry of Economy. Consequently, in cross-border transactions it is common for a notary public or public broker to make the registration using his or her electronic signature provided by the Ministry of Economy. The registration in the RUG consists of an online form that includes the necessary information of the guarantee or assignment to be registered, the data of the Seller and the Purchaser, and a description of the RPA that identifies the Receivables subject to it.