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Acquisition Finance

Mexico
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Law and Practice

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1. MARKET

1.1 Major Lender-Side Players

Mexican law generally allows a Mexican target or purchaser to obtain acquisition financing from diverse local and international sources, including local and international banks and direct lenders, resulting in acquisition financing being available in the market. Acquisition finance lenders play a pivotal role in the Mexican M&A market, where a majority of transactions are financed.

Local Financing

Local banks continue to play a leading role in structuring and financing M&A transactions, and in many instances may be regarded as the go-to structuring agents of banking acquisition finance as they usually have well-established business relationships and a deep knowledge of the sectors of either the target or the local purchasers. Local banks that have taken advantage of the restructuring facilities provided by the National Banking and Securities Commission with respect to their corporate portfolio will be the natural source of funding for upcoming acquisitions of restructured targets.

A number of Mexican banks have a well-established reputation with respect to acquisition finance facilities and are known to actively participate in the market. Mexican state-owned development banks continue to assume a very discrete role with respect to acquisition financing (usually participating in working capital tranches or in refinancing), given their mandates and per the policy of the federal government, and it is unlikely that they will increase their involvement in this kind of financing. Therefore, longer term and higher volume commitments are often assumed by international banks that take advantage of their comparatively larger capitalisations and, as the case may be, less stringent reserve requirements for transactions of this type.

Local banks usually act as structuring and administrative agents with respect to banking acquisition finance facilities, joined by other local and international banks. International banks also assume the role as agents and lead arrangers, usually in cross-border acquisitions. International banks often participate in acquisition financings that are structured and managed by their Mexican affiliates; however, in many instances, they also participate in club deals that are arranged by unrelated institutions. International institutions play an active role in the structuring of acquisition facilities, and international banks actively contribute key legal items in the relevant facility documents, especially when they assume larger commitments than local banks.

International Debt Funds

International debt funds also continue to play an important role in acquisition financings in Mexico. Although local and international funds have funded acquisition financings alongside Mexican and foreign banks, they are of particular interest for purchasers and targets that may not be financed by banks. In a few transactions, funds have participated as subordinated or mezzanine lenders.

Despite the slowdown of acquisition transactions during the last part of 2020, a number of international debt and private funds continue to explore business opportunities in Mexico with respect to rehabilitated or struggling Mexican targets, with the purpose of purchasing an interest in them and refinancing their debt. Funds will also have acquisition financing opportunities with respect to SMEs and certain mid-market companies in the form of mezzanine financing, as many local and international banks traditionally do not grant these kinds of financings.

State-owned Mexican development banks will have the opportunity to play a key role in restructuring the debt of a target and providing work-

ing capital in the context of an M&A transaction, especially with SMEs and mid-market companies. While the COVID-19 pandemic has opened opportunities to acquire troubled Mexican companies and assets, it may also affect the availability of acquisition finance for such transactions that may be affected by the uncertainty of the pace of recovery in several industries.

As in many other jurisdictions, acquisition finance faces the challenge of creating comprehensive and reliable financial models for targets. In many sectors, it is expected that such uncertainty will begin to dissipate by the second semester of 2021, as vaccines become available to the population at large and companies can access more elements to adjust their business plans accordingly.

Special Purpose Acquisition Companies

Mexican listed special purpose acquisition companies (SPACs) make it possible to carry out an IPO in order to carry out an acquisition, although only a couple of these vehicles have been listed since 2017. Such listed vehicles (which may not have any operations or assets) are allowed to receive capital investments to finance the acquisition of a certain company or project within a limited timeframe. A SPAC should have a renowned and solid group of managers, as investors would rely on them rather than the balance and operation of the SPAC. There have been no new IPOs or M&A acquisitions carried out by SPACs.

Although SPACs debuted in Mexico relatively recently, acquisition financing is not usually directly or fully sourced by the capital markets. Instead, publicly listed investment vehicles that are managed by a general partner – such as capital development certificates (CKDs) and investment project fiduciary securitisation certificates/*certificados bursátiles fiduciarios de proyectos de inversión* (CERPIs) – raise capital through the placement of certificates in the capital markets, and then create subsidiary vehicles to carry out private equity and M&A transactions in addition to their usual investment activities. Several CKDs, CERPIs and/or their vehicles have obtained financing facilities from local or international banks in order to carry out M&A transactions in Mexico through a two-layered structure, whereby lenders have a senior position with respect to any other financing, and the interests of the CKD, its vehicles and certificate holders are structurally subordinated.

AFORES

Although Mexican Pension Funds (AFORES) do not participate in acquisition financing directly, they indirectly participate in the market through capitalising the CKD and CERPI vehicles. AFORES were first allowed to invest in CKDs in 2008, and have consistently done so ever since. The CKD market has grown substantially, and about 17% of that market has been invested as mezzanine debt. In addition, companies may issue high-yield bonds in order to finance M&A transactions, although this sort of financing is rather rare in Mexico, and such instruments are usually issued in the context of a Rule 144A/Reg S offering or quasi-public offering in other jurisdictions.

Whenever possible or convenient, larger public companies tend to avoid the higher rate and covenant-heavy bank loans, and turn to stock offerings or private or quasi-public debt offerings in order to fund their M&A transactions. Depending on the size and complexity of the M&A transaction and the time constraints associated with each particular transaction, larger companies may take out bridge financings to fund the transaction, and seek to refinance such bridge loans through a syndicated facility or with the proceeds of a securities offering.

1.2 Corporates and LBOs

Reduction in M&A Activity

M&A activity in Mexico had reduced substantially by 2019 due to the change of the federal administration, and such deceleration deepened through 2020 as a consequence of the COVID-19 pandemic. In turn, the Mexican Federal Government's economic agenda driven by social expense provided little tax or credit support to Mexican companies during the pandemic. The downturn of the market is bound to be reversed following the expected recovery of the Mexican economy throughout 2021, except in certain sectors where the deterioration of the market may spur financed acquisition activity (such as the hospitality sector).

Currently, M&A activity continues to decrease steadily in volume and number of transactions, according to Transactional Track Record. Notwithstanding the foregoing, even when the still second largest economy of Latin America maintained most of its fundamental features, 2020 was slower than expected. 2021 presents several challenges for the Mexican market. Midterm elections will take place at the beginning of the second semester and will decide whether the President's political party maintains the majority in the House of Representatives. Despite this and the impact of the COVID-19 pandemic, the first quarter of 2021 saw increased activity levels, revealing an active market looking for acquisition opportunities. The commencement of the Biden administration in the United States of America and the measures to implement the USMCA are variables that will affect the market throughout 2021.

As in the previous year, M&A activity during 2021 is expected to be fuelled by the need of many Mexican companies to obtain refinancing. Over the past few years, Mexican companies have incurred a large amount of low-cost indebtedness, and 2020 presented a very adverse environment for most industries in Mexico, due to the COVID-19 pandemic, among other factors. A fair portion of the outstanding Mexican corporate debt is set to mature in the following couple of years, and this debt will need to be refinanced under more complex international and domestic economic conditions.

A considerable number of borrowers took advantage of the emergency administrative facilities provided by the Mexican banking regulator to restructure their loans in 2020, and in many instances have kicked the can for a year or two, where they will compete for financing sources and may become eligible as an acquisition target. As was expected during 2020 (although such expectation was proven wrong, largely due to the COVID-19 pandemic), many companies will compete for financing, and some may not get it on time or under the expected conditions. The increasing number of troubled or insolvent companies will likely result in a somewhat proportional increase of financed acquisitions of companies as well as asset transactions. This may represent an opportunity for international and local funds to engage in M&A activities, and their ability to secure financing or refinancing for their targets will be of paramount importance to closing M&A transactions in Mexico. In the following couple of years, M&A activity with respect to distressed companies is expected to rise substantially, and acquisition finance will gravitate towards workouts and restructurings of the targets.

LBO Facilities

As has been the case in recent years, LBO facilities and corporate loans with a rather substantial component of refinancing are likely to be seen more often, and players are likely to seek new structures to obtain LBO financings that partially refinance the target in order to maximise the tax attributes of targets. Consequently, asset deals (except for asset purchases from distressed

companies, which may actually increase) and mergers may decline in the following year, and loan documentation of acquisition financings may be increasingly covenant-heavy.

FIBRAs

M&A activity continues to be customary in the real estate and hospitality sectors, and is dominated by listed real estate investment trusts (FIBRAs), where managers are able to leverage their real estate assets under management to acquire or build new assets. FIBRA-sourced financing is also set to continue to play a very important role in the hospitality sector, where it has had increasing penetration with respect to stabilised properties. Hospitality properties may become the targets of acquisition transactions funded with asset-based facilities, as the owners may face liquidity constraints due to the productivity drop of hospitality properties due to the pandemic, and an expected recovery of the productivity of such properties in the short to medium term.

Foreign Players

Although international acquisition financing in Mexico has been traditionally led by US, Canadian and European banks and funds, there is an expectation that Chinese and other Asian players will begin to penetrate the market, as they have done elsewhere in Latin America. Bolstered by soft acquisition financings granted by Chinese financial institutions and incentivised by trade conflicts with other countries and opportunity costs in Mexico, Chinese companies may engage in M&A activity more broadly in the near future.

1.3 COVID-19 Considerations

COVID-19 has affected the timing of financed acquisition transactions for several reasons, ranging from difficulties in carrying out on-site due diligence and appraisals to closing mechanics.

The response times of diverse municipal, state and federal authorities for secured financings have impacted the execution timelines of acquisition financings, as obtaining certificates, permits and assignment clearances depends on authorities that in many instances have struggled to function with limited mobility and have accumulated substantial workloads. Even response times in other jurisdictions protract otherwise shorter timeframes. For instance, many transactions have been delayed because apostille offices in certain states of the US and other countries take weeks to issue an apostille that would have been issued in a matter of days in pre-pandemic times.

Certain authorities (mostly federal agencies, and notably the National Banking and Securities Commission) quickly adapted to the lockdown and went to extraordinary lengths to continue to provide their services in the face of several restrictions.

Any remediation or normalisation activities for due diligence findings also took much longer than in normal circumstances. Negotiations of covenants to remediate or normalise administrative aspects of Mexican collateral are difficult because in many instances the discussions may lack an objective basis, such as a certain normalisation date.

Mexican banks (including credit and risk committees) adapted very fast to the lockdown, and performed very well despite the pandemic restraints and the increased workload derived from numerous “COVID-19 restructurings”.

Remote working is expected to be slowly but steadily implemented within the federal, state and local administrations, and the more tech-savvy post-pandemic borrowers will increasingly demand financings to be negotiated, underwrit-

ten, documented and closed through digital means.

Due to this, transaction timelines for acquisition loans that did not involve major governmental participation (ie, authorisations of security interests on concessions or the security assignment of permits), or that were not secured with real properties, were not particularly affected by the pandemic (other than a common pencils-down decision at the beginning of the pandemic due to the uncertainty prevailing in the markets).

2. DOCUMENTATION

2.1 Governing Law

Acquisition finance is a broad term that refers to the use of capital (obtained through either equity, mezzanine, hybrid or debt instruments) to purchase a company or business, and encompasses corporate loans, LBOs and other sorts of financing structures to that end.

A corporate loan is, in a broad sense, a loan made to a company for a specific business purpose. In the context of acquisition finance, a corporate loan is usually made to the purchaser with the purpose of acquiring the target, refinancing its debt and/or providing working capital to the target.

In LBO transactions, the assets of the purchaser and the target collateralise and are an important source of repayment of an acquisition financing facility. LBO transactions generally require a well-capitalised and creditworthy target, and are based on the idea that the cash flow produced by the target is sufficient to cover the financing taken by the purchaser in the M&A transaction.

An acquisition financing may be granted in the form of a loan that is directly granted to the target simultaneously with the closing of an M&A transaction, or that is granted to the vendor and subsequently pushed down to – or assumed or collateralised by – the target at the closing or shortly thereafter. Vendors may be required to co-operate to implement acquisition financings where the funds are disbursed directly to the target and thereafter distributed to the vendors, or where the target should assume obligations under the acquisition financing or perfect security interests to secure such financing upon the closing of the M&A transaction and the disbursement of the loan proceeds.

Where international banks and funds are involved, acquisition financing documents are likely to be governed by New York or English law (or the laws of such other jurisdiction elected by the lenders). In transactions led and funded by local banks and funds, the loan documents are typically governed by Mexican law. In some instances, loan documents of club deals that are funded by international institutions together with Mexican lenders are governed by Mexican law.

M&A financing transactions governed by Mexican law are generally regulated by federal commercial statutes and the relevant case law of Federal Collegiate Courts and the Supreme Court. The Mexican Securities Law and regulations usually govern securities issued and distributed in the Mexican market, and foreign securities laws apply to those securities issued and distributed abroad.

The security documents would generally be governed by Mexican federal and/or state law, as applicable, depending on the nature and location of the collateral. A number of international institutions prefer a local bank to act as security agent of the bank syndicate, given the expertise of a local bank with respect to the monitoring and foreclosure on collateral located in Mexico.

M&A transactions of distressed companies also raise considerations under the Concurso Mercantil Law, especially with respect to preferential payments to any refinanced creditors and other types of creditor fraud. With respect to debtor-in-possession financings and M&A transactions relating to an insolvent target placed under *concurso mercantil*, the relevant transaction requires special approvals from the governing bodies for the relevant *concurso mecantil* procedure.

Other federal and state statutes may indirectly affect the acquisition financing in as much as they are applicable to the M&A transaction, depending on the nature of the transaction and the target, such as Antitrust Laws, the Securities Market Law (with respect to acquisitions of publicly traded companies) and other special laws applicable to financial institutions and other regulated companies.

2.2 Use of LMAs or Other Standard Loans

The loan documents of an acquisition finance loan may be based on the LMA form of agreement, particularly if the loan is governed by English law and granted by international institutions. Loan documents of acquisition financings granted by US banks and funds are usually based on LSTA forms and governed by New York law. When applied to Mexican acquisition financings, such forms of agreement should be adjusted so as to conform to certain aspects of applicable Mexican law.

Special lenders' counsel usually drafts and controls the loan documents governed by non-Mexican law for a particular transaction. More often than not, such loan documents are based on the LSTA or LMA forms. In many cases, however, such forms are practically redrafted by lenders' counsel for the relevant transaction. Depending on the complexity of the transaction, lenders' counsel may decide to use their own form of loan documentation, or to tailor the loan documents from scratch.

In Mexico there are no widely accepted standard forms for loan documentation similar to LMA or LSTA. Similar to international facilities, lenders' counsel is usually in charge of the loan documents. Mexican banks and funds may sometimes have preferred or internally approved forms of loan documentation, which are adapted for each particular transaction. In most cases, however, Mexican lenders' counsel has a lot of leeway with respect to the preparation of the loan documents, and many firms opt to customise their forms of loan documents to the relevant transaction.

Mexican law-governed loan documents for an acquisition finance normally include a loan agreement and a wide array of security documents, depending on the nature of the collateral. The most common collateral documents include mortgages for real estate assets, non-possessory pledges for movable property and certain intangible assets, stock pledge agreements and management and security trusts, which concentrate the revenue stream of the target and/or the purchaser (together with other assets) in a bankruptcy-remote vehicle to use for the repayment of the relevant facility.

2.3 Language

Loan documents may be signed in a language other than Spanish and still be effective in Mexico (except for documents that require a specific formality, such as mortgage deeds, which must be granted in Spanish before a Mexican notary public). Loan documents signed in a foreign language may be introduced as evidence of such agreement in a procedure before a court sitting in Mexico, but such documents shall be translated into Spanish in order to be considered in such procedure. If a mutually agreed Spanish translation of a document does not exist, then

the party introducing the document should also present a translation certified by an expert witness translator. However, the other party has the right to controvert such translation and provide another translation prepared by another expert witness translator, and such controversy would be solved by the translation of an expert witness translator appointed by the court.

In order to avoid procedural delays derived from the translation of loan documents (which are usually voluminous), lenders' counsel usually recommends either signing bilingual versions of certain documents, or producing Spanish translations of the loan documents and having them acknowledged by the parties in writing as being true and correct.

Most collateral documents are either granted in public deeds or ratified before Mexican public attestors. Such public deeds must be signed in Spanish. Mortgages and industrial mortgages (like any other document in connection with a real estate asset) must be signed in Spanish, as must collateral documents that are to be recorded in a public registry. Generally, public instruments can only be signed in Spanish, as can other documents subject to registration in public registries and certain private registries.

In international facilities, most of the financing documents are executed in English, and the collateral documents are either signed in Spanish or are bilingual documents.

2.4 Opinions

Lenders will usually require a legal opinion from both parties' external legal counsel in each relevant jurisdiction as a condition precedent for closing. Such legal opinions would cover the usual aspects addressed in an opinion issued for any other financing, including the capacity of the borrower and guarantors, the validity and enforceability of the loan documents, the creation and perfection of security interests, tax matters, applicable qualifications, etc. The legal opinion of lenders' counsel would be more focused on aspects related to the loan documents, including security documents and intercreditor agreements.

In the context of an LBO, many of the matters encompassed by the legal opinion of the borrowers' counsel shall also be referred to in relation to the target and other guarantors and security providers; if additional collateral or guaranties will be granted upon closing, the borrower's external counsel is likely to be required to issue a legal opinion with respect to such guaranties and security interests. Opinions are addressed to the parties of the lenders' side (including agents and hedge providers), and may be relied upon by any assignee or successor. Legal opinions will include qualifications with respect to claw-back risk if collateral is granted by a company under financial distress, among others.

3. STRUCTURES

3.1 Senior Loans

Senior secured loans are the most frequent structure for an acquisition finance transaction in Mexico, as lenders commonly expect to obtain security interests and guaranties from both the borrower and the target and its subsidiaries. In larger transactions, banks and funds may participate in other types of loans where there would be an agreed ranking of debt in the event of the insolvency of the borrower, with the corresponding differences in rates and fees. There may be different kinds of commitments among senior lenders, including revolving facilities, term loans and line of credit facilities. Senior lenders will usually obtain first priority security interests. In certain M&A transactions, lenders may provide asset-based financing as a tranche of the senior loans or as an additional facility, in which case

certain eligible assets are carefully defined and carved out from the security package of other lenders.

3.2 Mezzanine/PIK Loans

Mezzanine lenders assume higher risks in view of their payment priority, and obtain higher margins than senior lenders. As banking regulations usually require reserves for the loans made by banks based on the quality and priority of the collateral, mezzanine financings are usually provided by other sources. Debt service of mezzanine loans is usually subordinated to senior loans.

Mezzanine financing usually adopts the form of a term loan, which mimics many aspects of the senior loans and includes subordination features that are consistent with the relevant intercreditor agreement, and may be secured by a security interest that ranks below the senior lenders' security interests. A mezzanine loan may also be documented as convertible and/or subordinated debentures, which may be statutorily subordinated to all the debt of the issuer, and the interest thereunder is exempt from VAT. PIK loans are rarely seen in Mexico (in and outside the context of acquisition finance) due to their higher risk, and for tax and legal considerations.

3.3 Bridge Loans

Bridge loans are usually granted by banks; they adopt the form of senior secured term loans and are used in acquisition finance to deal with time constraints in connection with smaller acquisitions, or if the purchaser is not able to secure longer term loans for any other reason. Bridge loans may also be taken by an affiliate of the purchaser to cover a portion of the purchase price that exceeds the leverage level up to which other lenders and creditors are willing to grant or maintain other financings. Such loans are taken by a borrower with the intention of refinancing them in a rather short term with proceeds from other sources of financing. Therefore, borrowers normally negotiate for voluntary prepayment rights without prepayment fees. Bridge loans normally include mandatory prepayment clauses that are triggered upon the occurrence of certain events that increase the liquidity of the borrower.

3.4 Bonds/High-Yield Bonds

Loans are usually the go-to source of financing at the inception of an M&A transaction. Larger purchasers may issue bonds in order to partially finance the transaction, or to refinance senior loans. Bonds are more commonly used after the transaction has taken place, to refinance the acquisition financing, and are sometimes issued until the target has been stabilised and the synergies and benefits derived from the transaction are more tangible and ripe for disclosure to the market.

High-yield notes offer several advantages to purchasers, as they usually have longer maturities than loans, may include bullet repayments and can be comparatively cheaper and covenant-lighter than senior loans. The high-yield bonds market in Mexico does not have the depth that other markets abroad have, so a Mexican purchaser that opts to issue high-yield bonds will usually seek a Rule 144A/Reg S placement, and to list such bonds in overseas markets.

3.5 Private Placements/Loan Notes

Private placements have standard statutory requirements to circumvent the authorisation requirements of the National Banking and Securities Commission, including that the offering is made exclusively to institutional or qualified investors, or to fewer than 100 persons.

Private placements may be done with the purpose of obtaining mezzanine financing, as mentioned in **3.2 Mezzanine/PIK Loans**. Debentures, notes and other credit instruments may be secured and unsecured, and may be subject

to different priority rankings as described with respect to senior loans.

3.6 Asset-Based Financing

Most acquisition financings in Mexico are collateralised with the assets of the target. Mexican banks in particular usually require the real property of the target as collateral for an acquisition financing.

More often than not, purchasers try to preserve any existing equipment, inventory and accounts receivable financings that the target has in place, and lenders are usually amenable to such alternatives, depending on the final capital structure of the target. Factoring and reverse factoring facilities are also preserved to the extent possible as purchasers strive to preserve the liquidity sources of the target and the continuity of its supply chain.

Given that an acquisition financing usually replaces most of the financing of the target and entails the collateralisation of virtually all its assets, a purchaser will seek to either maintain or enhance the position of existing lenders (including through entering intercreditor agreements or collateral sharing arrangements or a parent guaranty of the purchaser), or to obtain a commitment for a revolver working capital facility together with the term loan acquisition financing.

Assets are collateralised through diverse security documents, depending on the industry and the structure of the borrowers. Such security documents usually include security trusts, non-possessory pledges, pledges on equity and mortgages. Depending on the nature of the lender, special privileges may apply to these security instruments, such as the "industrial mortgage", which encumbers all the assets associated with a certain facility (including real estate). Security instruments may also vary depending on the nature of the borrower. Borrowers engaged in regulated industries such as telecommunications usually require special administrative permits to create security interests on concessions and their covered assets.

Security structures will also depend on the nature of the collateral. For instance, oil rigs and other vessels may be subject to maritime mortgages or security trusts that may be primed by certain maritime privileges.

Non-possessory pledges and *fideicomisos de garantía* (security trusts) may have the effect of a floating lien, allowing the debtor and its corporate group to continue to operate their assets, and providing security interests to the lenders on assets at any stage of the business cycle, from raw materials to final manufactured products, and from accounts receivable to cash.

4. INTERCREDITOR AGREEMENTS

4.1 Typical Elements

Acquisition transactions are often funded by several sources, in the form of equity, debt, asset-based debt, mezzanine debt, bonds, convertible debt and hedge agreements, among others. Purchasers take the highest risk in acquisition financing. Investors and shareholders may also be lenders of some sort, and there may be a variety of lenders and administrative and security agents with respect to the acquisition financing.

Intercreditor Agreements

Intercreditor agreements are usually negotiated at length, particularly if they include all the stakeholders in an acquisition finance. Intercreditor agreements will include diverse layers of lenders, rules with respect to common security (or the collateral if this is exclusive to one layer of creditors), rules with respect to foreclosure, pay-

ment priority, acceleration, differences between the basic terms of the facilities, the sharing of recovery proceeds, the sharing of payments, subordination, voting rights to adopt certain actions, etc. Control of enforcement and collateral normally rests with senior lenders (who may share their collateral and priority with their relevant hedge providers). When international banks participate in the financing, they usually propose that the intercreditor agreements are prepared based on the LMA or LSAT forms. More often than not, the cash flow of the target and/or the purchaser is concentrated in a security trust, which serves as both a security instrument and a payment vehicle where the relevant trustee makes payments (including recovery proceeds) in accordance with the priority set forth by the parties. Such trust agreements double as a self-executing intercreditor agreement in many instances.

4.2 Bank/Bond Deals

Transactions with dual bank and bond financings may not include an intercreditor agreement, as the bondholders may be structurally subordinated or otherwise separated from the bank lenders' sources of payment and their collateral; otherwise, the parties will seek an intercreditor agreement, which must be approved by the banks (pursuant to their own intercreditor agreement or agency provisions) and by the bondholders, through a bondholders' meeting.

4.3 Role of Hedge Counterparties

Hedging plays an important role in any major financing, as financial models usually include caps to variable interest rates and/or exchange rate variations. Hedging transactions cover the borrower (and, ultimately, the lender parties to the financing) from external variations that may affect the payment of the facilities, and such risks are assumed by the relevant hedge providers at a premium. The common financial derivative transactions used to hedge the interest rate and exchange rate risk associated with a financing are swaps, puts, forwards and options referred to the relevant interest rate and/or the loan currency. Hedge providers usually share the security package and the priority of senior lenders to whom they provide coverage and rank pari passu with respect to the relevant senior lenders. Hedge providers in turn make their payments either directly to the senior lender or to the security trust concentrating all the funds to repay the acquisition financing.

5. SECURITY

5.1 Types of Security Commonly Used

Security Interests

Mexican law allows for the creation of a security interest on virtually any kind of asset, with few exceptions (eg, governmental assets that are subject to a concession, copyrights, tax refund rights, etc). Secured lending matters are basically governed by the Civil Code (*Código Civil*) of the jurisdiction where a real property is located, and, with respect to other assets, by the Commercial Code, the General Law of Credit Instruments and Transactions, and the Credit Institutions Law, among others. Other laws provide for special security interests or special procedures to perfect a security interest, depending on the nature of the assets (including pledges on trade marks and intellectual property, mortgages on vessels and aircrafts, and pledges on securities) and the nature of the secured party (Mexican banks may create a floating lien on an industrial unit pursuant to the banking law, known as an "industrial mortgage").

Common Security Arrangements

The most common security arrangements on Mexican assets are mortgages, pledges and guaranty trust arrangements. The type of security to be used in each case will depend on a variety of factors, including the type of assets that are

available as collateral (eg, tangible or intangible, real estate or personal property, present and/or future assets); the nature of the lender and the borrower (eg, if the lender is a banking institution or has an affiliate in Mexico; if the borrower is an individual or an entity; the borrower's line of business, including maquiladora); and the cost involving perfection of the security (eg, notarial fees, trustee fees and registration costs). Once these key aspects have been assessed, lenders should also consider the following elements before deciding which security instrument is to be used.

- Federal v local law – as mentioned above, each security instrument is subject to specific laws, which may vary from one state to another. For instance, mortgages are subject to local civil law, whereas guaranty trusts and pledges are subject to federal commercial law. Registration rules vary from state to state.
- Specific or floating liens – some security instruments can only be used to create liens on specific assets (eg, mortgages), while others can be used to create "blanket liens", which could include intangible assets and future assets as well as assets generally identified as a class (eg, guaranty trusts and pledgor-in-possession pledges).
- Due diligence and verification of pre-existing liens – there is no centralised system in Mexico to control debts and liens. The Sole Registry of Security Interests on Movable Assets and the Public Registry of Commerce allow the verification of the existence of liens on movable assets. Real estate property and certain security instruments are registered with Public Registries that substantially verify the title and pre-existing liens.
- Formalities and perfection – the perfection and formalities applicable to security instruments in Mexico vary depending on the type of collateral. Also, the perfection of a security interest between the parties is differentiated from its perfection vis-à-vis third parties. Matters to be considered with respect to formalities and perfection include:
  - (a) powers of attorney – parties may have to grant a power of attorney in compliance with Mexican law and international treaties so that their representatives may execute the corresponding security instrument in Mexico;
  - (b) notary public – certain security instruments must be granted or ratified before a Mexican notary public (eg, mortgages, certain guaranty trusts);
  - (c) registration at public registries – certain security instruments must be registered in the applicable Public Registry or in the Sole Registry of Guarantees (*Registro Único de Garantías*), as the case may be, in order to be opposable vis-à-vis third parties;
  - (d) notarial and registration fees – these vary from state to state but in most cases are calculated as a percentage of the amount of the secured loan. Registration fees are capped in some states;
  - (e) delivery of assets – the possession of collateral may be required in order to perfect the security interest. Stock pledges, for instance, are perfected through the endorsement of the corresponding certificates, the delivery of said certificates to the pledgee, and the annotation of the pledge in the stock registry book; and
  - (f) third party involvement – certain security arrangements require the involvement of third parties, such as a trustee under a guaranty trust, in which case the security interest is created by transferring ownership of the collateral to a trustee, which is typically a Mexican bank.
- Amendments, increase of secured obligations and collateral – some security instruments have flexible rules regarding amendments

to secured obligations and collateral. For instance, pledgor-in-possession pledges and guaranty trusts may automatically extend to after-acquired property, including the proceeds of collateral and property resulting from the transformation of collateral. On the other hand, mortgages require formal amendments.

5.2 Form Requirements

Form requirements vary depending on the type of collateral.

Mortgages

Mortgages must be executed in a public deed before a Mexican notary public. A mortgage will be effective vis-à-vis third parties upon its registration in the relevant Public Registry of Property. Mortgages on other assets that may be mortgaged will be perfected upon registration in the relevant registry (eg, mortgages on vessels must be recorded before the National Maritime Public Registry).

Pledges on Equity Interests

Depending on the nature of the equity interest, the requirements for creating and perfecting a pledge will vary. With respect to equity quotas or partnership interests (eg, *Sociedad de Responsabilidad Limitada*), a non-possessory pledge agreement must be executed in writing between the grantor and the secured party; such pledge agreement should be ratified before a notary public, and registered in the partners' registry kept by the company. Similarly, beneficiary interests in a trust may be pledged in the same manner, and the pledge should be registered in the Sole Registry of Security Interests on Movable Assets. With respect to shares, in addition to a stock pledge agreement, the share certificates must be endorsed in security and physically delivered to the lender or its security agent, and the stock pledge should be registered in the shares registry kept by the company.

Pledges on Movable Assets

Pledges on movable assets are created through non-possessory pledge agreements, allowing the pledgee to keep possession of the assets and use them in the ordinary course of business as agreed in the agreement. Such pledges must be formalised before a Mexican public attestor and registered in the Sole Registry of Security Interests on Movable Assets. Personal property may also be pledged through a pledge agreement, whereby possession of the assets is transferred to the pledgor or a third party appointed by pledgor.

Security Trusts

A Mexican security trust or *fideicomiso de garantía* allows the security providers, as settlors, to transfer and convey title to the collateral to a financial institution (usually a bank), as trustee for the benefit of the secured parties. The trustee will hold title to the collateral and be acknowledged as the owner thereof for all Mexican legal (other than tax) and insolvency purposes, creating a preferential right to foreclose on the collateral and a right to be paid with the proceeds deriving therefrom, in favour of the secured parties.

In order for the transfer of the collateral in favour of the trustee to be effective against third parties, the Mexican Security Trust must be registered with the Sole Registry of Security Interests on Movable Property if it is created with respect to personal property, and/or with the Public Registry of Property corresponding to any real property contributed to the trust. A Mexican security trust on movable property must be executed in Spanish, and its signatures must be ratified before a Mexican notary public to be in a form for registration with the Sole Registry of Security Interests on Movable Property. If the trust is created with respect to real property, it should be granted in a notarial deed, which shall be registered in the corresponding Public Registry

of Property. The security trust is a bankruptcy-remote vehicle whereby title to the assets conveyed and transferred to it will be segregated from the settlors' assets in an insolvency proceeding, and will not be commingled with such assets.

5.3 Registration Process

As a general rule, security interests granted in the context of acquisition finance are perfected when they are recorded in the registry where the relevant collateralised assets are registered. The entries where the relevant security interest is registered must remain in place for as long as the secured obligations are outstanding.

Certain registries (notably, the Public Registries of Property) allow lenders to deliver a pre-emptive notice with respect to the creation of collateral. The pre-emptive notice is registered with respect to the relevant property and remains in force for a term that varies from jurisdiction to jurisdiction. Once the security interest is created and filed with the registry, the priority of such security interest becomes effective as of the date upon which the pre-emptive notice was filed. Certain states have electronic-based registries that allow for a streamlined filing of pre-emptive notices and definitive notices with respect to assignments and security interests. The registration processes vary in length and requisites depending on the relevant registry, with some registries requiring the prior review and clearance of a public official of the registry.

In some instances, the registration of a security interest has to be carried out in a privately managed registry, such as the registry of shares of a privately held corporation or privately issued debentures. Such registrations are usually carried out by an officer of the issuer.

There are other security interests that do not require registration as they usually require the delivery of the collateral to the secured party or a special executor, as is the case for a pledge on securities. Special counsel shall determine when and where to register the security interests of an acquisition loan on a case-by-case basis, and also anticipate any matters that may obstruct the registration during the course of due diligence.

5.4 Restrictions on Upstream Security

There are no limitations on upstream security under Mexican law. The corporate purpose or organisational documents of a security provider must expressly contemplate the possibility of creating security interests to secure a debt owed by a third party.

5.5 Financial Assistance

No prohibitions or restrictions apply to financial assistance.

5.6 Other Restrictions

Under Mexican law, there are no other restrictions on a Mexican company granting collateral for the obligations of an affiliate or even a third party, including restrictions for upstream or downstream security, financial assistance or corporate benefit tests. The securing party does not have to be an obligor with respect to the acquisition financing. Collateral may be granted subject to the generally applicable rules for fraudulent conveyance.

5.7 General Principles of Enforcement

In general terms, foreclosure on collateral requires a final judgment entered in a judicial foreclosure procedure, except for an out-of-court procedure that may be agreed upon by the parties in a collateral trust and in a non-possessory pledge. If the party in possession of the collateral refuses to surrender possession, the secured parties may initiate a judicial foreclosure procedure. Enforcement actions are initiated by the collateral agent, administrative agent, indenture trustee or each particular lender, as

applicable, and in compliance with the relevant intercreditor agreement, as applicable.

6. GUARANTEES

6.1 Types of Guarantees

The basic form of guarantee under Mexican law is known as a *fianza*, which creates an obligation for a third party to pay an obligation due by the main obligor. Mexican law provides several statutory rights to protect the guarantor, including the right to collect from the main obligor before collecting from the guarantor, the right to seek foreclosure on all the assets of the main obligor before attempting foreclosure on the assets of the guarantor, and the right to divide the debt among the guarantors (if several guarantors guarantee the same obligation) so that the creditors may only collect from each guarantor the proportion applicable to the guaranty division, among others. These rights may be waived by guarantors (and usually are).

Certain Mexican-regulated financial entities are authorised to issue surety policies with respect to certain obligations in exchange for a premium. Such surety policies are usually issued upon the granting of a counterguaranty by the obligor, usually a real estate asset.

Another form of "guaranty" for contractual purposes is the assumption of the same obligations of the principal obligor by a joint obligor, who will be jointly and severally liable with respect to such obligations.

For negotiable instruments, a guaranty is named an *aval*, and may guarantee the full amount or a portion of a negotiable instrument (as is often the case for certain sponsors in promissory notes issued under a loan agreement). An *aval* guarantor is generally obligated by the same terms as the main obligor.

Bank guarantees are also taken for acquisition financings, and are the undertaking of a bank to guarantee the payment of an obligation owed by one of its clients for the benefit of a beneficiary.

6.2 Restrictions

In general terms, there are no restrictions on granting upstream guarantees or financial assistance, although the latter may be affected by insolvency law and fraudulent conveyance, making the solvency of the guarantor relevant as well. The delivery of financial information and representations are usually included for such purposes.

6.3 Requirement for Guarantee Fees

Mexican law does not require the payment of any guarantee fees. Affiliates do not usually charge any fee, but bond institutions and other financial institutions usually do – such fee is expressed as a percentage over the guaranteed obligation, and is determined by the market without legal restrictions.

7. LENDER LIABILITY

7.1 Equitable Subordination Rules

The concept of equitable subordination has been integrated into the insolvency (*concurso mercantil*) statute, which provides the following:

- creditors that control the debtor, are controlled by the debtor, are managers or shareholders of the debtor, or directors and officers of the debtor, and their relatives, are considered or classified as subordinated creditors (which is the most subordinated kind of creditor, ranking junior to unsecured creditors);
- the look-back period with respect to transactions undertaken with subordinated creditors will be two times the period set forth for the rest of the creditors; and

- subordinated creditors have limited voting rights in certain matters.

7.2 Claw-Back Risk

Mexican insolvency law provides that the *concurso* judge must determine the claw-back date upon the judgment declaring the *concurso* of the debtor. The general rule is a 270-day period from the date of the declaration of *concurso*. The claw-back period is doubled for subordinated creditors, and may be extended at the request of the receiver or any creditor up to three years before the *concurso* declaration.

In the context of an LBO, claw-back risk should be analysed with respect to both the purchaser and the target in connection with the granting of collateral and any seemingly preferential payments, and such risk is obviously heightened if the target undergoes financial distress and restructuring.

8. TAX ISSUES

8.1 Stamp Taxes

There is no stamp tax in Mexico.

8.2 Withholding Tax/Qualifying Lender Concepts

In terms of the Mexican Income Tax Law, interest paid by Mexican tax residents to non-residents will generally be subject to withholding tax, at rates that vary depending on the nature of the beneficial owner of the interest and the characteristics of the transactions that give rise to the interest. The applicable withholding tax rates contemplated under the law range from 4.9% (applicable to certain foreign banks, as detailed below) to 40% (applicable to entities who are residents in tax haven jurisdictions).

Interest arising from loans granted by foreign banks (including investment or non-bank banks) to Mexican residents shall be subject to a 10% withholding tax. Nevertheless, such withholding tax rate is reduced to 4.9% through a transitory provision that was enacted in 2014 and is still in force today. Under the transitory provision, the reduced rate shall apply if the beneficial owner of the interest payments (ie, the foreign bank) is a resident in a country that has entered into a tax treaty with Mexico, and if any applicable requirements established in the corresponding tax treaty to apply the reduced tax rate are effectively complied with. "Qualified Lender" usually refers to a lender (or its successor or assignee) that is eligible for a withholding tax rate that is not detrimental to the borrower, considering its gross-up obligations set forth in the loan documents with respect to the relevant withholding tax. Interest paid to domestic financial institutions is not subject to withholding tax.

8.3 Thin-Capitalisation Rules

In general terms, interest payments made by a Mexican resident to its foreign related parties are non-deductible for income tax purposes if the indebtedness of the Mexican resident exceeds a 3:1 debt to equity ratio of the Mexican payer. Exceptions may apply in certain industries (such as certain strategic and infrastructure sectors).

9. TAKEOVER FINANCE

9.1 Regulated Targets

See **9.2 Listed Targets**.

9.2 Listed Targets

The bidder has no obligation to guarantee payment or to confirm that it has the funds (or loan commitments or confirmations) to carry out a takeover transaction with respect to a listed or regulated target. Settlement of the consideration of a listed target must be carried out pursuant to the regulations of the relevant exchange. A financing provider will, however, include con-

ditions and representations with respect to the compliance of the applicable regulatory requirements for the acquisitions, which will vary depending on the nature of the target.

10. JURISDICTION-SPECIFIC FEATURES

10.1 Other Acquisition Finance Issues

Acquisition finance in Mexico has several relevant particular features that are either country-specific or industry-specific.

One example is the collateralisation of assets temporarily imported into Mexico. A number of United States companies locate their manufacturing facilities in Mexico, so raw materials and other assets are introduced into Mexico under temporary import programmes to be subject to a manufacturing process in Mexico in such facilities. Pursuant to the relevant temporary import programme, such imports may be exempt from import taxes, levies and duties if the relevant legal requirements are met. Foreclosing on such temporarily imported assets may trigger the initially exempted import taxes, levies and duties, which shall be covered prior to the application of proceeds to the payment of the secured obligations. Similar effects may be observed in the temporary imports of vessels and aircrafts, and privileged claims may exist, depending on the industry in which the borrower or the target is engaged. The payment of privileged claims and potential taxes is therefore usually considered in the relevant financial model.

Nader, Hayaux & Goebel is a market leader in M&A, banking and finance, securities and capital markets, tax, insurance and reinsurance, project finance, real estate, government procurement and antitrust, among other matters. The firm is made up of 17 partners and more than 35 associates, and fields one of the largest groups of corporate finance experts in the Mexican market. NHG is the only Mexican law firm with an office in London, with a strong focus on developing and pursuing business opportunities across Mexico, the UK and other European countries. The firm also enjoys excellent working relationships with law firms in all major cities around the world.

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