Article Title: ARCHIVE | Legal Criteria: Legal Issues in Mexican Asset-Backed Securitizations Data: (EDITOR'S NOTE: — This criteria article is no longer current. It has been superseded by the article titled, "Asset Isolation And Special-Purpose Entity Criteria--Structured Finance, " published on May 7, 2013.) This article seeks to identify certain key legal issues that arise in the context of Mexican asset-backed transactions based on Standard & Poor's Ratings Services experience in the Mexican asset-backed market. It also highlights the approach that Standard & Poor's has developed as an attempt to ensure that the transactions it rates display the legal robustness appropriate to that rating. This article is primarily a practitioner's guide rather than an academic treatise. For this reason, it does not seek to analyze every legal issue that may be involved in an asset-backed transaction, nor does it purport to be a full legal analysis of the complex underlying legal principles that are discussed. Rather, it focuses on issues that, in Standard & Poor's experience, often arise in practice and in the manner in which Standard & Poor's has adapted and applied its global criteria to these issues. Finally, this article is not a complete list of all the issues that can be and are relevant to Mexican transactions. Market participants seeking a Standard & Poor's rating continue to be invited to familiarize themselves with all of the published criteria that may be relevant to their transaction. Standard & Poor's rating criteria can be found on RatingsDirect, Standard & Poor's Web-based credit analysis system, at www.ratingsdirect.com, under Criteria. The published criteria are also available on Standard & Poor's Web site at www.standardandpoors.com. Under Resource Center, select Ratings Criteria, then Structured Finance. The Legal Framework for Asset Securitizations in Mexico Mexico, like many countries in Latin America, is a civil law jurisdiction. As such, its legal framework is based on provisions set out in formal civil codes. Since Mexico has not passed a specific securitization statute to specifically govern these types of transactions, securitizations must necessarily be structured in a manner that satisfies the existing formal legal requirements of the civil codes and other bodies of law. The complexity of structuring a transaction in Mexico is heightened by the fact that Mexico, as a federal republic, grants power to the Federal District and each of the 31 states to enact private law. As a result, in addition to the civil code of the Federal District, there are 31 other separate state civil codes that could potentially apply to a securitization in Mexico (State Civil Codes). In addition to the State Civil Codes, there is a separate federal civil code that could apply to a transaction depending on the type of assets that are being securitized (the Federal Civil Code, together with the State Civil Codes, the Civil Codes). Fortunately, there is a basic uniformity among the Civil Codes with respect to issues relevant to securitizations, and for purposes of this discussion, the relevant issues will be addressed generally as if applicable to each Civil Code. Where there are significant differences between certain of the Civil Codes, such as in the treatment of transfer issues in mortgage-backed securitizations, the new legal distinctions for such states will be highlighted. The recent growth in the Mexican securitization market is due, in large part, to a series of changes to the existing legal framework in Mexico over the last few years that cumulatively have provided significantly greater robustness to the legal structure underlying the transactions. While changes to the Civil Codes have had a significant impact on mortgage-backed securitizations in particular, recent amendments to the principal federal laws such as the Ley General de Títulos y Operaciones de Crédito (the Negotiable Instruments and Credit Transactions Law), the Ley de Concursos Mercantiles (the Insolvency Law), and the Ley del Mercado de Valores (the Securities Market Law), have helped to create a legal framework that is more conducive to securitizations in general. The Civil Codes generally set forth the requirements that must be met in order to perfect the transfer of assets by an originator to a securitization vehicle. The amendments implemented on a state-by-state basis, beginning in 1996, have eliminated many burdensome requirements related to the transfer of mortgages. On the federal level, developments favorable to securitization included the amendment of the Negotiable Instruments and Credit Transactions Law in 2000 and 2003, respectively, which incorporated regulations regarding Mexican trusts known as "fideicomisos," the special purpose entity of choice in Mexico, and the enactment of a new Insolvency Law in 2001, which has generally been viewed by legal scholars as providing enhanced protections for creditors in bankruptcy proceedings. The Securities Market Law, which was also amended in 2001, introduced the Certificado Bursatil, the security that is predominantly issued by special purpose entities in Mexico today. Special Purpose Entity A fundamental principle underlying Standard & Poor's securitization analysis is the bankruptcy remote characterization of the special purpose entity (SPE) issuing the rated obligations and holding the pool of assets generating the cash flow needed to service the rated obligations. Standard & Poor's takes the view that the bankruptcy remoteness of the issuer reduces the likelihood that the transaction's cash flow will be interrupted or compromised. For this reason, Standard & Poor's bankruptcy remote criteria were developed to reduce the potential for the issuer's bankruptcy. The bankruptcy-remote criteria for Mexico differs somewhat from Standard & Poor's criteria for other jurisdictions due, in large part, to the distinctive legal characteristics of special purpose entities commonly utilized in Mexico. Mexican Bankruptcy Remote Entities The SPE most commonly found in securitization transactions in Mexico is the trust ("fideicomiso"), which is similar in certain respects to a common law trust in the U.S. The Mexican trust utilized in securitizations is an unincorporated entity created under the Negotiable Instruments and Credit Transactions Law by a grantor ("fideicomitente") contributing property to be held by a trustee ("fiduciario") and managed for the benefit of the beneficial owners ("fideicomisarios"), pursuant to a written trust agreement between the grantor and the trustee. Like a common law trust, the Mexican trust is not a distinct legal entity and the trust property is not owned directly by the trust. Under Mexican law, only Mexican banks (and other financial institutions in limited cases) are authorized to act as trustees, and they become the owners of record of the transferred assets subject to the terms of the corresponding trust agreement. Standard & Poor's has found that the Mexican legal environment, as evidenced by recent reforms to legislation, court rulings, and advice from legal practitioners, to be particularly hospitable to the concept of bankruptcy-remoteness, particularly with regard to Mexican trusts that are created specifically as securitization vehicles. A key consideration in the analysis of the legal environment for SPEs in Mexico is the eligibility of an SPE to be filed either voluntarily or involuntarily into bankruptcy under the local bankruptcy regime. The extent to which an SPE could be subject to formal insolvency proceedings depends on whether such entity is subject to the Insolvency Law. In Mexico, the Insolvency Law applies only to the insolvency of "commercial persons" ("comerciantes") and defines "commercial persons" as "individuals or corporations that are deemed as such under the Código de Comercio (the Commerce Code). While it is somewhat unclear whether this definition is broad enough to include trusts, there is a risk that certain trusts may be subject to the Insolvency Law based on specific language in the Commerce Code that would appear to include trusts if the assets that are assigned to the trust are done so with "the purpose of conducting entrepreneurial activities ("actividades empresariales")." Ordinarily, without any clear evidence to the contrary, Standard & Poor's would assume that an SPE would be subject to the Insolvency Law. However, in the case of trusts that are utilized specifically as SPEs for securitizations, there appears to be a solid legal basis for interpreting such trusts as not being subject to the Insolvency Law or to any formal insolvency proceedings. Mexican legal practitioners interpret "entrepreneurial activities" to mean commercial, farming, livestock, fishing, and forestry activities, as that term defined in the Código Fiscal de la Federación (the Tax Code). Based on this legal analysis, the predominant view is that trusts used as SPEs would not be subject to the Insolvency Law since they would not be deemed to be engaging in any of the specified "entrepreneurial activities." Mexican legal practitioners stipulate that in the event that a securitization trust has insufficient assets to pay its liabilities, the terms of the trust agreement, not the Insolvency Law, will govern the process for liquidating the trust. Therefore, Standard & Poor's views the trust agreement as the central legal document setting forth the rights and obligations of the bondholders and the trustee in the event of an insolvency of the trust. Consequently, Standard & Poor's views Mexican trusts functioning as SPEs for securitizations (with clear trust agreement procedures for wind-down and liquidation) as being inherently bankruptcy remote, as they may not be filed into bankruptcy either voluntarily or involuntarily. Moreover, since there is no doctrine of "substantive consolidation" in Mexico, whereby the assets of a solvent subsidiary are consolidated in the insolvency estate of an insolvent parent, there would be no legal basis to consolidate the assets of the trust with the assets of the originator. There appear to be two principal risks to bondholders in creating a trust under Mexican law that should be addressed in the trust agreement. First, in order to avoid becoming subject to the Insolvency Law, trust agreements should not contain any provisions permitting the trust to engage in any endeavors that could be construed as "entrepreneurial activities," as that term is defined under Mexican law. Second, in order to avoid becoming subject to income tax and obligated to make periodic filings and payments to tax authorities as a "business trust" ("fideicomiso empresarial"), the transfer of assets into the trust must comply with specific regulations specified by the Mexican tax law. Standard & Poor's takes the view that its bankruptcy-remote criteria, which generally includes restrictions on the objects and powers of the SPE, limitations on indebtedness of the SPE, an independent corporate structure (e.g. separateness covenants, independent director/trustee requirements), limited recourse and non-petition language and security structure, are generally satisfied by the Mexican trusts that are created specifically as securitization vehicles so long as the special purpose nature of the trust is clearly set forth in the trust agreement and the trust avoids characterization as a "business trust." Trust Securities The importance of the trust as a securitization vehicle grew partly as a result of amendments to the Securities Market Law during 2001, which created the Certificados Bursatil and permitted trusts to issue these new securities. This development was a boon to the securitization market, as it was the first time trusts were permitted to issue debt securities. The new laws also eliminated many of the formal requirements that previously hindered a trust's ability to issue securities. A single trust may now issue multiple series and classes of securities of different seniorities and tenors, including debt and equity tranches. Trusts may also issue Participation Certificates ("Certificados de Participación Ordinaria o Inmobiliarios"; CPO). A CPO is a negotiable instrument that represents the right to an undivided ownership interest in the securities, assets, or rights pooled into the trust. These securities may only be issued by trusts. Under the Credit Transactions Law, the nominal amount of CPOs that are issued by a trust must be determined by Nacional Financiera, S.N.C. (a development bank), pursuant to the prior appraisal of the assets that were pooled into the trust. Since the Certificado Bursatil permits a trust far more flexibility than a CPO, it has generally replaced the CPO as the security of choice in most securitizations. Transfers of Assets/True Sale For structures involving a sale and transfer/assignment of assets (i.e. receivables), Standard & Poor's looks to the transaction participants to provide comfort on how assets can be transferred/assigned under Mexican law so that a bankruptcy/insolvency or corporate reorganization of the transferor would not adversely affect the timely payment of principal and interest on the rated securities. As a legal matter, a transfer can be thought of as fulfilling three specific goals, depending on whether it is valid and enforceable: As a contractual matter, against a solvent transferor and resulting in the transferee having priority against third-party creditors while the transferor is solvent; Against the regulator (if any), debtor in possession, or an insolvency administrator of the transferor, in an insolvency or reorganization proceeding, and against other creditors of an insolvent transferor; or Against account debtors, enabling the transferee to enforce the assets directly without relying on the transferor (e.g., the ability to instruct the account debtor to make future payments to the transferee, or the ability to foreclose on a mortgage or repossess an automobile upon default). A true sale of an asset, as a general matter, is a transfer that meets all three goals. An unperfected transfer may meet only the first two of the goals listed above, but may not be recognized in an action against account debtors. An unperfected transfer also may be more likely to be challenged in an insolvency or corporate reorganization proceeding. A promise to transfer assets in the future is only enforceable against the transferor, and would therefore meet only the first goal. Although the word "transfer" is often used without regard for its breadth, being able to define the breadth of transfer required for securitization and accomplishing the necessary formalities can lead to successful transactions. Mexican True Sale and Perfection A sale of intangible assets, including receivables, in Mexico is generally accomplished by way of a transfer agreement, which, by its terms, transfers title to the receivables from seller to the purchaser. In Mexico, unlike certain other jurisdictions, there is little risk of re-characterization of the sale as a secured loan. However, although the transfer agreement is sufficient to transfer title to receivables from the seller to the purchaser, the extent to which the sale is perfected vis-à-vis obligors and third-party creditors depends on the satisfaction of certain additional requirements. Notification and Consent of the Obligor Under Mexican law, notifying the underlying obligor is generally required in order to perfect a sale or assignment of receivables against such obligor. There is some debate, however, as to the formal requirements that must be met in order for such notice to be properly given or received in the context of a securitization. One view of the requirements of notification is derived from the Negotiable Instruments and Credit Transactions Law. This law, which was amended in 2000 and again in 2003 and generally enhanced the viability of trusts as securitization vehicles, contained a provision that provided for simple notification to the underlying obligor in order to perfect a sale or assignment of receivables (other than those documented by negotiable instruments, whether nominative or in bearer form or those pertaining to real estate assets such as mortgages) if the sale or assignment of receivables was made to a Mexican trust. Under this view, if simple notice to the obligor would perfect the transfer vis-à-vis third parties if the transfer were made to a trust, then such notice should also perfect the transfer vis-à-vis the obligor. Although this view is persuasive since it interprets the law as eliminating many of the formal notification requirements that would apply to general transfers of assets under Mexican law in the event that a trust is used as an SPE, Standard & Poor's believes that the law is not sufficiently clear as to whether simple notice would perfect vis-à-vis obligors, or as to defining the minimum requirements that should be met for notice to be effective. For this reason, Standard & Poor's believes that, unless there are specific provisions in Mexican law relating to perfection for specific types of assets, the preferred legal view on the notification requirements in order to perfect a transfer to an SPE trust vis-à-vis obligors in a securitization should be based on compliance with the formal requirements of the Civil Codes and commercial laws of Mexico that apply more generally to all transfers of assets whether or not made to a trust. Under the Civil Codes and commercial laws, notice is deemed given only if it is made judicially, with the presence of two witnesses or with a notary public, and notice is deemed received by an obligor if the obligor was present at the transfer and does not object to such transfer or has knowledge of and accepts such transfer. These formal requirements for notification would be extremely cumbersome and costly in the context of most securitizations. In Standard & Poor's view, the robustness of the legal structure of a particular transaction depends, in large part, on the extent to which the notification requirements are satisfied. In transactions that are not subject to specific exemption from these notification requirements, such as mortgages, Mexican legal practitioners have devised "deemed consent" structures in an effort to comply with these requirements. These structures, for example, may provide for notification to a large number of obligors through notices of the transfer contained in monthly account statements. These notifications typically allow for a determined period in which the obligor may object to the transfer. In the event that the obligor does not object, these notices typically provide for deemed acceptance as evidenced by continued payment by the obligor. Standard & Poor's believes that these deemed consent structures appear to meet the notification requirements of Mexican law in the context of a securitization, and such structures have been used in the vast majority of Mexican securitizations. It should be noted, however, that the validity of any of these deemed consent structures has not yet been ruled upon by Mexican courts. For securitizations that do not employ deemed consent structures, Standard & Poor's may require additional credit support to the extent that the notification requirements are not sufficiently addressed. In addition to perfecting the assignment against the obligor through notification, the effect thereof is to prevent the obligor from raising a set off defense that may arise subsequent to the date of notification. The problem of set off would occur if the sale or assignment were not properly perfected vis-à-vis the obligor, since the purchaser of the receivables would not have a valid claim against the obligor that makes payments to the seller and such payments are not transferred to the purchaser. Unlike notification, consent of the obligor is generally not required in order to perfect the sale of assignment vis-à-vis the obligor. However, there are certain situations where it may be necessary to obtain the consent of the obligor to perfect the transfer against such obligor. Two examples of scenarios where consent may be required would be: where there is a specific law that requires consent for the transfer of a specific type of asset; or if the underlying documentation evidencing the receivable requires the consent of the obligor for an assignment. In the context of most assets that are the subject of securitizations, it would be uncommon to find such requirements. However, consent of the obligor would have implications regarding set off, as an obligor that consents to a sale or assignment would lose any rights of set off against the transferor or transferee whether those rights accrued prior to or subsequent to the assignment. Registration and Effectiveness vis-à-vis Third Parties Mexican law generally provides that the transfer of receivables can be perfected vis-à-vis a third party either through registration in a public registry or through documentation of the transfer by means of a public deed that is ratified by a public notary or a commercial broker. The registration date or the date of the public deed will be "the effective date" for third party purposes. Determining how to perfect against third parties depends on the legal nature of the assets. In the case of receivables that involve assets that are subject to registration in a public registry, such as mortgage loans that are subject to registration in the Public Registry of Property or certain commercial loans that are subject to registration in the Public Registry of Commerce, the sale or assignment of the receivables must also be registered in the respective registries in order for the transfer to be effective against third parties. For all other types of assets, perfection of a sale or assignment of receivables vis-à-vis third parties would require a public deed. There is some debate among legal scholars in Mexico as to the extent to which perfection can be achieved against third parties. The concept of "third party" is not defined in the Federal Civil Code or in the Federal Code of Civil Procedures. The question as to whether the concept of "third parties" includes unsecured creditors of the seller of the receivables has not been clearly decided by Mexican courts. The prevailing view among legal practitioners is that the concept of third parties does include unsecured creditors; however, there are some cases where Mexican courts have ruled that the concept of "third party" does not include unsecured creditors of the seller since they would not have the same level of right as a non-registered purchaser. However, Standard & Poor's does not believe this distinction would impact a securitization transaction, since secured creditors would have priority over unsecured creditors in the event that they are not deemed to be "third party creditors" for purposes of registration. Certain exceptions exist to the requirement to perfect vis-à-vis third parties by either registration or public deed. One example, as discussed above, involves sales or assignments of receivables that are made to a trust pursuant to the Negotiable Instruments and Credit Transactions Law, since notification of the obligor can accomplish perfection against third parties (except in the case of receivables documented by means of negotiable instruments, whether nominative or in bearer form or those pertaining to real estate assets such as mortgages). Another example is the case of receivables backed by mortgages, where the requirements in certain Civil Codes have been modified to eliminate registration and public deed requirements. In these cases, it may nonetheless be advisable, as an additional level of protection for the investor, to transfer by means of a public deed, since, as mentioned above, the Civil Codes require that a "date certain" be achieved for the transfer to be effective against third parties. A single public deed, which may include the transfer of a large number of receivables in a securitization structure, is the simplest manner to achieve a "date certain" and to perfect against all third parties under Mexican law. The failure to properly perfect the sale or assignment against third parties would expose the purchaser to a subsequent wrongful sale by the seller to another third party, who, if it gave notice to the debtor, would have preference over the original purchaser. Perfection Issues for Specific Assets The following summary is a discussion of Standard & Poor's legal criteria that has arisen, in part, because of the specific nature and types of collateral being securitized in Mexico. Asset-specific criteria are in addition to Standard & Poor's structure-specific criteria discussed elsewhere. -MORTGAGE LOANS- As the general requirements to perfect a sale or assignment of assets that would ordinarily apply to a securitization under Mexican law are often cumbersome and costly, specific provisions governing the transfer of mortgage loans have been introduced in many Civil Codes in order to facilitate the transfer of mortgage loans and their ensuing securitization. Today, more than two-thirds of the states in Mexico, including the Federal District, have amended their Civil Codes to provide for the elimination of requirements for notification, documentation by public deed, and registration if the mortgages are sold by financial institutions or social security institutions and the seller retains the servicing of the loans. Under most of the amended Civil Codes, if the seller no longer services the loans at some point after the transfer, written notice to the debtors must be given of the transfer. To the extent that the servicer is changed subsequent to closing, Standard & Poor's views this as a potential contingent transfer since it would be unclear whether the SPE's interests in the assets would continue to be perfected until notification has been made to the obligors. In Standard & Poor's view, this risk must be addressed by making notification a condition to the transfer of servicing, or otherwise such a possibility will be considered as a liquidity stress on the rating. As discussed above, in order to provide additional comfort as to perfection vis-à-vis third parties, transfers of mortgage loans in the context of securitization schemes have generally been documented by means of a public deed. -COMMERCIAL LOANS- In addition to mortgage loans, the Mexican market has seen the securitization of other assets. These assets include commercial loans, such as credit agreements ("contratos de apertura de crédito"), revolving credit agreements ("contratos de crédito en cuenta corriente"), and secured credit agreements ("contratos de crédito de habilitación o avío y refaccionarios"). Depending on whether a commercial loan is secured or not, the requirements for its transfer may differ. In connection with unsecured loans, it is generally only required that the transfer be documented by means of a transfer agreement for the transfer to be effective vis-à-vis the seller. As explained above, in order for the transfer to be valid as against the obligor, notice to the obligor is necessary. In addition, with respect to third parties, such transfer must be documented by means of a public deed as required under the Federal Civil Code. In connection with secured commercial loans, to the extent the respective security interest is required to be registered with a public registry (such as "créditos de habilitación o avío" and "créditos refaccionarios"), the transfer would also be subject to registration requirements. -NEGOTIABLE INSTRUMENTS- To the extent that receivables are evidenced solely by means of negotiable instruments, such as "pagarés" (notes), the transfer of such receivables would only have to comply with the requirements for the transfer of negotiable instruments, which are generally simpler than those described above. Requirements applicable to the transfer of negotiable instruments in Mexico vary depending on whether negotiable instruments are nominative (registered in the name of the holder) or in bearer form. Nominative negotiable instruments may be transferred in two ways. One method of transfer is through a simple assignment. If the transfer of a nominative negotiable instrument is made through an assignment, the obligor will be permitted to claim against the purchaser, all of the defenses it had against the original holder that accrued prior to the transfer. In Standard & Poor's view, the preferred method to perfect the transfer of a nominative negotiable instrument against the obligor is through endorsement and delivery of the instrument to the purchaser since it would cut off any defenses that the obligor may have had against the original holder. The perfection requirements for the transfer of negotiable instruments in bearer form are far simpler and less open to debate. Perfection is accomplished upon delivery of the negotiable instrument to the purchaser. If the instrument being transferred is subject to registration in any registry of the issuer thereof (such as share certificates that must be registered in the share registry of the issuing company), in addition to endorsement (if applicable) and delivery, the transfer would also be required to be registered in such registry to be effective vis-à-vis third parties. -LEASES- To date, lease payments, other than in commercial leases, have not been securitized in Mexico, although it is possible that such payments could be securitized. For the assignment of a lease agreement to be valid as to the lessor, the transfer would only need to be documented by a valid transfer agreement. Vis-à-vis the lessee, such transfer would only be effective to the extent the sale is notified (in the manner described above) to the lessee. As to third parties, the transfer of the lease would only be valid if registered in the Public Registry of Property, or if such registration is not required by law, to the extent the transfer is documented by means of a public deed. It should be noted that certain Civil Codes might require certain lease agreements to be registered in the respective public registry of property. To the extent such registration is required, as mentioned above, any transfer of such lease would also need to be registered. As is the case in all contracted future cash flow securitizations, the securitization of lease payments would be subject to the performance risk of the lessor. A consideration that must be taken into account for these transactions is the ability of the lessees to suspend making lease payments or to set off such payments against expenses incurred or otherwise in certain scenarios under certain Civil Codes. -OTHER RECEIVABLES- There are other types of receivables that have been previously securitized successfully in Mexico and do not derive from a credit or similar transaction. Such receivables include assets such as toll road payments. To the extent these assets are governed by specific laws or derive from government concessions, additional requirements may apply. Such requirements may vary from notice to the government entity issuing such concession to the prior approval of such government entity. As to third party effectiveness, the rules described above would continue to apply. Given the undetermined nature of the account debtors in connection with this type of assets, in most of these cases requirements relative to account debtors are not relevant. Future Flows A number of participants in the Mexican market have been trying to structure transactions that securitize future cash flows from later anticipated business instead of from debts due on the date of the transaction. In order to understand the legal issues arising from such transactions, it is important to separate these future flows into four distinct categories: Receivables from existing contracts for performed services (unbilled receivables); Receivables from existing contracts for services not yet performed (future contracted receivables); Receivables from expected future contracts (future uncontracted receivables); and Cash receipts that are not receivables, as this term is ordinarily understood, i.e., a right to claim a payment from a debtor on a due date (future cash flows). Unbilled receivables are amounts due under a contract where the originator has fully performed its obligations relating to that receivable but where the debt has not yet been recorded in the originator's systems and/or the bill has not yet been sent to the customer. The classic case involves a customer who has used a telephone to make a phone call but has not received a bill for the call. However, in this situation, the telephone company's central computers have logged the call, but the entry has not yet been reconciled. Future contracted receivables are amounts that are expected to come due from existing framework contracts, but involve services that have not yet been performed. For example, these include amounts due from existing telephone customers in relation to calls not yet made. Future uncontracted receivables are amounts that are expected to come due from contracts to be entered into in the future by the originator. Future cash flows are sometimes erroneously described as "future receivables." They are, in fact, cash receipts where the payment of the cash is contemporaneous with the contract. Toll-road payments would fall into this category, as would payments for cinema or theatre performances. The first issue with all future receivables transactions is whether the receivables can be sold or whether any purported sale merely records an agreement for the sale of a receivable as and when the receivable comes into existence. In the latter case, such an agreement will usually fall upon the insolvency of the seller. The second issue is whether, even if a sale has taken place, the cash paid by the debtor after the seller has gone insolvent goes to the SPE or whether it falls into the into the estate of the seller. The resolution of these issues will depend on the specific structure of each future flow transaction. In Mexico, receivables from existing contracts for performed services that are unbilled or unregistered can be validly transferred by the holder. Likewise, receivables from existing contracts for services not yet rendered may also be assigned although the purchaser would assume seller performance risk, as the lack thereof, could entitle the debtor to itself abstain from performing (including making any payments due thereunder) under general principles of Mexican law. Although the Federal Civil Code permits sales of future assets (in which the purchaser basically assumes the risk of such assets not coming into existence and entitling the seller to the purchase price), provisions governing assignment only govern the transfer of existing receivables. Although sales of future uncontracted receivables or future cash flows have been known to take place, it is unclear whether such transfers would be upheld in seller bankruptcy or similar stress scenarios. Commingling Credit Loss or Liquidity Stress Standard & Poor's approach to assessing the risk in a transaction in which funds being held for the benefit of noteholders by certain third parties are commingled with funds belonging to such third parties, is to treat such funds as either a total credit loss or as a liquidity stress, depending upon the rights of the noteholders to such funds. The classic example of the problem of commingling occurs when the third party holding funds for the benefit of the noteholders either mixes the cash with its own cash or holds the funds in an account in the name of the third party and such funds either become "frozen" or lost in the insolvency of the third party. Such commingled funds would be considered as a total credit loss by Standard & Poor's if the issuer's claim to the money held on its behalf would be treated as an unsecured debt in an insolvency of the third party. If, on the other hand, the issuer retained a proprietary claim over the money so that the money did not form part of the insolvent entity's bankruptcy estate or the account was the subject of a valid security interest in favor of the issuer, then the cash would be viewed as "frozen" rather than lost and treated as a liquidity stress in the rating of the transaction. In this case, Standard & Poor's would seek to determine practically how long it would take for the issuer to assert these rights, which have a solid grounding in law, as against the bankruptcy trustee and competing creditors of the insolvent holder of the cash. Accordingly, the transaction will need to demonstrate features that will enable the issuer to meet in full and on a timely basis its current obligations under the rated notes, notwithstanding the delay in cash flows caused by the third party's insolvency. Although not the only situation in which commingling can arise, the most common type of commingling seen in Mexican transactions arises from the situation in which the underlying debtors will most often continue to make their payments under the sold receivables in accounts in the name of the originator considering that the originator normally continues acting as the servicer of the receivables. Insolvency of the Originator/Servicer As there is no law in Mexico that specifically addresses collections made by an originator or servicer in a securitization, the treatment of cash that is commingled in an account of the originator or servicer with other funds unrelated to the securitization will most likely be determined though application of the general principles of Mexican insolvency laws. Under the

Insolvency Law, assets that are in the possession of the insolvent entity as a result of a deposit, usufruct, or trust or that have been received in administration may be separated from the estate of the insolvent entity by the owner of such assets. This provision in the law would apply also in the case of insolvency of any third party that for any reason had possession of amounts collected under the receivables. To the extent funds belonging to the issuer are commingled with funds of the originator/servicer, upon the insolvency of the originator/servicer, the issuer would be entitled to seek the separation of such amounts during the insolvency proceeding, since the originator/servicer would be holding such amounts on behalf of the issuer as depositary or servicer. The issuer seeking to separate any such funds from the estate of the insolvent originator/servicer would have to identify such funds (or at least the respective amounts) to the satisfaction of the insolvency court, and would, to the extent consideration is still outstanding in favor of the originator/servicer, be required to pay any remaining part of the consideration payable to originator/servicer in connection with such funds in order to recover the commingled funds. However, since the Insolvency Law is still relatively new and there is no judicial authority on this point, it is unclear how a Mexican court would treat collections that had been commingled in a running account of the originator or servicer, or how efficient a separation of the funds from the insolvent's estate would be. Although a court may still view the funds as protected by the general principles of the Insolvency Law, in Standard & Poor's view, a sufficient uncertainty exists on the point so as to require money commingled in such fashion to be treated as a credit loss rather than a liquidity stress. Standard & Poor's is nevertheless satisfied that, so long as collections are collected by the originator/servicer in its capacity as agent for the issuer, the mere fact that the money stands in an account in the name of the originator/servicer would not, in and of itself, deprive the collections of the protections of the Insolvency Law. The preferred legal view is that, in the insolvency of the originator/servicer, so long as the collections had not been commingled with other monies, the collections would not fall into the bankruptcy estate of the originator/servicer and could be recovered by the issuer. Mexican federal courts have held the view that once the grantor has transferred assets into a trust, such assets are no longer a part of the grantor's estate but are legally owned by the trustee in such capacity, and constitute a part of the assets of the trust. The transfer of title of the assets and the disassociation with the assets of the settlor and other assets of the trustee is important in the event of bankruptcy of the settlor of the assets. Although such court rulings were issued in connection with the prior bankruptcy law, which has been revoked and superseded by the Insolvency Law, Standard & Poor's understands that the same principles should apply under the Insolvency Law. Therefore, based on the above analysis, Standard & Poor's will not treat money held in an account in the name of the originator/servicer as a credit loss so long as the following conditions are met: The collections must go into a dedicated account or set of accounts; The collections must not be commingled with other moneys belonging to third parties (including the originator/servicer); and The documents must make it explicit that the account holder is collecting the collections as agent for the issuer. If such conditions are met, Standard & Poor's will treat the presence of issuer monies in a third party account as a liquidity stress. The length of the period during which it will be assumed the cash will be delayed by an account holder's insolvency will vary, taking into account the rating sought (higher ratings driving more conservative and therefore lengthier periods) as well as the specific conditions of the transaction and the relative slowness of the Mexican judicial process. Account Bank Insolvency To the extent the securitization trust maintains deposit accounts at a banking institution that is declared insolvent, the trustee could technically request separation of the deposited amounts through the proceeding described above. However, considering the involvement of the Bank Savings Protection Institute ("Instituto de Protección al Ahorro Bancario"; the IPAB) and the National Banking and Securities Commission ("Comisión Nacional Bancaria y de Valores"), it is possible that such claims could be stayed in the precautionary measures issued by the insolvency court. The lack of experience in the insolvency of Mexican banking institutions provides no precedents as to this scenario. Therefore, in order to take account of this risk, Standard & Poor's requires that the rating of any financial institution in which deposit accounts are held be rated at least as high as the rating on the transaction. Insolvency of Issuers of "Permitted Investments" To the extent the amounts held in the securitization trust are invested in securities issued by an issuer that is rendered insolvent, under the terms of the Insolvency Law, the holders of such securities (the securitization trust) would be deemed creditors (either secured or unsecured, depending on the terms of the security) of the insolvent issuer and would only be entitled to restitution within the context of the respective insolvency procedure. Insolvency Claw-Back Almost all jurisdictions contain rules whereby transfers that would otherwise have been valid can be set aside in the insolvency of the transferor. These rules usually require that, at the time the transfer took place, the transferor was already insolvent or became insolvent as a result of the transfer. In Mexico, the only possibility to claw back a transfer prior to insolvency in the insolvency of the transferor is if the transfer is deemed a "fraudulent conveyance." The Insolvency Law defines "fraudulent conveyance" as such acts taken by the insolvent debtor prior to the declaration of insolvency, knowingly defrauding its creditors if the third party that was involved in the transaction had knowledge of such fraud. The Mexican Insolvency Law provides that certain transactions are deemed "fraudulent conveyances" and will not be valid and will be ineffective as to the insolvent estate if such acts were taken during the retroactive period, which is defined as the period beginning 270 days prior to the date of the insolvency declaration. Although, it should be noted that the law provides for the possibility of extending the retroactive period in certain cases. These transactions, which could be set aside by the court if they did not benefit the insolvent's estate, include the following: Gratuitous transactions; Acts and transfers where the insolvent entity pays a consideration of value that is evidently superior or receives a consideration of value that is evidently inferior to the consideration payable by the counterparty; and Transactions undertaken by the insolvent entity, the terms and conditions of which are significantly different to the market conditions prevailing at the location and time of the transaction, or to commercial practice or usages. There are also presumptions of fraudulent conveyances in the case of related party transactions and other transactions that are not typically involved in securitizations and would require additional certifications in order to rebut the presumption of fraud for such transactions. To protect the transaction against the risk of claw back in the case of originators that have a current Standard & Poor's rating in the investment-grade category, reliance will be placed on the originator's rating as a strong indication of its solvency. In these cases, the originators will not be required to enter into any additional steps. For originators that do not have a current Standard & Poor's rating, or for those whose rating is in the speculative-grade category, Standard & Poor's would expect to see evidence of good standing with respect to the originator dated shortly before the date of the transfer. In addition, Standard & Poor's would also expect to see solvency certificates signed by the managing director or the finance director of the company (or other appropriate person or body) and dated the date of the transfer of the receivables. These certificates should state without ambiguity that the transferor is solvent as at that date. Clearly, such certificates are not legally dispositive and a court could choose to ignore them in determining whether the SPE was or ought to have been aware of the insolvency of the originator. Nevertheless, in the absence of genuine fraud, such certificates should provide favorable evidence to strengthen the SPE's plea of ignorance. Standard & Poor's does not consider, though, that a mere representation by the originator as to its solvency that is embedded in the transaction documents will provide sufficiently robust evidence. If Standard & Poor's determines that there is a risk that a transaction could be deemed a fraudulent conveyance under the Insolvency Law (e.g., at sale price at a substantial discount to the face value of the receivables or a sale by a related party), further evidence may be sought evidencing that the sale of receivables was not made at an undervalue, either in the form of a legal opinion or an auditor's comfort letter. Setoff General Setoff risk is the risk that monetary obligations owed by party A to party B may be set off by party A against obligations owed by party B that for some reason party B has not paid. In the context of a structured finance transaction, where parties are modeling expected cash flows on a gross level, the exercise of setoff rights would decrease the actual cash flows received by the structure, which may threaten the structure's ability to make full and timely payment on the rated obligations. Setoff risk can materialize in a transaction in a number of ways, but is seen most often in relation to debtor setoff and account bank setoff. Debtor Setoff In all asset-backed transactions, it is a concern that, upon the insolvency of the originator, the receivables sold to the SPE may be decreased by the amounts that the underlying debtors set off against other obligations due to them by the seller. The classical case of debtor setoff would occur when a bank sold, for example, a pool of car loans, some of which had been made to the bank's own customers. Upon the insolvency of the bank, it is likely that some, if not all, of these customers would have money owed to them by the bank—namely the amounts standing to the credit of their current accounts. Depending on the jurisdiction, these bank customers may be entitled to deduct from the amounts due under the sold car loans the amounts standing to the credit of their accounts with the seller at the time of the latter's insolvency. This would reduce the amount that the issuer was entitled to collect on the securitized receivables and could, depending on the size of the reduction, cause a loss to the noteholders. This form of setoff may be recognized at law and results in a legal diminution of the debt. However, this form of setoff would not be permitted in Mexico as the Insolvency Law only permits setoff of obligations deriving from the same transaction and other forms of setoff described below. In addition to this "legal" setoff, there is also the risk of a "practical" setoff. This would occur when a debtor is faced with the loss of money due by the now insolvent seller. Having neither consented nor in some cases been notified of the sale of his or her receivable, the debtor may simply refuse to pay on the grounds that, irrespective of the legal position, the actions of the seller were iniquitous. In the case of a "practical" setoff, though, the right of the issuer to recover the sold receivable from the underlying debtor is not legally impaired. The issuer can expect delays, however, in recovering the amounts due to it. For this reason, Standard & Poor's will treat "legal" setoff as a credit loss to the transaction, while "practical" setoff will be treated as liquidity stress. In determining the nature of the risk of the setoff and its potential impact, it is necessary to understand the law of the relevant jurisdiction as well as the business of the originator. There will be cases where the existence of mutual rights between the underlying debtors and the originator are extremely unlikely, for example, where the originator is a special-purpose lender that does not have a deposit-taking business. In other cases, the existence of "no setoff" provisions in the contract between the debtors and the originator may be dispositive, as a matter of law, in removing the rights of setoff. In Mexico, under the Insolvency Law, from the date in which the declaration of insolvency is made, only (i) debts and rights of the insolvent entity that derive from the same transaction (and that is not interrupted by the insolvency), and (ii) debts and rights of the insolvent entity that were due before the declaration of insolvency and the setoff of which is permitted under applicable law, may be set off. As to both scenarios, consent and notice of and to the corresponding debtor will eventually determine whether a debt owed to a debtor of the sold receivables may be set off against the rights of such debtor against the insolvent seller. As a general matter, if the underlying debtor consented to the assignment, then an underlying debtor may not set off against the purchaser any claims it had against the seller. If the underlying debtor received notice of the assignment, however, then such debtor retains the right to set off any amounts due to him or her as of that date of notification, but all amounts due to such debtors by the originator following that date can no longer be set off as against the sold receivables. Legal Opinions True Sale Opinion/Sale Perfection and Tax Opinion Whenever Mexican law applies, to obtain legal comfort that a transfer of assets and the proceeds thereof from a transferor to an SPE constitutes a true sale, as a general matter, Standard & Poor's will request a true sale opinion and sale perfection opinion from Mexican counsel. The true sale opinion should state, among other things, that: All registrations, consents, and notifications required to perfect against third parties (other than the obligor(s) and/or guarantor(s) of the obligor(s), as the case may be) have been made, Where appropriate, all consents or notifications required to perfect such assignment against the obligor(s) or account debtors have been made, Where appropriate, the applicable transfer documents validly and effectively transfer to the SPE all of the transferor's right, title, and interest in and to the assets and proceeds thereof with no other formalities being required (other than described in the first two bullets above), The property being transferred and the proceeds thereof will not be property of the transferor's estate under the applicable insolvency legislation and possible other legislation applicable to the transfer or the transferor, and Creditors of the transferor (including a trustee in bankruptcy) could not look successfully to the transferred assets to satisfy a claim they may have against the transferor, whether before or after the insolvency of the transferor or in any proceeding instituted by or against the transferor under the applicable insolvency legislation. In addition, Standard & Poor's will request an opinion that the SPE or SPE Trust would not be viewed as a "fideicomiso empresarial" for Mexican tax purposes and would not otherwise be subject to entity-level tax. Standard & Poor's would like to thank the law office of Ritch, Heather Y Mueller S.C., Mexico City, for its assistance and advice in producing this article.