



LEASES IN MEXICO

Introduction

The economic power of the United States has undoubtedly influenced even the most remote parts of the world; American companies by injecting capital to foreign countries have rewritten our understanding of the word internationalism. In doing so, the Anglo-American legal tradition has come along infiltrating the legal reality of Civil Law countries, such as Mexico, and as a logical consequence, Civil Law countries are adapting to this reality, by enacting statutes that include these innovative ways of doing business. Nevertheless, those ways of doing business came to pass from very special circumstances and stages of the United States history. Along with this capitalist evolution, the legislative and judicial powers had to reinvent the law, in order to reflect the rapid change in the markets, in other words “business practice plays the tune and the law dances, not the other way around¹.” However, when the law has danced reacting to the business sounds, a new way of doing business has been erected, and everybody has to obey its melody.

In light of the foregoing, the rest of the countries are accepting these realities, thus accelerating their natural evolution, to not be relegated from the looming globalization.

The purpose of this article is to present how Mexico has reacted to this new way of doing business. Therefore this article is divided in three parts, laying down in Part One, how Mexico regulates and treats leases, what kinds of leases there are, the differences with U.S. law and how Mexican leases do not match with the U.S. leases or the idea of true lease and lease intended as security. Part 2 analyzes the legal consequences of the different kinds of leases in Mexico, and how easily the parties may confuse their nature. Finally, Part Three

¹ Lynn M. LoPucki & Elizabeth Warren, “*Secured Credit A Systems Approach*”, New York, 2006, pg. 324.

explores the idea if the parties may choose which lease to be in, and if so what difference does it make.

The consequences of misunderstanding the idea of what is a lease in Mexico, will invariably be analyzed and explored, hopefully being of use to the American leasing companies and their attorneys representing them, that are planning to invest in one of the most important emerging economies in the world.

I. Leases under Mexican Law

Mexico recognizes three types of true leases: (i) civil; (ii) financial; and (iii) operating, which are basically regulated by four statutes: the Civil Code², the Commercial Code³, the General Law of Negotiable Instruments and Credit Operations⁴ and the Federal Tax Code⁵.

(i) Civil Leases

The Mexican Civil Codes applies to non-merchants, so the leasing contract governed by them is of non-lucrative purposes and focusing primarily on real estate leases. We will focus our attention to the Federal Civil Code, as most of the states follow its language. Article 2398 defines a lease: "...When the two contracting parties reciprocally oblige themselves, one, to grant the temporary use of a thing and the other, to pay for said use a certain price". The rent or price may consist of money or any other certain and determinable thing⁶. In light of the foregoing, the civil leasing contract is (i) Independent- it does require to its existence a prior agreement by the parties; (ii) Typical and Nominated- it is expressly regulated; (iii) Bilateral- Performance by both parties is necessary; (iv) Lucrative- in opposition to gratuitous; (v) Commutative- the fulfillment of the contract does not depend upon chance; (vi) Consensual- The contract is perfected by the consent of the parties in opposition to actions "*in rem*" which require the actual delivery of the thing; (vii)

² *Código Civil Federal.*

³ *Código de Comercio.*

⁴ *Ley General de Títulos y Operaciones de Crédito.*

⁵ *Código Fiscal de la Federación.*

⁶ Mexican Federal Civil Code. Article 2399.

Formal (Statute of Frauds)- The statute requires that the contract be in writing⁷; (viii) Continuous- The contract is fulfilled in a definite lapse of time and not in a single act; and (ix) Use Contract- The lessor grants the use of the leased property temporarily, in exchange for consideration⁸.

Because most of the provisions contained in the Federal Civil Code regulate real estate leases, it is quite burdensome for lessors, in order to protect the lessee's unequal bargaining power. Only few sections in the Federal Civil Code are dedicated to personal property leases and from its language it is easy to infer that they refer to agricultural or rural type personal leases.

(ii) Financial Leases

Leases in Mexico can also be commercial. The Commercial Code recognizes these contracts as acts of commerce, and the General Law of Negotiable Instruments and Credit Operations expressly regulates the financial leasing agreement. Article 408 determines: "In virtue of the financial leasing agreement, the lessor is obliged to acquire certain goods and grant their temporary use, in a compulsory term to the lessee, who can be a natural person or a company, being obligation of the lessee to pay for the use, a determined or determinable quantity of money, that covers the value of acquisition of the goods, the financing costs or any other expense agreed and adopt at the end of the lease, some of the terminal options established in Article 410 of this Statute. The financial leasing agreements must be in writing and may be filed in the Public Registry of Commerce, prior request of the parties, being able the parties to file the lease in any other Registry determined by the law". Article 410 establishes the following terminal options mandatory to the lessor:

- a) "The procurement of the goods at an inferior price of their acquisition value, which must be included in the contract. In case the parties did not establish a price, the price must be inferior to the fair market value at the time of acquisition;

⁷ Id. Article 2406.

⁸ Francisco Lozano Noriega. "Cuarto Curso de Derecho Civil, Contratos," Mexico, 2001.

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- b) To extend the term of the lease, paying the lessee an inferior rent, according to the provisions established in the contract; and
 - c) To share with the lessor in the price of sale made to a third party, in the proportions and conditions set forth in the contract”...⁹

The intent of the parties and form of the contract is to acquire the goods at a nominal price, the conveyance of the title to the lessee at the end of the lease is for legal reasons, because technically the owner is still the lessor, even though in reality the lessee has paid the entire price, plus interest, expenses, financing costs, and any other expense that the Financial Leasing Company can think of.

The characteristics of the contract are the following:

- 1) The Financial Leasing Company is obligated to acquire the goods to be granted in leasing. The definition only contemplates indirect leases, not direct leases whereas the company is owner of the goods.
- 2) The main right of the lessee is to use the goods, terminology copied from Article 2398 of the Civil Code.
- 3) The term of the contract is mandatory for both parties, without a right to cancellation.
- 4) The total price of rents must exceed the fair market value.
- 5) The price must be paid periodically.
- 6) The lease contract has to have one of the terminal options established by Article 410 in favor of the lessee.
- 7) The lease contract must be in writing in order to be valid and may be filed in the Public Registry of Commerce, or any other Registry (in case of vessels or boats the lease would have to be filed in the National Maritime Registry or if the lease goods are aircrafts the lease must be filed in the National Aeronautical Registry).¹⁰

⁹ Javier Arce Gargollo, “*Contratos Mercantiles Atípicos*,” Mexico, 1994, pg. 89.

¹⁰ Soyla H. León Tovar, “*El Arrendamiento Financiero en el Derecho Mexicano, una Opción para el Desarrollo*,” Mexico, 1989.

The nature of the financial lease contract is commercial, as established by the Supreme Court of Justice in jurisprudence No. 353 under the name “Financial leases, their nature is commercial”, independently that financial leases are regulated in a commercial statute, such as the General Law of Negotiable Instruments and Credit Operations¹¹.

Mexico as a Civil Law Country, is very strict with the classification and categorization of its contracts, therefore the complication of not being able to assimilate the financial lease contract as a sale or as a security agreement or as a credit for that matter. Again, the Supreme Court and the Federal Courts ruled that this type of leases are different from the sale, because the sale is perfected when the parties agree on price and thing, even though the first has not been paid and the second delivered¹². It is also different from a security interest, because the existence of security interest depends upon the existence of a main or principal agreement, which is not the case, and finally different from a credit, because a credit conveys property and not the use of it. Notwithstanding the aforementioned, the Federal Courts determined that financial leases have some characteristics of sales, credits and security interests, but at the same time they are different, therefore *sui generis* and independent, Jurisprudences Nos. I.60.C.232 C, and 12098/84 under the names “Financial leases complex operations, that participates of several elements of nominated contracts” and “Credits and financial leases, characteristics”.

As mentioned before, when entering into financial leases, the lessee must have the right to choose between the 3 terminal options established by Article 410, being option 1, i.e. the sale at an inferior price to the lessee the only option exercised by lessees. The lessors’ sale the leased property at 1% of the value of the goods to the lessee, so that leaves little room to extend the term and much less to participate to the lessee of the sale made to a third party. Perhaps it makes sense to extend the term if the goods are very valuable such as aircrafts or boats and even to extend the price of 1% of the original value could be considerable. The Mexican Congress with complete lack of legislative and legal technique classified the extension of the term as a terminal option, although the Federal Courts have established

¹¹ Oscar Vázquez del Mercado, “*Contratos Mercantiles*,” Mexico, 2001.

¹² Id., Article 2249 of the Federal Civil Code.

that in order to extend a contract the parties must do it prior to the end of the term, because if they do it after, they would be entering into a new contract, Jurisprudence No. II.2o.C.383 C, under the name “Leases, the extension of the contract must not exceed the term of duration”¹³.

The rent in financial leases can be either determined or determinable, in opposition to Civil Leases where the rent needs to be determined or certain (term use by Article 2398 of the Civil Code)¹⁴. The Congress, when regulating financial leases, made this change from the language of the Civil Code from determined or certain to determinable, for the reason that the interest rate to calculate the rent in financial leases is most of the times a floating rate making the rent determinable not certain or determined, albeit, the Federal Courts determined that floating rates or index clauses used to calculate rents in a leasing are certain, trumping over the language of the Civil Code, Jurisprudence I.4o.C. J/26, under the name “Leases. The rent calculated with floating rates or index clauses, constitutes a determined price in the contract”.

One more Statute defines financial leases, Article 15 the Federal Tax Code determines: “For tax purposes, financial lease is the contract where a party is obliged to grant the temporary use of tangible goods in a compulsory term, and the other party must pay in partial payments as consideration, a quantity in money determined or to be determined that covers the acquisition value of the goods, the financing costs, and any other expense, and adopt at the end of the term some of the terminal options, established by the corresponding Statute. Financial Leases must be in writing and consign in them the value of the good and the interest rate agreed or the form to determine it”. The interesting thing is that financial leases for tax and accounting purposes are treated as sales¹⁵.

(iii) Operating Leases

Finally, there is another kind of commercial lease in Mexico, the operating lease, even

¹³ Civil Law countries do not publish in their cases the name of the parties, as Common Law countries do.

¹⁴ Fernando Vázquez Pando, “*En torno al Arrendamiento Financiero*,” Ed. Revista de Investigaciones Jurídicas, Mexico, 1990.

¹⁵ Arturo Díaz Bravo, “*Contratos Mercantiles*,” México, 1996.

though the Commercial Code does not explicitly regulates operating leases, it recognizes their existence as commercial acts in Article 75, Section I: “*The law regards as commercial acts: I. All acquisitions, alienation and leases made with the object of commercial speculation...*”.

The Mexican Commercial Code “Commercial Code”, adopted the word lease from the Civil Code of 1870 that differentiated the terms rent and lease, the former referring to real estate leases and the latter to personal property leases, so real estate leases are exclusively civil or for non-merchants (even though the contract is entered into by and between merchants) and personal property leases can be either civil or commercial depending on their nature, but again the Commercial Code recognizes their existence as commercial acts.

Now, how has Mexico dealt with the problem of operating leases? The Commercial Code recognizes as acts of commerce personal property leases with object of commercial speculation and on the other hand, Mexico adopted from the German Civil Code the concept of innominate and atypical contracts. Most of the times Mexican lawyers, scholars and judges will try to assimilate civil leases to commercial Anglo-American origin leases for many reasons: Both leases are possessory contracts; Mexican lawyers do not study in law school commercial leasing contracts; contracts that are not regulated in some statute tend to be confused by some of the regulated ones; to understand commercial leasing one must have knowledge of accountancy principles and financial matters.

The drafters of the Mexican Civil Code confronted the problem at hand by adopting Article 1858 that stipulates: “The contracts that are not specially regulated in this Code will be governed by the general rules of contracts; by the stipulations of the parties and if the foregoing is not sufficient, by the dispositions of the contract that is more analogous”.

Consequently, operating leases are atypical and innominate. The explanation as to why they are atypical is easy and complicated at the same time. Easy since operating leases are commercial contracts and the Civil Code does not apply directly, and complicated for the reason that a business, accounting and financial explanation is necessary to explain their

nature. The term operating lease is an accounting term; both the United States and Mexico do not have a definition for operating leases, therefore the difficulty to classify such leases¹⁶.

Since operating leases are atypical and innominated contracts, the general principles of contracts of the Civil Code apply by analogy, not the provisions of the civil leasing. As mentioned before, operating leases are commercial, therefore the Commercial Code rule their existence. However, the general principles of contracts are contained in the Civil Code not the Commercial Code¹⁷.

Most of the general principles of contracts are dispositive, allowing the parties great freedom to contract, oppositely to the provision of the civil leasing that are mostly non-dispositive, leaving little room for the parties to maneuver.

In conclusion, Mexican laws adopted from Roman law the civil leasing regulated in the Civil Codes of the States and in the Federal Civil Code. Civil leases are focused mainly on real estate leases and their nature is non-commercial. Furthermore, Mexico implemented from the U.S., the idea of commercial leases by regulating financial leases in the General Law of Negotiable Instruments and Credit Operations, financial leases are considered to be true leases for legal purposes, but for accountancy and tax purposes are considered to be sales.

On the other hand, in practice the large majority of leases entered into in Mexico are operating leases, leases that lack of legal regulation, although that are in nature true leases for legal, tax and accountancy purposes. See figure 1 below.

¹⁶ See. FASB 13 and Bulletin D-5

¹⁷ Article 2 of the Commercial Code: "Failing provisions of this ordinance and the other mercantile laws, those of civil law contained in the Civil Code applicable to federal matters shall be applicable to commercial acts."

All commercial laws in Mexico are federal in opposition to U.S. commercial laws that are local.

Leases in Mexico:



1.1. True Leases and Leases Intended as Security (U.S. Law)

In opposition to Mexico, the United States has two categories of leases: true leases and leases intended as security. Certainly, within the true leases category there are subcategories i.e. finance leases, consumer leases, Trac leases, synthetic leases, among others.

True lease is a term used by the U.C.C. and the American Courts, the rest of the countries use different terminology, Mexico uses the terms pure leases (operating) and financial leases (capital).

A full article may be written to outline the differences between true leases and leases intended as security from a legal point of view, hundreds of articles and court opinions have addressed this matter in the United States. An analysis may be drawn from Article 2A, Article 9, Bankruptcy Code, and remedies perspectives, hence the difficulty to enclose and summarize the subject matter.

Additionally, Michael L. Rustad in his book "*Sales, Leases and Licenses*"¹⁸ says that the conceptualization of leases developed from the Webster's Economy and Society¹⁹.

¹⁸ Michael L. Rustad. "*The Concept and Methods of Sales, Leases and Licenses*," U.S.A., 1998. pg. 390

¹⁹ Peter Kivisto, "*Key Ideas of Sociology*" 62 (1998).

Therefore, the four ideal types of leases are: (i) the lease intended as security; (ii) the finance lease²⁰; (iii) the consumer lease; and (iv) the plain vanilla lease²¹.

Article 2A applies to every lease transaction, § 2A-102: “This Article applies to any transaction, regardless of form, that creates a lease”, moreover, § 2A-103, defines a lease as: “means a transfer of the right to possession and use of goods for a term in return for consideration, but a sale, including a sale on approval or a sale or return, or retention or creation of a security interest is not a lease...”. Three vital things can be drawn from § 2A-102 and § 2A-103: (i) a lease transaction is based on substance; (ii) a lease is not a sale or a security agreement; and (iii) a lease means a right to possession of the leased goods.

- (i) A lease transaction is based on substance, will be analyzed in subsection 2.7.1 *infra*.

- (ii) A lease is not a sale or a security agreement: Sales are regulated by Article 2 of the U.C.C., notwithstanding the similarities with leases; they have their own nature and distinctiveness. § 2-106 (1) defines a sale as: “... the passing of title from the seller to the buyer for a price...” leases on the other hand, transfer a right of possession. The similarity between leases and sales comes into play when the title of the sale is not transferred immediately, but when the buyer retains the title as a security interest and Article 9 comes along, as in leases intended as security § 2-401 (1). The parties to the sale must explicitly agree to the reservation of the title, otherwise the title will pass to the buyer, at the time and place performance is completed by the buyer and the goods delivered by the seller § 2-401 (2).

As mentioned above a lease is not a security interest, hence the crucial question becomes what is a security interest, § 9-102 (73) establishes: “an

²⁰ Hal W. Mandel and Jeffrey M. Shapiro, “Finance Leasing Under New UCC Article 2A,” *The Metro. Corp. C.*, March 1996. pg. 7

²¹ Joseph W. Gelb and Peter W. Cubita, “*An Overview of State Automobile Leasing Legislation*,” 52 *Bus. Law.* 1087, (May 1997).

agreement that creates or provides for a security interest”. § 1-201 (35) moved the definition of security interest to §1-203 and Article 9 of the U.C.C. governing Secured Transactions. The aforementioned provisions set the objective rules to distinguish a true lease governed by Article 2A from a Security Interest governed by Article 9, §1-203, and the governing case law are analyzed below.

- (iii) As in every lease, the owner of the property conveys to another person the right to possess the property for a limited period of time. Black’s Law Dictionary defines possession as: “The fact of having or holding property in one’s power. The right under which one may exercise control over something to the exclusion of all others²²”. True leases only convey possession to the lessee, guarantying the lessor the lawful and non-disturbed possession of the goods. Leases intended as security convey possession also, thus in a disguised manner, the intent of the parties is to transfer title at the end of the lease, for a nominal consideration, therefore the similarities with Article 2 of the U.C.C., particularly with the sales retaining title of the goods as a security interest.

When Article 2A was enacted, the drafters proposed that former § 1-201(37) needed to be revised to draw a brighter line between true leases and leases intended as security, as the distinction was not clear from the case law, consequently incorporating § 1-203, apparently relying on objective criteria to make the distinctions. On the contrary, it has been suggested that true leases under former § 1-201(37), remain true leases under § 1-203; those disguised as security interests, remain so; and those that were borderline, remain borderline²³.

First, leases are determined by the substance of the operation and extrinsic evidence, in opposition to the words of the agreement or the form that was given to it by the parties²⁴.

²² Black’s Law Dictionary. Eighth Edition. pg. 1201.

²³ Thomas D. Crandall et al., I Uniform Commercial Code §9.3.3. at 9:18. (1933).

²⁴ Richard L. Barnes, “*Distinguishing Sales and Leases: A Primer on the Scope and Purpose of UCC Article 2A*”, 25 U. Mem. L. Rev. 873, 882-84 (1995). See also, James J. White & Robert S. Summers, Uniform Commercial Code 565 (4th ed. 1995 & Supp. 1998).

Also, the intent of the parties and the representations within the agreement cannot control the issue if the contract is a lease or a security interests, *In Re Homeplace Stores, Inc.*, 228 B.R. 88; 1998 Bankr.

Additionally, § 1-203 (a) establishes that the form of the transaction (lease or security interest) is determined in a case to case basis, many courts have approached this requirement set forth by subsection (a) of § 1-203 , *Addison v. Burnett*, 41 Cal.App.,4th 1288, 1996.

Second, § 1-203 (b) ascertains that the lease is a disguised security interest, if the lease is not subject to termination by the lessee, this termination requirement was reasoned by the Tillery and Tulsa courts, reasoning that the termination clauses in leasing agreements “recognizes the equity of the [lessee] in the vehicle because he is required to bear the loss or receive the gain from its wholesale disposition.” *In re Tillery*, F.2d at pg.1365; and *In re Tulsa*, F.2d at p.811. However, in the case of *Sharer v. Creative Leasing, Inc.*, 612 So.2d 1191, the Alabama Supreme Court disagreed with the Tillery and Tulsa courts, holding “it cannot be said that such a shifting of the risk of loss in value of the item alone is sufficient to hold that any lease agreement containing such a clause necessarily was intended to create a security interest.”

There are further requirements contained in § 1-203 (b), to characterize a lease as a security interest:

- a) The term of the lease is equal or greater than the economic life of the goods;
- b) The renewal option if any, is for the remainder of the economic life of the goods or the lessee must purchase them at the end;
- c) The renewal option is the remainder of the economic life of the goods or for no additional consideration; or

“Whether a document is a security agreement as opposed to a lease . . . is dependent on certain factors extrinsic to the document and not capable of control by words in the document.”

d) The lessee has the option to become the owner of the goods for nominal or not additional consideration.

Courts have struggled to find an equilibrium to determine the best test to interpret § 1-203. In re Bonner, the Georgian court established that the best test for determining the intent of the parties regarding the option to buy clause is if said option to buy the goods is for no additional consideration, then the lease is a security interest. If the additional consideration is not nominal, but instead a fair market value option, the transaction is a lease, In re Bonner, 06-50472 RFH, United States Bankruptcy Court for the Middle District of Georgia, 2006, Bankr.²⁵

In Re Hispanic American Television Co., Inc.²⁶, the court to determine if a contract is a lease or a security agreement, stated that the following aspects need to be considered: (i) the term of the contract; (ii) the existing circumstances prior to the execution of the contract (Parol Evidence Rule); (iii) the purchase option if it is nominal or fair value. The aforementioned, notwithstanding the intention of the parties to create a lease or not and the objective rule must be construed if a third party characterizes the lease as a security interest and the lessee for that purpose is the objective third party.

Now, In re Beckham²⁷, the court sitting in Kansas proposed a two part test for leases that are disguised as security interest, that in summary are the requirements of subsection (b) of § 1-203.

Moreover, the bright line test established by In re Sankey, adds an additional requirement “whether the lessor retained a reversionary interest. If there is a meaningful reversionary interest--either an up-side right or a down-side risk--the parties have signed a lease, not a security agreement.”

²⁵ see also, In re Copeland.

²⁶ In Re Hispanic American Television Co., Bankruptcy Nos. 89 B 15544, 89 B 15545, 1990.

²⁷ In Re Beckham, 275 B.R. 598, 606 (D. Kan.), affirmed, 2002 WL 31732497 (10th Cir. 2002).

The Court of Appeals of the Second District in Texas came up with its own two part test analysis: (i) When the purchase option is to exercised by the lessee it appears that it will acquire the goods for a lower price than the fair market value; and (ii) if the terms of the purchase option are such as to leave the lessee with no other alternative²⁸.

Apparently, courts have paid little attention to subsections (c), (d), and (e) of § 1-203, that pronounces that leases are not security interests if:

- (a) The value of the transaction is equal or greater than the fair market value of the goods;
- (b) The lessee assumes all the risks of loss of the leased property (Hell or High Water Clause);
- (c) The lessee pays all the taxes, insurance, filings, registration, service or maintenance fees;
- (d) The lessee has an option to purchase the goods or renew the contract;
- (e) The option to renew the contract is equal or greater to the fair market value of the goods, or the prediction of the fair market value; and
- (f) The purchase option is for equal value or more of the fair market value.

Furthermore, additional consideration is not nominal when exercising the purchase option if:

- (a) When the option to renew the lease is granted to the lessee, is at a fair market value, or at the time the option is performed; and
- (b) When the option to buy the goods is granted to the lessee, is at a fair market value, or at the time the option is performed.

Finally, subsection (e) determines that the fair market value for purchase or renewal must be determined according with the circumstances at the time the transaction is entered into.

²⁸ King Consultants, Inc. v. Bee Equipment Sales, Inc., No. 2-02-235-CV, Court of Appeals of Texas, Second District, Fort Worth, 2003.

“The reasons that none of these factors (nor all of them together) is sufficient alone to create a disguised sale is that each of them is consistent with the fundamental difference between a sale and a true lease: the retention of a substantial economic interest in the goods by the lessor. In fact, the presence of some of the factors makes it more likely that the transaction is a true lease rather than a disguised sale.²⁹”

The consequences in determining true leases as security interests comes when the debtor files for bankruptcy, since the creditor will be unperfected in its security interest, therefore, considered an unsecured creditor. It is always recommendable when entering into border line leases to file a UCC-1 Financing Statement, even though the transaction later on is considered to be a true lease by some court. Even if the lessor properly files a Financing Statement, a lessor under a true lease receives better treatment in bankruptcy than does a lessor who holds a disguised security interest. A detailed analysis of this issue is beyond the scope of this article. However, to address the point briefly, true leases are treated as "executory contracts" under the Bankruptcy Code and the lessee usually must begin making payments at the contract rate on the 60th day of the debtor's bankruptcy case. In addition, lessees under true leases can retain possession and use of the leased property only by curing defaults in payments, assuring future payments and compensating the lessor for pecuniary loss. On the contrary, if the transaction constitutes a disguised security interest, the lessee may "value" the leased property and take other steps that may result in reduction of the amount of rent required under the lease.

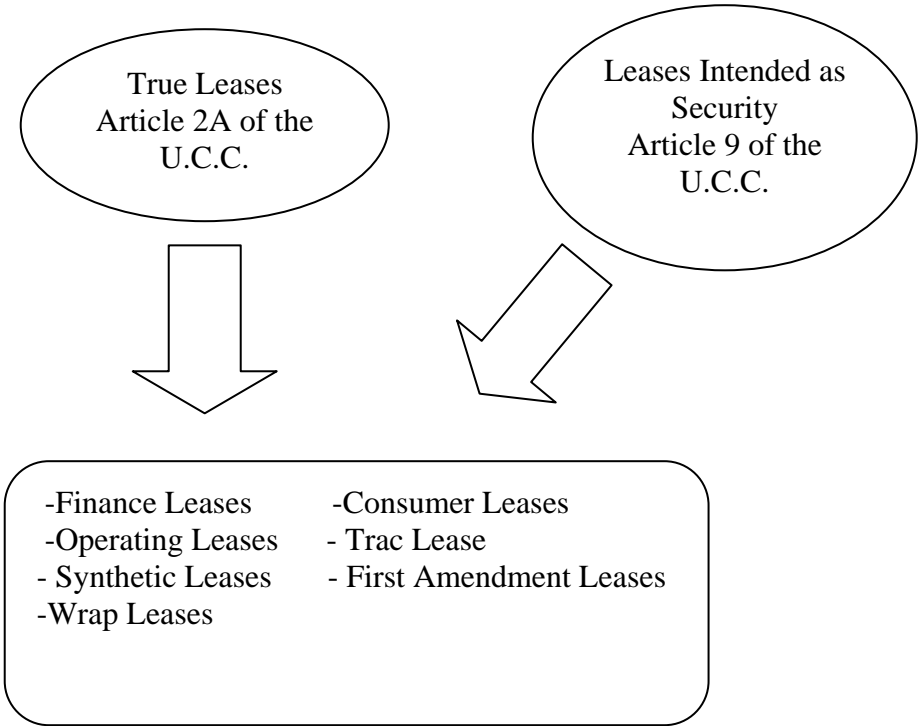
There are also implications outside of the bankruptcy context. For example, if the transaction creates a disguised security interest, the lessor must comply with Article 9 of the Uniform Commercial Code when repossessing and disposing of the property being leased. The provisions of Article 9 are designed, among other things, to protect the lessee's "equity" in the leased assets and generally result in more obstacles than a lessor would encounter under a true lease. For example: 1) a holder of a disguised security interest has to send out "Notices of Disposition" to certain parties (including any guarantors and other lien holders revealed by a UCC search conducted prior to disposing of the equipment); 2) the

²⁹ Gregory M. Travaglio, Robert J. Nordstrom & Albert L. Clovis, "*Nordstrom on Sales & Leases of Goods*," U.S.A., pg. 998.

sale of the repossessed equipment has to be commercially reasonable; and 3) lessee receives any surplus left after the lessor and any other junior lien holders are made whole.

Other examples of implications outside of the bankruptcy context include: 1) the fact that usury laws, which can operate to reduce the amount of interest the lessor may charge the lessee, generally apply to disguised security interests but not to true leases; and 2) lessors under true leases generally fair better against landlords and mortgagees than do lessors under disguised security agreements. See figure 2 below.

Leases in the U.S.:



As shown above, if the parties do not comply with Article 2A and § 1-203, any lease in the U.S. is virtually a security interest, notwithstanding what the parties intended. Additionally, only finance and consumer leases have special regulation under Article 2A of the U.C.C., and the general provisions of Article 2A apply to the rest of the leases, with exception of Trac leases described by the Internal Revenue Code in Rev. Proc. 75-21, 75-28, 76-30 and 7948.

1.2. The Mexican categories do not match the U.S. categories

Even though the idea of commercial leases was taken by the Mexican Congress from the U.S., the Mexican approach is completely different. In Mexico there is no distinction between true leases and leases intended as security, all leases are true for legal purposes, e.g. financial, civil and operative. However, financial leases are considered to be sales for tax and accountancy purposes. The Mexican accountancy rules are published every year in Bulletin D-5 by the Mexican Institute of Public Accountants, and the Mexican tax authorities follow its rules. The Commission of the Institute of Public Accountants analyzed the different types of leases and concluded that in Mexico two great groups exist: capital and operating leases. The bases for classification of these operations are described in paragraphs 30 to 33 of Bulletin D-5³⁰.

According to Bulletin D-5, within the operations of capitalize leases, financial leases stand out, leases carried out by specialized institutions inside a legal frame that defines them and the contract itself.

Capital Leases.- Are the leases that substantially transfer all the risks and benefits inherent to the property of an asset, independently that the property is or not conveyed.

Capital leases have the following characteristics:

- a) The contract transfers to the lessee the property of the leased goods at the end of the lease.
- b) The contract has a sale option at a reduced price.
- c) The term of the lease is substantially equal to the useful life of the leased goods.
- d) The present value of the minimum payments is substantially equal to the fair market value of the leased goods, net of any tax benefit.

³⁰ Instituto Mexicano de Contadores Públicos A.C. ,”*Principios de Contabilidad*,” Mexico, 2004, Boletín D5.

Capital lessors must report the rents, plus the residual value as a net investment of the lease. The difference between the net investment and the present value must be recorded as a financial income to accrue.

Capital lessees must record a capital lease as an asset and its correlative obligation, at an equivalent value between the present value of minimum payments and the fair market value of the leased property.

In contrast, the accountancy test in the U.S. to determine if a lease is true or intended as security are very similar to the tests established by the Statement of Financial Accounting Standards No. 13 “FASB 13”.³¹

An operating lease is not a capital lease according to the FASB 13, actually operating leases are all other leases that are not capital³², so what is a capital lease: “Leases that meet one or more of the criteria in paragraph 7”. Paragraph 7 of the FASB 13 establishes: (i) The purpose of the lease is to transfer ownership of the goods at the end of the lease; (ii) The lease contains a bargain purchase option, which establishes that the price of purchase will be considerable lower, than the fair market value of the property; (iii) The lease term is equal to 75 % or more of the economic life of the leased property; and (iv) The lease payments (rents) excluding insurance and other related expenses, exceeds 90% of the fair market value of the leased property³³.

If the lease meets one of the preceding criteria it will be considered a sale-type lease or a direct financing³⁴. The term financial or financing lease comes from Section 8 of the FASB 13, for the reason that Section 8 treats the terms capital and direct financing or financial lease as synonyms.

³¹ Financial Accounting Standards Board of the Financial Accounting Foundation. Financial Accounting Standards No. 13.

³² Financial Accounting Standards Board of the Financial Accounting Foundation. Financial Accounting Standards No. 13. Section 6, iv.

³³ Id. Section 7.

³⁴ Id. Section 8.

Moreover, the manner which lessees have to report the lease is imperative for our analysis. Lessees in a capital lease have to report the goods leased in the balance sheet as assets and the debt of the lease as an obligation³⁵.

In contrast, if the lease is operative, the rent has to be charged as an expense as it becomes due, outside the balance sheet, therefore the name to the operating leases as: off-balance sheet financing³⁶.

On the other side, lessors report capital and operating leases quite different. Capital lessors must report the rents as gross investment in the lease, the gross investment and the sum of present values shall be recorded as unearned income, the present value of the rent plus the interest rate shall be recorded as sales-price, and the residual value shall be review on an annual basis, if a difference between the estimated and the actual residual price exists, it shall be considered as a loss³⁷. Operating Lessors shall include the lease property in the balance sheet, depreciating according to their normal depreciation standards, the rent shall be reported as an income and the indirect costs of the lease may be reported as expenses³⁸.

Conclusively, operating and civil leases in Mexico are true leases for legal, accountancy and tax purposes. Financial leases are true leases legally, however, considered to be sales for accountancy and tax purposes. On the other hand, all leases may be true or intended as security in the U.S., depending if the parties are following the guidelines of Article 2A, § 1-203, the FASB13, and the case law.

II. Legal Consequences under Mexican Law

Several distinctions need to be made in order to describe the legal consequences in Mexico regarding leases. The distinction between civil leases and operating leases is the hardest to

³⁵ Id. Section 10.

³⁶ Id. Section 15.

³⁷ Id. Section 17.

³⁸ Id. Section 19.

grasp and comprehend. Nonetheless, there is also a thin line between the differences of operating and financial leases.

2.1. Financial and Operating Leases

In nature operating and financial leases are more analogous to each other for several reasons, both of them are of Anglo-American origin, both of them are of commercial natures. Several sections of the General Law of Negotiable Instruments and Credit Operations regarding financial leases may apply to operating leases by analogy. The analogy between operating and financial has always existed; nevertheless, applying sections of the regulation under the General Law of Negotiable Instruments and Credit Operations concerning financial leases was impossible for legal purposes.

The General Law of Negotiable Instruments and Credit Operations was recently amended³⁹; financial leases were regulated in the Special-Purpose Financial Intermediaries Law.⁴⁰ Since 1985 through 2006 only Special-Purpose Financial Companies could enter into financial leasing agreements or capital leases. In 2006, the Mexican Congress decided to derogate the financial leasing agreement from the Special-Purpose Financial Intermediaries Law and moved it to the General Law of Negotiable Instruments and Credit Operations, creating Section VI within Title II of said statute. The mayor achievement with the mentioned reform is that now everyone can enter into financial leases and not just Special-Purpose Financial Companies, as lessors of course. If a regular commercial company offered to its lessee financial leases and enter into these kind of arrangement, prior to the mentioned legal reform, the consequences could even arise to the closure of the business.

Now, the legal consequences for confusing financial leases from operating lease are not very important, however, the tax consequences can have a major deterrence effect. When the tax authorities audit the companies, they not only review the books and records, but also

³⁹ July 18th, 2006.

⁴⁰ *Ley de Organizaciones y Actividades Auxiliares del Crédito.*

how the contracts are structured, and if the leasing contract, plus the books and records reflect that a simulated operating lease was entered into when in fact the operation is in the nature a financial lease, the tax authorities will impose serious and onerous penalties to both lessors and lessees

2.2. Operating and Civil Leases

In contrast with the merely no legal consequences for confusing financial with operating leases, when the parties want to enter into an operating lease, their counsels tend to confuse these kinds of leases with civil leases. The legal consequences for negligently confusing these two leases may be of major importance. Remember that operating leases are non-regulated leases and the general principles of contracts contained in the Federal Civil Code apply. In opposition, civil leases have a very defined regulation with particular emphasis in real estate leases.

Normally, it is included in the leasing agreements, the Hell or High Water Clause (*Force Majeure Clause*), imposing the risk of loss to the lessee. Articles 2431, 2432 and 2433 dedicated to civil leases impose the risk of loss to the lessor, following the principle of *res perit domino*⁴¹.

In contrast, Article 1858 of the same Code, establishes that at the presence of an innominated contract, the general rules of contracts apply and Article 2111 within this general rules articulate: “Nobody is obliged to Force Majeure, except when one of the parties has caused it or contributed to it, when either party has accepted that responsibility or when the law imposes it”. According to the transcribed Article, the Hell or High Water Clause will be perfectly legal if the risk of loss or destruction is imposed to the lessee.

Also, as mentioned in Part I supra, the rent has to be determined in civil leases and can consist in money or any other determinable thing, i.e. personal property. From the language of the Civil Code when the rent is paid with a determinable thing the transaction is more in

⁴¹ The thing perishes to its owner.

the nature of barter than leasing. On the contrary, the rent in most operating leases is not determined as in financial leases. Most lessors use floating rates to calculate the rent payments, therefore the danger to confuse it with civil leases, virtually the rent payment would be considered void for not complying with Article 2399 of the Civil Code⁴².

Most of the provision contained in the contract when dealing with operating leases, are creation of the contracting parties, therefore, the convenience to deal with the general principles of contracts, instead of the archaic regulation of civil leases. Perhaps the most important principle or notion is the freedom of contract, whether the parties can agree what rules will apply to their transaction. Said principles govern the U.C.C., § 1-302 (a) [§ 1-102(3)], the Mexican Commercial Code, Article 78, and the Mexican Civil Code, Articles 6 and 1796. However, the limitations on the freedom of contract principle are quite different, § 1-302 (b) [§ 1-102(3)] of the U.C.C. establishes that the obligations of good faith, diligence, reasonableness and care cannot be disclaimed by the parties. Horizontally, Article 6 of the Civil Code establishes that the will of the parties cannot contravene the law and only private rights that do not go against public policy or third party rights can be disclaimed or waived.

Another important distinction between civil and operating leases is the remedies the parties have to enforce the contract in case of breach. Civil leases have no special remedy like repossession, only eviction in case of real estate leases. In addition, there are no special remedies contained in the general principles of contract, so operating leases have no special remedy. Yet, the General Law of Negotiable Instruments and Credit Operations⁴³, regarding financial leases encompass the remedy of repossession in case of breach in favor of the lessor, and given the analogy between financial and operating leases, the operating lessor can benefit from this remedy.

Most of the sections regarding civil leases cannot be waived by express disposition and to do so would be against public policy and considered void. Alternatively, the vast majority

⁴² “ The rent or price of the lease may consist in a sum of money or in any other equivalent thing, that is certain and determined”

⁴³ Article 416 of the General Law of Negotiable Instruments and Credit Operations.

of the general principles of contract can be waived, therefore the convenience to follow them when dealing with operating leases.

The real legal consequences appear when the parties try to enforce the leasing contract before a court of law, being the role of the attorneys of the utmost importance, to convince the judges that the contract at hand is not a civil lease, but an operating lease. If the lessee wins and convinces the judge that the provisions of civil leases apply and for example the leased property was lost because of Force Majeure, the Hell or High Water clause in the operating lease contract would be void and null. On the other hand, if the attorney representing the lessor has the sufficient knowledge to argue that operating leases are atypical and innominated contracts, then in the same example of Force Majeure, the Hell or High Water clause would be enforced against the lessee.

III. May the parties choose which lease to be in?

The parties may choose which lease to be in, depending on the nature of the lease. All real estate leases are governed by the Civil Codes of the States, notwithstanding that the intervening parties are merchants; both substantive and procedural laws govern real estate leases in a very specific way. In light of this, the parties cannot choose which regulation to be in when dealing with real estate leases, the Civil Code will apply automatically and there is a special procedure called Controversy of Real Estate Leases⁴⁴ within the Rules of Civil Procedure in case of debate between the parties. When dealing with real estate leases both substantive and procedural laws are state laws.

If the leased property is personal property and the parties are merchants or one of them is⁴⁵, then the parties may choose which lease to be in: (i) financial; or (ii) operating. In contrast with real estate leases, both substantive and procedural laws covering financial and

⁴⁴ *Controversia de Arrendamiento Inmobiliario*.

⁴⁵ Article 1050 of the Commercial Code: "Whenever, in conformity with the mercantile provisions, of the two parties who enter into a contract, one is in the nature of an act of commerce and the other of a purely civil act, and such contract gives rise to litigation, it shall be prosecuted in conformity with the mercantile laws."

operating leases are federal, i.e. Commercial Code⁴⁶, Federal Civil Code, and the Federal Rules of Civil Procedure.

On the other hand, if the contracting parties are non-merchants, they cannot choose which lease to be in. The Civil Code will apply automatically and they will be dealing with personal property civil lease, regulated by the Civil Codes of the States.

If the parties choose to enter into a financial lease, they need to comply with the General Law of Negotiable Instruments and Credit Operations, the Bulletin D-5 and tax rules. The contract must be in the form and substance of a financial lease, and both the lessors and lessees have to treat the lease as a sale for accountancy and tax purposes.

On the contrary, if the parties choose to enter into an operating lease, the general principles of contracts within the Federal Civil Code apply, and for accountancy and tax purposes the lease is a true lease.

Also, the parties may choose to enter into a combination of a financial and operating lease, the perfect example being a synthetic lease, whereas the contract is in the nature of a financial lease, but for accountancy and tax purposes the lease is considered operating, however, the aforementioned can only be achieved when the leased property is personal property. If the property is real estate the synthetic lease cannot be entered into between the parties and would be considered void and against public policy by the courts as the rules of the Civil Code apply.

In conclusion when dealing with real estate leases, the lease will always be civil and the rules of the Civil Codes of the States apply. When the lease is entered into by non-merchants, again the rules of the Civil Codes of the States apply. Oppositely, when the parties are merchants, or one of them is, the parties may choose to enter into a financial or an operating lease, following either the rules of General Law of Negotiable Instruments and

⁴⁶ In Mexico all commercial laws are federal, in opposition to the U.S. that most of the commercial laws are local.

Credit Operations for the latter or the general principles of contracts within the Federal Civil Code for the former.

Conclusions

I. Mexico recognizes the existence of three kinds of leases: (i) civil; (ii) operating; and (iii) financial. Civil leases are regulated by the Civil Codes of the States and are divided in real estate leases and personal property leases. Real estate lease are always civil notwithstanding that the parties are merchants or that the property is for commercial purposes. Personal property civil leases are entered into by and between non-merchants and their regulation is also covered by the Civil Codes of the States.

Financial leases are commercial type leases and their regulation is covered by the General Law of Negotiable Instruments and Credit Operations, they are considered true leases for legal purposes and sales for accountancy and tax purposes.

Operating leases are non-regulated leases, atypical and innominated, they are regulated by the general principles of contracts within the Federal Civil Code; they are considered true leases along with civil leases for accountancy and tax purposes.

The leased property in both financial and operating leases needs to be personal property.

II. The U.S. has a different category of leases: true leases and leases intended as security. True leases are covered by Article 2A of the U.C.C. and leases intended as security by Article 9 and §1-203. Virtually all true leases may be considered by the courts as leases intended as security if the parties do not comply with the aforementioned Articles and Section of the U.C.C. Also, the U.S. accountancy tests contained in the FASB 13 determines if a lease is true or intended as security.

III. The Mexican leases do not match the U.S. leases, all leases in Mexico are true leases for legal purposes, however, financial leases are considered sales for accountancy and tax purposes. Leases in the U.S. need to be true leases for legal, accountancy and tax purposes.

IV. The legal consequences in Mexico depend on whether the lease is civil, operating or financial. The regulation for civil leases is focused primarily on real estate leases, being burdensome for the lessor, protecting the lessees against their unequal bargaining power and protecting the right to a home. The regulation on personal property civil leases is focused mainly on rural or agricultural leases. There is no remedy like repossession covered by the regulation of the Civil Codes.

If the lease is financial the parties need to comply with the General Law of Negotiable Instruments and Credit Operations, the lessor needs to give the lessee one of the three terminal options foreseen by Article 410 of the General Law of Negotiable Instruments and Credit Operations. The rules regarding financial leases cover the right of repossession in favor of the lessor and both lessors and lessees need to treat the financial lease as a sale for accountancy and tax purposes.

Finally, the consequences for confusing operating leases with civil leases are quite burdensome, as the regulation regarding civil leases within the Civil Codes departs from their nature of a commercial operating lease. The attorneys structuring the operation need to be very careful to follow the general principles of contracts contained in the Federal Civil Code, and use by analogy the provisions contained in the General Law of Negotiable Instruments and Credit Operations, concerning financial leases.

V. The parties may choose which lease to be in, if the leases are operating or financial. On the other hand, if the parties are non-merchants and the leased property is personal, the lease is always going to be considered civil. Additionally, if the leased property is real estate, the Civil Codes of the States will apply independently if the parties wanted it or not and the lease will also be considered civil.