

**THE ONE-EDGED SWORD:  
THE HIGH RISKS OF COMMERCIAL TRANSACTIONS IN MEXICO  
(DENOMINATED IN EITHER PESOS OR OTHER CURRENCY) CREATED BY  
MEXICO'S MONETARY LAW AND FREQUENT PESO DEVALUATIONS**

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### INTRODUCTION

Mexico has an interesting monetary law that can have ruinous results for the unwary who enter into commercial transactions in that country.<sup>1</sup> The instability of the Mexican peso presents the economic side of the dilemma, whereas Mexico's monetary law creates the legal side of the dilemma. Together they provide the proverbial final nail in the coffin to the unwary. The cyclical ups and downs of Mexican markets, including the historical and present rapid devaluations of its peso make this article particularly timely for those who have entered into or plan to enter into almost any type of commercial transaction in Mexico. Unfortunately, contracting parties usually give little thought to the consequences and terms of repayment obligations under a particular contract entered into in Mexico and to the effect of legal provisions such as the Fourth and Ninth Transitory Article<sup>2</sup> of the Monetary Law of Mexico,<sup>3</sup> other than providing that payment will be made at a particular time, using a particular currency, and at a fixed or variable rate or amount.

### STATEMENT OF THE PROBLEM

The general rule under Mexico's Monetary Law states that all payment obligations acquired within or outside of Mexico which are payable within Mexico, shall be paid in Mexican pesos at the exchange rate applicable at the place in, and date on which payment is made<sup>4</sup>. It is the exception to this general rule that can have ruinous results.

The problem exists in some specific transactions under Mexico's monetary law which may legally enable a debtor party to a contract to refund, repay, or reimburse pesos to the other contractual party at the rate of exchange existing at the time the amounts were originally received, and not at the rate of exchange when the amounts are reimbursed. This is the result, even if the contract expressly states that such refund or reimbursement will be paid in dollars (or other non-peso currency) at the rate of exchange existing at the time of the reimbursement.

This article discusses the exception to the general rule, where the result is that the creditor party can receive an economic windfall (if the peso devalues) since payment can legally be made in pesos at the rate of exchange that exists at the time the debtor party originally received the pesos, notwithstanding written terms of a contract to the contrary. The differing results under the general rule and the exception (which is the discussion of this article) are due to a timing difference the debtor party can legally use to determine the currency rate of exchange applicable to the transaction.

By way of illustration, assume a U.S. corporation, as a buyer enters into a real estate purchase contract to buy a tract of commercial real estate from a Mexican seller located in the State of Jalisco.<sup>5</sup> The real estate purchase contract provides that buyer will make a one million dollar down payment payable in either pesos or dollars.<sup>6</sup> Assume the rate of exchange on the date the down payment was made was N\$ 3.4 to the dollar, and that buyer paid the down payment in pesos totaling N\$ 3,400,000. If certain conditions precedent are not met, the contract expressly requires that seller or escrow agent "shall return the one million dollar (US\$ 1,000,000) down payment to Buyer payable in U.S. dollars, payable either within the U.S. or within Mexico."

Next, assume the conditions precedent were never satisfied under the contract and therefore the seller (or the escrow agent) is contractually required to return the US\$ 1,000,000 down payment to buyer. However, in the interim, assume the peso has devalued so the exchange rate is now N\$7.6 to the dollar, meaning of course the US\$ 1,000,000 down payment is now worth N\$ 7,600,000.

Herein lies the dilemma. After consulting Article Eight and the Fourth Transitory Article of Mexico's Monetary Law, the seller (or the escrow agent) tells the U.S. buyer that instead of repaying the US\$ 1,000,000 in dollars (remember the

contract expressly requires the return of the down payment "payable in U.S. dollars"), the Seller will only pay pesos at the "old pre-devaluation rate" in a total amount of N\$ 3,400,000. The law in Mexico provides that under these circumstances the U.S. buyer only has a legal right to receive N\$ 3,400,000 from the seller (or escrow agent), leaving the buyer with an economic loss of US\$ 552,632 ((N\$ 7,600,000 - N\$ 3,400,000 = N\$ 4,200,000)/N\$ 7.6).

The end result is the U.S. buyer has lost over half of the initial payment (US\$ 552,632) of the original US\$ 1,000,000 "refundable" deposit by virtue of the decline in the Mexican peso and the effect of the application of the Fourth Transitory Article of Mexico's monetary laws, notwithstanding the express terms of the contract. Nor does the buyer have any legal right to the real estate.

In this scenario, there is only bad news for this U.S. buyer, but the good news is that if the transaction had been structured properly, the buyer could have avoided the draconian effects of the Fourth Transitory Article of Mexico's monetary laws.

### **PURPOSE OF THIS ARTICLE**

The purpose of this article is threefold. First, it will discuss the scope of the Fourth Transitory Article of Mexico's monetary law and its effects. Second, this article describes some typical commercial transactions, including the above real estate transaction, that can be adversely effected by the application of the Fourth Transitory Article. Finally, the authors discuss what steps can be taken and how transactions can be structured so as to avoid the damaging effects of the Fourth Transitory Article.

### **BRIEF HISTORICAL BACKGROUND**

In order to better understand the logic (or lack thereof) of the Fourth Transitory Article, it is important to have a brief understanding of the historical roots of this provision of law in Mexico. In 1918, during the last stage of the Mexican Revolution, President Venustiano Carranza issued a presidential decree granting legal effect (*curso legal*) to foreign currency<sup>7</sup> (which at the time usually had intrinsic value apart from the governmental political unit that issued the currency). In those days, coins usually were made wholly or partially from precious metals such as gold and silver. There was therefore no reason to prohibit the circulation of foreign currency which held intrinsic value, since an ounce of gold had the same value worldwide regardless of the political state that manufactured the currency.<sup>8</sup>

This presidential decree was effective only until Mexico adopted a new monetary law in 1931<sup>9</sup> which allowed the manufacture of coins and notes that had nominal physical value and did not contain precious metals. At that time economic forces were driving the value of currencies depending upon the strength of the national economy that supported such currency. Since currencies no longer had intrinsic value, contracting parties wanted to know what (1) currency, and (2) equivalency exchange rates would be allowed, or required by law in various commercial transactions.

Due to this substantial modification to the nature of the currency then circulating, the new law contained, as it is common practice in Mexico every time a new law or statute is enacted, transitory provisions which allow the new law to become effective without disrupting transactions entered prior to its enactment. The transitory provisions of the Monetary law of 1931 provide the exception to the general rule contemplated in Article 8, for cases where the debtor party can demonstrate that it received Mexican currency. This provision grants a debtor the controversial right to reimburse the obligation in Mexican currency at the later date.

Initially, various jurists interpreted these provisions in different ways. Some jurists took the position that the law dictated that if a contract says that payment must be made in a non-peso currency, or at a predetermined rate, then indeed the terms of that contract should be enforced and payment must be made as reflected in the contract. The reasoning was that the exception contained in the Fourth Transitory Article would apply, based on its transitory nature, only to specific cases occurring prior to, or continuing up through 1931 in order to protect individuals that received Mexican currency at any time before the Monetary Law was adopted.

In contrast, other jurists took the view that has been upheld by the Supreme Court of Mexico. This school of thought interpreted the Fourth Transitory Article as having no place among the transitory provisions, assuming the legislature should have caused such provision to be an explicit exception to the rule contained in Article 8; which should have been incorporated as part of the law and not as a transitory provision.

Of course, these provisions and their legal interpretation and effect would have no real importance from an economic perspective if the Mexican currency were to remain relatively stable in comparison with other foreign currencies. This has not been the case in Mexico in the twentieth century.<sup>10</sup> These provisions were not seriously considered and analyzed by jurists, business people and their lawyers until some of the more recent major peso devaluations. As the Mexican peso has suffered sequential devaluations over the years, deteriorating its value against stable currencies such as the United States dollar, Article 8 and the Fourth Transitory Article of the Monetary Law have been used as a shield by debtors to avoid making payments in a non-peso currency. This provides the debtor with a windfall if the peso devalues between the time of the contract was entered into and the date of payment.

The most recent overnight devaluation occurred on December 20, 1994, when the peso went from N\$ 3.4662 to the dollar to N\$ 4.8875 in a rapid period of time, representing a forty-one percent devaluation.<sup>11</sup> The peso continued to decline throughout 1995, and at one point exceeded N\$ 8 to the dollar. The peso further declined in 1998 and at one point exceeded N\$ 10.69.

In times of currency devaluations, the Fourth Transitory Article and its interpretation becomes extremely important. The above differing interpretations of the Fourth Transitory Article were settled by the Mexican Supreme Court in its opinions discussed in more detail below.

## **LAW, SOURCE OF LAW AND ANALYSIS**

As previously mentioned, under the Mexican civil law statutory system, the statutes, regulations, codes and laws (leyes) are normally accompanied by so-called "transitory provisions" (disposiciones transitorias). These transitory provisions are used so that a piece of legislation may become effective taking into consideration that special circumstances may require different treatment. For example, the Mexican Federal Law of Civil Aviation, enacted as of May 12, 1995, provides in its Third Transitory Article that all violations that were incurred prior to the enactment of such law will be sanctioned in accordance with the provisions of law that were effective at the time of their occurrence.

Provisions of this sort by their nature are necessarily of limited application, during a limited period of time. Their sole purpose is to provide a solution to particular cases that normally pertain to a particular period of time when the exact application of a statute may be in doubt, or when special circumstances need to be taken into consideration to permit the new law to enter into effect.

In some rare cases however, transitory provisions of law in Mexico, because of their continuing nature, can permanently become part of the statute losing their "transitory nature." Such has been the case of the Fourth Transitory Article of the Monetary Law (*Ley Monetaria*) which, as translated into English, provides that:

Payment obligations in foreign currency [i.e., other than in Mexican pesos] which are acquired within Mexico and which are to be complied within Mexico, shall be paid as provided in accordance with Article Eight of the Monetary Law, unless the debtor demonstrates, with respect to loan or credit operations, the currency initially received from the creditor was national currency of any sort, or that with respect to other operations the currency in which the operation was originally contracted, was national currency of any kind; in these cases the referenced obligations shall be resolved and payable in national currencies [i.e., Mexican pesos] in accordance with Articles Four and Five of this Law, at the exchange rate applicable at the time the obligation was initially incurred, or if not possible, at the legal rate.<sup>12</sup>

The above provision was a transitory provision adopted when the Monetary Law was originally enacted in 1931. Many legal scholars believed the Fourth Transitory Article should only apply to cases in which obligations were acquired prior to the enactment of the 1931 law.

For some reason, the foregoing arguments were apparently ignored by the Supreme Court of Mexico which changed the transitory nature of this article treating it as a permanent provision of the Monetary Law.

The Mexican Supreme Court, ruled in favor of the debtors, apparently ignoring the provisions of President Carranza's Decree of 1918.<sup>13</sup> The authors' opinion is that had this decree been considered, the Fourth Transitory Article would have indeed been treated as transitory instead of as a permanent provision of law.<sup>14</sup>

The consequence is that during times of peso devaluations, many Mexican debtors of non-peso currency can legally refuse to pay the non-peso currency and instead pay in "devalued" pesos. This law has given rise to numerous and long lasting litigation disputes, and the recent peso devaluations of 1994, 1995 and 1998 will undoubtedly spawn more commercial controversies.

Herein lies the "one-edged" sword. Based upon the express language of the Fourth Transitory Article, only the debtor party can economically benefit from a currency change in value, i.e., a peso devaluation.<sup>15</sup> Under no circumstances does the creditor party have the legal power to economically benefit from the Fourth Transitory Article. The language of the Fourth Transitory Article says that ". . . the exchange rate applicable at the time the obligation was initially incurred . . ." will be applied "if the debtor demonstrates . . . the currency initially received . . . was national currency . . ." In this sense, the force of the Fourth Transitory Article is solely within the power of the debtor party since only the debtor party can "demonstrate" that payment was made in pesos. If the creditor party were to try to "demonstrate" the form of payment, the creditor's activities would arguably not fall within the scope of the Fourth Transitory Article.

If the peso were to strengthen in value, the creditor party would only be entitled to receive the non-peso currency equivalent of the earlier weaker value of the peso.<sup>16</sup> Thus, under the unlikely circumstance that the peso would increase in value (or where the peso remains the same value vis-a-vis other foreign currencies and the U.S. dollar devalues vis-a-vis other foreign currencies such as the yen or pound), the debtor party could pay the creditor party in non-peso currency at an economically cheaper exchange rate, i.e., at the rate of exchange that exists at the time of payment and not at the rate

applicable at the time the obligation was initially incurred.

These provisions and interpretations of Mexico's Monetary Law can be a trap to those unaware of its provision and the general legal environment in Mexico.<sup>17</sup> Fortunately, precautionary measures can be taken in negotiating and performing under a Mexican contract that can protect a creditor from the onerous provisions of the Fourth Transitory Article.<sup>18</sup>

### **HYPOTHETICAL RISKY TRANSACTIONS**

The scope and application of the Fourth Transitory Article can be surprisingly broad. These provisions of law can apply to almost any commercial transaction in Mexico where some form of payment is initially made in pesos and for some reason must be reimbursed. There is no requirement that one of the parties be foreign to Mexico and the same results can apply between two Mexican contracting parties. The provisions of the Fourth Transitory Article could apply to an almost innumerable array of transactions.

The following factual scenarios help demonstrate the application of the Fourth Transitory Article. The authors will then discuss various steps and protections to assist a client to avoid the adverse results of the Fourth Transitory Article.

### **REAL ESTATE PURCHASE CONTRACT WITH DEPOSIT**

This transaction was described above where a U.S. buyer makes a US\$ 1,000,000 "refundable deposit" in pesos to purchase real estate located in Mexico.

### **PURCHASE AND SALE OF GOODS - WITH A LETTER OF CREDIT**

The second example, is where a U.S. buyer enters into a contract to purchase twenty thousand Mexican widgets from a Mexican manufacturer ("MEX.S.A.") for the equivalent of "US\$ 30 per widget payable either in Mexican pesos or in U.S. dollars." The Mexican widgets are used in personal computers and the rapid changes in technology can make them obsolete. Therefore, the terms of the purchase contract negotiated by the U.S. buyer grants an ". . . unconditional contractual right to return any or all of the Mexican widgets within forty five (45) days from receipt, in the event there is a material technological development that makes the Mexican widgets obsolete."

The terms of the contract further provide that upon the return of any or all of the Mexican widgets, MEX.S.A. shall pay directly to U.S. buyer the equivalent of US\$ 30 per widget, payable either in U.S. dollars or in Mexican pesos." The U.S. buyer shall bear the costs and risks of transportation under the contract.<sup>19</sup>

The transaction is financed using an irrevocable letter of credit confirmed by the Mexican bank for MEX.S.A. Assume the initial sale goes smoothly and the U.S. bank for U.S. buyer draws from the U.S. account to pay the full purchase price of US\$ 600,000 to an account for the benefit of MEX.S.A. However, as provided in the agreement, instead of paying MEX.S.A. US\$ 600,000 in dollars, the bank instead pays the then peso equivalent of N\$ 2,040,000 (N\$ 3.4 to the dollar). After U.S. buyer has used only 1,000 of the widgets and within 45 days after receiving the Mexican widgets, technology makes them obsolete, and under the express terms of the contract U.S. buyer can return the remaining 19,000 widgets and receive US\$ 30 per widget (19,000 x US\$ 30 = \$570,000). During this time the peso has devalued from N\$ 3.2 to N\$ 7.6.

Under the above scenario, applying the Fourth Transitory Article, the U.S. buyer is only entitled to receive as a reimbursement US\$ 255,000 (US\$ 570,000 X 3.4 = N\$ 1,938,000/7.6 = US\$255,000).<sup>20</sup>

### **LEASING OF MANUFACTURING EQUIPMENT BY MAQUILADORA**

The final example used for illustration purposes applies to a Mexican corporation ("MAQUIL") operating as a maquiladora. MAQUIL enters into a five year finance lease agreement to lease manufacturing equipment from another unrelated manufacturing corporation ("LESSOR"). MAQUIL has an affiliated U.S. corporation that operates in the United States ("USCORP") that markets and distributes all of the products manufactured by MAQUIL. USCORP often finances various operations and financial needs of MAQUIL directly or indirectly through U.S. banks since the cost of money is usually cheaper and more stable in the U.S. (including the financial requirements under the lease).

The finance lease of manufacturing equipment requires MAQUIL to make a refundable "initial rental payment" of US\$ 500,000 (payable in either dollars or in pesos at the current rate of exchange) to LESSOR. This US\$ 500,000 is refundable to MAQUIL over the life of the contract if certain maintenance standards, units of production, and insurance requirements are maintained. The terms of the lease contract require that these ". . . repayments shall be made and payable to MAQUIL in U.S. dollars." Separately, MAQUIL makes monthly lease payments of N\$ 350,000 under the contract, with adjustment factors that reflect inflation, interest rate risks, and an adjustment for Mexico's value added tax.

Assume further that USCORP obtains the initial financing for the lease from U.S. banks, and then USCORP loans U.S. dollars to MAQUIL in order for it to meet its payment obligations under the lease (including the US\$ 500,000 "initial rental payment"). MAQUIL generally uses pesos to pay its obligations arising in Mexico and therefore pays LESSOR the "initial

rental payment" in pesos at a time when the rate of exchange is N\$ 3.4 to the dollar, and therefore makes a total "initial rental payment" of N\$ 1,700,000. During the five year life of the contract, MAQUIL satisfies all maintenance standards, units of production, and insurance requirements under the contract so that it is entitled to the return of the US\$ 500,000 "initial rental payment" at the end of the five years. Finally, in the interim the rate of exchange went from N\$ 3.4 to the dollar to N\$ 7.6.

MAQUIL will not receive the US\$ 500,000 as required under the express terms of the contract. Instead LESSOR is only obligated under the Fourth Transitory Article to pay at the earlier rate of exchange (N\$ 3.4) and therefore must only pay US\$ 223,684 ((US\$ 500,000 x N\$ 3.4)/N\$ 7.6). The result is that MAQUIL will suffer a significant unexpected economic loss, and in turn so will its affiliated company USCORP if MAQUIL cannot make its payments to USCORP, since USCORP is obligated to pay the full loan amounts to the U.S. banks in U.S. dollars.

## **PROTECTIVE STEPS**

In each of the above examples, the transactions were structured in a manner that caused the creditor party to suffer very significant economic losses because of the application of the Fourth Transitory Article. Fortunately, protective steps could have been taken to avoid these disastrous results. This part of the article discusses what steps can be taken and how transactions can be structured to help assure that the draconian affects of the Fourth Transitory Article are not leveled against an unwary party.

Probably, the most important point to make is that contracting parties can not protect themselves by contractually waiving the requirements of the Fourth Transitory Article. The Mexican Supreme Court makes clear that the Fourth Transitory Article takes precedence over the contractual will of the parties. For instance, there would have been no legal effect to a contractual provision negotiated by the Maquiladora lessee (MAQUIL) that stated "notwithstanding any Mexican law to the contrary, the return of the US\$ 500,000 initial rental payment shall be payable in U.S. dollars or its equivalent at the rate of exchange existing at the time payment is due under the contract." In this case, the manifested intent of the contracting parties will not be honored by a Mexican court when the debtor refuses to pay the US\$ 276,316 of the total US\$ 500,000 called for in the contract. The Mexican Supreme Court makes it very clear that the will of the parties in this case will be ineffective.

## **PROTECTIVE STEPS WHEN INITIALLY STRUCTURING THE TRANSACTION**

Fortunately, the steps that can be taken to protect contracting parties can be fairly simple.

First, and most importantly, the party needs to make sure the initial payment was made in U.S. dollars (or the foreign currency of choice) and not Mexican pesos. This automatically brings this type of transaction within the realm of Article 8, thereby requiring payments to be made in non-peso currency, or Mexican pesos at the rate of exchange existing at the date of payment (not at the date the monies were initially received).

This is the best and most protective step that can be taken. In the above examples, the real estate purchaser simply needed to pay the US\$ 1,000,000 refundable deposit in dollars; the widget purchase price in U.S. dollars; and the refundable US\$500,000 lease deposit in dollars.<sup>21</sup> Most Mexican businesspersons are more than willing to accommodate a transaction so as to receive U.S. dollars as the form of payment.<sup>22</sup> As an evidentiary matter, a company should make sure that it receives a signed receipt from the payee, at the time payment is made in non-peso currency, and the receipt clearly reflects that payment was made in a currency other than pesos.

Second, if the financial costs of the transaction are great enough, a company might want to use a third party to the transaction such as a financial institution or escrow entity. With a third party, the creditor company can pay the amounts due under the contract to the third party in U.S. dollars or other non-peso foreign currency. The transactional documents could provide that any reimbursements due to the creditor party would be made by the financial institution third party, instead of the debtor party and that in the event the debtor party brings an action against the creditor party under the Fourth Transitory Article, the transactional documents will require the financial institution to indemnify the creditor party for any such damages. The third party would directly pay the "debtor company" in any currency form it chooses, thereby effectively shifting this commercial risk under the Fourth Transitory Article to the third party. This approach effectively shifts these risks to the third party financial institution, where presumably a Mexican financial institution can better assess the legal risks of Mexico, pertinent changes in the law, and foreign and domestic currency risks. Of course, this type of scenario will increase the costs of the transaction, but effectively provides a protective layer to the creditor company.

If a bank is a party to a transaction, the creditor party needs to make sure that any exchange of monies with a bank is bifurcated from any transfers of funds between the contracting parties. In other words, if a bank loans the creditor party pesos, the creditor party should make sure the relationship between it and the bank does not allow the bank's actions to be imputed to the creditor party as its agent. The creditor party should expressly hold the bank liable (and require indemnification from the bank) in the event the bank pays pesos to the debtor party. The authors recommend that this

approach normally be used when transactions are large and the economic risks of peso devaluations are high.

Next, the creditor party can protect itself by making sure the payment obligations are contractually required to be made physically outside of Mexico, and that any payments are indeed made outside of Mexico, thereby falling outside the scope of the application of the Fourth Transitory Article of Mexico's Monetary Law. For example, USCORP in the leasing example above should have contractually required for the initial refundable payment of US\$ 500,000 to be financed in such a way that payment is made to LESSOR in a U.S. bank account (or any other bank account physically located outside of Mexico, which will protect the transaction from the draconian effects of the Fourth Transitory Provision).<sup>23</sup>

Fourth, another protection method (although with less certain results because of questions relating to the meaning of the express terms of the Fourth Transitory Article) would require that some or all of the obligations (other than payment) under the contract be performed outside of Mexico. Remember, the Fourth Transitory Article only applies when "performance of those obligations is to take place within the United Mexican States." If all of the performance occurs outside of Mexico then this law might not apply to the transaction when determining what choice of law should apply. Nevertheless, if a Mexican debtor party brings an action against a foreign creditor party in a Mexican court, the Mexican court might well apply Mexican law and the provisions of the Fourth Transitory Article.

More problematic is whether this statute applies to the entire contract and its payments (or only a portion), when only part of the contractual obligations are performed outside of Mexico. Perhaps a court would make some type of allocation under the Fourth Transitory Article where only a portion of the payments may be subject to the Fourth Transitory Article? Because of the uncertainties surrounding this question, the authors think that this protective step is generally unadvisable (especially in light of the high probability that a Mexican debtor party would have an incentive to bring an action in a Mexican court for purposes of applying the Fourth Transitory Article to the detriment of the creditor party who may be from a foreign jurisdiction).

#### PROTECTIVE STEPS WHEN THE TRANSACTION ALREADY EXISTS

The above protective steps are relevant only before a transaction has been negotiated and entered into. These protective steps allow one to structure a transaction for purposes of avoiding the unintended consequences of the Fourth Transitory Article. But what if a transaction has already been negotiated and one of the parties realizes they could suffer a severe economic loss if there is another peso devaluation? What steps can be taken at this point?

Although it is advisable to initially structure a transaction in a manner that protects against the draconian effects of the Fourth Transitory Article, a party can take certain post-transaction steps for protective purposes **before a peso devaluation has occurred**. Once a peso devaluation occurs, there is very little the creditor party can do except to avoid the economic losses of yet another possible peso devaluation.

In each of the above examples (the real estate purchase contract, the sale of widgets, the equipment lease by the maquiladora) the creditor party could negotiate with the debtor party to return the initial payment of pesos in exchange for a dollar payment in an amount equivalent to the pesos at that point in time. If the other party is accommodating and agrees to such reimbursement in pesos and repayment in dollars (or other non-peso currency), the creditor party should make sure the form of payment is adequately documented and that the debtor party expressly agrees to such transactions. This scenario, however, would be equivalent to entering into a new or supplemental contractual relationship and would inevitably require the other party to agree to such an arrangement.

Alternatively, the creditor party could negotiate an early termination of the contract (thereby having a right to receive pesos before they become devalued) and then renegotiate a new contract. The economic benefits of renegotiating an entire transaction might well be worth the time and transactional costs, considering the potential losses that could be suffered by applying the Fourth Transitory Article. Both of these approaches require the consent of the debtor.<sup>24</sup>

#### CONCLUSIONS

Mexico's Monetary Law, and specifically its Fourth Transitory Article can have disastrous consequences to a creditor party that originally makes a payment in pesos and believes the terms of any contract and the will of the parties would be honored under Mexican law. As the examples in this analysis demonstrate, this assumption would be erroneous and can create highly unintended consequences. Fortunately, advanced planning of any commercial transaction in Mexico that requires some type of payment, reimbursement, refund, or other similar consideration, can avoid the application of the Fourth Transitory Article.

The constantly changing economic environment in Mexico requires that a business participant from outside of Mexico be aware of the mechanisms at their disposal to limit risks and be able to adequately plan for long term transactions. Although the economic environment in Mexico can carry many risks, these same risks can bring with them many economic advantages to the foreign business person if appropriate legal steps and business precautions are taken.

Businesses can avoid some of the economic risks associated with Mexico's historic and persistent peso devaluations by

having an appreciation of the legal environment in Mexico in general and of the specific application of the Fourth Transitory Article of Mexico's Monetary Law.

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## ENDNOTES

1. *Ley Monetaria de Los Estados Unidos Mexicanos (Legislación Bancaria)*, Publicada en el Diario Oficial de la Federación el día 27 de julio de 1931. Modificada en 1935. Modificada por última vez por decreto publicado el 8 de diciembre de 1992. This monetary law is a federal law and applies to transactions in Mexico, whether the transaction took place in the State of Jalisco, Monterrey, Quintana Roo, the Federal District, or any other location in the Republic of Mexico.

2. Throughout this article, the fourth transitory article of Mexico's Monetary law is referred to as the "Fourth Transitory Article," and was adopted in 1931 along with the new monetary law. The Ninth Transitory Article was adopted in the 1935 amendments to the monetary law and is almost identical in language, except for a minor difference relating to the timing of when the applicable exchange rate should be determined. See footnotes 12 and 15. Both the Fourth Transitory Article and the Ninth Transitory Articles are transitory articles. This article refers to the Fourth Transitory Article throughout, and the authors mean to also include the minor revisions that were made by the Ninth Transitory Article each time reference is made to the Fourth Transitory Article.

3. *The Fourth Transitory Provisions, Monetary Law*, Published at the Official Daily, July 27, 1931.

4. This rule is set forth in Article 8 of the Monetary Law (Artículo 8o de la Ley Monetaria) and is not a transitory provision of law. Official Daily, January 8, 1986 (Diario Oficial de 8 de enero de 1986).

5. The application of the Fourth Transitory Article normally applies equally to contracts for "personal" use and contracts for "commercial" use. The Fourth Transitory Article would apparently apply equally to a real estate purchase of a personal home as it would to a purchase of commercial property.

6. Please understand the Fourth Transitory Article could apply to an almost infinite number of transactions and therefore these hypothetical transactions are only provided for purposes of illustrating the application and consequences of the Fourth Transitory Article. Any party to a commercial transaction in Mexico that requires (1) contractual performance in Mexico, and (2) some type of payment, reimbursement, refund, or other similar consideration which must be complied within Mexico, should be wary of the potential application of the Fourth Transitory Article (regardless of the nationality of the creditor party).

7. *Presidential Decree for the recognition of legal effect to foreign currency*, Published in the Official Daily, May 17, 1918 (Diario Oficial de 17 de mayo de 1918).

8. The third article of the presidential decree established legal effect for currencies made of gold at the equivalency of one Mexican gold peso to three quarters of a gram of pure gold (*supra*). (Diario Oficial de 17 de mayo de 1918).

9. This law was then modified in 1935, amending Article 8, changing the date upon which the value of the currencies was to be determined in relation to the repayment date. Originally, the 1931 law provided that the value of the currencies was to be fixed as of the date the contractual obligation arose between the parties, whereas the 1935 amendments (which adopted transitory article 9, see footnotes 5 and 15) provided that the value of the currencies can be fixed as to the date at which the contractual obligation was acquired or if not determinable, then at the date at which repayment is actually made. The Fourth Transitory Article only referred to the date when the money was initially received (which is not necessarily the same date at which the contractual obligation arose) or if this date was not determinable, then at the rate determined by the competent authorities (however, since 1935 the government has never fixed such a rate).

10. Principle Peso Devaluations in Mexico During the 20th Century:

	<b>Year</b>	<b>Percentage Devaluation</b>	<b>Change in value</b>	<b>President in Office</b>
1	1902	13.3	2.11 to 2.39	Porfirio Díaz
2	1913	35.1	2.08 to 2.81	Francisco I. Madero
3	1914	17.4	2.81 to 3.30	Victoriano Huerta
4	1915	237.9	3.30 to 11.15	Eulalio Gutierrez
5	1916	113.7	11.15 to 23.83	F. Lagos Chazaro
6	1931	17.3	2.65 to 3.16	Ortiz Rubio
7	1932	19.2	3.16 to 3.50	A.L. Rodriguez
8	1933	10.8	3.16 to 3.60	A.L. Rodriguez
9	1938	25.6	3.60 to 4.52	Lazaro Cardenas
10	1939	14.8	4.52 to 5.19	Lazaro Cardenas
11	1948	18.4	4.85 to 5.74	Miguel Aleman
12	1949	39.5	5.74 to 8.01	Miguel Aleman
13	1954	44.5	8.65 to 12.50	A. Ruiz Cortinez
14	1976	22.9	12.50 to 15.36	L. Echeverria
15	1977	46.9	15.36 to 22.56	J. Lopez Portillo
16	1982	257.9	24.48 to 87.62	J. Lopez Portillo
17	1983	71.5	87.62 to 150.30	M. De la Madrid
18	1984	23.3	150.30 to 185.27	M. De la Madrid
19	1985	69.3	185.27 to 313.73	M. De la Madrid
20	1986	103.2	313.73 to 637.63	M. De la Madrid
21	1987	120.2	637.63 to 1404.02	M. De la Madrid
22	1988	63.2	1404.02 to 2291.24	M. De la Madrid
23	1990	14.4	2481.08 to 2837.13	Carlos Salinas

Source: La Carpeta Púrpura, No. 179, January 6, 1995 (page 8).

11. Source: La Carpeta Púrpura, No. 179, January 6, 1995 (page 8).

12. The literal text in Spanish of the Fourth Transitory Article provides in part as follows:

*Las obligaciones de pago en moneda extranjera contraídas dentro de la República para ser cumplidas en ésta, se solventarán en los términos del artículo 8o de esta ley, a menos que el deudor demuestre, tratándose de operaciones de préstamos, que la moneda recibida del acreedor fuera moneda nacional de cualquier clase, o que tratándose de otras operaciones, la moneda en que se contrajo originalmente la operación, fue moneda nacional de cualquier clase; en estos casos las obligaciones de referencia se solventarán en monedas nacionales, en los términos de los artículos 4o y 5o de esta ley, respectivamente, al tipo que se hubiere tomado en cuenta al efectuarse la operación para hacer la conversión de la moneda nacional recibida a la moneda extranjera, o si no es posible fijar este tipo, a la paridad legal. [Artículo 9 substituye la frase "... a la paridad legal" por lo siguiente "... al que haya regido el día en que se contrajo la obligación.]*

13.

a. *Semanario Judicial de la Federación. Época 7a: Tomos 151-156, Pág. 221; Tomos 163-168, Pág. 103; Tomos 109-114, Pág. 121; Tomos 139-144, Pág. 85; Tomos 151-156, Pág. 222; Tomos 193-198, Pág. 94. época 8a: Amparo Directo 2063/87 Pérez Avella y otra; Amparo Directo 478/86 Valencia Caballero. Informe de la Suprema Corte de Justicia de la Nación.*

b. *OBLIGACIONES CONTRAIDAS EN MONEDA EXTRANJERA, CUMPLIMIENTO DE LAS.- Amparo directo 2995/78. Blanca Aquila Lechuga de Rosado. 14 de enero de 1980. Unanimidad de 4 votos. Ponente: Raúl Lozano Ramírez. Secretario: José de Jesús Taboada Hernández. - Precedentes: Amparo directo 2450/77. "Mas de Reynosa", S.A. 26 de junio de 1978. Unanimidad de 4 votos. Ponente Raúl Cuevas Mantecón. Secretario: Gabriel Santos Ayala. - Amparo directo 5455/77. Banco de Londres y México, S.A., Sucursal Durango. 30 de junio de 1978. Unanimidad de 4 votos. Ponente: Raúl Lozano Ramírez. Secretario: Carlos Alfredo Soto Villaseñor. - Informe 1980. Tercera sala. Número 60. Pág. 64.*

c. *OBLIGACIONES EN MONEDA EXTRANJERA O SU EQUIVALENTE EN MONEDA NACIONAL, CUMPLIMIENTO DE LAS.- Amparo directo 2995/78. Blanca Aquila Lechuga de Rosado. 14 de enero de 1980. Unanimidad de 4 votos. Ponente: Raúl Lozano Ramírez.- Precedentes: Séptima Época: Volúmenes 105-144. Cuarta Parte. Pág. 122 (2 asuntos).- Semanario Judicial. Séptima Época. Volúmenes 133-138. Enero-*

junio de 1980. Cuarta Parte. Tercera sala. Pág. 164.

d. OBLIGACIONES EN MONEDA EXTRANJERA MUTUO EN EL QUE PARTE DEL PRESTAMO SE RECIBIO EN MONEDA NACIONAL. Séptima Época, 4a parte, Volúmenes 151-156, Pág. 221 Amparo Directo 6286/80. Carlos Villarreal Alanís y Ma. Elena Medina Ríos de Villarreal. 5 votos. Semanario Judicial de la Federación. Jurisprudencia del Poder Judicial de la Federación. Tesis de Ejecutorias 1917'1985. Apéndice al Semanario Judicial de la Federación. 4a parte. 3a Sala, México 1985, Págs. 528 y 529.

14. See also, Lic. Francisco Borja Martínez, *Aplicabilidad de Normas Transitorias Referidas al Pago de Obligaciones en Moneda Extranjera, HOMENAJE A MANUAL BORJA MARTÍNEZ* (México, 1992 - Editorial Porrúa).

15. The Fourth Transitory Article requires the debtor party to "demonstrate" that payment was originally made in pesos, thereby placing the initial burden of proof on the shoulders of the debtor party before any reimbursement can be made in devalued pesos.

16. For example, assume the rate of exchange that exists at the time payment is due is N\$ 6.5 to the dollar, and the rate applicable at the time the obligation was initially incurred was N\$ 7.5 to the dollar. If the creditor party originally paid the debtor party N\$ 750,000, then the debtor party would only pay dollars in the equivalent amount of N\$ 650,000 as the reimbursement payment, and of course would have no incentive to "demonstrate" that payment was initially made in pesos.

17. Before the authors explain how transactions can be structured to avoid the draconian effects of the Fourth Transitory Article, there are two important statutory provisions that should be considered. First, if a transfer of funds in non-pesos is made outside of Mexico to a payee/trustee, or other holder (with a right to later receive the monies), then the payor/creditor party has a right to a return of those monies in the currency originally paid (Paragraph 3 of Article 8 of the Monetary Law). The payee, trustee cannot return the amounts in pesos at the "old and devalued" exchange rate. In the above example of the real estate purchase contract, assume the contract provided the initial one million dollar (US\$ 1,000,000) down payment shall be made by Buyer within the U.S. in an account established by Seller with a U.S. bank." Assuming the Buyer paid the peso equivalent of N\$ 3,400,000 at the time of the deposit, the Buyer will nonetheless be entitled to the full US\$ 1,000,000 at the time of the reimbursement (even if the peso equivalent now requires 7.6 million pesos to equal one million dollars). Under this scenario, the Buyer will have a right to one million dollars or 7.6 million pesos and will not suffer an economic loss of US\$ 552,632. Secondly, if a deposit is made with a Mexican bank, and this fact is determined by a competent authority, the depositor has an unconditional right to a return of the exact kind of funds (even though banks become more than mere trustees of the deposit under Mexican law) (Paragraph 4 of Article 8 of the Monetary Law). The Civil Code of Mexico provides that any deposit by its nature should be returned or restored in the same kind. If dollars are deposited in an account then dollars in the same amount must be returned to the depositor (and the same would apply to any other form of deposit). For instance, if a person or company deposits US\$ 100,000 with a bank at a time when the peso was valued at N\$ 3.4, the bank cannot return only N\$ 340,000 to the depositor at a time when the peso has devalued to N\$7. The depositor is entitled to US\$ 100,000. Nor does this provision mean that a depositor would have a right to receive more than N\$ 340,000 if the deposit was originally made in pesos (even if the non-peso currency equivalent is worth much more).

18. Companies should also be aware of the special U.S. income tax consequences of these type of transactions, of the gains or losses relating to the currency (whether amounts are actually paid in a foreign currency or not, including certain payments when the amounts are based upon a reference to a foreign currency) apart from the separate tax consequences of the underlying transaction. The tax results and treatment of exchange gains and losses (their timing, amount, source and character) can be enormously different depending upon whether the U.S. dollar, the Mexican peso, or other foreign currency is the "functional currency" of the taxpayer under Section 985 of the U.S. Tax Code. See Internal Revenue Code ("I.R.C.") Sections 985-89. These foreign currency transactions are taxed differently (plus there may be different book and record keeping requirements, as well as required accounting methods) depending upon a number of factors including whether the U.S. entity is a corporation, partnership, trust, estate, or "qualified business unit" ("QBU"). Certain debt obligations are expressly included under the foreign currency transactions of Section 988. I.R.C. § 988(c)(1)(B)(i) and Treas. Regs. §1.988-1(a)(2)(i). Plus, the accrual of certain expenses or gross income or receipts that are to be paid or received after the date on which the transaction was originally accrued, are normally included as a Section 988 currency transaction. I.R.C. § 988(c)(1)(B)(ii) and Treas. Regs. §1.988-1(a)(2)(ii). However, certain contracts for the purchase or sale of goods in the future are not Section 988 transactions even if the underlying contract is denominated in a foreign currency or determined in reference to the foreign currency (non-functional currency). Treas. Regs. §1.988-1(a)(6). A detailed discussion of the foreign currency tax rules under I.R.C. Sections 985-89 are beyond the scope of this article, but foreign currency exchange gains and losses should be planned for and considered in these type of transactions.

19. Interestingly, this type of transaction would probably be governed by the U.N. CONVENTION ON CONTRACTS FOR THE INTERNATIONAL SALE OF GOODS. Article 1 of this Convention provides that it shall apply "to contracts of sale of goods between parties whose places of business are in different States: (a) when the States are Contracting States . . ." In this case, both Mexico and the United States are contracting states of the Convention and the places of business are in each of the two states, respectively.

20. This result also seems to hold true when applying the U.N. Convention (see footnote 22), even though the Convention normally respects the will of the parties and their intent as expressed in various writings, words, and acts (see for example Article 6 which provides that the "parties may exclude the application of this Convention or, subject to Article 12, derogate from or vary the effect of any of its provisions"). The Convention does not determine the choice of law that is to apply to a particular transaction. For example, Article 54 of the Convention provides that "The buyer's obligation to pay the price includes taking such steps and complying with such formalities as may be required under the contract or any laws and regulations to enable payment to be made." In this case, the Fourth Transitory Article would arguably be one of the laws that would be applicable (assuming Mexican law would apply) since it is a formality under Mexican law.

21. Companies can take precautionary measures to make sure that payments of these sorts are made in U.S. dollars (or non-peso currency) by establishing internal accounting and payment controls requiring approval from management or legal personnel before such payments are made.

22. Please understand, that any party to a contract, where performance is to take place in Mexico, has the legal right to pay pesos (although without necessarily obtaining an economic windfall if the Fourth Transitory Article does not apply), even in transactions where the parties contractually agree to make payments in some other currency such as dollars. See Article 8 of the Monetary Law. Additionally, in certain

*transactions, for instance, residential real estate leases, Mexican law is even more strict and specifically forbids parties to enter into lease agreements where payment is to be made in a currency other than pesos. Art. 24480 of the Federal Civil Code of Mexico.*

*23. For purposes of illustrating the above real estate purchase contract hypothetical, assume the contract provided that the initial one million dollar (US\$ 1,000,000) down payment shall be made by Buyer within the U.S. in an account established by Seller with a U.S. bank." Assuming the Buyer paid the peso equivalent of N\$ 3,400,000 at the time of the deposit to the U.S. bank account, the Buyer will be entitled to the full US\$ 1,000,000 at the time of the reimbursement (even if the peso equivalent now requires 7.6 million pesos to equal one million dollars).*

*24. Careful planning of "exit strategies" out of a business relationship in Mexico, and early termination provisions of a contract are probably of greater importance in commercial transactions in Mexico than in the U.S., since there are greater economic swings, and thus potentially greater financial risks related to peso devaluations, hyper-inflation, etc.*