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The Dilemma Surrounding International Real Estate: To Lend or Not to Lend?

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Americans have been buying unprecedented amounts of real estate in other countries, specially in Latin America and the Caribbean, including Mexico, Costa Rica, Dominican Republic, Panama, and Brazil, to name a few. Most of these purchases are vacation or retirement properties, but plenty of people are also buying for investment purposes. Much of this trend is connected to the increased wealth in the United States, which seems unlikely to change anytime soon, considering the number of well-off baby boomers inching closer to retirement. Multiple US-based real estate developers have also ventured into these markets.

These buyers and developers constantly require—or would like access to—financing sources. Unfortunately, local financing for US buyers or developers within these countries is extremely rare, and traditional financing sources in the United States have been reluctant to lend money for these ventures. In recent years, though, a number of nontraditional lenders, such as venture capitalists and other funds, have been lending money for these projects, and a number of more “traditional” sources, including GE Capital, GMAC-RFC, and others, have been entering the market.

RISK AND REWARD

Traditional financing sources in the United States are still very skeptical of other countries’

legal systems and other issues involved in lending money to buy and/or develop land outside of the United States. Some of these fears are generated by taboos and/or lack of information. One must recognize, however, that the risks of investing in these ventures may be greater than the risks of similar investments in the United States. These risks greatly increase if the lender does not perform the appropriate due diligence and is not duly assisted by legal counsel able to understand the differences of doing business in foreign jurisdictions. But the principle of “the greater the risk, the greater the return” also applies in these transactions. The rates and fees that lenders charge in these enterprises are far greater than those they charge in similar domestic operations.

Lenders’ typical questions include: How do I protect my investment? Would I recover my money if the borrower defaults? Can I obtain a mortgage that would be easily enforced in the event of a default? The legal systems in these countries have been improving; however, lenders must be prepared to deal with legal systems that may be substantially slower and, in some situations, less reliable than the US system. Unfortunately, problems of corruption and incompetence, while decreasing in the last few years, still exist.

Nonetheless, all these systems have mechanisms that allow lenders to obtain mortgages on the properties they are financing in a form that

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should, in theory, grant protections similar to those for mortgages in the United States. In addition, some of these countries will have other mechanisms, for example, trusts, intended to give lenders additional control on the projects financed.

THE SITUATION IN MEXICO

In Mexico, for example, lenders may obtain mortgages on the properties they are financing. These mortgages are created through a public deed executed by the borrower (and sometimes the lender) with a Mexican notary public. The mortgage (a) gives the lender the right to foreclose on the mortgage in the event the borrower defaults on his or her obligations under the loan and (b) guarantees that the lender will be paid from the proceeds in the same order of preference as the mortgage. In other words, if the lender has a mortgage in first place, the proceeds will be first used to pay the lender, but if the mortgage is in third place, the lender would get the remainder after the mortgages or liens in first and second place are paid off.

The foreclosure process has changed during the last few years, and legislation in different Mexican states may vary widely. Lenders must verify that their contracts contain paragraphs giving the lender the most favorable choice of law and choice of forum. As an example, the legislation for the Federal District (Mexico City) contains some very favorable provisions for lenders, including broad protection for the lender's rights and fairly straightforward foreclosure proceedings, with shorter timeframes for the process and limited defenses and motions that would allow the borrower to delay the foreclosure proceedings.

Mexico's General Law of Commercial Paper and Lending Operations (*Ley General de Títulos y Operaciones de Crédito*) regulates a form of trust (*fideicomiso*) in which the lender is designated as the primary beneficiary under the trust and the borrower is the secondary beneficiary. The lender's interest in the trust terminates upon payment of all the borrower's obligations. Should the borrower default on the loan, the lender has the right to instruct the trustee (which by law must be a Mexican financial institution) to sell the property to pay the amounts owed to the lender.

The trust is designed to provide the lender more control over title to the property and a quicker remedy in the event of a default without the need to go to court to obtain relief. However, if the borrower/secondary beneficiary challenges the instructions that the lender provides to the trustee, it is unlikely that the trustee would follow the lender's instructions without a court order. In this case, the lender would likely have to go to court to obtain an order directing the

trustee to follow the lender's instructions. Furthermore, the borrower might challenge each and every action proposed by the trustee to sell the real estate, which might force the lender into constantly going to court to obtain new orders. Obtaining these court orders may be as or even more complicated than the foreclosure process under a mortgage.

There are different forms to help lenders diminish the risks of a borrower dragging on the legal process. Lenders should use devices to give those associated with the borrower strong reasons not to interfere with the lender's rights. One example is to request personal guaranties from the borrower's principals, which may motivate them to refrain from interfering with the foreclosure process if the proceeds of the sale would be sufficient to satisfy all the obligations under the loan, thus avoiding legal actions against such principals. Another alternative is the inclusion of the so-called "bad boy" personal guaranties that provide the lender will not exercise its rights under the personal guaranties unless the lender or the guarantors take any action to prevent or delay the lender from exercising its rights.

If the lender has enough operations in Mexico or other jurisdictions that allow the use of guaranty trusts, the lender may consider forming or associating itself with a financial institution that may serve as trustee of the trusts formed to guarantee the lender's loans. In the event the borrower/secondary beneficiary defaults, if the lender controls the trustee, the lender would have a much better chance of convincing the trustee to proceed to sell the property even if the borrower objects to such sale. One of the more visible examples of this structure is provided by GE. GE MONEY Crédito Hipotecario, Sociedad Anónima de Capital Variable, Sociedad Financiera de Objeto Limitado is making loans and acting as primary beneficiary under the trusts created for such loans. GE MONEY BANK, Sociedad Anónima, Institución de Banca Múltiple is the Mexican financial institution that is serving as trustee.

DUE DILIGENCE

Yes, the legal process in foreign jurisdictions is different and may be more complicated—and sometimes less reliable—than the US legal process. If the lenders perform their due diligence and are advised by competent counsel, though, the legal system most likely will work.

Furthermore, lenders often seem to forget two very important factors: (a) the borrower is likely a wealthier, better-qualified borrower than the average US borrower buying a similar property in the United States, and (b) the lender would also have remedies under US laws enforceable in US courts.

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These circumstances outweigh the heightened risk of lending money for the purchase, improvement, or development of real estate outside the United States. These borrowers typically have better credit scores than the average borrower, have excess income at their disposal and, consequently, represent a lower risk of default to the lender. Moreover, buyers of international real estate typically have greater incentives to pay off their debts. These individuals have often accumulated wealth and assets in the United States and would not want to jeopardize the assets that represent their livelihood and their whole future to save a retirement home in the Caribbean or Latin America. These borrowers would know that the lender can sue them in the United States.

CONCLUSION

US lenders are passing up a huge market for lack of information. Lenders who perform their due diligence and retain the right counsel should be able to greatly diminish the additional risks associated with doing business in another country. The “quality” of the borrowers in these transactions is typically better than the average borrower. Moreover, the potential returns on these deals are much greater. Lenders from other countries, notably Spain, are already entering this market. The window of opportunity will not be open forever. The clear answer to the dilemma is “to lend.”

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