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Commerical Contracts, Including Joint Ventures, Acquisitions, and Real Estate, Under Mexican and United States Law

I. REAL ESTATE TRANSACTIONS

FERNANDO ORRANTIA:*

The most significant differences between real estate and contract transactions in Mexico and those in the United States arise from the differences in the language. The theories behind these transactions are very similar. Nevertheless, some differences do result because of basic distinctions between the two legal systems. An attorney or investor doing business in Mexico must keep in mind that Mexico is an undeveloped country. The Mexican legal system is very elementary. It lacks many dimensions of law found in the United States' legal system.

Many Americans have trouble with their Mexican investments because they mistakenly believe that they do not need an attorney. An attorney is indispensable where business investments are concerned. Almost all of the problems that United States investors encounter in Mexico occur because they fail to obtain proper legal counsel. Because of Mexico's special civil law system, the real estate transaction in Mexico is very formal. Some of the formalities include the use of a notary public, determining the applicable taxes for the transaction, and ascertaining what, if any, restrictions are placed on the ownership of some properties. Thus, investors, including those who are United States attorneys, need to secure competent legal counsel to guide them through the technicalities of real estate transactions in Mexico.

A. Notary Publics in Mexico

Mexican law requires that real estate transactions be handled by a notary public. The notary public is an impartial advisor to all the

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parties involved in a real estate transaction and is not an advocate for either party. Notary publics are also considered experts in commercial transactions and the incorporation process. As far as real estate transactions are concerned, the notary public in civil law countries exists to advise the participants in the real estate transaction.

The notary public serves many important functions. Included among the notary public's duties is the duty to inform the investor, or the investor's counsel, of any important legal aspects of the transaction that may jeopardize the investment. The notary public also informs all the parties of any special circumstances surrounding the real estate transaction. Moreover, the notary public is responsible for the transaction as a whole. The notary public researches the property in order to find any liens, tenants, or other general problems related to the transaction or to the property itself. Notaries public also discern if the taxes have been duly paid and, in that respect, function as tax collectors.

Some transactions are very complex and require depositing money in banks as security. In these cases, the attorneys for each party participate with the notary public on the legal aspects of the transaction. Purchasers may also desire their own attorneys to examine the title. Although this is the notary public's job, if a mistake is made, there is little recourse against the notary public. In such cases, a notary public must indemnify the people who are injured by the negligence. However, indemnification or compensation is guided by Mexican laws, which are very different from those of the United States. Furthermore, Mexico does not require professional liability insurance as does the United States. Therefore, the parties should stipulate the rights, duties, and liabilities placed on the notary public before proceeding with the transaction.

It is also normal for the parties in an important real estate transaction to negotiate and settle the notary public's fees in advance to avoid problems. The notary public may add costs to the transaction based on its complexity. Parties will not want an important transaction to be ruled by the cost of the notary public's fees. Therefore, parties should negotiate the notary public's fees in advance.

Another difference between real estate purchases in the United States and Mexico is that Mexico does not have escrow or title insurance. Title insurance in Mexico is not necessary because, theoretically, their methods of property recordation preclude the possibility of duplication. It must be noted, however, that property records in

Mexico are not completely reliable. Most title problems in Mexico stem from human error. For example, a notary will file the appropriate documents with the Public Land Registry. In turn, the Public Registry records those documents without even ruling on the validity of title being transferred. Thus, the Public Registry would not catch an error in the original notary's work. It is therefore advisable to retain an attorney who is familiar with the local area to make a thorough examination of the title.

B. Real Estate Transaction Tax

Another aspect of Mexican law which merits attention is the tax on real estate transactions. Taxes are an essential part of the real estate transaction. If they are not paid, the transaction will not proceed. The tax varies from six percent to ten percent of the property's value. Furthermore, each state levies different local taxes on real estate transactions.

Because of the tax implications, a Mexican real estate transaction becomes even more complicated. To ascertain the proper tax, there must first be a bank appraisal. The bank appraisal serves as the impartial reference in determining a property's value. In most cases, the bank's appraisal must be approved by the local fiscal authorities. After approval, the valuation may be used to determine the market value of the property. Moreover, the appraiser's advice can prove very helpful in negotiating a deal between the parties; this is information that the notary public is not in the position to provide.

An investor must avoid underestimating the property's value in order to avoid paying higher taxes and fees. Obviously, underestimating the property's value will cultivate some immediate advantages. However, the executed document that shows title also displays that undervalued amount. When the property is sold, that undervalued amount will be compared with the selling price, and the difference is profit, subject to a capital gains tax. Finally, one must also consider the interests of a potential purchaser. For example, a corporation or business purchaser would rather avoid potential complications with the tax authorities. Ultimately, it is unwise to understate the property's value, because one must live with the results.

C. Real Estate Acquisitions in Restricted Zones

To the foreign investor, perhaps the most interesting part of Mexican real estate transactions is the possibility of acquiring border

or coastal property. However, acquisition of property along those areas is restricted. Foreigners cannot purchase title to land located 100 kilometers from the border and 50 kilometers from the ocean. The roots of this restriction can be traced back to 1847 when Mexico lost half of its territory to the United States. Mexican law specifies that although foreigners may use land in the restricted areas, they cannot hold legal title to it. To use land located in these areas, a foreigner must act through a bank trust. Real estate trusts in Mexico are very similar to trusts in the United States except that only a bank may act as trustee. This restriction was enacted to provide reliability and certainty to the transaction and security to the general public.

Foreign investors' bank trusts used in restricted zones endure for thirty years, and due to modifications in federal legislation, may be renewed subject to certain requirements. A bank trustee holds legal title and the investor remains the beneficiary under the terms of the trust agreement. Furthermore, if the trustee and beneficiary remain the same, no transfer tax is levied. A beneficiary can sell or assign the property rights freely and obtain the proceeds, but the trustee remains the legal owner. Any earnings from the sale goes to the trust's beneficiary. If the investor-beneficiary wishes to sell the property rights to any party, Mexican or American, it is treated as an ordinary real estate transaction, invoking the applicable transaction taxes.

Real estate transactions made through a bank trust are more expensive because the trustee receives an annual administration fee for managing the trust. Investors may, however, negotiate the fee in accordance with the interest that the trustee possesses in managing the business and the amount of capital involved.

Guaranty trusts are also very popular in Mexican real estate transactions because they assist buyers and sellers in avoiding litigation. A guaranty trust is advantageous over a mortgage or other type of lien because it represents a contract whereby all parties agree to a foreclosure proceeding. Thus, the trustee will sell the property and distribute the proceeds as specified in the agreement without litigation. The only disadvantage to this type of arrangement arises in the trustee fees.

II. BUSINESS DEALS IN MEXICO

SEAN DOYLE:*

Today's panel addresses not only the business aspect of a real estate transaction, but the developing trends in the market place. In particular, four areas of development will become important in the next ten years, the industrial *maquiladora* program, retail, office, and tourism.

The industrial areas in the *maquiladora* environment exist primarily along the borders. This type of development has slowed down over the past year while companies analyze the general situation presented by NAFTA. Until recently, as far as the retail industry was concerned, the Mexican buyer had been ignored. Now, the Mexican market is expanding. Automotive and computer industries and furniture and watch manufacturers, for example, will be present in Mexico over the next two to three years. In the retail arena, retail business such as the Price Club and Sams have taken positions in Mexico as well. Generally, to enter a new market in Guadalajara or Mexico City, companies simply acquire the assets of existing firms. Many foreign purchasing firms create a separate corporation to purchase Mexican facilities and/or the land while it transfers its assets to the new corporation.

Foreign manufacturers and investors cannot overlook the fact that the general population of Mexico City exceeds twenty million people. Manufacturers and investors will inevitably consult attorneys in order to devise ways to reach this untapped market. Thus, it is important for attorneys to learn Mexico's customs regulations, environmental issues, transportation, import and export issues, and NAFTA to service their clients properly.

Several United States developers currently having a difficult time obtaining United States financing will likely enter the office development market. Currently, major computer firms such as Microsoft, Compaq, and Motorola are obtaining office space in Mexico City for sales and administrative offices in order to effectively access the Mexico City market. In the metropolitan areas such as Mexico City, Monterrey and Guadalajara, United States firms, as well as some joint ventures between Americans and Mexicans, pay anywhere from \$20 per square meter each month (which equates to about \$1.75 in United States currency) to upwards of \$65 and \$75 per square meter each

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month. The latter figure represents approximately twice what one would pay in Los Angeles.

The last area of growth is tourism. One of the largest southern California developers, the Koll Company, a major Newport Beach developer, has a substantial tourism development in Los Cabos. Recently, it obtained a \$54 million loan to complete infrastructure development, as well as to create a five star resort and upgrade a hotel project. Because land purchases in tourist areas can be held in a renewable trust, investors come from all over the world, including Japan and Europe.

Two ideas will guide investment in Mexico in the next five years, persistence and recognizing opportunity. An investor may possess a great idea and be willing to work hard at completing it. But an investor also needs attorneys, accountants, and business consultants to determine if the idea is feasible. Even after outlining a realistic goal, it takes a team to persist in completing the goal. At this point, there is an opportunity in the market place and in real estate transactions, and all an investor must do is exploit it.

The greatest difficulty a foreign investor encounters in Mexico is the language barrier. It is very difficult to bridge because miscommunication often causes misunderstandings among parties as to their expectations. For example, if someone enters into a lease contract, the lessor may promise water, electricity, sewer systems, and telephones. Unfortunately, this party could fail to tell the investor that Mexican utility companies require additional and significant infrastructure hookup and capacity fees. Thus, the investor ends up paying extra for these unknown costs.

Another area of conflict that arises from the language difference involves performance and guaranteed delivery dates. This especially presents a problem for retail centers such as Price Club and Sam's. Litigation is likely to arise in this area because retailers could conceivably sustain losses in excess of \$100 thousand to \$250 thousand per day. This is why foreign businesses must contact an attorney before investing in order to learn all the legal and business facets of the deal under both Mexican and United States law.

III. JOINT VENTURES, SHAREHOLDERS AGREEMENTS AND MEXICAN INVESTMENT LAW

JORGE CAMIL:

Over the past fifteen years, joint venture agreements have been

very important to the foreign investor because of the legal restriction that requires at least fifty-one percent of a Mexican company's equity to reside in the hands of Mexican investors. The foreign partner, with a mandatory maximum of forty-nine percent ownership interest, was compelled to enter into a joint venture agreement for a new company. These agreements outline very specifically the rights, duties and obligations of the parties in the joint venture and, more importantly, give the foreign investor an element of control taken by F.I.L. Shareholder and joint venture agreements continue to be useful, especially in light of the changes occurring in Mexican investment laws.

A. Changes in Mexican Investment Law

Mexico's relaxing of its Foreign Investment Law did not go so far as permitting all business ventures to be financed 100% by foreign investment. A catalog of activities still exists where, by virtue of the constitution, federal law, and provisions of the Foreign Investment Law, foreign investment must remain the minority investment. Noteworthy, however, is that these activities now represent the exceptions, whereas before they were the rule.

Foreign investors can participate up to 100% in business activities not included in the classification list. However, Mexican law still imposes some restrictions. Most important, Mexico must receive some benefit from the investment. The requirements address the amount of the investment, the transferred technology, the creation of Mexican jobs, and the establishment of industrial plants outside the highly polluted and highly populated areas. Moreover, financing a majority investment venture must be accomplished with foreign funds. This rule arose because Mexico does not want investment to compound Mexico's liquidity problem in its financial capital markets. Last, the foreign investor must have a zero trade balance. Mexico will not allow companies to simply import goods from their United States offices and sell them in Mexico. There must be some value for Mexico in the form of export commitment from this new business venture. If a foreign investor fulfills these requirements, which are not stringent at all for a serious foreign investor, then one can have a majority interest.

Another positive change for foreign investors is the ease in obtaining approval from the Mexican Foreign Investment Commission. In the past, almost every foreign investment was required to meet several strict standards. Further, an investor had to annually demon-

strate to the Mexican government continuing compliance with the Regulations. The current requirements are not nearly as stringent as those prior.

Today, a foreign investor may incorporate a company, if the requirements are fulfilled, without special permission from the commission. When an investor seeks permission to incorporate, the ministry must approve or deny the application within about two weeks. If the commission fails to respond within that period, their silence constitutes approval, and an investor can establish the plant or the company.

Often, investors can easily discern whether they are in compliance with the Regulations and can thus avoid seeking approval from the Foreign Investment Commission. For example, consider the requirement that a new business be established outside highly populated areas. If an investor establishes an industry outside Mexico City, Monterrey, or Guadalajara, the investor has complied. An investor need not ask the Commission if it is permissible to incorporate in Veracruz.

Similarly, investors can easily comply with the project financing requirement. If an investor finances an acquisition entirely with foreign funds, either from a foreign company or a United States bank, then the investor has clearly complied with this regulation. To satisfy the job creation requirement, the foreign investor only has to informally consult with the commission to assure compliance. Thus, the investor is able to avoid the one to two year waiting period previously required to obtain approval.

Traditionally, Mexico did not accept foreign investment in financial service businesses whatsoever. In the last few years, however, Mexico changed its financial services regulations as part of a continuous opening of the Mexican economy and in preparation for the free trade agreement. Foreign investors can now own substantial minority equity positions, up to forty-nine percent, in a number of financial services companies. Thus, allowing a thirty-four to forty percent investment in financial services companies represents a major step forward. Foreign investors can acquire a thirty percent share of a Mexican bank, thirty percent share of a brokerage house, and forty-nine percent share of insurance and bonding companies. These changes preempt NAFTA because, under NAFTA, financial services are expected to be deregulated. If financial services are deregulated, foreign banks and brokerage houses may operate in Mexico.

B. Shareholders and Joint Venture Agreements

Because of Mexico's liberalized regulations, foreign investors with capital, technology, new services, and products are buying into existing Mexican companies. Consequently, investors need to draft new shareholders agreements to delineate their rights. This need hastened the development of shareholders agreements in Mexico. Generally, the agreements provide the investor with protection beyond that already provided in the Mexican business organization floor. To avoid subsequent conflicts, these agreements should also determine the parties' rights and duties in any new association.

Shareholder agreements should contain several important provisions. First, the agreement should discuss future capitalization of the business. This is especially true in the insurance industry and brokerage houses. Because Mexico has suffered a liquidity squeeze in the past few years, most existing corporations are undercapitalized; and foreign investors with fresh capital are highly desirable. However, Mexican investors must commit to provide their share of the capital. The timing and amount of Mexican capitalization should be specified from the outset in the shareholders agreement, including provisions for a shift in stock in the event that the foreign partner becomes the only source of capital.

Second, these new Shareholder/Joint Venture Agreements should specify dividend payment schedules. Typically, foreign financial corporations require a deferral of dividend payments as part of a long range planning strategy. Thus, investors usually desire a provision specifying that dividends not be paid for five or six years.

Third, the Shareholder Agreement must consider that Mexican investors and Mexican partners in ongoing businesses create shareholder agreements among themselves. In the past, shareholders were limited to those between a corporation's foreign partners and the Mexican partners. However, shareholder agreements are becoming common among Mexican investors because these agreements determine which rights accrue to each party. A company may even have two shareholder agreements, one for only the Mexican investors and one for the Mexican and foreign investors. For example, the Mexican government recently approved the privatization of Mexican banks, though it limited individual participation to ten percent non-voting positions. Further, a panelist this morning estimated that the purchase price of investing in financial institutions is two to three times the company's book value. Because of these factors, we may

find thirty, forty, or even fifty native investors buying into Mexican banks. Therefore, shareholder agreements are becoming common among the Mexican investors themselves so as to determine which rights accrue to each party. A company may even have two shareholders agreements, one among only the Mexican investors and one between the Mexican and foreign investors.

Fourth, the possibility of shareholder agreements between foreign investors should be addressed. The Mexican government has not yet clarified whether the allowed thirty percent investment can be held by one equity shareholder or whether the thirty percent may be divided among two or three investors. Therefore, a Mexican corporation could have several foreign investors. All the terms of the investment between the foreign investors would be in the shareholder agreement.

Fifth, the shareholder agreement should address management issues. The management of a corporation is a very important consideration for potential investors. It would be unwise to invest in a large Mexican financial, insurance, or banking company without specifying the duties of the management in a shareholders agreement. It is especially important to establish the level of participation of the foreign partner in the management at the beginning of the business relationship, including the composition of the board of directors.

The shareholder agreement should establish the process of appointing the directors, the total number of directors, and which partners in the new business will control key positions. Normally, in a joint venture situation where the majority of capital is Mexican, the leadership position belongs to the Mexican group. But there are other important positions such as chief operating officer and the secretary of the board that a foreign investor may want to secure. However, the foreign investor should do so by including this in the shareholders agreement.

Sixth, the shareholder agreement can also govern the type of communication and computer systems the new business will use. A foreign investor may want a specific type of system to be compatible with the systems used at home. This is especially true in the financial arena. These agreements can also govern the use of any new technologies the foreign investor may bring to the corporation as well as the distribution of royalties from the use of the technology.

Last, shareholder agreements should consider the protection of corporate logos, corporate names and reputation. For example, as-

sume a very large money lender or bank in the United States bought a ten percent interest in a Mexican bank. Even though the investor's interest was only ten percent, the investor may still be liable for the actions of that Mexican bank. Creditors may expect the ten percent equity owner to fulfill international obligations of the Mexican bank. People dealing with that Mexican bank view the foreign partner as a guarantor of success. Thus, the foreign investor should attempt to protect its reputation by either directing the management or limiting the use of the corporate logo, for example.

Not all clauses in shareholders agreements of this type are enforceable. Those clauses which contradict Mexican corporate law are unenforceable. For example, consider a clause that commits the voting rights of shareholders from the beginning. Clauses that establish voting trusts or arrangements whereby the parties determine today how they will vote on issues arising at a later date are unenforceable to the extent that those clauses contradict Mexican corporate law.

An investor may still want an unenforceable clause in his shareholder agreement. International transactions and foreign investment are based on a great deal of trust between the parties. In this arena, a so-called "gentlemen's agreement" can be as important and as binding as a legally enforceable provision. Thus, attorneys should advise their clients of the legal enforceability of any provision in the agreement. They should not automatically eliminate any provision that may be legally unenforceable, because the parties may still consider that clause binding on them individually.

When drafting a shareholder agreement, an attorney should endeavor to provide more protection for the minority foreign investor than provided by Mexican business organization law. However, the attorney should not draft a shareholder agreement that specifies that foreign participation in management may not exceed its equity participation in the capital stock of the company.

The attorney should also endeavor to draft the shareholder agreement so as to keep the business investment flowing as smoothly as possible. This requires a sensitivity to the many different nuances between the cultures. The cultural differences often cause difficulties between the parties at the beginning of the negotiations, for example, while negotiating a corporate acquisition where the foreign partner, one foreign investor from the United States, was attempting to secure various positions on the board of directors. By law, the chair went to the Mexican investors, who held fifty-one percent of the company.

The United States company thus sought the senior executive vice president. However, this position is not used in Mexico. In Mexico, although there are vice presidents, they do not have the same status as a vice president in the United States. The negotiations almost came to a complete halt.

When queried, the United States investor replied that, since the Mexican investors had the chair, they were entitled to the vice chair. They were not happy with the disposition of some legal items, the minute book keeping, and the power of attorney that was granted to officers and managers. However, if these were their concerns, then they should have sought the position of secretary of the board. The secretary is directly responsible for all legal matters that take place in the corporation, such as bookkeeping, taking of the minutes, and issuing certificates of board resolutions. Because the investors did not understand the corresponding positions and duties, they were on the brink of terminating their relationship when it had not even begun. However, once the misunderstanding was cleared up, the Mexican group offered the secretary's position. Because of cultural misunderstandings, similar problems often arise.

FREDERICK HILL:

Considering contracts generally and the cultural differences between Mexico and the United States, some common difficulties arise with respect to forming contracts. For instance, there is an unfortunate stereotype that Mexican business people are not dependable and do not respect the law. However, based on personal experience, there are just as many dishonest people in the United States as there are in Mexico.

FERNANDO ORRANTIA:

On that same note, an investor should not confuse the actions or expropriations of the Mexican government with the actions of Mexican citizens in private transactions. Language is the most significant problem between investors in the United States and Mexico. The importance of the language differences cannot be overemphasized. Moreover, the two legal systems are conceptually different. All legal systems regulate human behavior, and there is no question that contracts in Mexico, England, Spain, France, Germany, and in most countries are very similar in their wording and the parties' expectations. The problem, however, is that different concepts and different words are used to describe the same things. Some United States in-

vestors come to Mexico and experience difficulties in communicating because of the language barriers and different expectations. However, the working relationship flows much more smoothly once a basic understanding is reached between the parties.

FREDERICK HILL:

Continuing the discussion of joint venture and shareholders agreements in real estate transactions and other property acquisitions in Mexico, Julio Treviño will comment on some of the elements that should also be found in a shareholder or joint venture agreement.

JULIO C. TREVIÑO:*

Investors should be aware of the United Nations Convention on Contracts for the International Sale of Goods ("Convention"). Both Mexico and the United States are members of this Convention. Unfortunately, few people in either country understand what it encompasses. The Convention establishes rules with respect to the creation of sales agreements between parties who are citizens of member countries. Articles 14 through 24 of the Convention contain useful provisions addressing the declaration of a contract through acceptance and affords protection if problems arise.

Because the Convention acts as the law governing transactions between the United States and Mexico, unless the parties waive them, its provisions will apply to the contract. As a result of ignorance about this Convention, the few people aware of its existence choose to waive its provisions. This is possible under the terms of the Convention itself. Investors from both the United States and Mexico request clauses in their contracts waiving the Convention's application. However, investors and business investors should become familiar with its provisions instead of avoiding them.

Considering the time and difficulty associated with litigation in either the United States or Mexico, investors should attempt to employ other mechanisms for solving disputes. These can be specified in a shareholder or joint venture agreement. For instance, the Mexican law regarding arbitration with respect to a real estate contract differs from the law regarding arbitration generally.

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An amendment introduced to the federal code of civil procedure in 1989 grants Mexico's national courts exclusive jurisdiction over actions on real estate and actions *in rem*. Legal experts have no final conclusion about the use of arbitration agreements in real estate transactions, but most suggest that arbitration for real estate is impermissible.

This is not to imply that an arbitration clause in a real estate agreement will be ignored. Like any other contractual agreement, if the parties are willing, they may bind themselves to the arbitration proceeding. Thus, parties should include an arbitration clause to avoid the time delay and expense of litigation.

Many contracts also contain a choice of forum clause. This allows the parties to choose the place where the litigation will be heard and the law that will apply. Just as with arbitration clauses, Mexican courts normally do not recognize a submission to a foreign court and to foreign law with real estate contract disputes. Mexican legal authorities argue that the civil code dictates that the law applying to real estate disputes shall be the *lex situs*.

However, forum and choice of law clauses are often used to enforce performance bonds in construction contracts. Arbitration clauses are also used in bank trust situations. Thus, the beneficiary has the right to pursue the goods wherever they are located because the investor's beneficiary rights are considered *in personam*. Essentially this is a right against the trustee bank, not a right *in rem*. Thus, an arbitration clause can be enforced provided that the arbitration does not involve the creation of the trust, the transfer of title to the trustee, or the real estate transfer.