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Panel Discussion: Securities Law Questions and Comments on the Comparison of Corporate and Securities Laws in Mexico and the United States

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PANEL DISCUSSION: SECURITIES LAW QUESTIONS AND COMMENTS ON THE COMPARISON OF CORPORATE AND SECURITIES LAWS IN MEXICO AND THE UNITED STATES

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Robert Kimball: I want to comment on the importance of having Mexican counsel involved in transactions of U.S. companies in Mexico. The more I read the descriptions of securities for Mexican companies, the more they remind me of something straight out of an S-1 Registration Statement for an initial public offering of a Delaware corporation. This concerns me, because I doubt the accuracy of some statements.

Let me illustrate. In Delaware, a preferred dividend is fixed. When people in the U.S. talk about a preferred dividend, they usually mean that holders get seven percent of their original investment. After that, they do not share in the distribution of corporate earnings. In Mexico, my understanding is that the preferred shareholder usually receives a fixed preferred dividend and shares *pro rata* with the common stock in the distribution of earnings. It is an important difference for valuation purposes.

Another difference exists for liquidation preferences. The liquidation preference in a Delaware company is typically limited to the dollar amount of the fixed preferential distribution before a distribution is made to the common stockholder upon liquidation. Under Mexico's *Ley Mercantil*, the preferred shareholder gets the preferred distribution and then shares *pro rata* with the common stockholder in the assets upon liquidation. This is similar to the sharing of dividends. One Mexican authority says that under the bylaws, one can limit that to a thirty percent participation, but no other authority states that. Under Delaware law, a company may authorize preferred shareholders to participate *pro rata* in corporate earnings after payment of preferred dividends.

These are examples of important financial terms where one may not have as much flexibility in Mexico as in Delaware. At least it demonstrates that United States attorneys need to consult with Mexican counsel about the enforceability of particular Mexican provisions.

Registration rights agreements are also interesting. Stockholder agreements are common in the United States, but the rules governing such

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agreements need to be incorporated in the bylaws of Mexican corporations. In U.S. venture capital transactions, it is common for the venture capitalist to either ask for a right to register the securities at a specified time so that they can be resold at public market or ask for a right to "piggy-back" off the registration of the company at an initial public offering. This is done so that when the company first sells its securities to the public, the joint venturers have a right to participate with some percentage of their stock and have it sold at public market. Registration rights agreements are not well known in Mexico. The enforceability of such agreements is subject to substantial uncertainty, especially because those agreements are not typically included in Mexican corporate bylaws.

There are also differences in the rights of stockholders versus those of directors. Stockholders in Mexico must participate in deciding money matters, which, in the U.S., is normally deferred to the board of directors. Shareholders in the U.S. may authorize directors to determine the terms of "blank check" preferred stock of U.S. corporations. In Mexico, determination of securities terms must be approved at a common stockholders meeting. Thus, when U.S. lawyers are dealing with Mexican securities, they should make sure that Mexican lawyers are looking at the terms of the securities and passing on them, as well as a disclosure about them. Very often U.S. lawyers get the right advice from Mexican counsel on the bylaws and then write the disclosure statement as though the securities were issued by a Delaware corporation.

Ignacio Gómez-Palacio: Another feature of the Mexican Company Law, which is a subject of some confusion, is the S.A. (*Sociedad Anonima*) versus the S.R.L. (*Socieded de Responsibilidad Limitada*). In the United States, corporations and partnerships are used all the time. In Mexico, that is not the case. All we have are S.A.s.

Under the Mexican Company Law, U.S. and Canadian lawyers will wonder whether they should incorporate a business as a corporation, a S.A., or should establish a partnership, a S.R.L. One of the most important differences between S.A.s and S.R.L.s is that the corporation or S.A. has shares of stock (*acciones*) and the S.R.L. has social parts (*partes sociales),* which is not a negotiable instrument like *acciones.* A S.R.L. is not an instrument registered in one's name which could be endorsed. The S.R.L. does not have stockholders and stockholders' meetings; it has partners and partners' meetings. A S.R.L. is usually appropriate for a personal business and cannot be used for a public offering. The S.R.L. has a maximum of fifty partners. Finally, the social parts of a S.R.L. are worth one Mexican peso, or multiples of a peso. The minimum capital for a S.R.L. in 1994 is 3,000 pesos, which is roughly U.S. $900. The minimum to incorporate a S.A. is 50,000 pesos, which translates into about U.S. $15,000 in 1994.

In Mexico, a company is a contract. Therefore, one needs at least two stockholders or two partners to form the business entity. Mexico does not recognize solely-owned corporations or partnerships. Thus, some rights for a Mexican company are going to be stricter, such as, rights of first refusal when a partner wants to sell his *partes sociales.*

Both the S.A. and S.R.L. have another important feature called the *comisario*, which is a corporate official who checks on the management in the interest of the stockholders or partners. A *comisario* is not the same as an auditor. A *comisario* is appointed by the stockholders or partners to oversee the acts of the board of directors. The word *comisario* should be translated as "inspector," "marshal" or "deputy".

The position of a *comisario* should be occupied by a lawyer, because a lawyer possesses the requisite knowledge to call attention to illicit acts, such as infringement of trademarks or failure to comply with consumer protection laws. A lawyer should also possess a knowledge of financial reporting. In Mexico, however, accountants typically occupy this position. Additionally, a *comisario* carries a tremendous amount of potential liability because their function is to call attention to any failure to comply with laws and regulations. The *comisario* must carefully look at the acts of board of directors and management and look at reports by the corporate management. Thus, accounting firms actually perform the external audit of a company. This is a distinctive feature of the Mexican Company Law.

Frank Gill: What is the difference between a *Sociedad Anonima* and a *Sociedad Anonima de Capital Variable* (S.A. de C.V.)?

Gómez-Palacio: Many companies in Mexico are U.S. subsidiaries and are not interested in Mexican financing. U.S. subsidiaries want to have the flexibility of increasing or reducing capital easily. Thus, if a company organizes as a variable capital company, one can always put nothing in C.V. In other words, one can have a S.A. de C.V. with a fixed sum and nothing in a C.V.

Mont Hoyt: For tax reasons in the United States, most U.S. corporations in Mexico prefer to create a U.S. tax partnership and use a *Sociedad de Responsibilidad Limitada,* a limited liability company, instead of using a *Sociedad de Responsibilidad.* Mexican attorneys, however, strongly discourage this.

Miguel Jauregui: It is possible to meet the U.S. Internal Revenue Service tax requirements with a S.R.L., if certain criteria are met. A commercial company with limited liability may serve as a partnership for tax purposes, allowing for investors to avoid double taxation such that investors will pay a Mexican tax and can use that payment as a credit on their U.S. tax obligations. That is really the purpose of the S.R.L.

John Stephenson: How is a S.R.L. taxed under the Mexican tax system? Is there a tax on a S.R.L. itself or do the individual members of a S.R.L. pay the tax?

Jauregui: Under Mexican law, the S.R.L. is a taxable entity by itself. For U.S. tax purposes, a S.R.L. is a partnership; but for Mexican tax purposes, it is a company paying corporate tax. In Mexico, a S.R.L. is a legal vehicle that has limited liability and looks and acts like a corporate entity.

Stephenson: The U.S. taxpayer ordinarily is seeking to have the best of both worlds: treatment as a corporation to limit personal liability in case of corporate bankruptcy or tort liability and treatment that a part-

nership undergoes to avoid payment of the U.S. corporate income tax before distribution of earnings to an owner, a distribution which is subject to U.S. personal income tax.

Bill Kryzda: There is a four-step test under U.S. tax law where the S.R.L. in Mexico qualifies as a corporation, but is nevertheless entitled to the tax benefits of a partnership.

Stephenson: The tests are: limited liability, lack of transferability, centralization of management and unlimited duration. You only need to violate two of the four tests to get the treatment in Mexico as a partnership. The S.R.L., however, must be dissolved upon the occurrence of certain specified events to get partnership tax treatment. The S.R.L. can be prepared so that it lacks two or three of the characteristics of a corporation and still meet the U.S. tax test.

I have a further concern. Is it possible to have sharing arrangements written into the bylaws of a S.R.L. under Mexican law which are different from participation or ownership shares in capital investments?

Abdon Hernández: Sharing arrangements are governed by Article 16 of the Mexican Company Law. In addition, Article 17 states that any stipulations excluding one or more associates from participation in the profits shall have no legal effect whatsoever. Therefore, for each peso contributed per share, one shares equally with other associates. One is then entitled to the same rights and voting privileges. Theoretically, that means that one could build in, at least in the case of a *limitada*, special arrangements.

Gómez-Palacio: But that is only for dividends, not voting rights. Basically, there are corporate rights and patrimonial rights and there is a distinction between them.

Robert Rendell: I would like to address a different topic. Assume that a U.S. company has 100% control of proposed activities in Mexico and finds that the Mexican Company Law is very burdensome or archaic. What is the possibility for setting up a branch of a Delaware corporation and doing business in Mexico through that branch?

Jauregui: Historically, branches have not been popular vehicles for doing business in Mexico, because they were not able to give Mexicans more than a 50% ownership and they were discouraged by the government. The Regulations of 1989, however, permitted formation of entities similar to a branch, offices of representation with income.

Two trends have developed regarding branches. One trend, the 1993 Foreign Investment Law, now regulates the establishment of branches. The other trend is that taxing authorities now are specifically regulating the taxation of income of these branches. Although a U.S. corporation may avoid going through the Mexican Company Law by having a branch registered in Mexico, one must then consider how will a branch be taxed, either as a S.R.L. or a S.A. de C.V.?

Michael Gordon: Assume that a U.S. corporation registers a branch in Mexico but runs into some difficulty. Will a Mexican court apply the law of the state of incorporation, which would be Delaware, or would the court apply the Mexican Company Law to this enterprise doing

business in Mexico? I would assume the issue would depend on what the matter is and whether Mexico considers that particular matter to be of special interest to the Mexican public to apply the Mexican Company Law rather than the provisions of the Delaware law.

Gómez-Palacio: If the issue was to supply products to a corporation of the Mexican government and a power of attorney was issued by a Delaware company, I would imagine that Mexican courts would apply Delaware law to determine whether that power of attorney was ineffective.

Gordon: What if there is an external agreement among shareholders of the Delaware corporation, recognized as valid by Delaware law, would the Mexican court recognize the legitimacy of the shareholders' agreement?

Gómez-Palacio: Yes, because the court should apply Delaware law unless the agreement is found to be against public policy of Mexico. I would not imagine that a regulation of a Delaware law allowing stockholders' agreements would be considered against the national interests of Mexico.