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Structuring Private Equity Transactions in Mexico

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I. Introduction.
   A. Recent Trends in Foreign Investment in Latin America.
   
   Attracted by the return of political stability, sound macroeconomic policy, favorable regulatory environments, and the possibility of superior rates of return, international investors have invested significant amounts of capital in Latin America over the course of the last ten years. The majority of this activity has been concentrated in the form of portfolio investment tied to privatization programs. In line with this trend, portfolio investment increased from an annual average of U.S.$5.4 billion for the period 1986 through 1990 to approximately U.S.$68 billion in 1993. The remainder of Latin America's capital inflows has, until recently, been the result of foreign direct investment by international investors.

1. See Enrique R. Carrasco & Randall Thomas, Encouraging Relational Investment and Controlling Portfolio Investment in Developing Countries in the Aftermath of the Mexican Financial Crisis, 34 Colum. J. Transnat'l L. 539, 543 (1996). Portfolio investment is defined as "cross-border financial and capital market purchases of financial assets, by foreign individuals and institutional investors, that do not result in managerial responsibility. These investments can be held in domestic government debt securities and bank deposits, or as highly liquid equity securities and debentures of the private non-financial corporate sector." The IMF defines portfolio investment as the "international placement of bonds, issues of equities in international markets, and purchases by foreigners of stocks and financial market instruments in developing countries' domestic markets." David Folkerts-Landau et al., International Monetary Fund, International Capital Markets: Developments, Prospects and Policy Issues 35 (1995).

2. In the case of Mexico, the number of state-owned enterprises has decreased from 1,155 in 1982 to 247 in 1999. Of the 247 remaining state-owned enterprises, fifty-two are currently in the process of being privatized. Considered from the perspective of commercial lending, it is significant to note that between 1983 and 1998, the total percent of bank credit allocated to the public sector dropped from seventy-seven percent to twelve percent. See Mexican Ministry of Finance, Mexico: Challenges and Opportunities at the Turn of the Century, Sept. 1999 (visited Jan. 7, 2000) http://www.shcp.gob.mx/english/docs/991007.html [hereinafter SHCP Report].

3. The 1993 figure represented approximately sixty-six percent of gross capital inflows into Latin America. The leading recipients were Argentina, Brazil, and Mexico. See Carrasco & Thomas, supra note 1, at 557.

4. Foreign direct investment, technically considered, entails the transfer of resources together with the acquisition of a controlling interest in a company. See id. at 544.
companies looking to make strategic acquisitions or develop new joint ventures. Investment of this latter type increased from U.S.$30 billion to U.S.$50 billion between 1996 and 1997.5

B. THE SHORTCOMINGS OF PORTFOLIO INVESTMENT AND THE ALTERNATIVE OF PRIVATE EQUITY.

Notwithstanding the significant amount of capital provided by portfolio investment, its effect on balance has not always been positive. One criticism concerns its "hot" nature. That is, portfolio investors have little or no interest in the long-term future of the countries in which they invest. According to one commentator, they "want immediate returns, and will pull out of a country quickly if they do not get them."6 Portfolio investors' ability to move quickly in and out of Latin American capital markets can make them a highly destabilizing force.7 As experience in Mexico and Brazil has demonstrated, rapid capital movements can cause "massive disruptions in local stock markets, drastic swings in interest rates and huge increases in unemployment rates..."8

Given the nature of portfolio investment—the purchase and sale of publicly traded equity securities—Latin America's large, high profile companies have tended to be the primary beneficiaries of such financing. The consequence of this tendency is to place small to medium-sized entities (SMSEs) whose stock is neither listed nor traded, in a disadvantageous financing position, irrespective of their relative profitability or financial condition. This unequal access to capital is compounded by a number of factors: Latin America's historically low rate of savings; the fallout from the financial crises that have hit Asia, Russia, and Brazil; the comparatively high cost of commercial credit in the region;9

5. See Robert Danino, Corporate Finance in Latin America: Quenching the Thirst for Capital, LATIN FIN., Mar. 1997, at 2, available in LEXIS, Country and Region (excluding U.S.) Library, Mexico File. As was the case with portfolio investment, the primary Latin American recipients of foreign direct investment were Brazil (approximately U.S.$8 billion), Mexico (approximately U.S.$7 billion), and Argentina (approximately U.S.$3.2 billion). The balance was split between Peru, Chile, Colombia, and Venezuela. Id.

6. In an effort to guard against such occurrences, some countries restrict the ability of investors to remove capital. In Chile, for example, Decree Number 600 mandates that capital cannot be repatriated for a period of one year following an initial investment (remittances of profits can, however, be made without limit). See Anthony M. Vernava, Latin American Finance: A Financial, Economic, and Legal Synopsis of Debt Swaps, Privatizations, Foreign Direct Investment Law Revisions and International Securities Issues, 15 WIS. INT'L Y. 89, 117 (1996).


8. Carrasco & Thomas, supra note 1, at 543. The response of portfolio investors to this criticism is that by conditioning continued investment on the maintenance of sound economic policy they serve as economic disciplinarians that foreign governments can blame for necessary but unpopular domestic programs. Id.

9. There is no effective usury law in Mexico and interest rates on commercial bank lending can be as high as thirty percent or more. Elsewhere in Latin America, interest rates can range between forty percent and 100 percent. See Sergio R. Bustos, Overwhelming Interest, LATIN TRADE, Feb. 1999, at 22.
and the free trade-induced effects of increased competition. As the director of one Brazilian fund management company observes: "[s]mall and medium companies are squeezed in Latin America. High interest rates, combined with increased competition from imports, have made it difficult for companies to pay their debts and even more difficult for them to raise the capital to finance expansion." Insofar as the majority of commercial entities in Latin America fall within the small to medium-sized classification, the continued coalescence of these factors poses a serious threat to the region's future economic development. In their attempts to avoid the detrimental consequences of over relying on portfolio investment, many Latin American nations have begun to encourage the development and/or adoption of new forms of attracting capital and promoting economic growth. The regional advent of private equity financing represents one of the most promising manifestations of these initiatives.

C. GENERAL CHARACTERISTICS OF PRIVATE EQUITY FINANCING.

Acting for self-interested reasons, private equity funds counter the disruptive effects of hot money and disparate development by taking long-term, relatively illiquid equity positions in companies with either demonstrated growth potential or little appeal to portfolio managers.

While many private equity funds take minority positions, the degree of control actually sought may be a function of the company's overall development stage, its performance, and the circumstances of the surrounding economic context. A fund may be more inclined to control an investment in a young company with a new management team than it would an investment in a late stage entity with an established management team. Generally, private equity funds will want to have a board position and/or the right to participate in strategic decisions. This type of investment monitoring stands in sharp contrast to the absence of managerial responsibilities or involvement characteristic of portfolio investors.

11. See Patience is Virtue in Dealing with Mexican Businesses, J. Com., Aug. 31, 1992, at 3A.
12. According to the CEO of BISA, a private equity fund active in Argentina, funds are "there to make a lot of money for themselves and their investors." Private Equity Funds, Newsletter (Consulate of Argentina), Mar. 1999 (visited Jan. 5, 2000) http://www.consargtoro.org/mar99.htm [hereinafter Consulate Newsletter].
13. Equity stakes obtained can consist of either common, preferred, or convertible preferred shares.
14. Majority positions can—and are—taken by private equity firms, even though in a strict economic sense such action would constitute a "foreign direct investment." Carrasco & Thomas, supra note 1, at 544. An example of a firm that prefers majority or controlling investment stakes, particularly with respect to family-run companies, is the Advent International Fund. See Mark Mulligan, Latin America: Healthy Appetite for Funds (visited Jan. 5, 2000) http://www.ft.com/ftsurveys/industry/sc2b3a.htm.
15. In this regard, one private equity practitioner notes: "venture capital/private equity investing is significantly different from passive selection and retention of stock and debt investments by a money manager." Jack S. Levin et al., Structuring Venture Capital, Private Equity and Entrepreneurial Transactions 1-3 (1999).
The private equity investor's corporate governance role may be enhanced by the practice of targeting companies and sectors with which the fund has prior experience. The element of "added value" inherent in a fund's contribution of both managerial and sectoral expertise, together with its willingness to share in the risk associated with the business venture, underlines the genuine quality of the fund's commitment to the recipient company. A private equity fund's ability to provide these benefits in a way that does not substantially offend the host nation or recipient company's notion of economic or corporate sovereignty positively serves the long-term interests of all parties to the transaction.

Private equity financing can be applied to a broader range of entities on the commercial continuum than that covered by portfolio investment. For example, a private equity fund may provide seed or start-up financing for a "zero" or "early" stage entity. Venture capital received from private equity funds can be used to complete the testing and marketing of new products or technology and to establish initial manufacturing and distribution capabilities. Typically ranging from $500,000 to $2 million, zero and early stage transactions are characterized by longer lock-in periods and the uncertainty associated with a new business concept. To compensate for the elevated degree of illiquidity and risk, high rates of return are usually required by private equity investors. This reality is reflected in discount rates that reach as high as thirty-five percent to seventy percent per annum.

Alternatively, a private equity fund may invest in an already established, privately held later stage or middle-market firm. Capital invested by private equity firms can be applied to a variety of ends including the expansion of a firm's plant and equipment, the development of new products or technology, the strategic acquisition of a related business (facilitating industry consolidation), or the realization of a change in ownership or capital structure by way of a management buy-out (MBO), leveraged buy-out (LBO), or sale to a third party.

A variant application involves investments in financially distressed companies. These can be made in either privately held or publicly traded entities. Most private equity financing available for distressed privately held firms is supplied by specialized "turnaround partnerships." These groups seek out investments in undervalued companies that can be subsequently restored to profitability and sold. Turnaround transactions generally...

16. Zero stage companies characteristically have a founding management team and may or may not have developed a business plan, completed a prototype, and engaged in beta testing. Early stage companies, in contrast, typically have completed beta testing, demonstrated the initial viability of the concept, and generated minimal revenues. Under normal circumstances early stage companies have no significant earnings or cash flow. See Cobblestone Private Equity, L.L.C., Common Venture Capital Terms (visited Nov. 3, 1999) http://www.cobblestone-pe.com/ven_cap_term.htm [hereinafter Common Venture Capital Terms].


18. See id.

19. See id.

20. Typical characteristics of later stage or middle market firms are an established, recognized product and/or market, a history of growth, positive earnings and cash flow, a demonstrated ability to meet forecasts, strong exports, and a seasoned, capable management team. See Common Venture Capital Terms, supra note 16.
range in value from $25 million to $200 million.\textsuperscript{21} When the recipient of private equity financing is a publicly traded company, the funds are frequently used to supplement working capital or strengthen balance sheets. The opening up of large, publicly traded companies to private equity financing can result in a corresponding decrease in the amount of capital otherwise available for SMSEs.

Last, private equity funds can also play an important role in the provision of short-term (six to eighteen months) bridge or mezzanine financing. This type of financing usually occurs in conjunction with a subsequent initial public offering (IPO).

Later stage or middle-market private equity transactions generally range in value from $2 million to $100 million.\textsuperscript{22} Because of the lower levels of uncertainty and shorter lock-in periods, the rate of return is not as high as that required by investors in zero or early stage deals.\textsuperscript{23} The discount rate used to convert an estimated terminal value to a present value may range between fifteen percent and forty percent, depending on the circumstances of the investment.\textsuperscript{24}

While the exact duration of a private equity investment varies in relation to the developmental stage, condition, and objective of the recipient, the term typically ranges from two to ten years, with many investments clustering between the three and seven year marks. The heightened degree of temporal certainty associated with private equity financing enables recipient entities and host nations to plan their financial future in a way superior to that permitted by portfolio investment.

When the objectives of the recipient company have been accomplished, private equity investors exit the investment either by conducting an IPO or private placement, making the company available for acquisition by another company, coordinating a repurchase of the shares by the company, or arranging for a secondary purchase of the equities by a third party. Considered from the perspective of a host economy, exits accomplished by IPO can be doubly beneficial in that they simultaneously increase the volume of trading and the number of issuers on a local market. This outcome helps host nations with thinly developed capital markets. As one trade publication notes in this regard, “private equity funds may play a critical role in increasing the limited number of Latin American issuers inasmuch as most of these funds aim at exiting their investment through the listing if their investee companies.”\textsuperscript{25} By way of contrast, portfolio investment impacts the volume of trading activity on a market, but not the actual number of issuers.

D. AN OVERVIEW OF PRIVATE EQUITY FINANCING IN LATIN AMERICA.

Viewed as the “last step of all things that have come before in Latin America,”\textsuperscript{26} private equity financing has attracted a lot of attention since the mid-1990s. Private equity funds are considered to be “active new players”\textsuperscript{27} that provide “key sources of

\textsuperscript{21} See Fenn et al., supra note 17.
\textsuperscript{22} See id.
\textsuperscript{23} See id.
\textsuperscript{24} See id.
\textsuperscript{25} Danino, supra note 5.
\textsuperscript{26} Id.
\textsuperscript{27} Id.
capital.” In what is touted as the arrival of a “second wave” of capital investment, the amount of capital raised and invested by Latin American-oriented private equity funds has increased each year from U.S.$107 million in 1992 to over U.S.$8 billion in 1999. As a result of high domestic interest rates and restricted access to local and international capital markets, many Latin American companies have turned to private equity financing to satisfy their demand for additional capital. As one Brazilian fund director notes, “there are no other solutions than equity financing.”

Reflecting the “enormous” nature of its potential, private equity financing in Latin America has a broad range of commercial applications. Some capital has gone to fund start-up ventures, and experience in this context indicates that high-tech and e-commerce firms enjoy a significant competitive advantage.

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32. See Danino, supra note 5.

Notwithstanding the view of some financiers that venture capital is the “most important finance tool in Latin America,” this sub-type of private equity constitutes the smallest amount of investment to date. This situation can be attributed to two primary factors: (1) the relative paucity of high-tech or Internet companies operating in Latin America and (2) the perception of the international business community that intellectual property protection and enforcement in Latin America is anemic. Increased Internet access and respect for intellectual property rights going forward could contribute to an increase in the amount of venture capital invested in Latin America.

Investment Managers (U.S.$50 million available for investment), Interprise Technology Partners, L.P. (U.S.$110 million available for investment), Banco Bozano, Simonsen (U.S.$100 million available for investment in Brazil), Advent International, GP Investimentos (U.S.$1.3 billion total invested, U.S.$200 million of which are specifically invested in Internet projects), Latinvest Asset Management (administers U.S.$1.2 billion in Latin America, and U.S.$960 million in Brazil), Pactual Electra Partners (U.S.$15 million invested), Westsphere Equity Investors (U.S.$28 million under administration), Banco Opportunity (U.S.$280 million available for investment), Intel Venture Capital for Latin America, (approximately U.S.$450 million available for investment), Softbank Latin America Ventures (U.S.$100 million available for investment), Citicorp Venture Capital, BancBoston Capital, Southern Cross Group. See Montes, supra note 28, at 28.


35. A telling manifestation of this fact is the relatively low number of patents filed by Latin American entities in the United States (which action best ensures world ownership). A sharp contrast in registration practices exists between South Korea (which registers approximately 3,400 patents per year in the United States) and the largest nations of Latin America, none of which has ever registered more than 100 patents in the United States in a single year (in 1998, Brazil registered eighty-eight patents, Mexico registered seventy-seven, and Argentina registered forty-six). See Andres Oppenheimer, Patents Key to New Economy, MIAMI HERALD, Oct. 10, 1999, at A15.

36. See Josh Lerner & Gonzalo Pacanins, Private Equity in Developing Countries (visited Nov. 8, 1999) http://www.people.hbs.edu/jlerner/develop.html.

37. Latin American venture capital providers are excited by projections that the volume of e-commerce in Latin America will grow from the current 1998 level of U.S.$167 million per year to over U.S.$8.3 billion per year by 2003. This represents an annual growth rate of 117 percent. See Lisa Krochmal, Can the Venture Capital Model Work for Latin America? (visited Jan. 5, 2000) http://www.latpro.com/articles/venture-capital.htm. Free Internet access in several major Latin American Nations—including Argentina (i.cero), Brazil (Bradesco, Unibanco, Terra, amongst others), and Mexico (Terra Libre)—is now a reality. The former free service, i.cero, is expanding its capacity to Mexico, Colombia, and Ecuador. Free access is expected to drive greater levels of e-commerce. See Andreas Adriano & Max Alberto Gonzales, Antes y Despues de Bradesco, AMERICA ECONOMIA, Jan. 27, 2000, at 44. In Mexico, Telemex has introduced free access in conjunction with the purchase of computers through its prodigy Internet plus program. See Angelo Young, Mexico's Future on Line, MB, Dec. 1999, at 39.

38. Illustrative of this trend is the recent establishment in Miami of the Tokyo-backed Softbank. This group will supply venture capital specifically to high-tech companies in Latin America. See John Dorschner, Softbank Sets Up Fund for Latin Web Ventures, MIAMI HERALD, Jan. 14, 2000, at 3C. In the same vein, Grupo Empresarial Bavaria, a Colombian Conglomerate, recently announced the establishment of a U.S.$100 million Latin American investment fund to be headquartered in Miami. See John Dorschner, Colombian Fund Bets on S. Fla., MIAMI HERALD, Feb. 26, 2000, at 1C.
The lion's share of Latin American private equity financing, on the other hand, has been invested in "already established firms in traditional industries." Recipient firms may be in solid financial condition with strong growth potential or financially distressed. As one private equity financier summarizes: "In Latin America, most of the money has gone for company buy-outs or late stage investing in . . . established companies, rather than as venture capital to start ups." The companies that receive this type of financing are typically not in the high-tech sector, but rather in basic retailing (for example, Quantec S.A., computers, Chile; Tia, S.A., groceries, Argentina; Comercial Prat, general retail, Chile; and Microsiga Software of Brazil), manufacturing, and distributing industries. Other favored investment sectors have been financial services, telecommunications (for example, Telmig Celular of Brazil), energy, insurance (for example, Mass Seguros of Chile), health care (for example, Provincia and Emergencias, S.A., both of Argentina), entertainment (Showcenter, S.A. of Argentina, Cines Unidos of Venezuela), infrastructure (for example, Sanepar, water management, Brazil; Santos, port operation, Brazil; Metro, subways, Brazil; and Tramaca, transportation, Chile), and primary materials (for example, San Miguel, agriculture, Argentina; Desde el Sur, cotton, Argentina; Abolio y Rubio, dairy, Argentina).

Having specifically targeted companies with extraordinary growth potential and/or obvious resale potential, the majority of Latin American private equity investments are exited either by sale to an international strategic investor looking for a foothold in the region or management buy-out. Sales that occur in sectors ripe for consolidation can engender greater economic efficiency through the introduction of larger scale operations. The other principal form of exiting is by way of an IPO on a local exchange. While a public offering of a company's shares can result in the highest valuation for a company,

39. Lerner & Pacanins, supra note 36.
41. See Fenn et al., supra note 17.
42. See Ariel Kas, Private Equity in Latin America: Regional Leaders (visited Jan. 13, 2000) http://www.latpor.com/articles/private-equity.htm. Private equity funds should be positioned to profit, given demand projections for Latin American infrastructure projects on the order of U.S.$70 billion per year. See Danino, supra note 5.
44. An example of a management buy-out involves Vascal Industria, a Bolivian food and drinks group. See Mulligan, supra note 14.
46. See Christopher J. Mailander, Searching for Liquidity: United States Exit Strategies For International Private Equity Investment, 13 AM. U. INT'L L. REV. 71 (1997). While it is often the case that an IPO will result in the highest valuation, success is by no means guaranteed. In the wake of the explosion of technology-related IPOs (over 1,000 since 1990), many newly public entities have languished. As one industry publication relates, of those 1,000-plus domestic IPOs, almost 200 have price/earnings multiples below twenty, and approximately 300 are trading below their offering price. See David G. Barry et al., As Technology Industry Matures, Firms
the actual potential for accomplishing this sort of exit in Latin America is limited. Generally considered, institutional investors that purchase Latin American stocks focus on the issues of a handful of top-tier industrial conglomerates, as opposed to unknown companies with relatively short performance records. The negative consequences of this focus are exacerbated by the fact that most Latin American equity markets lack sufficient liquidity for smaller domestic issuers to make successful offerings. In the view of one regional business publication, "with the exception of Argentina, Brazil, and Mexico, the markets of other Latin American economies are either too small or too unstable to be considered potential destinations.

An increasingly popular alternative is to offer shares on an exchange in a developed country. For example, a Latin American company may do a private placement in the United States pursuant to Regulation D or a public offering. Although such action does not directly contribute to the development of a Latin American nation's securities market, it is a nonetheless desirable outcome in that it helps Latin American enterprises beat the capital squeeze and bolsters the notion of rigorous financial reporting in Latin American business culture. Recent examples of private equity financed transactions that eventually went to a foreign market include Terra Networks, S.A. (an Internet company active in Latin America whose shares are traded on the NASDAQ), El Sitio.com (an Argentine-

47. It is significant in this connection that no recently established Latin American Internet company has issued stock on a local exchange. See Eduardo Garcia, *Mexico May Ease Rules for Stock Listings*, MIAMI HERALD, Feb. 26, 2000, at 2C.

48. Latin American stock markets have historically had concentrated capitalizations, few companies, and a low turnover ratio. As of the end of 1995, the capitalization held by the ten largest stocks in Argentina, Brazil, Chile, and Mexico represented, respectively, 47.5 percent, 37.1 percent, 36.5 percent, and 36.5 percent of the market. See Vernava, *supra* note 6, at 123.

49. John Watling, *Invest in Mexico Now*, MB, Mar. 1999, at 35. This said, Advent, one of the most powerful private equity groups operating in Latin America, has succeeded in bringing more than one hundred of its investments public on fifteen different stock exchanges. See Kas, *supra* note 42.

50. Internet-related high-tech companies that issued shares in the United States during 1999 participated in a record-breaking performance in terms of the average return for IPOs at the end of the pricing year. Prior to 1999, the highest average return for an IPO at the end of its pricing year was 28 percent. In 1999, the average return for all IPOs was 82 percent. For Internet-related shares, this percentage jumped to 165 percent. See Dorschner, *supra* note 38. Financial analysts believe this level of performance to be unsustainable going forward. Pointing to the continued non-profitability of internet-related companies with publicly traded shares, many investment professionals are expecting a substantial industry shake-out. See John Dorschner, *Internet Stocks Surf on Thin Ice*, MIAMI HERALD, Feb. 6, 2000, at A1.


based Internet portal whose shares are traded on the NASDAQ),\textsuperscript{53} Impsat (an Argentine Internet infrastructure company whose shares are traded on the NASDAQ),\textsuperscript{54} and StarMedia Networks, Inc. (one of the biggest Internet portals in Latin America; its shares are traded on NASDAQ and STRM).\textsuperscript{55} Private equity funded companies that have announced future plans to issue shares, principally on the NASDAQ,\textsuperscript{56} include Yupi.com,\textsuperscript{57} LatinStocks.com (a Buenos Aires-based Internet financial services company),\textsuperscript{58} Patagon.com Int’l Ltd. (founded by Argentines, this Internet site provides personal financial services for Latin American users),\textsuperscript{59} MercadoLibre, S.A. (an Argentine on-line market site),\textsuperscript{60} and UOL (a Brazilian ISP with localized Web portals in the United States, Venezuela, Chile, Colombia, and Mexico).\textsuperscript{61} An example of a private equity transaction that did a private placement is UOL.\textsuperscript{62}

Possible divesting difficulties aside, experience has shown that “pioneer” equity ventures involving Latin American SMSEs can yield significant economic, social, and financial benefits.\textsuperscript{63} Positive regional GDP growth rates, combined with internal rates of return on the order of thirty to fifty percent (117 percent in one case\textsuperscript{64}) have attracted the attention of U.S. private equity funds, many of which are presently flush with cash\textsuperscript{65} and anxious to replicate their successes in new lands.\textsuperscript{66} This attraction is, in turn, strengthened by

\textsuperscript{53} Id.
\textsuperscript{55} See Montes, supra note 28, at 26.
\textsuperscript{56} This practice is characteristic of the so-called “New Economy,” wherein the old-line industrial and service companies of the Dow Jones are considered to be representative of the past, and the technology firms of the NASDAQ composite Index are thought to auger the future. Said dynamic has been described as a “massive structural shift in the U.S. economy.” Gregg Fields, Dow Jones Slides Below 10,000, Hints at New Economy, MIAMI HERALD, Feb. 26, 2000, at A1.
\textsuperscript{57} See Gregg Fields, Spanish Web Portal Yupi Files for U.S.$172M Stock Offering, MIAMI HERALD, Jan. 20, 2000, at C1.
\textsuperscript{58} See Panorama, supra note 33, at 11. This company is controlled by Exxel, a large Argentine private equity group.
\textsuperscript{59} See Darrigrandi, supra note 33, at 25.
\textsuperscript{60} See id.
\textsuperscript{61} See Panorama, supra note 33, at 12.
\textsuperscript{62} UOL recently raised U.S.$100 million through a placement to a group of institutional investors headed by Morgan Stanley Dean Witter & Co. See UOL Da el Salto, AMERICAECONOMIA, Oct. 21, 1999, at 8.
\textsuperscript{64} See Evans, supra note 28, at 23. The 117 percent internal rate of return earned by U.S. buy-out firm Hicks, Muse, Tate & Furst in an Argentine cablevision transaction helps substantiate MIT professor Rudiger Dornbusch’s claim that equity investments in Latin America can lead to “high growth rates and big time profits.” MIF, supra note 63.
\textsuperscript{65} Having raised U.S.$54 billion in 1997 alone, the U.S. private equity market currently has a tremendous quantity of money to invest. See Mckenna, supra note 51.
\textsuperscript{66} See Roldan, supra note 34, at 42.
U.S. investors' demonstrated interest in purchasing and holding foreign securities and the diminishing average rates of return being realized in U.S. (domestic) private equity investments. A recent report by Goldman Sachs quantifies this trend by pointing out that between 1992 and 1995 the percentage of international private equity investments increased from zero percent to 5.8 percent of all alternative investments. "In a few short years, participation in this asset class went from . . . zero to 51%." The Goldman Sachs report concludes by identifying international private equity investment as the asset class that will deliver the highest future returns.

E. THE POTENTIAL FOR PRIVATE EQUITY FINANCING IN MEXICO.

Consistent with the experience of its Latin American neighbors, private equity financing in Mexico has increased steadily since the mid-1990s. According to the findings of one study, Mexico has received approximately U.S.$1.7 billion in private equity funding. This figure represents approximately nine percent of all capital raised by Latin American private equity funds and 17.3 percent of the total value of all deals closed in the

67. See J. Carter Beese, Jr., Reengineering Regulation: Maintaining the Competitiveness of the United States Capital Markets, 18 WASH. Q. 133 (1995), available in LEXIS, News Library, Curnews File. U.S. investors have historically shown "little interest in holding equity positions in foreign companies. However, with the dramatic growth of U.S. mutual funds and pension funds over the last decade, these institutional investors have begun to increase the allocation of their holdings dedicated to foreign equities." Between 1980 and 1994 foreign equity investment by U.S. investors increased from U.S.$17.9 billion to over U.S.$850 billion. Id.

68. The average rate of return on a U.S. (domestic) private equity investment has declined from approximately forty percent in the 1970s to a current approximate rate of twenty percent. This rate is expected to drift further downwards to seventeen or eighteen percent. See Molinski, supra note 10.


70. It should be noted that the concept of venture capital (capital de riesgo) is not totally foreign to Mexico. For some time, the government has used the Sociedad de Inversion de Capital de Riesgo (venture capital societies, or SINCAs) to promote investment in specified regions or entrepreneurial activities. These societies are distinguishable, however, from private equity funds in several basic respects. First, the source of their capital is primarily the government, as opposed to the private sector. Second, their organization is open-ended, unlike the close-ended nature of U.S. private equity funds. Last, the goal of the society has not been to take the recipient company public but, rather, to plow profits back into the company. As of 1997, there were about fifty SINCAs operating in Mexico, with total assets of N$2.8 billion. Of this money, approximately eighty percent was invested in companies, eighteen percent in fixed-income securities, and two percent in other assets. See Baron F. Levin, A New Player in the Market, BUSINESS MEXICO, Apr. 1, 1997, available in LEXIS, Country & Region (excluding U.S.), Mexico, Country Reports.

region between 1996 and 1997. Responding to this growth, the number of private equity funds operating in Mexico has gone from zero to approximately fifteen.

The increasing importance of private equity in Mexico reflects the existence of local conditions favorable to its florescence. Relative to investment opportunities in either the United States or other economies, many companies in Mexico are undervalued by as much as twenty percent. As Jorge Mariscal, the head of emerging markets strategy at Goldman Sachs notes, "a quick look at the Mexican market shows it is undervalued relative to any measure you choose." Attracted by the potential for valuation increases of up to twenty percent and thirty percent, foreign investors have begun to purchase large shares of these private companies.

The near collapse of the Mexican banking system and the consequential drying up of productive credit has also contributed to the increased interest in private equity. With interest rates as high as thirty to forty percent, commercial credit initially slowed to a trickle and then actually shrank. As a leading business publication points out, "financing by commercial banks to the private sector has contracted every year" since Mexico's devaluation-driven financial crisis in 1995. In this spartan credit environment, companies desperate to meet their financing needs and/or survive are willing to absorb the relatively high costs associated with private equity financing.

Another factor conducive to private equity financing in Mexico involves the nation's positive long-term macroeconomic growth prospects. Average post-NAFTA foreign direct

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72. See id.
74. In this vein, one financial writer recently observed that private equity investors are a "new breed of investor" that have "perceptibly" changed the nature of investing in Mexico. See Jean Michael Enriquez, Recurring Legal Issues for Private Equity Funds in Mexico, Aug. 15, 1999 (visited Nov. 12, 1999) http://www.wtexec.com/mf081599.html.
75. See Watling, supra note 49, at 33. While this statement was based on the analysis of P/E ratios of companies whose stock is publicly traded in Mexico, it also constitutes an accurate characterization of the relative value of Mexico's privately held corporations.
76. See Watling, supra note 49, at 33
77. See Watling, supra note 49, at 35.
79. The FOBAPROA bailout cost over U.S.$80 billion. This amount—representing approximately fifteen percent of Mexican GDP—has become public debt. See Ricardo Sandoval, Audit Faults Mexican Government, MIAMI HERALD, July 22, 1999.
80. See Bustos, supra note 9, at 22.
investment of over $10 billion per year, combined with strong GDP growth over the same period has made Mexico the fourth fastest growing economy amongst the world's thirty largest economies. The fact that Mexico's economy is expected to "post the best growth rates in all of Latin America in the coming years" appeals to investors whose ultimate return is a function of both a recipient company's profitability and the economy's long-term vitality.

The last condition, giving rise to increased private equity financing in Mexico involves the effect of ongoing pension fund reform. Mexico's newly privatized pension fund management system (Administradora de los Fondos de Retiro, or AFORES) has until now been limited to the ownership of one mutual fund. Liberalization of the number of mutual funds that can be owned by AFORES, coupled with a grant of authority to invest in a wider range of instruments including the stock market, will simultaneously deepen the capitalization of Mexico's market and enhance the attractiveness of going public. The recent opening up of Mexico's insurance industry and health care system dovetails perfectly with this dynamic insofar as stepped up reliance on private insurance coverage could result in greater levels of portfolio investment in local companies by increasingly well-capitalized insurance companies.

An important corollary to the aforementioned investment conditions is the overall growth potential for private equity financing in Mexico. Indicative of this potential is the fact that in spite of being the region's second largest economy, Mexico has only received 17.3 percent of total Latin American private equity financing. This share is much less than that received by nations with significantly smaller economies (for example, Argentina and Chile). As international investors continue their entry "into new market niches, such as financing small and medium companies," it is reasonable to think that Mexico will be the recipient of a more proportional share of total private equity investment.

In this last connection, it should be noted that there is no shortage of investment opportunities for private equity funds in Mexico. Recent econometric data indicates that approximately 2,000 small and 500 medium-sized businesses have a combined demand for investment.
for private equity totaling between $7.2 and $8 billion. Private equity financing can be used, inter alia, for financing start-up companies, restructuring corporate liabilities, expansion, acquisitions, and the direct capitalization of economic groups of all sizes. Specific economic activities and/or sectors in Mexico that have already received private equity include light industry (Vidrio Formas, Collado), retail (Latin Americano, S.A. de C.V.), food and beverage (La Corona/Grupo Corvi, Grupo Embottelladora Sureste, Fomento Alimenticos), infrastructure, health care, entertainment (Cinemex, S.A.), and high-tech or Internet-based entities.

From the foregoing it is evident that there exists a tremendous unrealized potential for private equity investment in Mexico. As noted by the investment community, SMSEs in Mexico present an "outstanding opportunity to couple the strengths of local innovation with foreign capital." This paper will explore the practical issues, challenges, risks, and rewards associated with that potential from the perspective of a North American investor.

Because private equity strategies and techniques developed in the United States cannot always be directly applied to investments elsewhere, a large part of this paper is directed to the prudent structuring of private equity transactions in the context of Mexico's legal, political, social, and economic environment. Specific structuring aspects addressed include the realization of due diligence, the drafting and execution of the investment agreement, and fundamental exit strategies. As a basic analytical proposition, this investigation carries forth from the perspective of a minority stakeholder, unless otherwise noted. The reason for this qualification is that majority shareholders, by virtue of their investment, have all the control they should need to protect their investment and realize its objectives. Accordingly, many of the issues that are potentially problematic in private equity transactions never arise. To the extent they are available, actual examples of transaction structuring in Mexico will be provided.

Having looked at the legal steps and mechanisms entailed in a private equity transaction, this paper concludes by identifying the special risks and challenges associated with private equity transactions in Mexico. Where available, means of mitigating against said risks are noted. The final part of the conclusion offers a series of observations and recommendations, the implementation of which will facilitate the optimal future development of private equity financing in Mexico.

91. See Capital de Riesgo/Desarrollo, supra note 71.
92. See Capital de Riego/Desarrollo, supra note 71.
93. See Jack S. Levin et al., supra note 15. See also Kas, supra note 42.
95. In this spirit, the head of Morgan Capital's private equity group notes that "investing as a minority investor is a much bigger challenge than being able to take a controlling stake." A Private Affair, Latin Fin., Dec. 1998, available in LEXIS, Country and Region (excluding U.S.), Mexico, News.
II. Structuring Private Equity Transactions in Mexico.

A. PRIVATE EQUITY INVESTORS.

Private equity firms manage portfolios consisting of legally discrete investments, the majority of which are organized as limited partnerships. These limited partnerships often have a contractually fixed lifetime of ten years. This period can, by agreement, be extended in one or two-year increments up to a maximum period of four years. These funds may either have an affiliation with a larger financial institution or be an independent "boutique." Acting as financial "intermediaries," limited partnerships are responsible for the management of approximately eighty percent of all private equity investment. Typically a fund invests no more than ten percent of the aggregate value of its portfolio into a single deal. Most of these funds are American, although several regionally oriented firms have emerged over the last few years (for example, Buenos Aires, Sao Paolo, Rio de Janeiro, and Mexico City). Some funds have also begun to base their operations out of offshore money havens such as the Cayman Islands.

U.S. private equity limited partnerships are composed of general and limited partners. The number of total partners may be kept small so as to exempt the limited partnership from unnecessary Securities and Exchange Commission (SEC) regulation. The general partners assume professional responsibility for raising, making, managing, and exiting investments. As a result of the Small Business Investment Incentive Act's redefinition of private equity partnerships as "Business Development Companies," general partners are not governed by the Investment Advisers Act of 1940.

The primary purpose of the limited partners, on the other hand, is to invest money and earn a return. Outside of these functions, limited partners are often specifically prohibited from taking an active role in the management of the investment. Typical U.S. limited partners are pension funds (both public and corporate), endowments and foundations, bank holding companies, insurance companies, investment banks, and high net worth indi-
viduals or families.\textsuperscript{105} Pension funds have provided approximately forty percent of total investable capital with the remainder being equally split between the other sources.\textsuperscript{106}

Having invested their money, with the expectation that risk adjusted returns on private equity investments are greater than the risk adjusted returns on other investments, private equity limited partnerships generally require rates of return ranging from fifty percent for an early stage deal to twenty-five percent for a later stage transaction.\textsuperscript{107} These elevated rates of return can be enhanced insofar as taxes are "typically paid not at the fund level, but rather by individual general and limited partners."\textsuperscript{108} This pass through taxation scheme "enables tax exempt investors to avoid almost all tax obligations."\textsuperscript{109}

1. The Partnership Agreement.

Due to the inherent risk associated with international investments of this type, it is important that there be a functional relationship and clear understanding between the general and limited partners. The primary mechanism for accomplishing this end is through a written partnership agreement.

Because limited partners forego virtually all control over the management of an investment, there is a great potential for conflict within the partnership. To discourage general partner opportunism, private equity funds carefully ensure that the general partner's overall compensation is properly aligned with the interests of the limited partners. In this connection, the general and limited partners together determine the general partner's management fee percentage and associated carried interest (i.e., their share of partnership profits). A general partner's management fee will usually be between one percent and three percent of any profit earned, while the carried interest tends to be in the vicinity of twenty percent.\textsuperscript{110} Compensation can be in the form of cash, stock, options, or a combination thereof.\textsuperscript{111} By directly tying the general partner's compensation to the performance of the investment in this way, limited partners can be reasonably sure their interests will be reflected in management's decisions and actions.

While the partnership agreement is the basic vehicle for ordering the relations and rights between general and limited partners, other steps can be taken. For example, general and limited partners may negotiate and enter into collateral and security covenants, thereby limiting the amount of partnership capital that can be invested in one firm, precluding investments in ventures that deviate from the partnership's main focus, and mandating the immediate disbursement of funds on receipt.

\textsuperscript{105} See id. To this pool must be added U.S. government foreign aid organizations (USAID), quasi-governmental corporations (OPIC), multilateral financial institutions (for example, the IFC), and national development banks (for example, NAFINSA in Mexico). These government-related investors may measure the return on their investments more in terms of democracy and development rather than dollars. See Nacional Financiera, U.S.-Mexico Chamber of Commerce Sign Cooperation Agreement (visited Jan. 5, 2000) http: www.usmcoc.org/rel10598.html.

\textsuperscript{106} See Lerner & Pacanins, supra note 36.

\textsuperscript{107} See Fenn et al., supra note 17.

\textsuperscript{108} Id.

\textsuperscript{109} Id.

\textsuperscript{110} See id.

\textsuperscript{111} The Incentive Stock Option Law of 1981 made the use of options more attractive by deferring the tax liability to the time of sale, as opposed to the time of option exercise. See id.
Limited partners may also successfully negotiate for and obtain oversight and control rights. The obtainment of an oversight role entails belonging to an advisory board of limited power. Control rights, conversely, can be quite significant insofar as they may give the limited partners the ability to vote on the removal of a general partner or the termination of the partnership before its scheduled date. General partners zealously resist the granting of these rights.112

B. Deal Selection.

The first step in a private equity transaction is investment selection. This screening process may focus on targets within a specific niche113 or, alternatively, range broadly over market segments114 and industries.115 Given the increased interest in private equity financing, the market for investment opportunities has become more competitive. In the view of one trade publication, "private equity firms are lining up at the trough in search of the tastiest deals."116

Although private equity funds may receive hundreds of leads from a variety of sources (including entrepreneurs, lawyers, accountants, bankers, consultants, etc.), many fund managers prefer to select investments on the basis of personal knowledge of and prior experience with the target. Funds affiliated with an investment banking operation have the advantage of being able to consider companies controlled by groups or people with whom the organization has a standing relationship. In this regard, the managing director of JP Morgan's private equity fund notes, "we try to limit our activity to investing in businesses which we feel extremely comfortable with the controlling shareholders; . . . we take a lot of comfort from investing with people that we feel will protect our interests over the period of our investment."117

Absent the ability to generate new investments from prior relationships, a fund has no choice but to reach investment decisions on the basis of factors such as the "chemistry" between the parties, its impression of the company's commitment, drive, honesty, reputation, and creativity, and, most importantly, the results of the due diligence investigation.

The last point on the subject of investment selection involves the physical location of a fund. Funds with a physical presence in the country that they target will be more attuned to recent developments and opportunities than a fund based outside the target country. As the chief executive of one of the few private equity funds with its headquarters in Latin America notes, "if you're not down here you don't really know what's going

112. See id.
113. As one industry publication notes: "another trend is concentration on one kind of investment . . . funds are taking a focused investment approach, concentrating, for example, on insurance, health care, . . . and in the case of a Venezuelan fund, the restaurant sector." Evans, supra note 28, at 23.
114. Some firms limit their investments to deals of a certain minimum size. See id.
115. It is usually larger funds that have the ability and resources to diversify their investment scope in this way. See id.
116. Id.
117. A Private Affair, supra note 95. As shall be taken up, some investors view an established relationship as the most effective means of avoiding litigation in local courts.
Having the advantage of being a first mover in a market that is increasingly competitive can be significant.

C. GENERAL DUE DILIGENCE CONSIDERATIONS.

After successfully narrowing the field of potential investments, private equity fund managers engage in the critical process of due diligence. "Partnership managers receive hundreds of investment proposals. To be successful, they must be able to select efficiently the 1% of those proposals that they invest in each year."119 An effective due diligence program will critically evaluate the company, its management, the industry, the legislative environment, and the country in relation to the fund's investment criteria and objectives.

Due diligence is a detail-rich and time-consuming process120 that can constitute a significant transaction cost. To protect their economic interests, fund managers may attempt to negotiate a letter of intent (LOI) containing, inter alia, a "no-shop" provision obligating the parties to deal exclusively with one another for the duration of the investigation. Alternatively, fund managers may consider including in a LOI an expense reimbursement provision allocating financial responsibility for the costs of the due diligence in the event the transaction ultimately falls through. While this tactic has met with success in the United States, it is not widely used in Mexican transactions.

The preliminary and non-binding nature of the LOI should be expressly noted, lest a court find it to be an enforceable agreement. This said, however, the LOI may, to the extent it represents the high degree of the parties' commitment, be extremely useful when dealing with government agencies in subsequent stages of the investment. LOIs are usually drafted by the fund and countersigned by the representative of the target company.

Because due diligence is prodding and invasive, the process can pose a problem with respect to small to medium-sized commercial enterprises in Latin America. Having often been run in the same way by a single family (or group of families) for generations, the typical small to medium-sized entity may be unfamiliar with and/or hostile to the rules, procedures and timetables entailed in a private equity fund's due diligence. Moreover, as a result of not previously having had to open itself up to outside examination, many of these firms may not be accustomed to sharing otherwise secret information with non-family members.121 As one

119. Fenn et al., supra note 17.
120. Private equity related due diligence may be more challenging than due diligence in other financing transactions due to the fact that most of the targets are closely held companies about which there is little publicly available information. See id.
121. See Boyer, supra note 29, at 62. The importance of this socio-cultural phenomenon for business dealings cannot be underestimated. Statistical studies have identified the significant level of distrust that Latin Americans have for one another and their leaders. See Marta Lagos, Public Opinion in New Democracies: Latin America's Smiling Mask, J. DEMOCRACY, July 1997, at 128. As Ilya Adler points out, the economic development of Mexico can, in part, be linked to this tendency: "... societies with low levels of trust, such as Mexico, are less likely to spawn large corporations, whereas societies with high trust levels, such as the U.S. and Canada, are capable of organizing themselves into large, private enterprises. In low trust societies, businesses tend to be family centered precisely because others can not be trusted." Ilya Adler, Family Affair, BUS. MEX., Oct. 1998, at 18. U.S. private equity funds should always keep in mind that business relationships in Mexico are not casually formed. Rather, they are the end product of a long and substantial period of meetings and familiarization.
Mexican economist notes, "family-owned firms . . . are extremely reluctant to give any information . . . not out of dishonesty, but out of a parochial attitude." Echoing this thought, a senior analyst at a Mexico City brokerage house, adds: "It's a problem of culture. It's a very closed culture."

Where there is an existing relationship—and consequently less of a concern about the transparency of the target company's operations—this problem may be sidestepped. Absent such a relationship, however, requests for detailed information from a company with whom the fund has no standing relationship may not be well received. To mitigate the effects of any cultural collision, fund managers may execute a confidentiality agreement covering the substance of the due diligence investigation. By providing an enhanced level of security and comfort, fund managers might be more successful in obtaining full disclosure and cooperation.

The efficient selection of private equity deals may be described as "more art than science" and heavily dependent on the "acumen of the general partners." Often, fund managers possess specialized professional knowledge of the target company's industry, to the partnership's benefit. Irrespective of such specialized knowledge, however, fund managers should always conduct due diligence investigations in person and with the assistance of legal and accounting counsel familiar with local business customs and norms.

An effective due diligence program can produce two important results. First, by uncovering concealed facts it can help a fund avoid unnecessarily risky, problematic, or approval-contingent deals. Second, properly conducted due diligence can flush out problems and/or issues that bear on the negotiation of the subsequent term sheet, investment agreement, and deal valuation.

Depending on the circumstances of a contemplated investment, the entire process may be accomplished in as little time as a few weeks or as long as several months. The due diligence process usually takes longer to complete for Latin American companies than it does for U.S. entities.

1.2. Patience is Virtue in Dealing with Mexican Businesses, supra note 11.
1.23. Id.
1.24. Confidentiality agreements can be drafted to (1) limit the access of certain people to information pertaining to the contemplated deal; (2) commit the parties to the agreement to an extended period of confidentiality in the event the transaction falls through; and (3) provide for the return of previously disclosed material or information upon the occurrence of certain events.
1.25. Lerner & Pacanins, supra note 36. U.S. investors should always refer to the following "cardinal rules" of due diligence: "(1) Never accept the first answer you get to a question; (2) Never assume anything is done unless you have seen it yourself; and (3) Never assume the rules are the same for two transactions." Andrew D. Soussloff & Frank H. Golay, Jr., Conducting Due Diligence Investigations in Securities Offerings by Non-U.S. Issuers, in Conducting Due Diligence 533 (L. Markus Wiltshire & K. Hudson Zrike eds., 1999).
1.26. The involvement of local professional counsel for the purpose of conducting due diligence is essential insofar as many fund managers "do not have a clue about" Latin America. Evans, supra note 28, at 23. On the other hand, fund managers should be careful not to rely too heavily on input of local advisors. An unnamed New York private equity fund did this only to end up "pouring money into a black hole of debt with no apparent escape route." Mulligan, supra note 14.
1.27. Evans, supra note 28, at 23.
D. MEXICO-SPECIFIC DUE DILIGENCE CONSIDERATIONS.

Effective due diligence in Mexico requires, at a minimum, understanding the substance and application of Mexico’s foreign investment and corporate laws. Depending on the objectives of the investment, the scope of the due diligence investigation may be expanded to include Mexico’s intellectual property, environmental, and antitrust laws. Certain aspects of said regulations may be informed and/or superseded by Mexico’s regional and supra-national obligations (under NAFTA, the OAS, the WTO, etc.). Recent jurisprudencia from Mexico’s Supreme Court confirms the superior position of international treaties and obligations relative to federal laws.\(^{128}\) Given the legal complexities associated with a Mexican due diligence program, the involvement of local legal counsel is highly recommended. The following subsections identify and evaluate the basic considerations that should be part of a Mexican due diligence program.

1. Foreign Investment Framework.

Foreign investment may participate in any proportion (up to 100 percent) in the capital stock of a Mexican company.\(^{129}\) This said, however, fund managers must evaluate the particular activity associated with a contemplated investment in relation to the specific limitations set forth in articles 5-9 of Mexico's Foreign Investment Law (Ley de Inversión Extranjera, or FIL). Under the aforementioned articles, foreign investment may be exclusively reserved to the state, reserved to Mexican companies with foreigner exclusion clauses,\(^{130}\) restricted to a predetermined percentage not exceeding forty-nine percent,\(^{131}\) or subject to the favorable authorization of the Foreign Investment Commission (Comisión Nacional de Inversión Extranjera, or CNIE).\(^{132}\)

In addition to these potential limitations, Mexico’s FIL can impose other obligations. For example, CNIE authorization is mandatory with respect to foreign participation greater than forty-nine percent (1) in the economic activities and companies enumerated in article 8 of the FIL or (2) when the value of the total assets of the target company exceed the amount annually established by the CNIE.\(^{133}\) The CNIE must rule on requests


\(^{130}\) Id. art. 6.

\(^{131}\) Id. art. 7.

\(^{132}\) Id. arts. 8 & 9. The FIL does set forth specific rules for neutral investments (participation that results in economic benefits but no right to vote in ordinary general shareholders meetings). These rules are not addressed, as it is an analytical assumption of this paper that private equity foreign investment will entail the right to meaningfully participate in the corporation’s governance.

\(^{133}\) Id. art. 9. The current general threshold is approximately N$712 million. Telephone Interview with Lic. Jorge Ogarrio Kalb, partner, Ogarrio & Diaz, S.C. (Apr. 2, 2000). Pursuant to NAFTA, the threshold amount effective between 1997 and 1999 was U.S.$50 million. [Investing in Mexico Today (1999) (report prepared by Santamarina y Steta, Mexico) (on file with author)].
for authorization within forty-five days. If no response is made within this time, the request is deemed approved by operation of law.\textsuperscript{134} Failure to obtain this authorization can result in the imposition of a fine ranging between 1000 to 5000 daily Mexico City minimum wages.\textsuperscript{135}

Another administrative aspect of Mexico's FIL that fund managers may find burdensome is article 32. Under this provision, participation of foreign investment in Mexican companies must be registered at the CNIE within forty days of an investment.\textsuperscript{136} Compliance with this obligation is the responsibility of the foreign investor, and failure can result in a fine ranging between 30 and 100 daily Mexico City minimum wages.\textsuperscript{137}

At present, there are no restrictions on remittances or repatriations out of Mexico.\textsuperscript{138} Moreover, U.S. investors are guaranteed national treatment with respect to the establishment, acquisition, expansion, management, conduct, operation, sale, or other disposition of an investment.\textsuperscript{139}

2. Understanding the Target Company.

A fund manager's due diligence must also examine the target company's organization, capital structure, corporate governance, financial condition, and overall legal position. Key areas of inquiry are presented below.

a. Corporate Organization.

Information about the target company's organization may be found in its organizational instrument (escritura constitutiva). This document (or copies thereof) may be found with the company, in the protocol of the notary who created it, or in the public registry of commerce. Organization-related issues that could affect a private equity fund's investment include:

(i) Corporate Form.

Mexican law permits the formation of different types of commercial entities; some are better suited to private equity investments than others.\textsuperscript{140} Where a fund will take an equity interest, due diligence should confirm that the target company is organized either as a S.A. (Sociedad Anonima) or S.A. de C.V. (Sociedad Anonima de Capital Variable).\textsuperscript{141} The reason for this is that other corporate forms—for example, the S.R.L. (Sociedad de Responsabilidad Limitada) or the S.N.C. (Sociedad en Nombre Collectivo), inter alia—do not issue stock.\textsuperscript{142} Logically, when a fund thinks it may exit by IPO, utilization of a corporate form that contemplates the issuance of equity is essential.

\textsuperscript{134} See FIL, supra note 129, art. 28.
\textsuperscript{135} Id. art. 38.
\textsuperscript{136} Id. art. 32.
\textsuperscript{137} Id. art. 38.
\textsuperscript{139} Id. ch. 11, art. 1102(1).
\textsuperscript{140} "Ley General de Sociedades Mercantiles," D.O., 4 de agosto de 1944, art. 1 [hereinafter LGSM].
(ii) Corporate Purpose.

The organizational instrument must identify a company's purpose. In their due diligence, fund managers should ensure that it is legal and consistent with fund investment objectives. Companies with illegal purposes are null and subject to immediate liquidation. Moreover, indications of multiple past purposes may provide insights into the overall soundness of the corporation's business concept and/or management.

(iii) Compliance with Necessary Formalities.

Article 5 of the LGSM requires that companies be organized either before a notary or in accordance with the procedures entailed in a public subscription. Non-compliance with this requirement could result in the subsequent institution of summary proceedings, contrary to the fund's interest.

b. Capital Structure.

A crucial dimension of the due diligence process is the target company's capital structure. The organizational instrument should contain useful information regarding the number, par value, and characteristics of the shares comprising capital stock. Where a fund's investment requires the holding of stock with particular features (for example, convertible preferred), the due diligence process should determine whether that class is expressly provided for in the company's organizational instrument. Where the desired class is contemplated in the organizational instrument, the acts of the shareholders' meetings should be checked to determine whether said shares have been the subjects of any corporate action.

If a fund does seek preferential shares, fund managers must also consider the acceptability of the voting limitations set forth in article 182. Should they not be

141. While either a S.A. or a S.A. de C.V. will technically satisfy the equity and exit interests of a potential private equity investor, the S.A. de C.V. may prove more flexible in that its capital stock can be increased with greater ease and less cost. See id. art. 213. It is, moreover, possible to transform a S.A. into a S.A. de C.V. See id. art. 227.
142. S.R.L.s cannot, by statute, raise capital by public subscription. Id. art. 63. With the proper foundation, however, it is possible to transform these types of corporations into S.A.s or S.A. de C.V.s. See id. art. 227.
143. Id. art. 6.
144. Id. art. 3.
145. Id. arts. 5 & 90.
146. Id. art. 7.
147. Id. art 91.
148. Mexico's LGSM permits the creation of various classes of shares with special rights pertaining to each. If so provided in the organizational instrument, one part of the shares may only be given the right to vote in extraordinary assemblies. Shares with such limited voting rights do, however, have preferential status with respect to the payment of dividends and liquidation. Id. art. 113. Moreover, article 114 of the LGSM provides for the issuance of special shares to persons who furnish services to the company. Id. art. 114.
acceptable, the fund manager must determine the target company's willingness to expand the fund's voting rights.

The due diligence process should also determine the distribution of shares within a company's capital structure. This can be accomplished by examining the company's stock ledger.\footnote{\textit{Id.} art. 128.} To the extent that most SMSEs in Mexico are controlled by a family or a small group of families, this inspection should not be overly complicated, assuming records have been maintained. Through this means, the fund can, in theory, gain a clear idea of all parties with an interest in the target company.

c. Corporate Governance.

Due diligence programs must also consider the structure of corporate governance established in the target company's organizational instrument. In undertaking this consideration it is important that U.S. investors understand that contrary to the general U.S. practice of centralizing power in the board of directors, ultimate power in Mexican companies is vested in the assembly of shareholders. The most basic determination a fund manager must make in this connection is whether the rights and responsibilities set forth in a company's organizational instrument depart from the standards published in the LGSM.

(i) Directors.

Information pertaining to a company's administration must be presented in its organizational instrument.\footnote{\textit{Id.} art. 182.} Representation of the company can be vested in a board of directors appointed by shareholders or a sole administrator.\footnote{\textit{Id.} art. 6.} Said appointments are temporary and revocable.

Through due diligence, fund managers should determine whether directors have been issued powers of attorney to sign for and otherwise act on behalf of the company pursuant to articles 10 and 100 of the LGSM. Where applicable, fund managers should review and understand the scope of the authority conferred.\footnote{\textit{Id.} arts. 10 & 100.} Additional information

\footnote{149. \textit{Id.} art. 182. Article 113 shares are only permitted to vote on the following issues at extraordinary meetings: (1) an extension of the duration of the company; (2) the planned dissolution of the company; (3) a change of the company's purpose; (4) a change of the company's nationality; (5) transformation (the conversion of the company from one type to another); and (6) a merger with another company.}

\footnote{150. \textit{Id.} art. 128.}

\footnote{151. \textit{Id.} art. 6.}

\footnote{152. \textit{Id.} arts. 10 & 100.}

\footnote{153. Powers of attorney in Mexico constitute a contract by which the principal empowers an agent to perform acts having legal effect (\textit{actos juridicos}) on behalf of the principal. Their significance should not be underestimated, as they are usually the first point of attack in any controversy, and defects therein can be legally fatal. Mexican powers of attorney can be either general (full) or special (limited). General powers include: (1) the general power of attorney; (2) the general power of attorney for litigation and collections; (3) the general power of attorney for acts of administration; and (4) the general power of attorney for acts of ownership. Special powers of attorney include: (1) the special power of attorney to issue, endorse, and guarantee negotiable instruments; (2) the special power of attorney to open, cancel, and sign checks against bank accounts; (3) the special power of attorney for labor matters; (4) the special power of attorney for customs matters; and (5) the special power of attorney to participate in}
about directors may be obtained through the use of questionnaires (looking into, for example, stock owned, other financial interests, benefits, compensation, personal background, etc.).154

(ii) Managers.

Either the board of directors or the general assembly of shareholders may name general or special managers.155 Where this has occurred, fund managers should identify the scope of managerial authority granted (for example, through powers of attorney), as well as the manager's professional qualifications. Fund managers may request that managers fill out a due diligence questionnaire similar to that discussed for directors, supra. Managerial positions can be revoked at any time per article 145 of the LGSM.

(iii) Comisarios.

Fund managers must also investigate the target company's statutory examiner, or comisario. Responsible for general financial oversight and auditing, comisarios must meet specific standards of independence.156 Should a fund be dissatisfied with the target company's comisario, it is possible to arrange for a replacement.157

(iv) Shareholders.

The last class of actor whose corporate governance role must be taken into account is the general assembly of shareholders. Constituting the "supreme organ of the company,"158 it may, depending on the terms of the grant of authority set forth in the company's organizational instrument, agree to ratify all acts and operations. Given the potentially huge degree of control that can be exercised by this group, fund managers must determine whether the procedures and subject matter pertaining to ordinary and extraordinary assemblies are acceptable in light of fund investment criteria and objectives.159

d. Past Acts.

Documentation and records related to past corporate meetings must also form part of a fund manager's due diligence investigation. While these records may not always be kept in smaller, more informally managed commercial entities, they can, where available, help fund managers obtain a clearer idea of the target company's developmental history. Assuming availability, fund managers should specifically examine the minutes of past

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154. See Javier F. Becerra & George Humphrey, Powers of Attorney in Mexico: Guidelines and Strategies, in MEXICAN LAW: A TREATISE FOR LEGAL PRACTITIONERS AND INTERNATIONAL INVESTORS 69, 73-104 (Jorge A. Vargas ed., 1998). Powers of attorney that have been properly issued can be examined in the company's folio mercantil at the Registro Publico de Comercio.
156. See LGSM, supra note 140, art. 145.
157. Id. art. 165.
158. Id. art. 164.
159. Id. art. 178.
board meetings, as well as the resolutions of past ordinary assemblies.\textsuperscript{160} If it is the case that the company has had an extraordinary meeting, resolutions taken therein can be found at the notary before which they were registered or the public registry of commerce within which they were inscribed.

A final point that should be considered with respect to the investigation of past meetings is that Mexican corporate law does permit the taking of board and shareholder decisions outside of the procedural framework otherwise prescribed, provided, in both cases, that the vote was unanimous and confirmed in writing.\textsuperscript{161} The records pertaining to any such decision will need to be requested directly from the company.

3. Financial Condition.

The ultimate worth of a fund manager's due diligence will be determined by his or her access to reliable and meaningful historical and pro forma financial information. Minimally, fund managers should request and review all LGSM article 172 director reports (i.e., progress and projects, accounting standards and informational policies, financial condition, income—explained and categorized, changes in financial position, changes in assets, and clarifying notes) and LGSM article 166 comisario audits and opinions (audits of operations, documents, records; annual opinion of truthfulness, sufficiency, and reasonableness of the board's information to shareholders; annual opinion on adequacy of the company's informational policies and accounting standards; and annual opinion that directors' information correctly and sufficiently reflects the financial condition and income of the company).\textsuperscript{162}

While not expressly mandated by Mexico's corporate legislation, the prudent fund manager may additionally seek from the comisario and/or external accounting firm an opinion letter regarding the company's current tax status. This opinion should indicate whether the company has previously (1) made any tax ruling requests, (2) been the subject of either federal claims for past due employee related taxes or contributions such as Instituto Mexicano de Seguridad Social (IMSS), INFONAVIT, or state payroll taxes, (3) been delinquent on payment of real property taxes (obtain copies of the receipt for the impuesto predial), or (4) been involved in tax litigation.\textsuperscript{163}

Concomitant with said examinations, fund managers should also inspect the company's "books." Notwithstanding the existence of certain statutorily prescribed managerial duties and accounting standards, caution should be exercised, as it is easy for companies (particularly smaller, more informally run entities) to maintain parallel sets of books and

\textsuperscript{160} Id. art. 194.

\textsuperscript{161} Id. arts. 134 & 178.

\textsuperscript{162} In the event the fund is dealing with a S.A. de C.V., the manager should review increases and reductions of capital stock recorded in the special register book mandated by article 219 of the LGSM. \textit{Id.} art. 219.

\textsuperscript{163} These inquiries are essential to the avoidance of future problems insofar as it was, until recently, easy for Mexican companies to regularly ignore their tax obligations with impunity. As revenue policy changes and tax collection techniques sharpen, many companies have found themselves with large past due tax balances.
As a supplement to these examinations, fund managers should identify and seek leave to review any and all bank, brokerage or investment accounts, trade receivables, loan agreements, lines of credit, letters of credit, contingent liabilities—whether disclosed or not, and royalty or technical assistance obligations.

a. Financial Areas of Special Consideration.

Two aspects of a fund manager's due diligence that merit special attention are accounting and debt.

(i) Accounting Practices.

Article 158 of the LGSM imposes on directors a duty to create and manage systems of accounting, control, and bookkeeping and filing. Because such systems are more often than not non-compliant with U.S. GAAP, fund managers must realize that important measures of the company's financial performance or condition may be distorted.

While significant progress has been made over the last years to toughen accounting standards in Mexico, the rules set by the Mexican Institute of CPA's (the CPC, or Comisión de Principales de Contadores) are less onerous than those mandated by the FASB in the United States. Where no Mexican rule or standard exists CPC bulletins call for the use of international accounting standards (IAS), effective January 1, 1995. As of this writing, IASC records indicate that only two Mexican companies have fully implemented IAS standards. Should the accounting situation prove unacceptable, a fund manager

164. Adding impetus to this practice is the fact that commercial entities that employ large numbers of people often maintain parallel corporate structures (one is used for storing profits while the other employs workers). While this practice enables Mexican employers to circumvent the mandatory profit sharing provisions set out in articles 113 and 114 of the Federal Labor Law, it also can obscure a company's true financial condition. Additionally, in examining a company's books, fund managers should be on the look out for signs of money laundering activity (for example, the structuring of deposits involving cash, checks, money orders, and/or wire transfers to fall below the U.S.$10,000 mark). Private equity investments—particularly those involving the Internet or e-commerce—do provide attractive opportunities in this connection. Mexico has recently enacted anti-money laundering transaction reporting requirements similar to those of the United States.

165. Detailed accounting records in Spanish using-Mexican pesos should exist for the general ledger, the general journal, and the record of inventories and trial balances. These records should be on file at the official domicile of the business for the preceding ten-year period. See Ernst & Young, Doing Business in Mexico (visited Jan. 21, 2000) http://www.taxsites.com.

166. Examples of differences between Mexican and United States generally accepted accounting principles include the statement of cash flow (Mexican inflation adjusting techniques may differ from U.S. GAAP), deferred income taxes (temporary differences flow from the way purchases may be deducted for tax purposes under U.S. and Mexican GAAP), and employee profit sharing (the effects of any deferral are not recorded under Mexican GAAP). [Prospectus of Coca-Cola FEMSA, S.A. de C.V., Prospectus with Registration Nos. 333-5764 and 333-5868, Oct. 30, 1996.]

167. A small number of Mexican companies do report in U.S. GAAP or in a format that is otherwise U.S. GAAP reconciled. These exceptions tend to be large, publicly traded entities.

may require U.S. GAAP reconciled financial statements with accompanying notes. Although such action would be difficult and costly in the short term, it could ultimately streamline the exit process.

(ii) Debt Position.

The other potentially troublesome area for many Mexican companies involves their debt position. Having been exposed to almost constant financial crises since the early 1980s, many Mexican businesses carry significant, if not unmanageable, debt burdens. This over-leveraging underlies the Mexican banking industry’s massive portfolio of non-performing loans, the socially divisive FOBAPROA bailout, and the populist “el Barzon” movement. In a domestic context, private equity financiers would surely attempt to obtain an indemnity agreement with respect to the outstanding obligations. In Mexico, however, article 13 of the LGSM precludes this strategy by mandating that “a new partner or shareholder of a company already organized shall be responsible for all company obligations contracted prior to his admission. Any agreement to the contrary will have no effect to the prejudice of third parties.” Accordingly, it is important that funds obtain a realistic assessment of a target company’s debt position.

4. Legal Position.

With respect to the target company’s overall legal position, fund managers should review, as appropriate, the company’s contracts with key employees, property records, environmental permits, intellectual property registrations, import/export licenses, and litigation history. Moreover, where the fund’s exit strategy looks to a merger or sale, close consideration must be given to Mexico’s antitrust laws. The following subsections identify the key issues associated with each legal consideration.

a. Key Employee Contracts.

The employment contracts of all key employees should be carefully reviewed by fund managers, keeping in mind that (1) employee relations in Mexico are not at will and (2) removing problematic personnel can be a delicate and expensive process. Fund managers should specifically understand what notions, if any, of “just cause” are laid out in

169. LGSM, supra note 140, art. 13.
170. This situation is not helped by the fact that Mexico will have jurisdiction over a Mexican labor dispute. See Luis Ruiz Gutierrez & William E. Mooz, Jr., Labor Relations in Mexico, in AN INTRODUCTION TO DOING BUSINESS IN MEXICO 217 (William E. Mooz, Jr. ed., 1995). Moreover, to the U.S. investor’s detriment, there is no legal possibility for a diversity-based removal, like in the United States. As Mexican legislation notes, the possibility of bias or prejudice on the part of a magistrate or judge is neutralized by his or her duty to be impartial. U.S. private equity investors should realize, however, that if the recipient company meets the standards of commercial informality set out in article 352 of the Ley Federal de Trabajo (LFT) (i.e., the entity is a family business, operated primarily by family members with fewer than two employees), the protections of the LFT will not be available to workers (excepting the provisions on health and safety). “Ley Federal de Trabajo,” D.O., 1 de abril de 1970, art. 352. [hereinafter LFT].
employment contracts, as well as the extent of any severance benefits.\textsuperscript{171} Early identification of labor related obstacles could enhance the fund's comfort with the investment.

Alternatively, should an employee be particularly valuable, fund managers should determine whether (1) there is key person insurance coverage on that person and (2) the adequacy of that individual's current compensation package. The latter point can be especially significant in the context of venture capital transactions insofar as the overall success of the investment may depend on giving proper incentives to the founders to build the company. To date, Mexican companies have not made wide use of U.S. style compensation strategies such as stock option plans, largely because the majority of corporations in Mexico have unlisted shares. Increased foreign investment, coupled with a rise in listings, may facilitate the introduction of a broader range of compensation packages going forward.\textsuperscript{172}

Last, fund managers should ascertain whether any key personnel are subject to immigration restrictions. Where a key individual is foreign the due diligence process should determine whether there is any risk of adverse performance by the company as a result of the temporary or permanent immigration-related absence of the non-Mexican individual.

Outside of the aforementioned labor issues, a fund manager should discover (1) whether the company has been effected by strikes in the past, (2) the strength of labor unions within the base of workers, and (3) the general nature of company-syndicate relations.

b. Property Records.

Where the target company owns fixed assets or equipment of value, fund managers should review the validity of all associated documents, deeds, titles, etc.\textsuperscript{173} In this way, the fund will be able to avoid time consuming and costly future disputes regarding ownership or rights. Items whose existence and validity should be confirmed are: recent surveys of property conducted by a registered professional; a certified copy of the history of the property (\textit{historial de la propiedad}) issued by the public registry of property (akin to a title search); acquisition deeds, if any; deeds of merger and/or sub-division (\textit{fusion} or \textit{re-lotificacion}); the agrarian certification of the enterprise, if applicable (\textit{certificado de inafectabilidad agraria}); a certificate of no liens (\textit{certificado de libertad de gravamenes}); docu-

\textsuperscript{171} See LFT, supra note 170, arts. 47 & 53. Where an employee challenges a dismissal, the employer carries the burden of proof on the issue of just cause. \textit{Id.} art. 48. Mexico's labor laws are very protective of workers. Upon a termination imputable to the employer, the indemnity entailed in the severance package consists, generally, of three months salary plus, in certain cases, an amount representing the equivalent of twenty days pay for each year of service. \textit{Id.} Alternatively, the employer may choose to reinstate the employee. \textit{Id.} See also Charles A. Beckham, Jr., Texas/Mexico Cross-Border Insolvency and Collections, Paper presented at the State Bar of Texas Seminar "Business and Litigation in Mexico" (Feb. 1999).

\textsuperscript{172} In an important break from traditional compensation practices, some private equity financiers insist that local founders receive attractive option packages, largely to ensure their continued maximum performance. As Susan Segal, the head of Chase Capital Partners, notes with regard to that private equity group's practice of offering stock options worth approximately fifteen percent of a deal, "Queremos que todos esten motivados, desde la secretaria para arriba" ("We want everybody to be motivated, from the secretary up"). Darrigrandi, \textit{supra} note 33, at 23.

\textsuperscript{173} The validity of title should be given extra scrutiny where real property has been recently acquired from what had been an \textit{ejido}. 


mentation pertaining to any guarantees issued by the company affecting or encumbering real property; a complete list of all machinery, equipment, or other heavy duty assets, together with proof of purchase (or lease) and payment; complete files and titles for any vehicles; and documentation pertaining to any liens or encumbrances on non-real property. Fund managers should also ascertain whether the target company is current on its utilities or miscellaneous obligations (water, gas, electric, phone, computer leases, etc.) and not open to future claims of liability for past due balances.

c. Environmental Records.

As a result of the recent strengthening of Mexico's environmental laws, a fund manager's due diligence must confirm a target company's environmental compliance. This investigation, when applicable, is crucial as violations can result in substantial fines to the detriment of the fund's investment. The need for a heightened level of attention in this regard stems jointly from (1) the past tendency of Mexican companies not to comply with environmental laws and (2) the recently demonstrated interest on the part of the state in enforcing its environmental regulations.

To protect the fund from unwanted and unnecessary liabilities, fund managers should confirm the existence and validity of the following: all environmental applications or registration documents (including the Comprehensive Environmental License applications, the Operating License application, any applications for the generation and/or handling of hazardous wastes, waste water discharge registrations, and the SEMARNAP registration); any accompanying environmental surveys, reports, studies, or statements (including the company's Environmental Impact Statement, and Preventative Report); all licenses and rulings, specifically its Operating License (laconic de funcionamiento); any monthly or periodic reports otherwise required by SEMARNAP; blueprints, plans, and specifications for hazardous waste storage facilities; contracts for the storing, collecting, transporting, recycling, incineration, or final disposal of hazardous waste; cargo manifests or bills received from a consignee of hazardous waste; the findings of any inspection visits by either federal or state authorities; and any claims filed against the corporation by either governmental agencies or private parties.

d. Intellectual Property.

Where applicable, the due diligence process should include a review of the target company's intellectual property. This aspect of the due diligence is particularly meaningful when a fund's investment is closely linked to technology-sensitive operations.

With respect to proprietary intellectual property, fund managers should review any patents, trademarks, trade names, trade secrets, or copyrights owned by the company. IMPI (Instituto Mexicano de Propiedad Industrial) registrations should be confirmed (so

174. A vivid example of this tendency involves the disposal of hazardous waste. Of the eight million tons of hazardous waste recently produced in Mexico, the location of only one ton is known; the remaining seven tons of hazardous material were presumably disposed of illegally. See Sam Quinones, Mexico's Wastelands, Bus. Mex., Apr. 1999, at 38.
as to be valid against third parties) and the duration of the intellectual property's beneficial term noted.\textsuperscript{175}

If the investment contemplates the subsequent registration of intellectual property, fund managers must consider the procedures and protections set forth in Mexico's recently updated industrial property legislation.\textsuperscript{176} Notwithstanding the many improvements contained therein, the official publication of applications can be subject to substantial delays.\textsuperscript{177} This fact may be significant in relation to investment opportunities that are time sensitive. U.S. parties that make medium to long-term investments need not worry that the beneficial changes brought about by national legislation will be repealed in future years as NAFTA effectively freezes the terms of local law.\textsuperscript{178}

In the event the business of the target company depends on or utilizes licensed intellectual property, the fund manager should (1) define the remaining term of the license agreement and (2) confirm that it is properly recorded with IMPI. The adequacy and terms of any related technical assistance, services, and know-how agreements should also be reviewed.

Finally, fund managers should determine whether any infringement claims have been raised either by or against the company. This step is particularly relevant in the case of an investment that contemplates heavy Internet or e-commerce activity. To this end, fund managers should ensure there is no conflict regarding desired domain names and trademarks.

e. Customs Regime.

Where a target company's operations are tied to either importing or exporting, a fund manager must review its customs and foreign commerce programs. Specifically, a fund manager should confirm the existence and validity of the company's permanent and temporary import declarations (pedimentos), documents from customs valuation proceedings, maquila or other export agreements, and eligibility for either federal or state export incentives.

\textsuperscript{175} U.S. investors should realize, however, that registration alone is no guarantee that a company's intellectual property will be immune from infringement. While Mexico was finally removed from the USTR's list of the world's most egregious intellectual property violators, rampant piracy and weak enforcement continue to characterize the system. As recently as 1998, Mexico was given a warning by the USTR to beef up its intellectual property protections. According to the USTR's report, piracy and counterfeiting remain major problems in Mexico with U.S. industry losses increasing annually. Ana Machuca, \textit{Software Bandits}, \textit{Bus. Mex.}, Oct. 1998, at 38.

\textsuperscript{176} "Ley de la Propiedad Industrial," D.O., 27 de junio de 1991 [hereinafter LPI].

\textsuperscript{177} Article 52 of the Industrial Property Law requires the publication of patent applications in the Gazeta de Propiedad Industrial within eighteen months of filing. \textit{Id.} art. 52. To the extent that the Gazeta has a history of being behind schedule, the date on which coverage begins may be delayed. Gretchen A. Pemberton & Mariano Soni, Jr., \textit{Mexico's 1991 Industrial Property Law}, 25 \textit{Cornell Int'l L.J.} 103, 109 (1992).

f. Antitrust Review.

Where a fund anticipates exiting by sale to or merger with another corporation, the due diligence process must consider Mexico's antitrust laws. Taking into account the amount of the investment, the size of the private equity fund, and the size of the target company, fund managers must determine whether the contemplated investment qualifies for an antitrust exemption or, alternatively, whether the transaction will be subject to registration with and the approval of the Federal Competition Commission (Comisión Federal de Competencia, or CFC). "Investments by private equity funds, particularly first time investors in Mexico," usually do not raise competition concerns.

If it is determined that there is no exemption and CFC approval is necessary, the resultant filing must be submitted prior to the execution of the transaction documents. In this case, subsequent transaction documents will reflect the authorization of the competition commission as a condition to closing and include an unwind mechanism whereby an investor can divest in the event that the CFC denies or adversely conditions approval.

The requirement of CFC approval may subject a fund to additional financial disclosure. Moreover, delays associated with the obtainment of CFC approval can materially compromise previously established investment timetables and objectives. As one practitioner notes, regulatory delays of several months can thwart the parties ability to (1) take advantage of favorable market conditions or (2) accomplish certain time-sensitive objectives (for example, pay a maturing debt or make an acquisition of assets). Given these opportunity costs, it is essential that a private equity fund understand in advance whether a deal will be subject to CFC approval.

g. Other Aspects of Due Diligence Review.

The final element of a fund manager's due diligence entails the identification of any pending litigation and an examination of the target company's key commercial relationships. With respect to pending litigation, the fund manager should learn of all past and/or present lawsuits, arbitral proceedings, mediations, and conciliations. If a matter has been litigated or otherwise submitted for resolution, the fund manager must determine whether any appeal has been taken, keeping in mind that Mexico has several different types of appeal. In all cases, the fund manager should endeavor to communicate with the lawyer who handled the matter.

180. See id. art. 20.
181. Enriquez, supra note 74.
182. See id.
183. CFC-related disclosure will include: (1) answering a questionnaire; (2) a legal and business description of the parties to the transaction, including the partners of the fund's limited partnership; (3) a description of the transaction at issue; (4) annual reports of the fund; (5) audited financial statements of the fund; (6) the fund's incorporation documents; and (7) any other information the Commission deems necessary. See id. See also LFCE, supra note 179, arts. 21, 24, & 28.
184. Arbitration is the primary form of ADR in Mexico. Mediation has, however, been growing in importance.
As for key commercial relationships, fund managers may request that the target company supply a list of suppliers, distributors, commission agents, or otherwise material contracts. In addition to gaining an understanding of the substantive terms of these relationships, the fund manager may, by visiting with the representatives of these entities, obtain valuable disinterested insights into the operations and reputation of the target company.

Through the due diligence process a private equity fund stands the best chance of uncovering facts and issues that could ultimately prove detrimental to its investment. When such issues are identified, the fund manager must either negotiate a resolution or forgo the investment.

Problems revealed through due diligence may be addressed by an amendment to the target company's organizational instrument. Generally, a target company's organizational instrument can be freely amended through the services of a notary. However, parties to the transaction must ensure that the resulting modification does not violate certain non-derogable provisions of Mexican corporate law. In this connection, fund managers should understand that the following attempted changes constitute automatic violations of Mexican corporate law and are of no effect: (1) any modification of the company's bylaws in violation of the LGSM; (2) any attempt to excuse a new shareholder from responsibility for a pre-existing debt or obligation of the corporation; (3) any provision that excludes a shareholder from participating in the gains of the company; (4) any provision authorizing a distribution prior to the restoration or absorption of losses from prior years; (5) any decision of the board or general assembly of shareholders contrary to capital reserve requirements; (6) any provision that seeks to deny the minimum right of a twenty-five percent shareholder to appoint at least one director (ten percent shareholder in publicly traded corporation); (7) any provision that calls for the holding of ordinary or extraordinary shareholders meetings in any place other than the company's domicile, except in the case of impossibility or act of God; and (8) any agreement restricting the voting rights of shareholders.

Some of these issues can present significant problems for U.S. private equity investors (consider, for example, the prohibition on provisions that restrict the voting rights of shareholders). Fortunately, the effects of such prohibitions can be circumvented through the innovative code interpretation and deal structuring efforts of local counsel.

Other due diligence problems can stem from either the non-existence or a lack of target company information. Such problems can, under certain circumstances, be resolved by the target company's submission of detailed warranties and representations. While this strategy is not the best solution for a fund trying to fully assess whether to make an investment, it may be adequate where the fund manager has developed a high degree of trust in the target company and its management.

185. See LGSM, supra note 140, art. 5.
186. Id.
187. Id. art. 13.
188. Id. art. 17.
189. Id. art. 19.
190. Id. art. 21.
191. Id. art. 144.
192. Id. art. 179.
193. Id. art. 198.
E. **The Investment Agreement.**

Having determined that it will invest in a target company, the parties to the transac-
tion next negotiate and execute a series of agreements regarding the valuation of the com-
pany, the acquisition of the fund's ownership stake, shareholder's participation and govern-
nance rights, and exit options and procedures.\(^{194}\) Representing the heart of the transac-
tion, these agreements frequently integrate points previously established in the LOI or, where applicable, term sheets. To the extent possible, the substantive terms of these dis-
crete agreements will be incorporated into the recipient company's organizational instru-
ment. Said changes will be effective as between the parties to the agreements immediately. They will have no effect, however, with regard to third parties until the time that the revised organizational instrument is inscribed in the public registry of commerce.\(^{195}\)

1. **Pricing the Transaction.**

One of the most difficult tasks in any private equity transaction is reaching an agree-
ment between founders and investors as to the price of the deal. While a fund’s actual
required rate of return will vary in accordance with the circumstances of the investment, the valuation process is critical insofar as it often informs the size and nature of the fund's
ownership stake.

Regardless of the type of equity issued, a fund's investment share is commonly deter-
mined by “projecting the company’s value on some future date and backing out the per-
centage of ownership that provides the partnership with its required rate of return.”\(^{196}\) Said values are “typically based on multiples of projected after-tax earnings, earnings before interest and taxes, or cash flow.”\(^{197}\) Factors that can complicate the valuation of a
Mexican company include the tendency of family-owned companies to not have audited
financial statements readily available, lingering problems with respect to the reliability of
government generated economic reports and financial projections, and the divergent
objectives of the parties themselves.\(^{198}\) On the latter point, the company may want to
project a high future value, thereby reducing the amount of stock it will have to relin-
quish, whereas the fund may seek a more conservative forecast as a means of maximizing
its ownership interest.

2. **Acquiring an Ownership Stake.**

Depending on the results of the valuation, a fund will take either a majority or a
minority position in the target company's common stock, convertible preferred stock,
convertible subordinated debentures, straight preferred stock, or straight subordinated

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194. In a typical private equity transaction, these agreements will be memorialized in a shareholder
agreement and a stock purchase agreement. These documents are herein collectively referred
to as “transaction documents.”

195. Alexis Rovzar, *El Convenio o Acuerdo entre Accionistas*, paper presented at the conference on
*Capital de Desarrollo en Mexico* (Nov. 10-11, 1999) Veracruz, Mexico.

196. Fenn et al., *supra* note 17.

197. *Id.*

debentures. A majority investment in a Mexican entity may (but does not necessarily) entail the right to control and direct the daily administration of the company. Funds that invest in companies with unproven or failed management frequently seek majority interests. Minority investors, in contrast, do not usually participate in the company's daily administration. They do, however, often negotiate board representation as well as certain control, approval, and transfer rights. It is "typically the case" that funds take minority positions in Mexican companies.

3. Changes to Ownership Stake.

A fund's ownership interest may be modified prior to its formal exit in certain situations. For example, the fund may incorporate equity "earn-out" provisions into key employment contracts as an incentive to perform and/or manage responsibly. Under this strategy, management is permitted to increase its ownership share at the expense of investors if pre-determined performance objectives are met. Objectives can be stated in terms of earnings, the market value of the firm, or a combination thereof. The same principal can be applied in a way that punishes poor managerial performance or excessive risk taking. In this situation, the fund, pursuant to previously negotiated buy-back rights, re-acquires stock owned by the outgoing manager, thereby assuring the integrity of ongoing operations.


Funds that take majority stakes generally have absolute discretion with regard to corporate governance, and therefore do not negotiate for special rights. Funds that take minority stakes, on the other hand, have a natural interest in securing the strongest participation and minority rights possible. Key corporate governance features for which minority investors may negotiate are considered below.

a. Board Representation.

Private equity funds with minority stakes typically seek to strengthen their ability to participate in and monitor company affairs through board representation. While Mexican corporate law statutorily guarantees minority shareholders representing at least twenty-five percent of the capital stock (ten percent in the case of a company whose shares are traded on the stock exchange) the right to name at least one director, there is

199. Levin et al., supra note 15, at 1-4. The investor may also negotiate the acquisition of options and/or warrants. The fund's choice will in most cases be driven by the circumstances of the transaction. As previously mentioned, this paper focuses on the acquisition of equity securities.

200. See Rovzar, supra note 195.

201. Enriquez, supra note 74. While minority investments may be primarily a function of the valuation analysis, other factors that can account for minority positions include (1) a conscious desire on the part of the fund to avoid the fiduciary responsibilities associated with control and (2) an unwillingness on the part of the founding family to relinquish control, regardless of circumstances. See id.

202. See Fenn et al., supra note 17.

203. See id.

204. See id.
no prohibition against a fund using its leverage to obtain more positions.\textsuperscript{205} This said, however, board members in Mexican companies tend to be elected in proportion to their level of participation.\textsuperscript{206} Small investors typically gain a board seat with limited veto rights, while large investors gain an increased number of seats and enhanced veto authority. To guard against reductions of a fund's equity stake, founders may insist that a director "step-down" mechanism be included in the shareholders agreement.\textsuperscript{207}

As a means of ensuring their meaningful board participation, funds may negotiate to: (1) require that its directors are necessary for the purpose of constituting a quorum; (2) limit the recipient company's ability to remove directors; (3) have the right to fill vacancies on the board; (4) be represented on all committees;\textsuperscript{208} (5) restrict changes to the size of the board; (6) require the company to nominate its officers; and (7) obtain voting agreements from the other shareholders to ensure the election of its nominees.\textsuperscript{209} As was the case with the general appointment (and step-down) of directors, agreements to this effect should be confirmed in the shareholders agreement and, to the extent possible, incorporated into the entity's organizational instrument.

b. Control Rights.

Private equity investors may also seek to enhance their security by negotiating for a variety of control rights. As previously noted, foreign investors may, depending on the characteristics of the stock, be entitled to certain statutory rights of participation.\textsuperscript{210} While the rights contained in said provisions may, in some cases, overlap with those required by a private equity investor, they are, for most foreign investors, incomplete.\textsuperscript{211} As a supplement to rights set out in the LGSM, private equity investors may seek to obtain the following additional control rights.

\begin{enumerate}
\item[205.] LGSM, \textit{supra} note 140, art. 144.
\item[206.] See Rovzar, \textit{supra} note 195.
\item[207.] See Alison Ressler, \textit{Shareholder Agreements, in SUCCESSFUL PRIVATE EQUITY INVESTING}, 254 (Terrene M. O'Toole & Mitchell S. Presser eds., 1998).
\item[208.] Outside of the board of directors (\textit{consejo de administracion}), Mexican companies typically have the following committees: the \textit{ejecutivo} (with daily decision-making authority), the \textit{auditoria} (which maintains control of the financial aspects of the company), and the \textit{compensaciones} (responsible for setting compensation, bonuses, etc.).
\item[209.] See Ressler, \textit{supra} note 207, at 254. In this last connection, it will be recalled that article 198 of the LGSM prohibits the introduction of any rule restricting the voting rights of shareholders. The solution to this problem rests in the use of a shareholder voting trust (\textit{fideicomiso de accionistas}), as shall be explored in greater detail, \textit{infra}. LGSM, \textit{supra} note 140, art. 198.
\item[210.] Notwithstanding article 112's pronouncement that shares be of equal value and confer equal rights, the rights set forth in articles 112 and 113 are variable. LGSM, \textit{supra} note 140, arts. 112 & 113.
\item[211.] In this connection, preferential shareholders are not accorded the right to participate in (1) the appointment of directors, (2) certain remuneration issues, (3) decisions to increase or reduce capital, (4) the redemption of shares, and (5) the modification of the organizational instrument. \textit{See id.} arts. 181 & 182.
\end{enumerate}
(i) The Realization of Major Decisions.

Through this means, private equity investors are able to restrict the ability of the founders to enter into certain types of decisions or transactions. Examples of major decisions or transactions investors seek to control include: (1) proposed mergers, consolidations, re-organizations, or changes of control; (2) changes in business purpose; (3) investments or capital expenditures beyond a certain level; and (4) budgeting. These restrictions are expressly set forth in a list that is, in turn, incorporated into both the shareholders agreement and, where possible, the company's organizational instrument.

(ii) Access to Additional Financing.

To the extent that the success of the investment is tied to the financial condition of the recipient company, U.S. private equity investors may want to regulate the subsequent issuance of debt or equity securities as well as the company's ability to incur indebtedness. In this connection, a fund may regulate the timing of future financing rounds, thereby giving the recipient company the greatest possible incentive to perform. Should a fund adopt this strategy, the terms and timetables should be memorialized in the shareholder's agreement and, where possible, the company's organizational instrument.

(iii) Access to Information.

Even though Mexico's LGSM gives shareholders certain information rights, a fund may seek to re-enforce and/or expand these rights by including a clause in the shareholders agreement confirming its right to access premises, inspect books and records, and receive in a timely manner all reports prepared by the board and comisario. Advances in travel and communications technology have worked to the benefit of foreign investors intent on tracking investments by making it easier to attend meetings and monitor corporate practices.

(iv) Employee Relations.

Through due diligence, a fund should already be aware of all key employment relationships. Because positive performance depends on the superior quality of a company's management, U.S. private equity investors may insist on being able to control the hiring, firing, and retiring process. In this way funds can strike an optimal balance between personal chemistry, professional talent, and profitability.

(v) Modifications.

The last issue for which a fund may seek to acquire control rights involves the procedure for modifying the recipient company's organizational instrument. Because the investment interests of private equity investors can be influenced by changes in said instrument, funds may insist on having the right to control future modifications.

212. Id. art. 113.
213. As in the United States, it can be easier to obtain information about publicly traded companies (through securities authorities) than for privately held companies.
214. As one fund manager relates, "if the CEO knows you have the power to fire him or her, . . . you'll get your calls returned and be able to direct strategy." A Private Affair, supra note 95.
c. Enforcing the Terms of the Shareholders Agreement.

The substantive terms contained in the shareholders agreement should to the extent possible be incorporated into the company's organizational instrument. For the majority of control-related issues presented, there should be no problem obtaining enforcement (in some cases the right might already even be available by operation of Mexico's corporate law). Where a provision encroaches on a shareholder's right to vote (i.e., participate in the company), however, the enforcement of the control right can be a delicate matter.

In order to effectively exercise control rights, a fund may condition its investment on a recipient company's grant of unconditional approval rights. To this end, fund investors in Mexico obtain super-majority or veto protections in the form of a qualified voting quorum, thereby requiring the affirmative vote of the investor with respect to the aforementioned control issues. Structuring deals in this way is desirable in that the private equity investor is able to secure the approval rights it deems crucial to the investment in a way that does not violate the LGSM's prohibition on provisions restricting a shareholder's right to vote.

To avoid claims that the founders' grant of approval rights to foreign investors impermissibly interferes with a shareholder's right of participation the parties may consider leaving super-majority clauses out of the organizational instrument. Should this strategy be pursued, the non-inclusion of the term would not vitiate its effect, specifically for the reason that Mexico's corporation law recognizes the validity of decisions taken outside of formal meetings (i.e., board and shareholders) by unanimous vote and contained in writing.

5. Transfer Restrictions.

As private equity investments can last anywhere from three to ten years, it is important for parties to have some means of assuring the "stability" of the capital financing and pool of participating investors during the investment. Where one investor is particularly large—or where a fund has made a co-investment with another fund—sudden divestment can have seriously destabilizing effects on the overall transaction. Financial certainty can be effectively secured, however, by incorporating the following specific transfer restrictions into the investment agreement.

a. Retention Agreement.

The prohibition of any transfers for a pre-determined period of time is called a "lock-up." The mechanism used to accomplish this end is often referred to as a "retention agreement."

215. See Enriquez, supra note 74. Said procedures are not expressly provided for in Mexico's LGSM. In what constitutes a good example of the flexibility and ingenuity of Mexico's commercial laws, however, these procedures are widely used and upheld in practice. See Michael W. Gordon et al., Panel Discussion: A Hypothetical Problem on Securities Law, 3 U.S. MEX. L.J. 93, 98 (1995).

216. LGSM, supra note 140, arts. 143 & 178.
b. Prior Consent.

Parties to a transaction may permit a contemplated transfer, but only with the prior consent of the other shareholders. This strategy permits funds and founders to preserve the final word on who becomes an investor.217

c. Objective Standard.

In a strategy similar to the preceding, a transfer may be permitted only if the purchaser meets specified objective standards (for example, financial strength, standing in the industry, etc.).

d. Right of First Refusal.

A transfer may be permitted subject to a right of “first refusal.” That is, should an unrelated third party seek to buy the shares of an existing party to the investment agreement, the other fund partners and founders would have the right to purchase the shares sought by the third party in accordance with the proposed price, terms, and conditions.

e. Right of First Offer.

Finally, a transfer may be permitted subject to a “right of first offer.” Under this provision, any party to the investment agreement that should wish to sell its shares must offer the same to the other fund investors and founders. Only upon the refusal of the latter will the selling party have leave to proceed.


It is difficult to know in advance which strategies will ultimately be available for a fund’s exit. Because IPOs tend to deliver the greatest return, funds generally hope for a market exit. Should an IPO not be possible, however, a fund must look to alternative exit strategies such as the sale of shares to founders or third parties. Given the potential incongruity between a fund’s need for investment liquidity and the unpredictable nature of the exit process, funds usually incorporate into the shareholders agreement clauses to cover every conceivable situation. The main features and legal considerations associated with the three primary exit options—sale to third party, sale to shareholders, and IPO—are presented below.

a. Sale to Third Party.

Depending on the degree of control exercised by a fund, it will obtain either “tag along” or “drag along” rights with respect to a subsequent sale of company shares or assets to a third party. Such provisions supplement the control rights discussed supra.

Designed to protect the interests of a minority investor, tag along rights provide that if “one or more shareholders sell in excess of a specified number or percentage of their shares to a third party,” shareholders with the tag along rights have the right to participate in the sale on a proportionate basis.218 These rights are valuable in that they reinforce the

217. See id. art. 130. This provision states that a company’s social contract can contain pacts requiring the board of directors to authorize any transmission of shares.

218. Ressler, supra note 207, at 259.
rights of minority shareholders to participate in the sale of a company and receive their pro rata share of the proceeds.

Drag along rights, alternatively, are useful in situations where the majority shareholder encounters elements of internal opposition to a proposed sale. Pursuant to these rights, shareholders who desire to sell their shares to a third party can require the other shareholders to sell their shares under identical conditions in the same transaction. The exercise of this right usually occurs in conjunction with the sale of an investor's entire equity interest.

b. Sale to Shareholders.

Other mechanisms by which private equity investors assure the liquidity of their investment are "puts" and "calls." A put option entitles an investor to require the recipient company to purchase the former's equity interest and thereby facilitate its exit. The price of the shares is usually determined by reference to a pre-established formula designed to provide the investor with the purchase prices plus a premium. A call, on the other hand, permits the recipient company to take out an equity investor at an agreed price that incorporates a guaranteed return. Puts and calls usually become operative within fixed periods of time, for example after the expiration of a lock-up period or during the pendency of an IPO. Put and call provisions are frequently the subject of intense negotiation.219

c. Public Sale of Shares.

To exit via an IPO, private equity investors must negotiate for and incorporate into the shareholder agreement "registration rights." "Demand" registration rights require that upon receipt of notice from private equity investors, the recipient company will initiate and use its best efforts to realize a registered public offering that includes the shares of the former party. "Piggy back" rights, in contrast, give private equity investors the right to register their securities if and when the recipient company registers its securities. This clause works in tandem with the control rights discussed supra to assure private equity investors (particularly minority shareholders) that their interests will not be disregarded by the majority.

Initial public offerings can be made to either Mexico's stock market (the Bolsa Mexicana de Valores, or BMV), a foreign market (for example to NASDAQ or the NYSE), or on multiple international markets.

Recipient companies that intend to do an IPO on Mexico's BMV must have the approval of the CNV (Comisión Nacional de Valores),220 register with the RNVI (Registro Nacional de Valores e Intermediarios),221 and obtain a listing with the BMV. Registration requires the payment of fees, disclosure, and, ultimately, subsequent reporting. Basic

219. See id. at 263.
220. "Ley del Mercado de Valores," D.O., Jan. 2, 1975, art. 2 [hereinafter LMV]. An exemption to CNV approval appears to be available for trades in securities that also do not constitute a public offer and have as their object (1) the subscription of stock, (2) the merger or reorganization of corporations, and (3) the sale of substantial portions of the assets of a business. Id. art. 13.
221. Id. art. 14.
aspects of disclosure include audited financial statements (Mexican GAAP) going back three years from the time of the listing application, certain legal information, and demonstrated positive earnings for the same time period. Upon successful subscription with stock market authorities, the company’s shares, depending on the size of the entity and its issue, will be offered in either the “Section A” or “MMEX” (Mercado para la Mediana Empresa Mexicana) market segments. The BMV’s Section A has forty actively traded companies. In contrast, the twenty-two entities on the intermediate exchange tend to be more illiquid.

Notwithstanding the creation of this special “microcap” market and the BMV’s continually increasing levels of capitalization, there have not been a significant amount of exits by IPO. This situation is expected to change as Mexico’s AFORES are permitted to...

222. See Eduardo Trigueros, Opciones de Salida, Paper presented at the conference on Capital de Desarrollo en Mexico (Nov. 10-11, 1999) Veracruz, Mexico. The issuing company should ensure that (1) the registration is in fact properly accomplished and (2) the information provided is accurate and truthful. The consequences for failure in this regard include: the cancellation or suspension of the registration, an administrative fine (for furnishing false or misleading information in relation to the economic condition of the company or the securities issued, per article 51, II of the LMV), or a prison sentence (for knowingly disseminating false information to obtain a gain or avoid a loss, per article 52 Bis 2, I of the LMV). Violations of the latter type may be prosecuted at the request of the Secretaria de Hacienda y Credito Publico based on the prior opinion of the CNV, per article 52 Bis 3 of the LMV. LMV, supra note 134, arts. 51 & 52.

223. Companies that make Section A offerings must have (1) net worth in excess of 125 million UDIs (capital contable), (2) stockholders’ equity in excess of 125 million UDIs, (3) average earnings of at least 62.5 UDIs for the three previous years, (4) offered securities equal to at least fifteen percent of the company’s paid in capital, and (5) a minimum of two hundred stockholders after the issue. Companies making MMEX offerings must have (1) net worth in excess of 20 million UDIs (capital contable), (2) stockholders’ equity in excess of 20 million UDIs, (3) positive average earnings for the three years prior to the application, (4) offered securities equal to at least thirty percent of the company’s paid in capital, and (5) a minimum of one hundred shareholders after issue. See INTERNATIONAL SECURITIES REGULATION, RELEASE No. 98-2, at 4 (Robert C. Rosen ed., Oceana Publications, 1994). A “UDI” is a unit of account used to adjust financial and commercial operations for inflation. In April 1995, one UDI equaled one peso. As of August 26, 1999, a UDI equaled 2.59 pesos. The UDI rate is adjusted daily. See SHCP Report, supra note 2. According to one authority, the CNV’s review process lasts approximately two months. See INTERNATIONAL CAPITAL MARKETS AND SECURITIES REGULATION, RELEASE NO. 132, VOL. 10C, at 4A-39 (Harold S. Blumenthal & Samuel Wolff eds., Dec. 1999). Shares that are publicly offered are not permitted to be in bearer form. See id. at 4A-41.


225. The capitalization of Mexico’s stock market has increased from 1.37 percent of GDP in 1984 to 25.9 percent of GDP in the first half of 1999. SHCP Report, supra note 2. Analysts believe the market has plenty of room to grow in the coming years. See Baron F. Levin, Flash in the Pan?, Bus. MEX., Aug. 1, 1997, at 26.

226. If the trend established in Argentina and other Latin countries with respect to the making of IPOs by infantile high-tech Internet start-up companies continues, Mexico, which is expected to account for approximately twenty percent of the Latin American e-commerce market by 2005, may see an increase in the number of IPOs. See John Dorschner, Internet Gold is Still Years Away, MIAMI HERALD, Feb. 16, 2000, at C1.
invest in a broader range of instruments and insurance companies find themselves with increased levels of investable income. In this regard, one industry observer comments: "I think in the next few years we will start seeing life and property and casualty companies growing into a more active lending or investing role." This expectation is additionally supported by the BMV's recent expression of willingness to relax traditional registration requirements (including the provision mandating the submission of three years of financial data) under certain conditions with an eye to listing an increased number of start-up (particularly internet-related) companies.

By making the prospect of raising money on local markets more viable than before these developments are likely to incite an increase in the number of private equity-related listings and offerings going forward. Early examples of this include: Latin Americano Duty Free, S.A. de C.V., Arabella, Milano, Agriexp, and Tekchem.

Whereas Mexican companies normally issue shares into the United States or other foreign markets (for example, London, Tokyo) only after having first previewed the shares on the BMV (thereby establishing a trading range), it is possible for a Mexican company to make a transnational offering simultaneously in Mexico and abroad. With respect to issues in the United States, Mexican companies can pursue either a public offering or a private placement. As there are normally greater initial disclosure and subsequent reporting requirements associated with a public offering, many Mexican companies opt for a private placement under Section 4(2) of the Securities Act.

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227. Recent reform of the Mexican Social Security System (Instituto Mexicano de Seguridad Social, or IMSS) will contribute to the generation of domestic long-term resources to finance investment and the deepening of Mexico's capital market. See SHCP Report, supra note 2.

228. As a result of recent deregulation, foreign insurance companies can now invest in Mexico and certain types of coverage have become mandatory for citizens (for example, automobile insurance). Working hand in hand with these developments are (1) the decreased role of the state in providing health care and (2) the de-regulation of Mexico's health care industry. The net effect of these changes is that insurance companies will have more money available for investment. See Oliver Libaw, Long-Term Benefits, Bus. Mex., Aug. 1, 1997, at 28.

229. Rogers et al., supra note 86, at 70.

230. See Eduardo Garcia, Mexico May Ease Rules for Stock Listings, Miami Herald, Feb. 26, 2000, at C2. Requests for exemptions from traditional registration requirements will be reviewed on a case-by-case basis by a committee composed of independent local business people.

231. See Trigueros, supra note 222.

232. See LMV, supra note 220, art. 11. Securities issued by Mexican "moral persons" (companies) offered for subscription or sale in foreign countries must be registered in the "seccion especial" (special section) of the RNVI.

233. First time issuers in the United States are required to file, inter alia, an F-1 in accordance with either U.S. GAAP or home country rules accompanied by a U.S. GAAP reconciliation. See Luis F. Moreno Trevino, Access to U.S. Capital Markets for Foreign Issuers: Rule 144A Private Placements, 16 Hous. J. Int'l L. 159, at 163. The trade-off entailed in a public offering for the comparatively higher degree of disclosure and reporting in increased liquidity and prestige.

The most common means of accomplishing an exempt private placement of foreign securities pursuant to section 4(2) is via Regulation D. In this type of transaction, shares are restricted in that they can only be sold to accredited investors (non-dealers) without having been the object of a general solicitation. While some disclosure is required of the issuer, public policy considerations make it considerably less onerous than that entailed in a public offering. Regulation D offerings are usually accomplished through the use of an offering memorandum.

Public offerings and private placements of Mexican Securities to U.S. investors have increased significantly in recent years. Facilitating this trend, in part, has been the exploitive use of ADRs and, with respect to private placements, the promulgation of clearer rules regarding the subsequent re-sale or secondary trading of restricted securities. Moreover, the execution of a "Memorandum of Understanding Between the Securities and Exchange Commission and the Comisión Nacional de Valores of Mexico" on consultations, technical assistance, and mutual assistance for the exchange of information has served to bolster the confidence of U.S. investors instinctively attracted to the promising returns associated with Mexican stocks but wary of local business practices. As long as businesses in Mexico remain undervalued and American investors maintain their emphasis on portfolio diversification, more cross-border securities transactions can be expected.

235. 17 C.F.R. § 230.501-.506 (1993). Although Regulation D does not constitute the exclusive means of making a private placement of foreign securities, it is heavily relied upon. Private placements can also be accomplished through Regulation S. 17 C.F.R. § 230.901-.904 (1993).
237. Because the scope of disclosure depends on the value of the offering, an issuer may or may not be required to file an F-20. Where a company is required to file an F-20, the exercise should not, in theory, be too difficult given the fact that Mexican corporate law mandates annual financial reporting. The exception to this, of course, will be contending with divergent accounting standards and practices. Id. § 230.502(b).
238. ADRs are negotiable receipts representing the securities of a foreign company that may be kept in the vault of a U.S. bank. Through this arrangement, U.S. investors may trade the foreign securities in the United States and receive dividends. See The Mexican Stock Market, supra note 224. As noted by one financial reporting service, "As little as 10 years ago, there were only a handful of ADRs from Latin America. Now the list is bulging with companies eager to tap into the growing U.S. interest in investing in Latin America." Michael Molinski, Latin Investors Should Mix Mutual Funds and ADRs, Jan. 3, 1997, (visited Sept. 9, 1999) http://www.latinolink.com/BIZ/010397BB.HTM.
240. Memorandum of Understanding Between the U.S. SEC and the Comisión Nacional de Valores of Mx. on Consultation, Technical Assistance, and Mutual Assistance for the Exchange of Information, Securities and Exchange Commission, Int'l Ser., Release No. 181, [1990 SEC LEXIS 3953] at 1 (Oct. 22, 1990) [hereinafter MOU]. In this MOU, the United States and Mexico pledge to work together and/or use best efforts to (1) preserve the stability, efficiency and integrity of the markets, (2) promote the development of Mexico's securities market, (3) exchange information in conjunction with the investigation of the market and the enforcement of securities laws, and (4) facilitate the conduct of investigations, litigation, or prosecutions in cases where information located within the jurisdiction of the requested authority is needed to determine or prove that the laws of the requesting authority have been violated. Id. at 8.
7. **Enforcing Transfer Rights.**

Private equity investment that constitutes a majority in a company should encounter no difficulty in enforcing the aforementioned transfer rights. The same cannot be said, however, with respect to investors with a minority stake. As presently written, Mexico's corporate laws do not provide minority investors with any statutory means of forcing the recipient company to uphold previously negotiated transfer rights. Rather, Mexico's corporate laws protect local shareholders against any corporate acts that restrict their right to vote.

Several different self-executing mechanisms have been developed to guarantee the compliance of the recipient company's shareholders with the transfer rights set forth in the shareholders agreement. For example, U.S. investors may negotiate for and obtain an irrevocable power of attorney establishing their authority to exercise transfer rights.241 Alternatively, a fund may require that U.S. law govern the shareholders' agreement.242 The most reliable mechanism, however, for assuring compliance with the transfer rights contained in the shareholder agreement involves the establishment of a shareholder voting trust (fideicomiso de accionistas).243

"Under such an instrument, controlling shareholders deposit their shares and specifically pre-instruct the trustee to vote them in accordance with the instructions delivered by the investor in certain circumstances" including, for example, the implementation of registration rights, the sale of certain assets, or compliance with drag along or tag along provisions.244 Through this mechanism, a fund will be able to insulate itself from claims that it has violated the rights of local shareholders to vote and ensure the availability of an exit option.

8. **Other Considerations Bearing on Private Equity Transactions.**

Aside from issues of stock purchase terms, corporate governance, and transfer rights the investment agreement should also clearly address issues pertaining to representations and warranties, the duration of the agreement, distributions, liquidation procedures and rights, and the resolution of disputes. The key points associated with each issue are presented below.

a. **Representations and Warranties.**

Independent of any representation and/or warranty obtained in lieu of reviewable documentation during the due diligence, investors typically seek extensive, detailed, and specific representations and warranties concerning the business assets, liabilities, and financial condition of the recipient company, its compliance with any applicable law

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241. See Enriquez, supra note 74.

242. See id.

243. See id.

244. Id. The strategic advantages of this mechanism are echoed by the remarks of another Mexican practitioner: "I want to caution U.S. attorneys about article 198, which provides that any agreement which restricts the freedom to vote of the stockholders is null and void. Because this language has not been interpreted definitively, if one really wants to control the vote, a voting trust must be established." John M. Stephenson, Jr. et al., Panel Discussion, Securities Law Questions and Comments on the Comparison of Corporate and Securities Laws in Mexico and the United States, 3 U.S. MEX. L.J. 29 (1995).
and/or regulations, and its possession of all permits, authorizations, and/or licenses. Investors may also request of the founders covenants and indemnifications in favor of the investors for damages arising out of any breach by the founders. Said representations, warranties, and covenants are set forth in the stock purchase agreement, and should be structured so as to be effective for the duration of the investment.\textsuperscript{245}

b. Duration.

In the interest of certainty, parties to the transaction should expressly define the duration of the agreement. Typically, investors will demand that the rights and obligations of the parties terminate on the consummation of (1) an underwritten public offering or the realization of a private placement; (2) a sale of all, or substantially all, of the company’s assets or capital stock; (3) a merger, consolidation, reorganization or other business combination of the company resulting in the transfer of a pre-determined percentage of voting securities; or (4) at some specified future time. This term is usually set forth in the shareholders agreement.\textsuperscript{246}

c. Distributions to Shareholders.

An issue of critical importance that must be addressed in the shareholders agreement involves investors’ dividend entitlement. The amount of a dividend is usually in proportion to the shareholder’s contribution, unless otherwise agreed.\textsuperscript{247} Notwithstanding their ability to negotiate for a larger share, investors should realize that provisions that exclude a shareholder from participating in gains are of no legal effect.\textsuperscript{248}

The taking and holding of preferential shares provides the clearest statutory protection of a U.S. private equity investor’s distribution rights and interests.\textsuperscript{249} According to article 113 of the LGSM, the holders of preferential shares have a superior, and cumulative dividend entitlement relative to the holders of ordinary shares. As described by one practitioner, “the preferred shareholder usually receives a fixed preferred dividend and shares pro rata with the common stock in the distribution of earnings.”\textsuperscript{250} Should the attributes associated with this type of stock be inadequate, the parties may choose to effectively create special shares with mutually determined conditions and features in accordance with the more flexible terms of article 114 of the LGSM.\textsuperscript{251}

\textsuperscript{245.} See AROCENA, supra note 30, at 21.


\textsuperscript{247.} See LGSM, supra note 140, art. 16. Similarly, article 113 provides that the organizational instrument may provide dividends for shares with limited voting rights superior to dividends for ordinary shareholders. Id. art. 113.

\textsuperscript{248.} Id. art. 17.

\textsuperscript{249.} Recall, however, that preferred shares, as presented in the LGSM, may have limited voting rights. As article 113 notes: “the organizational instrument may (emphasis added) provide that one part of the shares shall have the right to vote in extraordinary assemblies” (as opposed to an unqualified right to vote). Nothing prevents U.S. private equity investors from negotiating more expansive rights. Id. art. 113.

\textsuperscript{250.} Stephenson, Jr. et al., supra note 244.

\textsuperscript{251.} LGSM, supra note 140, art. 114. These special shares are issued when (1) a person furnishes services to the company and (2) the organizational instrument so provides.
U.S. investors must further understand the absolute limitations imposed by Mexico's corporate law with respect to distributions. First, where the recipient company has experienced a loss of capital, no distribution can be made until the loss has been restored or the company's capital has been reduced.\(^{252}\) Secondly, article 19 of the LGSM states that distributions can only be made where (1) the financial statements have been duly approved at the assembly of shareholders, and (2) losses suffered in previous fiscal years have been restored, absorbed or otherwise offset by a reduction of capital.\(^ {253}\) Any action to the contrary shall have no legal effect, and either the company or its creditors can demand recovery or reimbursement for the wrongful distribution.\(^ {254}\) Moreover, in the case of a young company, at least five percent of net profits must be withheld each year for the purpose of establishing a reserve fund. This mandatory withholding must continue until the amount of the fund is one-fifth of total capital.\(^ {255}\) Such a restriction could present an obstacle to the exit of a zero or early stage investment.

Finally, U.S. investors must consider the tax consequences of private equity transactions. While a full treatment of the issue is beyond the scope of this paper, distributions paid by a Mexican company to U.S. investors fall within the ambit of the U.S.-Mexico Double Taxation Treaty.\(^ {256}\) U.S. investors should consult with local tax counsel to determine whether the fund (or a co-investor such as a pension or retirement fund) is eligible under Mexican law for a reduced tax rate or exemption.\(^ {257}\)

d. Liquidation and Bankruptcy.

The investment agreement should anticipate and expressly establish the rights and procedures that will be utilized in the event of dissolution or bankruptcy. Notwithstanding the approval rights a fund may have negotiated with respect to the winding down of a business, Mexican corporate law provides that an entity may be dissolved in the following circumstances: (1) expiration of the term established in the organizational instrument; (2) impossibility or consummation of the principal purpose; (3) agreement of the shareholders, in accordance with the terms of the organizational instrument; (4) the reduction of the number of shareholders to an impermissible level; and (5) loss of two-thirds of capital stock.\(^ {258}\) Pursuant to the procedures set forth in the LGSM, shareholders should present any claim to the liquidator\(^ {259}\) within the fifteen-day period following the publication of the balance sheet of liquidation in the Official Daily Gazette.\(^ {260}\) Upon the subsequent approval of this balance sheet, the liquidator will pay

\(^{252}\) Id. art. 18.

\(^ {253}\) Id. art. 19.

\(^ {254}\) Id.

\(^ {255}\) Id. art. 20.


\(^ {257}\) See Enriquez, supra note 74.

\(^ {258}\) See LGSM, supra note 140, art. 229.

\(^ {259}\) The liquidator is the legal representative of the company. Said representative is liable for acts executed beyond the limit of their authority. This includes the responsibility to maintain the books and records of the company for ten years following the conclusion of the liquidation. Id. art. 235.

\(^ {260}\) Id. art. 247.
each shareholder his or her corresponding due against cancellation of that individual's share certificates. 261 No shareholder may be paid, however, prior to the extermination of all company liabilities. 262

It is similarly important that parties clarify the rules that are to govern in the event of bankruptcy. In order to secure the most reliable protection 263 U.S. investors could, theoretically, require that any bankruptcy action be brought in a U.S. bankruptcy court, 264 regardless of the fact that the relevant entity's principal place of business and place of incorporation are in Mexico. Unless it is proven, however, that the U.S. court observed the requirements contained in the Ley de Quiebras y Suspension de Pagos (LQSP), 265 a foreign judgment declaring bankruptcy will not be executed. Consistent with the insistence on the application of Mexican bankruptcy laws, the effects of any foreign judgment recognized will be governed by Mexican law. 266

The alternative is to rely on the Mexican rules of bankruptcy 267 as administered by either a Mexican federal district court with full civil and criminal jurisdiction or the state courts of general jurisdiction. 268 Where parties so provide, U.S. investors should realize

261. Id. art. 248.
262. Id. art. 243. Partial distribution may be authorized, however, under certain circumstances. Id.
263. A fund may seek out the protection of U.S. bankruptcy courts so as to avoid the type of extra-judicial solutions that Mexican entities commonly resort to as a consequence of deficiencies in Mexico's bankruptcy laws. One particular deficiency is the slow speed at which proceedings are resolved. As one Mexican practitioner notes, "liquidation cases can take up to 15 years or more to conclude." Victor Vilaplana, Bankruptcy, in MEXICAN LAW: A TREATISE FOR LEGAL PRACTITIONERS AND INTERNATIONAL INVESTORS, supra note 153, at 521. Independent of the foregoing facts, business people in Mexico tend to avoid bankruptcy because of the potential criminal liability.

264. See 11 U.S.C. § 109 (2000). Almost any company with operations or property on both sides of the U.S.-Mexico border is eligible to file bankruptcy, even if the debtor is a foreign corporation. See In re Lopez, (5th Cir. 1997) (No. 96-50744) (mem. opinion June 3, 1997).
265. "Ley de Quiebras y Suspension de Pagos," D.O., Apr. 20, 1943 [hereinafter LQSP].
266. LQSP, art. 14. This said, however, it is important to note that some foreign trustees (sindicós) have been successful in gaining recognition and enforcement of their bankruptcy claims in Mexico. See Pesa Electronica, S.A., (7th Civ. Ct. of the City of Puebla) (File No. 37/96); Morgan Trust Company of Canada v. Falloncrest Financial Corp. et al. (1st Court of First Instance of City of Acapulco, Tabares Judicial District, State of Guerrero) (File No. 90-3/91) cited in THE TRANSNATIONAL INSOLVENCY PROJECT: INTERNATIONAL STATEMENT OF MEXICAN BANKRUPTCY LAW 112 (The American Law Institute ed., 1998). When considering whether to pursue a claim in Mexico, creditors should keep in mind the fact that the assets sought may be long gone by the time it takes to comply with all the substantive and procedural requirements.

267. These rules are currently undergoing reform. Designed to give banks broader power to recover collateral (in the hope that this will help reactivate credit flows), the new law was approved by the Mexican Senate on December 8, 1999, and subsequently sent to the House of Deputies. As the law exists in this preliminary stage, it does not apply to debts less than four hundred thousand UDIs. This qualification is a political and economic concession to "el Barzon," the grass roots debtor movement. See Bankruptcy Laws Passed in Senate Despite PAN Opposition, CORP. MEX., Dec. 8, 1999.

268. See "Constitucion Politica de los Estados Mexicanos," D.O., Feb. 5, 1917, art. 104 [hereinafter MEX. CONST.]. As Mexico City has been the seat of a specialized bankruptcy court since 1988, corporations that intend to start a bankruptcy case may change their domicile to the capital so as to be able to avail themselves of that court's expertise. See Vilaplana, supra note 263, at 519.
that one of a Mexican trustee's first acts upon commencement of a bankruptcy proceeding\textsuperscript{269} will be the removal of extant directors and management.\textsuperscript{270} To the extent that bankruptcy proceedings can be initiated in a way that is completely beyond the control of a private equity investor, Mexican bankruptcy law can pose a real threat to the ongoing security of a fund's investment.\textsuperscript{271}

Following the creation of a plan of liquidation and the proper giving of notice to creditors, the trustee pays the company's liabilities. U.S. investors are accorded non-discriminatory treatment, meaning their interests will be satisfied in accordance with their position in Mexico's hierarchy of priority. As creditors with "special privileges," U.S. preferred shareholders will be paid in advance of common shareholders.\textsuperscript{272} However, before a U.S. preferred shareholder receives its share, Mexican bankruptcy law mandates the payment of: (1) singularly privileged creditors (this is a super-priority extended to the employees of the debtor with wage claims that existed prior to the declaration of bankruptcy); (2) secured creditors; and (3) tax claims held by the \textit{Secretaria de Hacienda y Credito Publico}.\textsuperscript{273}

Provided assets remain at the U.S. investor's priority level, the LQSP provides that the payment of the liability can be made in full or on a discounted basis. Although Mexican law technically requires that debts be extinguished in Mexican pesos, debts associated with bankruptcy can be documented in foreign currency.\textsuperscript{274} Where this is the case, the applicable rate of exchange is that in effect at the time the case began. U.S. private equity investors should exercise caution in this regard, as drawn out bankruptcy proceedings can produce an undesired currency exchange loss.

A final point that must be considered involves the potential for board member criminal liability. According to articles 95 and 99 of the LQSP, members of the board of directors can be prosecuted and put in jail if their imprudent or fraudulent actions cause the bankruptcy of a company.\textsuperscript{275} Funds that regularly place partners on the boards of the recipient companies in which they invest should be cognizant of this potential liability exposure.\textsuperscript{276}

e. The Resolution of Disputes.

U.S. private equity investors should incorporate into transaction documents features that reduce the likelihood of disputes. For example, a fund may limit its investment activity to a recipient with which it has an established relationship premised on mutual trust

\textsuperscript{269} Bankruptcy proceedings can be begun either voluntarily (i.e., by the company) or involuntarily (i.e., pursuant to an action by a creditor or the attorney general of Mexico). See \textit{id. at 521}.

\textsuperscript{270} See LQSP, \textit{supra} note 265, arts. 46-57.

\textsuperscript{271} U.S. investors that have successfully negotiated approved rights should have a greater degree of control with regard to voluntary declarations of bankruptcy.

\textsuperscript{272} See LGSM, \textit{supra} note 140, art. 113.

\textsuperscript{273} See Vilaplana, \textit{supra} note 263, at 527. The claims of common shareholders are satisfied at the next level down (common creditors from mercantile transactions). At the bottom of the list are common creditors under civil law. See \textit{id. at 525}.

\textsuperscript{274} See \textit{id. at 525}.

\textsuperscript{275} LQSP, \textit{supra} note 265, arts. 95 & 99. These articles, respectively, establish the elements and consequences of culpable and fraudulent liquidations.

\textsuperscript{276} The practical reality, however, is that board members are rarely prosecuted under these provisions.
and confidence. Similarly, the clear and proper structuring of approval, control, and transfer rights will reduce the likelihood of inter-party disputes. Last, U.S. investors can insist on the inclusion of a clause fixing liquidated damages in the event of any breach of the agreement.\textsuperscript{277}

Should these built-in dispute avoidance strategies fail the investment agreement must clearly indicate the manner in which conflicts will be settled. U.S. private equity investors are best served by the establishment of a two-tiered dispute resolution mechanism (at a minimum) involving arbitration followed by litigation.

(i) Arbitration.

Independent of the fact that article 2022 (1) of NAFTA encourages the use of arbitration for the settlement of commercial disputes between private parties,\textsuperscript{278} U.S. investors may wish to use arbitration to avoid having to submit a matter to a slow and potentially corrupt local court presided over by a judge inexperienced in matters of sophisticated finance.\textsuperscript{279}

If parties wish to arbitrate subsequent disputes, they should express this intent in the transaction documents. Parties are free to choose either an institutional (for example, under the rules of the AAA, ICC, IACAC, or UNCITRAL) or an ad hoc arbitration (i.e., the parties supply their own rules and procedure). If no procedural rules are selected, then those contained within Mexico’s Commercial Code will apply.\textsuperscript{280}

Important related considerations involve the choice of forum and substantive law. Mexican law permits parties to choose a foreign forum.\textsuperscript{281} While convenience will be a factor in this determination, U.S. investors should remember that to the extent arbitral awards are enforced in accordance with the law of the country where the arbitration took place, not all fora are equal. In this connection it is important to note that it is common for U.S.-Mexico investment agreements to include a New York forum selection clause. Regarding choice of substantive law, Mexican courts will generally respect the legal and equitable selection of the parties,\textsuperscript{282} provided it does not violate any rule requiring an issue to be determined under Mexican law.\textsuperscript{283} Absent a choice by the parties, an arbitral panel is free to determine the applicable law.\textsuperscript{284}

\textsuperscript{277} Mexico’s public policy involving liquidated damages is not as restrictive as that of the United States. See “Codigo de Comercio,” D.O., Oct. 17, 1889, arts. 1840-1844 [hereinafter COD.COM.].

\textsuperscript{278} NAFTA, supra note 138, art. 2022 (1).

\textsuperscript{279} In this connection, one commentator has described Latin judicial processes as expensive, time-consuming, and inefficient. See David Swafford, Storming the Castle, LATIN FIN., at 20. Notwithstanding the general slowness of Mexican courts, it is possible for a case to proceed on an expedited basis. An example of this involves suits based on negotiable instruments (such as checks, mortgages, and guarantees). See COD.COM., supra note 277, arts. 1391-1414. Amparo actions, moreover, are designed to provide an expedited measure of relief. See Kenneth L. Karsa & Keith S. Rosenn, LAW AND DEVELOPMENT IN LATIN AMERICA, tentative 2d ed., at 188 (2000).

\textsuperscript{280} COD.COM., supra note 277, arts. 1435, 1439, & 1440.

\textsuperscript{281} COD.COM. art. 1436.

\textsuperscript{282} COD.COM. art. 1445.

Arbitration is a meaningful process only insofar as arbitral awards are ultimately enforceable. As between U.S. and Mexican parties, enforcement of arbitral awards is generally governed by the United Nations Convention on the Recognition and Enforcement of Foreign Arbitral Awards (the New York Convention). Challenges to the enforcement of an award can be raised under the New York Convention, although these have been narrowly construed. It is also possible for the enforcement of an arbitral award to be challenged under Mexican law on grounds akin to those permissible under the New York Convention.

Assuming a challenging party's inability to establish a defense, both the New York Convention and Mexico's Código de Comercio mandate the enforcement of awards. The courts of both the United States and Mexico have demonstrated a consistent willingness to enforce valid arbitral awards. This trend has led some Mexican lawyers to observe that U.S. parties may have a better chance of entering an arbitral award in Mexico than a foreign judgment, thereby giving an additional impetus for parties to choose arbitration over litigation.

b. Litigation in the United States.

Should arbitration fail, parties will be left with no alternative but to litigate their disputes. To the extent Mexican law upholds parties' freedom to choose the forum and gov-

284. See COD.COM., supra note 277, art. 1445.
285. Convention for the Recognition and Enforcement of Foreign Arbitral Awards, June 10, 1958, 9 U.S.C. § 201, 330 U.N. Treaty Ser. 38, No. 4739 (1959) [hereinafter New York Convention]. The United States and Mexico are party to another treaty on the subject, the Inter-American Convention on International Commercial Arbitration of 1975 (also known as the "Panama Convention"). Where both conventions are applicable, the conflict is determined in accordance with the inquiry set out in 9 U.S.C. § 305.
286. See COD.COM., supra note 277, art. 1457 (nullity and voidness of award) and art. 1462 (denial of full faith and credit).
287. See COD.COM., supra note 277, art. 1461. There is a three-year statute of limitation for enforcing arbitral awards under the New York Convention. Mexico's commercial code, alternatively, does not expressly indicate the time period within which an action to enforce an arbitral award must be brought. It does, however, require that any challenge to an award's enforceability be brought within three months from the date notice was given. Id. art. 1458.
289. See William E. Mooz, Jr. & Alejandro Ortega, Options for Resolving Commercial Disputes in the NAFTA Era, in AN INTRODUCTION TO DOING BUSINESS IN MEXICO, supra note 170, at 300.
erning law, a U.S. private equity fund may seek to have all actions brought in the courts of and governed by the law of a particular American state.

Where litigation conducted in the United States (by agreement of the parties) leads to a judgment, its enforcement in Mexico is "at best difficult and problematic." That is not to say impossible. But, absent an international treaty mandating otherwise, Mexican courts will neither recognize nor enforce foreign judgments unless they comply or satisfy a complicated set of procedures and requirements.

c. Litigation in Mexico.

If parties do not expressly choose a forum and governing law, disputes, more likely than not, will be litigated in Mexico in accordance with Mexican law. The application of this default selection with respect to commercial entities in Mexico is entirely consistent with the generally accepted principle that a shareholder's contract of membership is governed by the law of the place of incorporation (lex societatis).

Private equity-related disputes that have a strong potential to involve U.S. investors include the enforcement of rights established in the shareholders agreement (and other

290. A forum selection clause will be upheld provided that the location has some connection with the dispute and does not involve an issue of public policy or purely local significance. See CFPC, supra note 283, art. 566. A choice of law clause, alternatively, can be freely made within certain parameters. See "Codigo Civil para el Distrito Federal," D.O., Mar. 26, 1928, art. 13 [hereinafter CCDF]. Unlike the black letter of U.S. law, issues involving publicly traded securities in Mexico are not expressly within the exclusive jurisdiction of the nation. See Scherck, supra note 288. (Court upheld foreign arbitration agreement, notwithstanding securities regulation prohibiting waiver of a U.S. party's right to the protection of U.S. securities laws).

291. Given the fact that both Mexico and the United States are federal systems composed of multiple states, parties should always be specific when selecting a forum. Choice of law tends to be less of an issue in Mexico, as the primary substantive laws bearing on private equity transactions are federal.


293. Mexico, like many other nations, does not have a treaty with the United States to govern the recognition and enforcement of foreign judgments due to its generalized wariness of the potential for U.S. juries to award exorbitant damages. Foreign judgments submitted to Mexican courts may or may not have to be legalized. See CFPC, supra note 283, art. 552. Having satisfied this requirement, the certified translation must then be properly transmitted through the designated competent authority using a letter rogatory (note that an exception exists for parties situated in adjacent border states). Id. art. 553. Said material is next subjected to a procedure known as an incidente de homologacion, whereby a Mexican court confirms that the matter satisfies and/or does not offend Mexican requirements and notions of due process, subject matter jurisdiction, public order, finality, and comity. Id. art. 569. See also Cod.Com., supra note 277, art. 1347(a). Regarding finality, U.S. investors should realize that unlike the case in the U.S., Mexican courts do not consider judgments rendered by trial courts to be res judicata. As for comity, the willingness of U.S. courts to honor valid Mexican judgments is well established and therefore should not operate as a bar to the enforcement of U.S. judgments in Mexico. See Southwest Livestock and Trucking Comp., Inc. v. Reginaldo Ramon, 169 F.3d 317 (5th Cir. 1997).

transaction documents) and acts that constitute breaches of responsibility by either a director or the comisario.

The enforcement of contractual rights amongst shareholders by Latin American courts has been described as an "age-old" problem. In Mexico, the resolution of disputes arising from such agreements may, depending on the circumstances, be governed by the LGSM, the Codigo de Comercio (to the extent that the purchase and sale of a participation, share and bond of a mercantile association is considered to be a commercial transaction), the Codigo Civil and customary law (insofar as said laws fill in gaps created by the Codigo de Comercio), and the Ley del Mercado de Valores (in the event an IPO, private placement, or otherwise exempt offering is involved).

Directorial and comisarial responsibilities are, on the other hand, proscribed by the LGSM. U.S. private equity investors should understand that directors are (1) jointly liable with the company for the factual existence of capital contributions made by shareholders, compliance with the requirements of the law relating to the payment of dividends, the existence and maintenance of systems of accounting, control, bookkeeping, and filing, and strict compliance with the resolutions of the assembly of shareholders; (2) jointly liable with preceding directors for any irregularities committed by the latter; (3) personally and jointly liable (with other directors) for authorizing the acquisition of shares in violation of article 134; and (4) liable for failing to abstain from discussions or decisions in which he or she has a conflict of interest.

A shareholder may seek redress by going against the bond a director or comisario may have been required to furnish. When such a guarantee was not required the liability of a director or comisario may become the subject of a suit pursuant to the decision of the general assembly of shareholders. An exception to the foregoing applies to shareholders that own thirty-three percent of the capital stock. These individuals or entities may directly institute proceedings for civil damages against a director or comisario provided (1) the claim includes all damages in favor of the company (and not just those relating to the personal interest of the shareholder) and (2) the shareholder did not previously concur in any decision of the general assembly of shareholders to refrain from taking action. The proceeds of any recovery belong to the company.

295. See Swafford, supra note 279, at 18.
296. Cod.Com., supra note 277, art. 75.
297. The LMV, in turn, sets out its own hierarchy of applicable supplementary laws: (1) commercial laws, (2) stock exchange and commercial practices, (3) the Civil Code for the Federal District, and (4) the Federal Code of Civil Procedure. LMV, supra note 220, art. 7. Should a U.S. shareholder become the victim of fraud or deceit in connection with a private sale of stock, the investor can (1) request that government authorities institute proceedings against the selling party in either state or federal court or (2) independently file a complaint in civil court to obtain a recovery. See Blumenthal & Wolff, supra note 220, at 4, A-44.
298. LGSM, supra note 140, art. 158.
299. Id. art. 160.
300. Id. art. 138.
301. Id. art. 156.
302. Id. art. 152.
303. Id. art. 161.
304. Id. art. 163.
305. Id.
While the LGSM does not specify any statute of limitations, the *Codigo de Comercio* does set forth a five-year period, starting from the time an action could legally have been exercised through judicial proceedings, for suits “stemming from agreements between corporations and other entities and transactions regarding the rights and obligations with stockholders or members; by stockholders or members against the entity; and between stockholders or members relating to the legal entity.”\(^{306}\)

U.S. private equity investors should avoid becoming involved in litigation in Mexico. Experience has shown that outside of the expedited proceedings discussed, *supra*, lawsuits in Mexico are long, drawn-out affairs\(^{307}\) whose outcomes can be highly uncertain given extensive levels of corruption.\(^{308}\) Compounding this situation is the fact that Mexican judges—particularly those in rural areas—may not be familiar with the financial issues involved in private equity transactions. In this regard, U.S. investors should consider that beyond a handful of large “blue-chip” Mexican corporations, Mexican business people, lawyers, notaries, and judges have not had extensive exposure to shareholders agreements, principally due to the fact that until recently there was no class of parties whose relationship with the company could not be totally managed through the organizational instrument.\(^{309}\)

### III. Conclusion.

Notwithstanding the attractive opportunities associated with the future of private equity in Mexico, certain aspects of Mexico’s political, economic, and social landscape

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306. *COD.COM.*, *supra* note 277, art. 1045.
307. Mexican legal proceedings can become excessively drawn out as the result of a generalized lack of judicial resources and the abundance of opportunities for interlocutory action.
309. See Gordon et al., *supra* note 215, at 104. Mexican practitioners note that registration rights agreements “are not well known in Mexico.” Stephenson Jr. et al., *supra* note 244.
continue to pose substantial risks for foreign investors. Absent the adequate resolution of these risks, the diverse and mutually beneficial rewards of private equity financing may not be fully realized.

A. POLITICAL RISK.

Transnational investment transactions typically entail a degree of political risk, and Mexico is no exception. Ever since the oil crisis of the early 1980s Mexico has patiently pursued a policy of political transformation characterized by increased transparency and competition. Mexico's long dominant party (the Partido Revolucionario Institucional, or PRI) of over seven decades has ceded significant amounts of political control to opposition parties (principally the PAN and the PRD). As a result of these changes, more opposition governors are in power today in Mexico than ever before. Similarly, the PRI recently conceded its loss of control of the lower legislative body, the Camara de Diputados. In addition to a genuine desire for change on the part of the people, the transformation accomplished to date can be attributed to the combination of the recent presence of international observers at Mexico's elections and the introduction of meaningful electoral laws and controls.310

The most spectacular manifestation of this political transformation occurred this summer when Vicente Fox of the PAN put an end to the PRI's seemingly permanent control of the executive power. In what is looked to as a precursor of Mexico's future political environment, this radical break with past ways was accomplished in a relatively peaceful and orderly manner. Fox's election is not, moreover, expected to produce any significant discontinuation of economic and investment policy. As one trade publication observed, having reformed so many aspects of Mexico in the last twelve years, "[i]t [would] be very difficult to go back now."311

Another aspect of political risk U.S. investors should be aware of involves the existence and operation of small pockets of leftist insurgents in rural parts of Mexico's poor south, namely the states of Chiapas, Guerrero, Oaxaca, and Tabasco. While the actions of some of these groups have succeeded in capturing global attention in recent years, the current degree of armed opposition does not pose a significant threat to the interests of U.S. private equity investors.

The last aspect of political risk investors must consider is expropriation. NAFTA provides that nationalizations or expropriations are not permitted unless (1) for a public purpose, (2) on a non-discriminatory basis, and (3) in accordance with due process of law. Compensation equivalent to the fair market value of the expropriated investment immediately before the expropriation or nationalization occurred must be paid to the investor.312 The elements of expropriation and nationalization under domestic Mexican

310. "Codigo Federal de Instituciones y Procedimientos Electorales," D.O., Aug. 15, 1990, as amended by 1992, 1993, 1994, and Aug. 22, 1996 [hereinafter CFIPE]. U.S. investors will also recall that there was a rash of high profile politically motivated killings in 1994. This type of activity had not been characteristic of Mexican politics for many decades, and has not been repeated since.


312. NAFTA, supra note 138, ch. 11, art. 1110.
law are substantially similar, requiring the existence of a public need and indemnification.\textsuperscript{313}

Following years of disagreement between the United States and Mexico\textsuperscript{314} as to what legal standard should be applied to expropriations, the two nations have determined that such matters should be resolved in accordance with the dictates of international law, including fair and equitable treatment and full protection and security.\textsuperscript{315} To the extent that the historical record may inform the present and future, U.S. investors are advised that past expropriations have been compensated, but not necessarily at the just and fair rate, nor in a rapid manner. Given NAFTA's clear and protective approach to the subject, it is unlikely that expropriation will be an issue going forward.

Private equity investors can take steps to insulate themselves against civil disturbance and expropriation. Pursuant to article 2 of its convention, the Multilateral Investment Guarantee Agency (MIGA) will "issue guarantees . . . against non-commercial risks in respect of investments in a member country which flow[s] from other member countries."\textsuperscript{316} Assuming a transaction's qualification under article 12 of the convention,\textsuperscript{317} MIGA coverage does extend to equity investments involving shares in corporations.\textsuperscript{318} Moreover, per paragraph 1.94(IV) of the Draft Operational Rules of the MIGA, the fact that the stake may represent a minority position will not preclude coverage.\textsuperscript{319}

Regarding the risk of civil disturbance, MIGA coverage extends to "organized violence directed against the host government which has as its objective the overthrow of such government or its ouster from a specific region,"\textsuperscript{320} as well as to certain types of "riots" and "civil commotions." Examples of this coverage include revolution, rebellion, insurrection, and coup d'etat.\textsuperscript{321} Loss coverage extends to the removal, destruction, or damaging of an investment projects assets or cases where there has been substantial interference with the operation of an investment project.\textsuperscript{322}

\textsuperscript{313} MEX. CONST., supra note 268, art. 27.
\textsuperscript{314} Takings issues between the United States and Mexico date back at least as far as the end of the Mexican Revolution. In 1938, the U.S. Secretary of State articulated the U.S. position that takings of American property committed by foreign governments should be done in accordance with universally accepted principles of international law, based on the dictates of reason, equity and justice. In the American view, due compensation should be prompt and just. The Mexican government, in turn, maintained the position that there is no obligation under international law to make either immediate or deferred compensation in the context of general and impersonal expropriations. According to Mexico, this position was particularly valid where the expropriations had been carried out for purposes that went to a larger social goal (for example, the redistribution of land pursuant to an agrarian revolution). 3 HACKWORTH DIGEST OF INTERNATIONAL LAW 655-61 (1942), in TRANSNATIONAL LEGAL PROBLEMS 418 (Henry J. Steiner & Detlev F. Vagts eds., 2d ed. 1976).
\textsuperscript{315} NAFTA, supra note 138, ch. 11, art. 1105(1).
\textsuperscript{317} Id. at 111.
\textsuperscript{318} Id. at 112.
\textsuperscript{319} Id.
\textsuperscript{320} Id. at 135.
\textsuperscript{321} Id.
\textsuperscript{322} Id.
MIGA's expropriation coverage, alternatively, "may encompass, but is not limited to, measures of expropriation, nationalization, confiscation, sequestration, seizure, attachment, and freezing of assets. These measures may be coverable in relation to self-executing legislation as well as administrative omissions. In all cases, however, the action or omission must be attributable to the "host government," a term that is read to mean any "public authority." Not surprisingly, some confusion has been associated with the exact scope of "public authority."

B. ECONOMIC RISK.

As was the case with politics, it is common for transnational investment transactions to entail a degree of economic risk. This is particularly true in Mexico, where, notwithstanding significant economic reform and progress, there continue to exist certain fundamental economic infirmities.

One of the most significant economic problems Mexico has recently had to face concerns the FOBAPROA (Fondo Bancario para Proteccion al Ahorro) scandal. Years of operation, characterized by non-accountability, self-dealing, and fraudulent deposits left Mexico's banking system, much of which had been privatized in 1991, weak and on the verge of insolvency. While the cost of the recently negotiated settlement is high, the overall experience has served as a positive catalyst for the introduction of a number of badly needed economic changes. For example, the former practice of providing full deposit insurance was abolished in December of 1998, and a new organization was created for the protection of bank savings (the Instituto para la Proteccion al Ahorro Bancario, or IPAB). To the extent the new IPAB rules limit maximum deposit insurance coverage to 400,000 UDIs (approximately U.S.$110,000), per person, per institution by 2005, they may provide a degree of moral hazard to bankers that have otherwise been inclined to misuse depositors' money. As a recent government report notes, "the limits on deposit insurance should foster market discipline and self-regulation by banking institutions, while protecting small depositors' savings."

323. Id. at 125.
324. Id. at 126.
325. One clear manifestation of Mexico's progress in the eyes of the financial world is its recent attainment of investment grade status for its sovereign dollar denominated debt by Moody's. See Moody's Upgrade a Boost for Mexico, MIAMI HERALD, Mar. 8, 2000, at 26.
326. The Mexican government's bailout of the banks will cost Mexican taxpayers approximately U.S.$80 billion. Under the terms of the deal, all outstanding bank liabilities will be converted to public debt payable over thirty years. This outcome raises the total public debt burden to over forty percent of Mexico's GDP. See Robert Salinas-Leon, Mexico's Bank Bailout Quarrel Misses a Key Point, June 26, 1998 (visited Dec. 25, 1999) http://www-personal.umd.umich.edu/~mtwomey/newspapers/062698me.html.
328. Id.
329. See Rogers et al., supra note 86, at 68.
port. To this end, the CNBV (Comisión Nacional de Bancos y Valores) recently introduced a regulation making it difficult for borrowers with bad credit to obtain additional credit (this regulation is to be enforced via the credit bureau).331

The legislative resolution of the FOBAPROA crisis generally bodes well for private equity in Mexico. Previously, companies with large quantities of unresolved debt had been unable to attract private equity backing for recapitalizations. Now there is clear guidance with respect to corporate debt, industry practitioners expect to see an increase in private equity led restructuring activity.332

An exception to the foregoing observation involves the negative fallout that resulted from U.S. investors having witnessed the way in which many Mexican debtors, once under financial pressure, simply disregarded their contractual obligations to service their debts. The uncertainty engendered by this practice recently prompted one fund manager to comment: “that has made me . . . worried about being a minority investor in a country where you could walk out on your contract.”333 The obvious significance of this experience should not be lost to U.S. private equity investors in Mexico.

Another economic risk a U.S. private equity investor may encounter involves currency transfer controls. Until recently, Mexico prohibited the repatriation of capital for a period of twelve years following investment.334 As noted, supra, this prohibition has been repealed and investors can now freely transfer currency out of the country.335

This said, however, foreign investors must nonetheless be careful. Outside of NAFTA article 1109's general promise of freedom to repatriate, NAFTA article 2104 specifically leaves the door open to Mexico's introduction of capital controls under certain conditions (for example, in response to a balance of payments emergency).336 NAFTA article 1410 may accomplish the same end, albeit in an oblique manner, by permitting member states to adopt reasonable measures for prudent reasons. Under this article, a NAFTA member, citing the need to maintain the safety and soundness of its financial institutions and systems, could impose capital transfer restrictions.337

As was the case with civil disturbance and expropriation risk, an investor can obtain protection against the imposition of capital controls through the MIGA Convention. Specifically, article 11(a)(i) provides coverage against “any introduction attributable to the host government of restrictions on the transfer outside the host country of its currency into a freely usable currency or another currency acceptable to the holder of the guar-

331. See SHCP Report, supra note 2.
332. See A Private Affair, supra note 95.
333. Id.
334. This policy was designed to help prevent the draining of Mexico's foreign currency reserves, especially in times of capital flight. See Zahralddin & Jones, supra note 94, at 913.
335. NAFTA, supra note 138, ch. 11, art. 1109(4)(a)-(e). This article does permit, however, transfers to be prevented in an equitable, non-discriminatory, and good faith manner. Examples of transfers that can be prevented in this way are those relating to bankruptcy, securities issues and trades, criminal actions, the satisfaction of judgments, and reports of transfers of currency or other monetary instruments.
336. Id. ch. 21, art. 2104.
337. Id. ch. 14, art. 1410(1)(b) & (c).
antee." Investors should realize, however, that coverage only extends to currency representing returns on, or repatriated capital of, the guaranteed investment.

While the foregoing economic risks are largely the function of events internal to Mexico, economic events external to the country can also pose risks. Consider, in this connection, Mexico's balance of payments record. Over the last twenty years, Mexico has been unable to produce economic growth "without also creating the conditions for an eventual balance of payments crisis." Although Mexico has taken a number of positive steps to overcome this recurring problem, namely, the encouragement of domestic savings, the maintenance of a tight control over the current account, and the continuing promotion of exports, the possibility always exists that the purchase of imports on credit could again inappropriately exceed exports.

Mexico's traditional dependence on revenues raised through taxes on the sale of oil also presents an economic risk. Insofar as the government's budget is "largely" funded by these proceeds, sudden changes in the price and demand for oil can result in economic disjointment. Per one industry publication, a drop in the price per barrel of oil can force the government "to reassess spending as tax revenue falls in line with lower [oil] prices. That will mean less money for education, health care, investment in infrastructure and a host of other programs." As a means of circumventing this dependency, Mexico has over the last years taken steps to increase the tax base and fight tax evasion. As the Mexican treasury's millennium report states, "The structural reform of the tax system is an ongoing process. Thus, every year the government has tried to close . . . loopholes, while taking the necessary steps to make tax collection more efficient, transparent and equitable. . . . [T]he government intends to implement . . . measures that [consider] tax evasion above certain threshold [levels] as a serious crime, as is the case in other OECD countries." Since the introduction of these tougher tax policies circa 1994-1995, tax revenue as a percentage of GDP has increased slowly and steadily.

338. MIGA, supra note 316, at 123.
339. Id.
341. Mexico's domestic savings rate has increased over the last five years from 14.8 percent of GDP in 1994 to 22.1 percent as of the first quarter of 1999. SHCP Report, supra note 2.
342. In 1994, the current account represented seven percent of GDP. That percentage dropped to 2.7 by the first half of 1999. Id.
343. As the result of well-organized export programs at both the federal and state level (for example, PITEX, ALTEX, ECEX), Mexican exports have grown substantially since 1994. Total exports were U.S.$117 billion in 1998. To Mexico's further credit, oil exports have dropped from approximately forty percent of the total exports in 1982 to approximately 21.4 percent of total exports in 1999. Id.
344. See Watling, supra note 49, at 36.
345. Id.
346.
347.
The last economic risk private equity investors should contemplate involves Mexico’s capacity to withstand financial crises or shocks around the globe. While it did experience turbulence following the Brazilian and Asian crises, Mexico’s economy bounced right back. In the case of the Brazilian devaluation, Mexico’s stock exchange actually went on to quickly surpass the pre-Brazilian devaluation level of trading. These facts indicate that Mexico is today more resilient to the shocks that periodically reverberate throughout the global economy.

From the foregoing it is clear that Mexico’s economic system, like that of many countries in the throes of substantial transformation, has experienced fundamental difficulties. It is also clear, moreover, that there exist a number of issues that have the potential to become economic problems, given the right coalescence of circumstances. As noted, supra, Mexico’s recent and ongoing reforms will help avoid such problems.

In this same preventative spirit, private equity investors should ensure that they recognize the significance of the fact that the United States and Mexico are neighbors. More than one political analyst has noted how events that transpire in Mexico—for example, a currency fluctuation, a trade spat, illegal immigration patterns, narcotics distribution practices, etc.—are of the utmost importance to the U.S. government. Indeed, as subtle as the characterization may seem, many political analysts view Mexico as one of our country’s top national security concerns. This point is illustrated by the way the Clinton administration arranged for an emergency loan package in response to Mexico’s 1994 devaluation larger in size than that entailed in the Marshall Plan.

From the perspective of economic risk, these events and facts communicate a very important message. That is, by virtue of our proximity to and inter-connectedness with Mexico, we have a strong interest in seeing Mexico succeed. To the extent that the strength of this interest can be relied upon going forward, U.S. investors may be inclined to feel less threatened by Mexican economic risks. In the event this does not constitute sufficient assurance, U.S. investors should consider the components of the “Financial Strengthening Program.” Totaling U.S.$16.9 billion, the resources represent a combination of loans, credit lines, and stand-by arrangements from the IMF, World Bank, Inter-American Development Bank, and the Exim Bank for the benefit of Mexico’s immediate development and continued economic security.

C. THE CHALLENGES OF INVESTING IN A FAMILY OWNED BUSINESS.

Perhaps the most unique risk associated with private equity transactions derives from being a minority shareholder in a small to medium-sized Mexican company. Unlike the United States with its abundance of publicly owned corporations, the basic business model

348. Actions taken to this end include: (1) the elimination of the immediate depreciation scheme, (2) restricting the ability of related firms to consolidate losses, (3) the enhancement of taxpayer registration programs, (4) the introduction of tougher penalties for non-compliance, and (5) expanding the legal audit and confiscatory powers of fiscal authorities. See SHCP Report, supra note 2.

349. Id.

350. See id.
in Mexico is the family-based firm.\textsuperscript{351} Consistent with the Mexican family's traditional role as the central social unit, the maintenance of absolute control has historically served as a means of simultaneously generating revenue and strengthening the nation's social fabric.\textsuperscript{352}

With time, however, this tradition is starting to loosen. Faced for the first time in decades with meaningful economic competition, many Mexican companies have begun to view the prospect of taking on outside investors as crucial to their survival. Alternatively, the recent boom in Latin American merger and acquisition activity has served as an inducement to other family run firms to exit their holdings altogether or consolidate for globalization.\textsuperscript{353}

Implicit in this process is the unprecedented opening up of Mexico's boards. Picking up on this trend, one trade publication notes how "many Latin American companies want their operations more professionally managed, and therefore view the involvement of sophisticated financial investors as a means to that end."\textsuperscript{354} While this practice in Mexico started with larger sized (often publicly traded) companies (for example, Carlos Slim's Grupo Carso, Alejo Peralta's Iusacell, the Lucioni family's Carsa, Carlos Gonzalez' Comercial Mexicana, Ricardo Salinas' TV Azteca and Grupo Elektra, and the Garza Laguera's Coca-Cola Femsa), it now serves as a model for SMSEs interested in private equity.

Notwithstanding this positive trend, however, family-run Mexican companies continue to maintain controlling positions. As one financial commentator observed, Mexico's corporate culture has become more modern, but "many Mexican companies remain closely held by families."\textsuperscript{355} This is echoed by the commentary of another industry practitioner who relates, "[o]n the equity side, . . . most Mexican issuers are not issuing securities that represent a controlling position, and . . . most of the original owners of these companies continue to control them."\textsuperscript{356}

The taking of a minority position is rich in opportunities for abuse and, as one financial publication points out, "the infringement of minority shareholders rights in Latin America is nothing new."\textsuperscript{357} For example, majority founders may not willingly provide reliable, up-to-date information, personalities may conflict, and finances may be commingled. Alternatively, minority outside investors may find themselves unable to participate in such a way as to effectively protect their financial interests.\textsuperscript{358} Because it is impossible for a private equity investor to foresee the treatment it will receive as a minority shareholder, it is again recommended that U.S. parties incorporate the rights and mechanisms discussed \textit{supra} into the investment agreement. This action, coupled with a wise investment selection process, will mitigate the risk aspects of investing in a family-run business in Mexico.

\textsuperscript{351} Following the poorly executed currency devaluation, the exchange rate fell fifty-four percent between December 1994 and March 1995. This event caused a devastating reduction in Mexico's purchasing power. See Rogers et al., \textit{supra} note 86, at 74. In a sign of economic vigor, Mexico paid off its U.S.$50 billion loan ahead of schedule.

\textsuperscript{352} See SHCP Report, \textit{supra} note 2.

\textsuperscript{353} See Adler, \textit{supra} note 121, at 18.

\textsuperscript{354} See id.

\textsuperscript{355} See Swafford, \textit{supra} note 279, at 17.

\textsuperscript{356} A Private Affair, \textit{supra} note 95.

\textsuperscript{357} Brendan M. Case, \textit{All in the Family}, LATIN TRADE, Sept. 1998, at 36.

\textsuperscript{358} Rogers et al., \textit{supra} note 86, at 72.
D. Observations and Recommendations.

1. Observations.

Despite private equity financing's increasing popularity in Mexico, it is still very much in a "formative" stage. Its nascent nature is clearly reflected in the observation of Jacques Gliksberg, a fund manager with the Latin American Group of the Bank of America, that he spends more time explaining the concept of private equity than actually constructing deals.

Initial experience with private equity financing in Mexico indicates that its effects can be beneficial on several different levels. U.S. investors willing to put their money into long-term, risk-laden transactions are compensated with greater than average returns. Capital-starved, competition-weary Mexican companies receive the financing they need, as well as the managerial expertise of foreign directors. And, as a result of the diversification of foreign investment inflows, the Mexican government has a better chance of achieving balance and stability in the nation's economic development.

Central to the success of private equity is a fund's ability to exit an investment. In this regard, Mexico has demonstrated no shortage of viable alternatives. To date, the most obvious means of exit has been by sale of a fund's stake, either to extant management or a third party with strategic interests. This practice coincides profitably with the increased quantity of mergers, acquisitions, and industry consolidation that has recently swept Latin America, as well as the positive clarification of the private sector's FOBAPROA-related debt situation. Insofar as consolidation is expected to continue for the foreseeable future, U.S. private equity funds have reason to be confident of their ability to exit.

Exits accomplished by way of IPO on the other hand, have not been as common. In contrast to some of its Latin neighbors, Mexico has yet to produce a line of high profile, NASDAQ-oriented "punto-com" entities. In fact, the handful of Mexican private equity transactions that have resulted in IPOs demonstrate little consistency in terms of the underlying type of business.

The probability that this situation will change going forward is good. Legislative, economic, and political change has resulted in the creation of a pro-investment environment characterized by an expanded number of potential investors with improved access to capital. Mexico's newly attained investment grade status may enhance this environment insofar as foreign institutional investors will now be able to hold larger amounts of Mexican securities.

Drawing on the early experience of Argentina, these investors, along with venture capitalists, will represent the most important source of financing available to the increased number of Internet-based e-commerce sites that are projected to be established.

359. Swafford, supra note 279, at 17.
361. See Mailander, supra note 46, at 71.
362. See Evans, supra note 28, at 23.
in Mexico and Latin America by 2003. To the extent that foreign Internet ventures have resulted in IPOs, it is expected that this trend will result in an increased number of Mexican entities going to market either on the BMV or abroad. In this connection, the BMV’s recent expression of willingness to waive the strict time requirements associated with a prospective issuer’s financial disclosure will directly accommodate the listing of Internet start-up companies. Similarly, U.S. exchanges continue to relax listing and trading requirements with the hope of attracting more foreign companies. Each of these developments bode well for the future of private equity in Mexico.

2. Recommendations.

Implementation of the following recommendations would help Mexican and U.S. parties secure the maximum benefits available through private equity financing.

a. Mexico.

Domestically, Mexico must continue the process of pro-investment legislative reform. While solid progress is being made to update Mexico’s commercial code for the purpose of e-commerce, the LGSM, which was first introduced in 1934 (and been the subject of few revisions since), is badly outdated in certain areas crucial to private equity financing. For example, there are no express provisions in the LGSM addressing shareholders agreements, super-majorities, and registration rights. Absent such provisions, U.S. investors interested in protecting their rights must contend with the additional complexity, cost, and time associated with the establishment and maintenance of a voting trust. As Mexico moves to bring its other laws into line with contemporary commercial reality, it should not fail to modernize the LGSM.

In related fashion, Mexico should also ensure that it completes the initiatives it has taken to liberalize the investment discretion of AFORES and the requirements for listing equities on the BMV.

Private equity’s future in Mexico can additionally be strengthened by events and actions that have an international nexus. Mexico’s anticipated adoption of the OECD’s proposed Multilateral Agreement on Investment (MAI) would work in conjunction with instruments such as the MIGA to enhance foreign investors’ sense of investment security.

363. Mexican companies that did IPOs after receiving private equity funding include Latin Americano Duty Free, S.A. de C.V. (retail), Agriexp (agribusiness), Tekchem (chemicals), Milano, and Arabela. See Trigueros, supra note 222.

364. While the Mexican government has established a development fund called “FIDETEC” (under the SEP’s Consejo Nacional de Ciencia y Tecnologia) to provide low interest financing and matching grants to high tech start ups, its financing abilities amount to a modest $8 million per year. See Young, supra note 37, at 41.

365. To this end, TELMEX’s Carlos Slim and Microsoft have joined forces to create a new Latin-oriented Internet portal. An initial presence has been established in the United States and six other Latin nations. See id. at 39.

366. See Krochmal, supra note 37. The implications of this fact are of historic proportions. Mexico has traditionally been a nation of exporters of primary materials, distributors, licensees, and franchisees. With the advent of the Internet, Mexico has been afforded the opportunity to exchange its passive economic development model for one involving independent innovation. As the experience of the last five years has demonstrated, this development has opened the door to the introduction of financing mechanisms previously incompatible with Mexico’s economic reality.
Moreover, having recently adopted the World Bank’s "Principles of Best Corporate Governance Practices," Mexico’s private sector commercial organizations and chambers of commerce should encourage their widespread application. Effective advocacy on this point, combined with the recent imposition of tougher accounting practices, should provide U.S. investors with a greater degree of confidence regarding the financial dealings of their Mexican business partners.

Last, Mexico should maintain the various lines of credit and support available under its "Financial Strengthening Package." Given the unpredictable frequency and intensity of both international and domestic shocks, financial "back-up" of this type can work in conjunction with Mexico’s geo-political proximity to the United States to further strengthen the confidence of U.S. investors.


Successful private equity transactions for U.S. investors are those that simultaneously maximize protection and profit. In order to accomplish this, U.S. investors must be both informed and vigilant.

On the front end of a deal, U.S. investors must select investment targets with special care. While Mexican entities, with whom the U.S. investor has an established relationship are always safest, the recommendation of a trusted local source should not be discounted. An effective due diligence program, carried out jointly by Mexican counsel and U.S. fund managers, will serve to confirm the wisdom (or imprudence) of the investment selection.

Once committed to a transaction, it is imperative that U.S. investors retain local counsel for the structuring and execution of the investment agreement. Given the relative novelty of private equity financing in Mexico, U.S. investors should ensure that said counsel is knowledgeable and experienced in the realization of this type of transaction. To the extent that they understand Mexico’s deal-specific regulations and general legal environment, U.S. investors will be able to participate more effectively in a transaction. Particular attention should be paid to the granting of rights, the formation of voting trusts, and dispute resolution mechanisms.

Finally, vigilant monitoring of the investment by U.S. investors may be accomplished through either the involvement of a fund representative in the daily management of the recipient company or the meaningful representation of the fund in the Mexican company’s board. Improved means of disseminating information (for example, over the Internet) and communication (for example, by video conferencing or e-mail) directly facilitate the ability of U.S. investors to monitor investments.