The Entrepreneur's Guide to Private Equity in Mexico

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# The Entrepreneur's Guide to Private Equity in Mexico

James B. Hallmark, Luis Fernando Gonzalez Nieves, Santiago Pardo, and David M. Hryck*

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PRIVATE equity financing offers a potential source of capital to the Mexican entrepreneur who has insufficient access to conventional sources of capital to finance his business operations. Many entrepreneurs, however, do not fully understand private equity financing or the process for obtaining it. This article is intended to help the entrepreneur and his advisors gain such knowledge in order to facilitate the flow of private equity investment into his company.

2. The term “company” in this context refers to either (i) Mexican early-stage (defined in note 4 below) and later stage companies (defined in note 5 below), or (ii) U.S. or “offshore” holding companies that the entrepreneur forms to own his Mexican company.
This article is divided into four sections. Section I provides entrepreneurs with a basic understanding of the fundamentals of private equity financing (i.e., what is it? What is the general process for obtaining it? What basic financial instruments are used to secure it? What are the major risks to those who provide it?). Section II focuses on key issues within the life of a private equity investment that entrepreneurs should consider. Section III discusses whether an entrepreneur should form a U.S. holding company to own his Mexican company to better attract private equity financing. Section IV offers some concluding thoughts about obtaining private equity in Mexico.

A. WHAT IS PRIVATE EQUITY FINANCING?

Private equity\(^3\) financing generally refers to investments that professional investors make in early stage\(^4\) and later stage\(^5\) companies with a high risk profile.\(^6\) The expectation by the professional investor is that such investments will yield high rates of return. From the entrepreneur's perspective, private equity offers financing to companies that no longer may rely solely on financing from themselves, their “friends and family,”\(^7\)

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4. As used here, “early stage” generally refers to businesses that may or may not have a complete management team, an operating history, developed a business plan, completed beta testing, demonstrated the initial viability of their business concept, or generated any revenues. See Robert M. Kossick, Jr. & Julian Fernandez Neckelmann, Structuring Private Equity Transactions in México, 6 NAFTA L. & Bus. Rev. Am. 105, n.36 (2000).

5. As used here, “later stage” generally refers to the following types of businesses:

1) small and medium size firms that have an established product or market, a history of growth, an experienced management team, positive earnings and cash flow, and that need money to expand the firm’s operations, develop new products, or acquire a related business; and

2) private or public companies that are in financial distress (such as businesses that are over-burdened with debt).


6. See section I.D. for a description of the major economic, legal, and political risks that investors face in making private equity investments in Mexico.

7. Although friends and family make private equity investments (generally in exchange for common stock or debt convertible into common stock), many observers do not consider “friends and family financing” to be private equity because their investment decisions are motivated by their relationship to the entrepreneur in addition to any potential returns. See Morrison & Foerster, supra note 3, at n.2.
or their suppliers and customers to fuel their growth, but that because of their risk profile, cannot raise capital through conventional channels, such as borrowing from banks or issuing public securities. Private equity fills this gap between self-financing and conventional capital market activity by offering entrepreneurs an attractive mid-point along the financing spectrum.

In exchange for investing in high risk companies (many of which fail), a private equity fund expects financial returns that exceed conventional investments, often 25 percent or higher, compounded annually. To achieve such returns, investors look for a company that has the potential to grow quickly and significantly. Before investing, investors often undertake a rigorous and intrusive due diligence investigation of the company's managers and operations. Once they invest, investors generally take an active role in the management of the business, claim a priority

8. In some businesses, entrepreneurs may be able to generate capital by carefully managing cash flow. For example, a business may be able to obtain advance payments or deposits for its products and services or obtain payment within fifteen days of shipment instead of the more customary thirty or forty-five days. Similarly, a business may be able to postpone making payments to suppliers until sixty or ninety days after shipment is received. Last, a company may lease equipment instead of purchasing it to conserve cash. See Bagley & Dauchy, supra note 3, at 105-06.


11. Venture capitalists, in particular, seek investments that, at a minimum, satisfy the following characteristics: (i) new technology, marketing concepts, market opportunity, product applications, or other elements that provide the potential for extraordinary success; (ii) products or processes that, as a result of innovation, patent protection, trade secrecy, or “first mover” advantage, allow for the creation of a market niche or head-start on the competition; (iii) management with outstanding competence and integrity; (iv) investments that have a reasonable exit or liquidity strategy within a few years; and (v) situations that permit the investors to make a contribution to the success of the business beyond the capital invested. See Reinaldo Pascual, Venture Capital in Latin America, Corp. Fin. (Issuing Securities Supp.), Sept. 2000, at III-VI.

12. See section II.A.1 infra for a description of some of the important issues that an investor typically reviews in its due diligence investigation of the entrepreneur’s business.

13. In contrast, “angel investors” (such as wealthy individuals or funds that specialize in start-up and early stage companies) often are interested more in a return on their investment than in taking an active role in the management of the company. That is, angel investors may or may not insist on board representation or the right to approve or select key employees. They usually require no more than the right to veto major changes in the business, such as increases in top management’s compensation and the amount of stock available under the company’s stock option plan. Angel investors generally do not demand as much equity as a venture capitalist, so dilution of the entrepreneur’s ownership interest in the company is minimal. See Bagley & Dauchy, supra note 3, at 102-03. See Mayer, Brown & Platt,
interest in its assets, and control key actions that the enterprise may take. Target companies for private equity include businesses that are too new to have a convincing track record. Also, those early stage and later stage companies that need expansion capital or those not yet exposed to the capital markets are candidates for private equity finance. Finally, financially distressed companies that are over-burdened with debt or those with opaque financial reporting standards that discourage investors or those perceived as undervalued may access private equity financing as a vehicle for growth.

Funds typically raise their capital from institutional investors. These institutional investors may be public and corporate pension funds, endowments and foundations, bank holding companies, insurance companies, investment banks, multilateral financial institutions, national development banks (e.g., Mexico's Nacional Financiera, S.N.C.), government organizations, wealthy individuals and families, other corporations, and investors' groups (fund investors). Fund investors expect a fund to deliver to the fund investors at least a 20 percent compounded return on their investment in the fund within the agreed duration of the fund, which is usually seven to ten years. Given that a fund sometimes does not make an investment in a portfolio company until its second year or later, the fund seeks to exit from (i.e., sell its investment in) the company within three to five years after the date of such investment. The goal is to return the proceeds from such sale to the fund investors within the life of the fund. If an entrepreneur is looking for a longer time horizon — a


14. See infra notes 191 and 200 for a list of corporate actions that investors often want to approve before the company takes such actions. See Morrison & Foerster, supra note 3, at 1; see Leeds & Sunderland, supra note 3, at 3; see Mailander, supra note 5, at 73; see FENN ET AL., supra note 10, at 43.

15. "Expansion capital" refers to financing needed to expand the firm's plant and equipment, develop new products or services, acquire a strategic or related business, or realize a change in ownership or capital structure through a management buy-out, leveraged buy-out, or sale to a third party. See Kossick & Neckelmann, supra note 4, at 110.

16. See Leeds & Sunderland, supra note 3, at 2-3; see Kossick & Neckelmann, supra note 4, at 110-11; see Mailander, supra note 5, at 73.

17. See FENN ET AL., supra note 10, at 49; see Mailander, supra note 5, at 73; see Kossick & Neckelmann, supra note 4, at 121-22; see Josh Lerner & Gonzalo Pacanins, Private Equity in Developing Countries, at http://www.ksg.harvard.edu (last visited May 21, 2003).

18. See Morrison & Foerster, supra note 3, at 10; see Kossick & Neckelmann, supra note 4, at 121; see Griffith, supra note 9, at 22; see BAGLEY & DAUCHY, supra note 3, at 105.

19. See Morrison & Foerster, supra note 3, at 10; see BAGLEY & DAUCHY, supra note 3, at 105, 191. See Paul Kilby, Heading for the Exits, LATIN FIN., May 1, 1999, at 31. But see also Kossick & Neckelmann, supra note 4, at 111 (while the exact duration of a private equity investment varies in relation to the developmental stage, condition, and objective of the company, the term of investment typically ranges from two to ten years, with many investments clustering between three and seven years).
factor that should be discussed with the fund managers – the enterprise may not be suitable for private equity financing.

The roots of private equity in Mexico are found in the Mexican government’s use of the Sociedad de Inversion de Capital de Riesgo (venture capital societies or “SINCAS”) to promote investment in specified regions of Mexico and certain entrepreneurial activities. SINCAS are still the principal private equity investment vehicles in Mexico, yet have few funds available for, and even fewer funds invested in, local companies. This situation is partially explained by the lack of support and incentives for private equity investment. There is also the absence of a well developed private equity industry because players and intermediaries are scarce, and technical support, both private and state sponsored, is virtually nonexistent. Further, individual investors typically are adverse to risk and often lean towards real estate and other type of sectors that have demonstrated their resiliency throughout several economic crises.

Pension funds are another source of private equity capital in Mexico. These funds consist of the retirement administration funds (Administradoras de Fondos para el Retiro, hereinafter AFORES) and investment companies specialized in retirement funds (sociedades de inversión especializadas en fondos para el retiro, hereinafter SIEFORES). AFORES directly manage SIEFORES with a view to obtain “an adequate return in the investments at the lowest risk possible.” By definition, SIEFORES have to implement a low risk investment policy, inconsistent with the characteristics of private equity investment. That is, all investments made by SIEFORES must bear a risk qualification of “D” or higher, with a further requirement of committing a large proportion of the available funds in instruments bearing a risk qualification of “B” or higher. In addition, SIEFORES by law are not allowed to acquire instruments that may be converted into private company shares, which is a common investment vehicle in private equity. Given the low risk investment guidelines that SIEFORES must follow and specific prohibitions on investing in convertible instruments, Mexican pension funds, probably the most relevant institutional investor in the country, are largely unable to provide

20. Motivational chapter of the Resolution amending sections 9 and 15 of the Regulations for the Investment of Technical Reserves of Institutions and Mutual Insurance Companies (Exposicion de Motivos al Acuerdo por el que se Modifican la Novena y Decima Quinta de las Reglas para la Inversion de las Reservas Tecnicas de Instituciones y Sociedades Mutualistas de Seguros), Federation’s Official Gazette, Aug. 18, 2000.


23. See Law for the Retirement Saving System (Ley de los Sistemas de Ahorro para el Retiro), art. 18.

24. For risk classifications, see the qualifications used by Moody’s, Fitch Mexico, or Standard & Poor’s.
resources to foster the Mexican private equity industry. Pressure, however, has been growing to reform the current law to allow pension funds to diversify their investments. Such pressure has initially resulted in an August 2001 amendment to the Rules for the Minimum Guaranty Capital of Insurance Institutions (Reglas para el Capital Mínimo de Garantía de las Instituciones de Seguros), which allows insurance institutions to invest part of their reserves in private equity funds, SINCAS, as well as trusts designed to increase investment in domestic companies. To be eligible for such investments, these private equity funds and trusts must obtain authorization from the Ministry of Finance and Public Credit (Secretaría de Hacienda y Crédito Público). This authorization is subject to the following requirements:

(i) The private equity fund and/or trust may only invest in entities incorporated in Mexico and with permanent residence in Mexico, and

(ii) The funds and trust investment portfolio must be diversified, and investments in a single company or a group of related companies may not exceed 20 percent of the total portfolio. In addition, the insurance institutions are limited in the amount of funds that they can invest in certain types of entities.

B. WHAT IS THE GENERAL PROCESS FOR OBTAINING PRIVATE EQUITY?

If an entrepreneur wishes to obtain private equity financing, the general process that an entrepreneur follows to obtain such financing is set forth below. Section II contains a more specific discussion of key issues that entrepreneurs should consider within this process.

1. Business Plan

Generally, the first step to obtaining private equity financing is to prepare a business plan that demonstrates that the entrepreneur knows his business and has formulated a viable plan for making money from this business. An effective business plan briefly describes the entrepreneur’s business, products and market, the qualifications of management, the company’s competitors and any obstacles that prevent competitors from entering its market (such as patents), the risks in invest-

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25. The Rules for the Minimum Guaranty Capital of Insurance Institutions (Reglas para el Capital Mínimo de Garantía de las Instituciones de Seguros) were repealed and new rules came into effect as of February 10, 2003; however, the provisions introduced by the August 2001 reform were maintained in the new Rules.

26. A business plan should be succinct. Investors have little tolerance for reading more than a fifteen or twenty page business plan. See DAVID GLADSTONE, VENTURE CAPITAL HANDBOOK, 26-30 (1988); see BAGLEY & DAUCHY, supra note 3, at 194-95.

27. Investors often say that the three most important factors in making an investment are “people, people, and people.” The right team can fix a flawed business concept, but a flawed team cannot get a brilliant concept to market. Any weaknesses in the entrepreneur’s team (e.g., the team has no experienced managers, lacks a
In the company, the venture's financial history and goals, the amount of money needed to attain these goals, how the company will spend this money and how it intends to return this capital to the fund. In short, the business plan should describe all of the important information that a well-informed investor should know about the company. Investors generally are busy people, so most want to quickly review a one to three page summary of the business plan to determine whether they are interested in reviewing the full business plan and pursuing further discussions with the entrepreneur. The International Finance Corporation / World Bank Group offers an “SME Toolkit” at www.ifc.org/sme/html/sme_community.html to provide online resources to small and medium enterprises to develop their businesses, including a format for building business plans.

2. Legal Advisors

The entrepreneur should retain a law firm that specializes in representing investors and entrepreneurs in private equity transactions. Such a firm can assist greatly the entrepreneur in editing his business plan and building a corporate structure that is attractive to investors. Such a specialized firm also can be helpful in introducing the company to investors who would be the most interested in investing, negotiating the terms of the financing and the related documents, and generally ensuring that the financing process runs smoothly.

3. Finding Private Equity

In seeking private equity investors, entrepreneurs should first determine what they want from the investor. Is only funding desired, or are other services necessary, such as financial, management, and/or marketing advice, helping to raise capital, identifying and attracting key employees to the company, or developing business for the company?

Once this determination is made, a good way to find private equity money is to contact the Latin American Venture Capital Association (www.lavca.com), the National Venture Capital Association (www.nvca.com), the European Venture Capital Association (www.evca.com), and other trade associations comprised of investors who provide private equity investments to entrepreneurs. Another effective way to find such financing is to arrange an introduction by someone who knows the investor, such as friends who have obtained financing and lawyers, accountants, or bankers who provide services to funds, companies, or fund strong chief financial officer, and the like), should be acknowledged in the business plan. See Bagley & Dauchy, supra note 3, at 194.

28. See Bagley & Dauchy, supra note 3, at 110, 194; see Gladstone, supra note 26, at 26-30.

29. Most private equity investors specialize in certain industries (e.g., software, healthcare, electronics, etc.) and/or in a particular stage of development (e.g., seed, early stage, later stage, mezzanine, etc.), so it is important to target the right type of investors. See Bagley & Dauchy, supra note 3, at 193.
investors.\textsuperscript{30} Many companies obtain financing by attending venture fairs where they make presentations to an audience of investors. Less effective ways to obtain financing include sending unsolicited business plans to funds that an entrepreneur finds online or through various published guides. The problem with this route is that investors receive dozens of these plans each week and rarely read such plans thoroughly, if at all.\textsuperscript{31}

Finding investors who are willing to make private equity investments is an arduous task, but finding funds that provide such financing to Mexican entities is especially challenging since such funds are relatively scarce and typically are located outside of Mexico. As described in section II below, however, some entrepreneurs may improve their chances of attracting such financing by forming a U.S. holding company to own their Mexican operations because this structure offers investors the best of both worlds: the advantages of operating in Mexico (e.g., cost savings) and the flexibility and protection of U.S. corporate laws, enforcement of U.S. courts, and access to more exit opportunities (e.g., U.S. capital markets).

4. \textit{Due Diligence Review}

Once an investor has reviewed the full business plan and decides to pursue further discussions with the entrepreneur, the investor will perform a due diligence investigation, the process through which investors (and their legal and financial advisers) examine a company's business, products, markets, financial health, and legal situation and conduct background checks on the management team.\textsuperscript{32} While the fund is investigating the company, the entrepreneur should also conduct a due diligence review on the fund. Section II.A.1 below describes the due diligence process in greater detail and the types of materials that investors and entrepreneurs typically review during their respective due diligence investigations.

5. \textit{Term Sheet}

After the investor has completed its due diligence examination and has indicated a serious interest in making an investment in the company, the investor (or his attorney) typically prepares a term sheet to outline the principal terms of the investment, including the investor's valuation of the company.\textsuperscript{33} After the entrepreneur and his attorney have reviewed and discussed the term sheet,\textsuperscript{34} the investor and entrepreneur negotiate its terms. If other investors have invested previously in the company, they

\textsuperscript{30} See id. at 192.
\textsuperscript{31} See id. at 191-92.
\textsuperscript{32} See id. at 196.
\textsuperscript{33} Section II \textit{infra} discusses valuation and other principal terms that a term sheet typically contains. The valuation of the company determines the price that the investor pays for stock in the company.
\textsuperscript{34} The entrepreneur's attorneys should review the term sheet before the entrepreneur signs it to ensure that the entrepreneur understands the ramifications of each term and protects the company's interests.
usually will join these negotiations, which commonly complicate discussions. The pressure of these negotiations offers a great opportunity for the parties to evaluate their ability to work together. If the chemistry between the parties is not good, often it is a mistake to make and accept the investment, particularly where cultural and language differences are likely to accentuate such bad chemistry. Section II.A.2 below examines key provisions in the term sheet that the entrepreneur should consider especially carefully.

6. Investment

When the parties have negotiated and signed the term sheet, the investor's attorney normally prepares the financing documents, which set forth all of the parties' rights and obligations with respect to the investment. The entrepreneur's attorney then reviews the financing documents to ensure that they reflect the terms of the term sheet and the parties' agreement. Even if the financing documents accurately reflect the term sheet, the parties also typically negotiate the terms of the financing documents because the term sheet only outlines the general terms of the investment whereas the financing documents detail the specific rights and obligations of the parties, many of which raise issues that the parties must resolve prior to the investment. Once the parties have completed and signed the financing documents, the investor makes the investment. Sometimes the fund makes its investment in several “tranches” (partial payments), each upon the occurrence of a certain milestone or other event.

7. Management

To achieve the high financial returns that a fund expects from the company, the investor normally takes an active role in the management of the business. This management role often includes sitting on the company’s board of directors, retaining a veto right over important actions that the company may take, requiring the company to provide the investor with certain financial and other information on a periodic (e.g., monthly or quarterly) basis and generally providing managerial and marketing advice to the company. Many entrepreneurs, however, especially older family-owned firms, are skeptical about the benefits of shared management and resist sharing power and business information with an outsider. If an entrepreneur cannot share power and information with the investor, a factor that often becomes obvious during initial negotiations between the parties, the enterprise may not be suitable for private equity. Thus, it is important for all parties to negotiate clear and effective mechanisms to regulate the relationship among all stockholders, especially the terms and conditions dealing with governance, financial decisions, day-to-day management, dispute resolution, and the investor’s exit from its investment in the company.

35. See Leeds & Sunderland, supra note 3, at 7, 10.
8. Exit

As mentioned above, investors seek to sell their investment in the company within three to five years after the date of investment in order to return the sale proceeds to the fund investors within the life of the fund. An investor generally expects to sell his investment in the company in one of the following ways: (i) to the general public through a public sale of the company's stock (public sale), (ii) in a private sale to a third party who buys the company's stock or assets (private sale to third party), 36 (iii) in a private sale to another stockholder who buys the investor's stock (private sale to stockholder), or (iv) in a private sale to the company itself who repurchases (or "redeems") the investor's stock (redemption or private sale to issuer). 37 As discussed in section II below, an investor's exit from an investment in a Mexican company is limited because (i) a redemption generally is illegal in Mexico, (ii) a public sale through Mexican public markets normally is not available for a small or mid-sized Mexican company, 38 (iii) the pool of buyers willing to purchase the stock or assets of a Mexican company in a private sale to third party is relatively small in Mexico, and (iv) other stockholders often are unwilling or unable to purchase the investors' equity in a private sale to stockholder. Section III below discusses how an entrepreneur may increase his exit opportunities (and thus his chances of attracting private equity investment) by forming a U.S. holding company.

C. What are the Basic Financial Instruments Used to Provide Private Equity?

In obtaining private equity financing, the entrepreneur must decide whether to raise this capital in the form of equity (such as preferred stock) or debt. In simple terms, the equity of a company is the value that someone is willing to pay for it minus any liability attached to it (for example, its fair market value minus its debt). 39 Although the term "private equity" suggests that companies only issue equity instruments (such as stock) and not debt instruments (such as promissory notes), in practice, companies commonly issue both equity and debt instruments to investors.

36. Potential purchasers include competitors, strategic investors and later-stage investors. Id. at 9.
37. See Morrison & Foerster, supra note 3, at 10; Leeds & Sunderland, supra note 3, at 8-9; Mailander, supra note 5, at 73; Kilby, supra note 19, at 32-34; Griffith, supra note 9, at 23; Kossick & Neckelmann, supra note 4, at 111-16, 144-48; John Barham, Venture Capital's Dark Cloud, LATIN FIN., Oct. 2001, 30, 31, 34; Mark Piper, Waiting for a Way Out, LATIN FIN., Nov. 2000, 40, 41; Mayer, Brown & Platt, supra note 13, at 11; Jorge E. Alers et al., Strategizing Your Exit from Private Equity Investments in Latin America, presentation at the Institute on Small Medium Enterprise Financing sponsored by the Multilateral Investment Fund, Nov. 8-12, 1999, at 9-16.
38. See Kossick & Neckelmann, supra note 4, at 114, 166; Barham, supra note 37, at 31-33; Kilby, supra note 19, at 32-34; Pascual, supra note 11, at IV.
39. For example, property having a fair market value of $20,000 with debt of $15,000 has equity of $5,000 ($20,000 minus $15,000 equals $5,000).
in return for private equity financing. Below is a brief description of the basic equity and debt instruments issued in private equity financing.

1. Equity Instruments

Once the entrepreneur and investor determine the valuation of the equity in the company, the entrepreneur can then sell parts of the equity in order to raise capital. The company sells equity to investors in the form of stock or as rights to acquire stock (such as stock options, warrants, and convertible debt).

From the company's perspective, one of the benefits of selling equity to raise money is that the company generally does not have to return the money to the fund unless the company has paid all of its debts and has money remaining to return to its stockholders. In addition, the interests of an investor holding stock are more aligned with the interests of the other stockholders in the company since none of them make money unless the company builds equity. Thus, such investors will have a greater incentive to use their experience and contacts to open doors for the company and help the company grow as quickly as possible.

One disadvantage of selling equity is that the company allows the fund to become a co-owner of the company, thereby diluting (or decreasing) the existing stockholders' ownership interest in the company. As the company grows, the company often will be under pressure from existing stockholders to limit the degree of dilution resulting from additional equity financing. Also, there are usually tax factors and other business implications that affect whether the company obtains debt or equity financing.

Below is a brief description of the basic instruments that a company can use to sell equity to investors.

a. Common Stock

Common stock generally is the ordinary stock of the company and gives the holder the right to participate in the company's profits after the company has paid all of its debts to creditors and its obligations to the preferred stockholders. That is, common stock typically is the last to share in the equity of the company. A company typically issues common shares to the entrepreneur and his employees, friends, and family who have invested in the company.

b. Preferred Stock

To protect their investment, investors commonly obtain preferred stock from the company, which gives them rights in addition to those given to

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40. From a tax standpoint, some corporations can deduct their interest payments.
41. For example, common stockholders typically have the same rights to vote, to receive dividends, and to receive their pro rata portion of the assets of the company upon a sale or liquidation. See Bagley & Dauchy, supra note 3, at 116.
common stockholders. These preferential rights often include liquidation preferences, dividend rights, redemption rights, conversion rights, antidilution protection, and voting rights (which rights are described in detail in section II below).

c. Stock Options and Warrants

A stock option and a warrant each give its holder the right to purchase a certain amount of equity for a specific price at a certain period of time. A stock option differs from a warrant in that a company generally grants stock options to its employees and consultants, whereas a warrant typically is sold to investors and other third parties. A company commonly issues stock options to employees and consultants as an additional incentive to work for the company, giving them an opportunity to share in any appreciation in the value of the business without having to invest any of their own money until a future date. That is, to motivate employees, a company offers stock options to employees that “vest” over time (e.g., monthly or quarterly over a four-year period). An employee can exercise vested stock options to purchase stock, but cannot exercise unvested stock options. So, the longer that an employee works for the company, the more vested stock options the employee earns, which the employee can exercise to purchase stock in the company at a favorable price.

In contrast, a company often issues warrants as a sweetener or “kicker” to induce investors to (i) make a bridge loan to the company while the company raises additional financing or (ii) purchase additional shares of the company’s preferred stock by giving these investors the right to use these warrants to purchase lower-priced common stock in conjunction with their purchase of higher-priced preferred stock, thus lowering the average price that the investor pays for its equity (and thus increasing its potential return on investment). An entrepreneur also may issue a warrant to third parties to induce them to lease real estate or equipment to the company or to enter into a business relationship with the company. As discussed in section II below, Mexican law does not allow a company to issue stock options and warrants.

d. Restricted Stock

Restricted stock is equity that an employee purchases from the company but which the company can repurchase from the employee if he leaves the company or is terminated prematurely. In the typical case, the shares that the employee purchases are subject to a vesting schedule pursuant to which the employee’s shares will vest over a period of three to

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42. Id. at 117, 226.
43. See id. at 117. See Michael J. Halloran et al., 1 Venture Capital and Public Offering Negotiation 13-2 (3d ed. 1983).
44. See Halloran et al., supra note 43, at 6-3.
45. Investors often require entrepreneurs to hold restricted stock so that the entrepreneur will have an incentive to continue to work for the company for a period of time.
five years.\textsuperscript{46} If the employee leaves or is terminated prematurely before his stock fully vests, the company can repurchase the unvested portion of the shares. The purpose of the vesting provisions is to require the employee to earn his stock by working for the company for a period of time.\textsuperscript{47} Restricted stock differs from stock options and warrants in that restricted stock are shares that the employee actually holds but can lose in certain circumstances whereas stock options and warrants only represent a right to purchase stock that the employee can exercise in certain circumstances. As discussed in section II below, Mexican law generally does not allow any redemption, thus a private Mexican company cannot repurchase any unvested restricted stock of an employee who leaves the company or is terminated prematurely.

2. \textit{Debt Instruments}

A company that raises capital through debt financing does not sell its equity, but instead borrows against it. This means that the investor who holds debt in the company gets paid before the investor who holds stock. For this reason, investors making high risk private equity investments\textsuperscript{48} are more apt to make a debt investment in a company instead of an equity investment so that if the company fails, the investor holding debt will get its money back before any stockholder is paid. Thus, the interests of an investor holding debt are less aligned with the interests of the company's stockholders since such investor is more focused on getting his money back and less concerned about the company as a whole. So, investors holding debt generally will be less inclined to use their experience and contacts to open doors for the company and grow the company as quickly as possible.

From the company's perspective, an advantage of selling debt to raise money is that the investor will not become a co-owner of the company, so the existing stockholders' ownership interest in the company is not diluted. Also, there are usually tax factors\textsuperscript{49} and other business implications that may prompt a company to obtain debt financing over equity financing.

Below is a brief description of the basic instruments that a company can use to sell debt to investors.

\textbf{a. Convertible Loan}

From the investor's perspective, the disadvantage of a debt investment is that the investor does not have an ownership interest in the company and thus cannot enjoy any of the upside potential of an equity investment.

\textsuperscript{46} See \textsc{Halloran et al.}, supra note 43, at 6-3.
\textsuperscript{47} See \textit{id}.
\textsuperscript{48} An investment in a distressed company, in a developing country where the economic, legal, and political risks are high, or during an economic downturn are examples of high risk investments.
\textsuperscript{49} From a tax standpoint, some corporations can deduct their interest payments.
if the company is successful. To remedy this problem, investors sometimes use a convertible note to give them the best of both debt and equity. In simple terms, a convertible note is debt that the investor can convert to equity (such as common or preferred stock) upon the occurrence of a specific event (e.g., when the company secures a subsequent round of financing, the company becomes profitable, or reaches some other milestone). With a convertible note, the investor has the protection of a debt investment (thus, getting its money from the company first) and upon conversion the benefits of equity (such as shares in the equity of the company if it is successful). Of course, other ways that investors can "equitize" their debt investment are to receive warrants to purchase additional shares of the company at a favorable price to give themselves an equity sweetener on a debt investment\textsuperscript{50} or any of the debt payments described below.

Convertible debt might be more advantageous to the company if it carries a lower interest rate than straight debt. Also, when the entrepreneur and investor are unable to agree on the valuation of the company's equity (or want to postpone an equity financing), the company often will issue convertible debt to the investor in the form of a bridge note, which the investor can convert into common or preferred stock of the company upon the occurrence of a future event.

b. Miscellaneous Debt Payments

Instead of taking equity in the company, some investors require the company to pay them a certain percentage or other amount of the revenue or profits that the company receives over a period of time as a service fee, a commission, royalty payment, or other type of payment. The disadvantage of this type of arrangement for the company is that it allows the investor to share in the company's revenues or profits before any stockholder receives any money.

c. Secured vs. Unsecured Loan

Although investors who hold debt are paid before stockholders, some debt holders want secured debt to ensure that they are paid before other debt holders. Secured debt is debt that is backed (secured) by a pledge of collateral. Some investors require that the company pledge some or all of its assets as collateral to secure payment of their loans. If the company defaults on a secured loan, the creditor generally has recourse against either the borrower or the specific property that the borrower pledged as collateral. If the borrower defaults on an unsecured loan, however, the creditor only has recourse against the borrower. A convertible loan generally is unsecured, but can be secured.

\textsuperscript{50} See Halloran \textit{et al.}, supra note 43, at 6-3; Mayer, Brown & Platt, \textit{supra} note 13, at 10.
D. What Risks Do Investors Face in Making Private Equity Investments in Mexico?

Investors making private equity investments in Mexico face a variety of legal, economic and political risks, some of which are outlined below.

1. Economic Risks

Investors making private equity investments in Mexican companies face a variety of economic risks besides the usual high risks that come from investing in early stage companies that have unknown management, a limited operating history, and unproven business concepts and later stage companies that are financially distressed (such as over-burdened with debt) or are seeking to expand into new markets. Some of these additional economic risks are described below.

a. Weak Accounting Standards

Investors often find that Mexico lacks, in practice, standardized accounting principles and that local practices are incompatible with U.S. Generally Accepted Accounting Principles (hereinafter U.S. GAAP). Although Mexico recently has made significant progress to toughen its accounting standards, the rules set by its own Institute of Public Accountants (Instituto Mexicano de Contadores Publicos) are less onerous than those mandated by the Financial Accounting Standards Board in the United States. Examples of differences between Mexican and U.S. GAAP include the statement of cash flow (e.g., Mexican inflation adjusting techniques may differ from those in U.S. GAAP), deferred income taxes (such as some temporary differences that flow from the way purchases may be deducted for tax purposes under U.S. and Mexican GAAP), and employee profit sharing (e.g., the effects of any deferral are not recorded under Mexican GAAP).

b. Contingent Liabilities

Investors making private equity investments in Mexican companies have difficulty quantifying the amount of contingent liabilities (such as back due taxes, delinquent social security contributions, environmental clean-up costs, and the like) that the company might have prior to mak-
ing its investment. For example, tax audits in Mexico may not be final determinations, so investors (and the entrepreneur) may not know whether the company owes taxes until after the investor has made his investment. Moreover, Mexican law provides that a new stockholder in a Mexican company is liable for all pre-existing obligations of the company, so the Mexican company arguably cannot indemnify the investor for the amount of the taxes. Directors also are liable for the failure of the Mexican company to (i) create and manage systems of accounting, control, bookkeeping, and filing, (ii) ensure that stockholders have made their capital contributions to the company, and (iii) pay dividends properly. Of course, the difficulty in gauging a company's liabilities, contingent or otherwise, adversely affects the valuation of the company that the entrepreneur and investor negotiate, and increases the risk that the investment will not be profitable.

c. Currency Devaluations

Another key element that funds consider when making investments in Mexican companies is the currency devaluation risk, which is always integrated into the price of the target company and the expected returns on the investment. The Mexican peso underwent a series of devaluations during the 1970s. During most of the 1980s and the early 1990s, the Mexican government set target ranges for the international value of the peso and entered the currency markets whenever the peso's exchange value fell out of a predetermined range. In 1988, a strategic decision to peg the peso to the dollar was adopted as a stabilization plan, which was part of a structural reform program that helped reduce inflation from 159 percent in 1987 to 7 percent in 1994. Yet, a classic case of exchange rate overshooting occurred in the wake of a brutal collapse of confidence in the peso and a massive suspension of private capital flows. The result: a peso depreciation of over 100 percent, from 3.5 pesos to 7.3 pesos to the U.S. dollar. Since then, the Mexican monetary policy regarding currency devaluations is to leave the peso sub-

operation (CEC) – an intergovernmental body created by NAAEC itself – to assess whether a NAFTA country is failing to enforce its environmental laws. As a result of such proceeding, the CEC may elaborate a factual statement regarding the alleged omission. This mechanism of citizen participation, however, cannot result in a binder resolution. See NAAEC, arts. 14, 15.

55. Other contingent liabilities include employee claims, employee pension funding, uninsured product liability, breached product warranties, and contracts. See Morrison & Foerster, supra note 3, at 3; Kossick & Neckelmann, supra note 4, at 131.

56. See Morrison & Foerster, supra note 3, at 3.

57. Id.


61. See id.
ject to a floating regime. The peso has been stable for the last six or seven years at an average cost of nine to ten pesos per U.S. dollar. Several different institutions forecast the peso will close the year at 10.80 pesos per dollar. The Central Bank categorically insists that a floating regime will be followed, and that monetary policy will be anchored on targets for domestic credit expansion.

d. Family-Owned Business

The relationship between the investor and entrepreneurs is complex and often contentious, even in the best of circumstances. This issue becomes more problematic when investing in family-owned firms. One observer has summarized the issues about investing in family-owned firms as follows:

Although widespread in all countries, family ownership tends to be even more prevalent in developing countries. The prototype is an entrepreneur who has built a successful business with virtually no capital or shareholders beyond his immediate family and close friends. Absent the necessity of accountability to outside shareholders, the interests of the owner and the firm are indistinguishable, and financial accounts are frequently intermingled. These traditions of autonomy, secrecy and independence run deep within the corporate culture of most developing country firms, rarely challenged until the need for outside capital becomes imperative.

2. Legal Risks

In addition to economic risks, investors making private equity investments in Mexican companies find a less flexible corporate law regime, fewer legal instruments to structure investments, and inadequate enforceability of the available instruments. This increases the risk of making private equity investments in Mexican companies, thus making investors less likely to invest in Mexican ventures.

a. Inflexible Investment Structures

Private equity financings require flexible corporate law regimes that provide for a wide variety of enforceable legal instruments to structure investments. Due to the codified nature of the Mexican legal regime as a civil law system, the corporate laws in Mexico, although developed, do not adequately provide the variety of flexible legal mechanisms or the enforceability of those available necessary to facilitate private equity investments. Examples of these limitations are outlined below and described in greater detail in section II below.

63. See Leeds & Sunderland, supra note 3, at 7.
64. See Morrison & Foerster, supra note 3, at 5.
65. See id.
(i) **No Advance Waiver of Preemptive Rights**

Mexican law grants all stockholders of a Mexican company the right to purchase their pro rata portion of any new stock that the Mexican company issues.\(^6\) This preemptive right (*derecho de preferencia*) is designed to protect minority stockholders from having their ownership percentage in the company diluted (decreased) by new stock issuances and stockholders cannot agree to waive this right prior to such issuance. As discussed in section II.A.2 below, the inability of stockholders to waive their preemptive rights in advance (prior to the stock issuance) prevents the Mexican company from issuing future equity pursuant to stock options, warrants, anti-dilution rights, registration rights and other mechanisms commonly used in private equity financings.

(ii) **No Stock Options and Warrants**

In the United States, stock options, warrants, and similar rights are important tools that an entrepreneur uses to attract and retain key employees and consultants\(^6\) and to induce investors to invest in his company. Mexico’s current legal framework, however, does not allow a Mexican company to issue such rights for the reasons set forth in section II.A.2 below.

(iii) **No Voting Agreements**

Investors making private equity investments typically become minority stockholders in the target company (meaning they purchase less than 50 percent of the company’s stock). To protect themselves against the actions of the majority of the stockholders, investors often require the entrepreneur and other major stockholders in the company to enter into an agreement to vote in a certain way on key issues affecting their investment in the company (such as election of directors, drag-along rights, and the like). As discussed in section II.B below, however, Mexican law zealously protects the voting rights of all stockholders and thus does not allow stockholders to waive their right to vote or agree in advance to vote in a certain manner.\(^6\) Consequently, investors must find mechanisms other than voting agreements to protect themselves against majority stockholders.

(iv) **Limited Dividend Rights**

Private equity investors typically obtain preferred stock with dividend rights that require the company to pay a dividend first to the preferred

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6. Stock options have the dual purpose of rewarding the employee by allowing him to participate in any increase in the value of the company and ensuring that the employee stays with the company for a certain period of time in order to share such profits. See Morrison & Foerster, *supra* note 3, at 7.
stockholders before it pays any dividend to the common stockholders. In many cases, these dividend rights require the company to pay an annual fixed dividend (e.g., 8 percent per year) to the preferred stockholders, similar to interest that accrues on debt. Section II.A.2 below, however, details how Mexican law limits a Mexican company's ability to pay dividends.

(v) Limited Liquidation Rights

Preferred stock typically provides that, upon any liquidation, the company must pay a portion of any assets that it has after paying its debts first to the holders of preferred stock and then to the holders of common stock. In short, a liquidation preference allows the investor to retrieve his investment from the company before other stockholders receive any money. Mexican law provides that certain stockholders may enjoy a liquidation preference, if such preference is included in the Mexican company's bylaws or is approved at an extraordinary shareholders meeting in which the preferred stock issuance is approved; however, Mexican law prohibits stockholders from waiving their right to participating in the profits of the company. Section II.A.2 below explores this issue in greater detail.

(vi) Limited Redemption Rights

As discussed above, investors usually expect to be able to sell their investments in a U.S. company either in a public sale, private sale to third party, private sale to stockholder, or redemption. In many cases, redemption constitutes the investor's only viable exit from the company. Unfortunately, Mexican law prohibits redemptions (except in limited cases), thus depriving investors of a significant (and perhaps the only) way for them to exit from their investment and preventing Mexican companies from using restricted stock, as a Mexican company cannot purchase the restricted stock of an employee who leaves the company or is terminated prematurely.

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69. See Bagley & Dauchy, supra note 3, at 118; Mayer, Brown & Platt, supra note 13, at 11.
70. See General Law of Business Organizations, supra note 58, art. 19.
71. In private equity financings, the investment documents often provide that the company is deemed to have liquidated if it sells substantially all of its assets or the stockholders agree to merge the company with another company.
73. See General Law of Business Organizations, supra note 58, art. 17.
74. See id. art. 134; see Morrison & Forster, supra note 3, at 5-6.
75. Private Mexican companies cannot repurchase their own shares unless there is a judicial order for the purpose of satisfying credit obligations. See General Law of Business Organizations, supra note 58, art. 134. See also infra notes 220 and 221.
b. Weak Minority Stockholder Rights

In addition to the limitations imposed by the lack of flexible investment structures, many investors find that existing Mexican corporate law does not give them sufficient minority stockholder rights to protect their investment and to exit successfully from the company. One commentator summarized the rights of minority stockholders in Mexican corporations (sociedades anonimas) as follows:

[With few exceptions, majority stockholders in Latin American corporations can, as a matter of statutory right, impose their will on the minority. Their dominant position when convening a stockholders’s meeting, adopting resolutions or distributing dividends has been bolstered by the lack of stockholders’s derivative lawsuits or class action mechanisms analogous to those available in the United States.]76

Section II.B below outlines the weak position that minority stockholders generally have in Mexican companies.

c. Weak Enforcement Mechanisms

The problems related to minority stockholder rights are due partly to the absence of effective legislation but mostly to the manner in which these rights are enforced by Mexican courts.77 The Mexican court system often has been characterized as slow and cumbersome and, in some cases, corrupt. A recent analysis of Mexico’s criminal judiciary system prepared by the United Nations evidenced the need to introduce comprehensive amendments to current procedures and applicable legislation.78 Some of the conclusions reached for the criminal judiciary are also valid for the entire Mexican judicial system, including the need to:

[Encourage greater accessibility of legal texts and judgments of superior courts, the development and expansion of professional bar associations, increased fiscal resources for the judiciary, the protection of privileges of access and confidentiality between lawyers and their clients, assessment of the number of federal and state courts needed to meet demand, alternative dispute resolution, mechanisms to reduce burdens on the judicial system, continuing legal education emphasizing international human rights standards, a uniform ethical code for magistrates and judges, regular auditing of judges and magistrates to monitor corruption, and greater transparency at all levels.]79

Although there have been some advances, such as the enactment of the Transparency and Public Access to Information Law (Ley Federal de

76. See Jose W. Fernandez et al., Corporate Caveat Emptor: Minority Shareholder Rights in Mexico, Chile, Brazil, Venezuela, and Argentina, 32 U. MIAMI INTER-AM. L. REV. 157, 160.
77. See Morrison & Foerster, supra note 3, at 2, 5.
79. Id.
which improves access to public information, the absence of a reliable judiciary system for the enforcement of contractual arrangements reduces the attractiveness of Mexican ventures as recipients of private equity investments. To compensate for the weaknesses of the judiciary system, investors must design complex and expensive contractual structures providing for "self execution mechanisms," adhere to costly private dispute settlement mechanisms, such as international arbitration, or form U.S. or other offshore holding companies. Sections II.B and III below outline some of these alternative enforcement mechanisms.

d. Local Unfamiliarity with Private Equity Financing

Besides inflexible investment structures, weak minority stockholder rights and poor enforcement mechanisms in Mexico, Mexico’s legal infrastructure—lawyers, accountants, judges, and bureaucracy often have little experience with private equity investment structures, which adds to the cost of making such investments in Mexico and increases the risk that such investments will not be successful.

e. Limited Exits

As discussed in section II.C below, an investor’s exit from an investment in a Mexican company is limited because (i) a redemption generally is illegal in Mexico, (ii) a public sale normally is not available (or viable) to a small or mid-sized Mexican company, (iii) the pool of buyers willing to purchase the stock or assets of a Mexican company in a private sale to third party is relatively small, and (iv) other stockholders often are unwilling or unable to purchase the investors equity in a private sale to stockholder.

Even when an exit is available, the entrepreneur and investor may disagree on whether to exploit it. That is, although the entrepreneur and investor share the common goal of maximizing the company’s profits, they may have conflicting interests deriving from the investor’s desire to sell his investment within three to five years after the initial investment date and the entrepreneur’s desire to maintain control of the company. Without the cooperation of the entrepreneur and an enforceable exit mechanism, an investor has little hope of obtaining any return on its investment.

82. See General Law of Business Organizations, supra note 58, art. 134; Morrison & Foerster, supra note 3, at 5-6. See also infra notes 220 and 221.
83. See Kossick & Neckelmann, supra note 4, at 114, 166; Barham, supra note 37, at 31-33; Kilby, supra note 19, at 32-34; Pascual, supra note 11, at IV.
f. Regulatory Obstacles

(i) Limits on Foreign Ownership

Mexico has one of the most stringent foreign investment law regulations in Latin America. The current Foreign Investment Law (Ley de Inversion Extranjera), one of several compromises under the North American Free Trade Agreement (NAFTA), prohibits or restricts foreign ownership in strategic areas exclusively reserved for the Mexican state, areas exclusively reserved for Mexican nationals or Mexican corporations whose bylaws must include a specific provision prohibiting the participation of foreign investment, activities and/or industries where foreign investment is permitted but capped to a specific maximum percentage stock participation, and activities and/or industries that require authorization for foreign participation to exceed 49 percent. As a result, foreign private equity may not have access to certain economic segments, and may not exceed certain participation percentages in others.

As a result, investors considering an investment in a regulated area face additional costs and delays in order to obtain governmental approvals. Even in industries where a degree of foreign ownership is permissible, foreign funds often prefer not to waste time identifying potential deals because ownership constraints may limit their flexibility and profit

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84. Foreign Investment Law (Ley de Inversion Extranjera, Diario Oficial, 27 de diciembre de 1993). The Foreign Investment Law was enacted in 1993. The Regulations to the Foreign Investment Law and to the National Registry of Foreign Investment (Reglamento de Ley Inversion Extranjera y del Registro Nacional de Inversiones Extranjera, Diario Oficial, 8 de septiembre de 1998) were issued in 1998 to clarify certain provisions of the Foreign Investment Law.


86. Domestic land transport of passenger, tourists, and cargo, not including messenger or package delivery services; retail trade in gasoline and liquefied petroleum gas; radio broadcasting and other radio and television services, other than cable television; credit unions; development banks and institutions, in terms of the law governing the matter; and the rendering of such professional or technical services as are expressly established in the applicable legal provisions. L.I.E. art. 6, Foreign Investment Law, supra note 84.

87. A maximum of 25 percent foreign ownership is allowed in domestic air transportation and a maximum of 49 percent in currency exchange houses and insurance companies. Id. art. 7.

88. For example, cellular phone and legal services require an authorization from the Foreign Investment National Commission (Comisión Nacional de Inversiones Extranjeras) for the foreign investment to exceed 49 percent. See id. art. 8.

89. The Foreign Investment Law, however, allows Mexican companies to issue neutral or series "N" shares to foreign investors to allow them to exceed the limitations on the permitted ownership interest in a Mexican company. Series "N" shares are not counted in calculating the foreign ownership of a Mexican company. They grant their holders a full economic interest (but limited corporate rights) in the company and require the prior approval of the Foreign Investment National Commission and of the National Banking and Securities Commission (Comisión Nacional Bancaria y de Valores), if applicable. Id. art. 20.
potential; thus foreign investors sometimes tend to steer away from the list of industries where foreign investment is limited to a given percentage and investment approval is required by law.

(ii) Antitrust Restrictions

To protect competition in Mexico, a Mexican company that will receive a private equity investment must file a notice of investment with the Federal Competition Commission (Comisión Federal de Competencia) if the size of the company, investors, or proposed investment exceeds certain thresholds set forth in the Federal Law of Economic Competition (Ley Federal de Competencia Económica). Such filing consists of a questionnaire with information about the company, the investors, and the proposed investment, including annual reports, audited financial statements, and investor background information. In addition, certain investments in specific industries (such as telecommunications and banking) may require additional governmental approvals from the authorities regulating such industry.

(iii) Currency Exchange Controls

Under current Mexican law, investors are not restricted in the amount of Mexican currency that they can exchange into U.S. dollars or other foreign currency. There are no filings before the Central Bank (Banco de México) or authorizations required for the remittance of dollar denominated dividends back to the investor’s country. Before NAFTA, and at different stages throughout time, several currency control exchange mechanisms were put into effect either to help overcome financial crisis or as a continuing monetary policy. However, since NAFTA came to life

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90. Federal Law of Economic Competition (Ley Federal de Competencia Económica), art. 20, establishes:

“The Commission must be notified of the following concentrations before they are carried out:

I. If the value of a single transaction or series of transactions amounts to over 12 million times the minimum general wage prevailing in the Federal District;” (approximately $46,767,857 in U.S. dollars at an exchange rate of eleven pesos for one U.S. Dollar in force in March 2003).

II. “If a single transaction or series of transactions implies accumulation of 35 percent or more of the assets or shares of an economic agent, whose assets or sales amount to more than 12 million times the minimum general wage prevailing in the Federal District;” or (approximately $46,767,857 in U.S. Dollars at an exchange rate of eleven pesos for one U.S. dollar in force in March 2003).

III. “If two or more economic agents take part in the transaction, and their assets or annual volume of sales, jointly or separately, total more than 48 million times the minimum general wage prevailing in the Federal District, and such transaction implies an additional accumulation of assets or capital stock in excess of four million eight hundred thousand times the minimum general wage prevailing in the Federal District” (approximately $18,707,142 in U.S. dollars at an exchange rate of eleven pesos for one U.S. dollar in force in March 2003).
in 1994, these currency control obligations and mechanisms have disappeared and have not been reinstalled, not even through the 1994 “Tequila Effect” crisis.

3. **Political Risks**

Investors making private equity investments in Mexican companies also confront certain political risks, such as political upheaval and the expropriation of property by the Mexican government. Note that chapter 11 of NAFTA protects investors of one NAFTA country making investments in another NAFTA country against various political risks, including expropriations,\(^9\) performance requirements,\(^9\) prohibited transfers,\(^9\) and obligatory local management.\(^9\) In short, NAFTA requires each NAFTA country to treat investors of another NAFTA country and their investments no less favorably than its own investors and no less favorably than investors of other countries. At a minimum, each NAFTA country must treat investors from another NAFTA country in accordance with international law, including fair and equitable treatment and full protection and security. Mexican law also requires the Mexican government to pay the market value of any expropriated property, regardless of whether it is owned by a Mexican or a foreigner.

Despite some isolated problems, such as the Indian uprising in Chiapas in 1994, Mexico has a track record of peace and social stability for the past seven decades. The successful and peaceful democratic transition in 2000 from the long-standing *Partido Revolucionario Institucional* (PRI) to the *Partido Acción Nacional* (PAN) headed by President Fox, established an important milestone for Mexico and has increased investor confidence both within and outside the country. Observers agree that the current administration is working hard to control crime by increasing security,\(^9\) preventing corruption and drug trafficking, and enforcing the law.

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91. No NAFTA country may directly or indirectly nationalize or expropriate an investment of an investor of another NAFTA country except for a public purpose, on a nondiscriminatory basis, in accordance with due process of law, and international law and on payment of fair and adequate compensation. See North American Free Trade Agreement, Dec. 17, 1992, 32 I.L.M. 289, art. 1101 [hereinafter NAFTA].

92. No NAFTA country may impose or enforce “performance requirements” in connection with investments in its territory, such as commitments or undertakings relating to exports, domestic content, local sourcing, trade balancing, technology transfer, or product mandates. See id.

93. Subject to certain exceptions, no NAFTA country may prevent an investor of another NAFTA country from making transfers relating to its investment, including profits, dividends, interest, capital gains, royalty payments, management fees, technical assistance, or proceeds from the sale or liquidation of an investment. See id.

94. No NAFTA country may require a company formed under such country’s laws, which is an investment of an investor from another NAFTA country, to appoint individuals of a certain nationality to senior management positions. A NAFTA country may, however, require that a majority of the board of directors or any committee thereof, be of a particular nationality. See id.

II. KEY ISSUES IN THE PRIVATE EQUITY PROCESS

Section I above reviewed the fundamentals of private equity financing, including the general process for obtaining such financing. Section II focuses on key issues within this process that entrepreneurs should consider. To organize the discussion of these issues, the process is discussed in three stages - obtaining private equity financing, living with it, and ending the financing through the exit process.

A. OBTAINING PRIVATE EQUITY

This first section focuses on the key issues that the entrepreneur should consider in negotiating the terms of the investor's investment in the company.

1. Due Diligence Review

As mentioned above, once an investor has reviewed the company's full business plan and decides to pursue further discussions with the entrepreneur, the investor will perform a due diligence investigation of the entrepreneur's business, employees, and business plan. The entrepreneur should use this time to conduct due diligence on the fund as well. To protect themselves and their confidential and proprietary information, the entrepreneur and investor should each sign a mutual non-disclosure agreement to prevent each party from disclosing or using any of the information obtained from the other party for improper purposes. Below is a list of key materials that the entrepreneur should expect the investor to review in its due diligence investigation of the company and the entrepreneur should review in his due diligence investigation of the investor.

a. Due Diligence by Investor

An investor generally begins the formal due diligence process by giving the entrepreneur a due diligence checklist listing the materials that the investor wants to review in the entrepreneur's business. A basic due diligence checklist is attached hereto as Exhibit A. Some of the more important items on this checklist that the investor will want to review are discussed below.

(i) Corporate Structure

The investor will want to review the company's organizational documents and corporate books, board and stockholder resolutions, powers of attorney, and other corporate records in order to understand its corporate structure (such as Sociedad Anonima, Sociedad de Responsabilidad Limitada, and the like) and to ensure that the company is operating in conformity with its corporate purpose, its internal procedures, and applicable law.96

96. See Kossick & Neckelmann, supra note 4, at 127-30.
(ii) Capital Structure

The entrepreneur should also expect to provide the investor with a copy of the company's stock ledger and other records listing all of the company's stockholders, the amount and class of stock that each hold, and any special rights or restrictions that any of the stockholders have. The fund also will need to ensure that all of the company's stock was issued in conformity with applicable law.97

(iii) Financial Condition

Perhaps the most important aspect of the investor's due diligence is obtaining accurate historical and pro forma financial information about the company, including its business plans and budgets, the reports, audits and opinions of the company's directors, comisarios, and external auditors, and statements from the company's bank, and its brokerage and investment accounts.98 The common practice of maintaining two or even three sets of accounting records in order to avoid the tax collector frustrates the due diligence team's task of gaining an accurate picture of actual performance.99

(iv) Material Agreements

Investors will also review all of the company's material agreements, including employment contracts with the company's key employees, agreements with the company's suppliers, customers, affiliates, and competitors, any documents evidencing any indebtedness of (or owed to) the company, and any contracts related to the company's assets, including intellectual property.100

(v) Disputes

Entrepreneurs will also be asked to disclose any information about any pending or threatened litigation, disputes, proceedings, or investigations involving the company, including any labor or tax claims against the company.101

Many investors experience difficulty in conducting due diligence on companies in Mexico, particularly on family-owned businesses. Observations about conducting due diligence on such companies includes:

Because due diligence is prodding and invasive, the process can pose a problem with respect to small and 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

97. See id. at 128-29.
98. See id. at 131-33.
100. See Kossick & Neckelmann, supra note 4, at 133.
101. See id. at 127-28.
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. As one 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." Due diligence is a standard practice in financing transactions and is a prerequisite to any investment. In short, a private equity investment is a marriage of sorts, so the investor needs to get to know the entrepreneur and his business – the good and the bad – before entering into the relationship.

b. Due Diligence by Entrepreneur

While the investor is conducting its due diligence investigation, the entrepreneur should conduct due diligence on the investor and its fund. The entrepreneur, at a minimum, should ask the investor about the following things:

(i) The fund itself (Does the fund have money to invest now? Is the fund able and willing to participate in the current and future financings? How many years remain for the fund to make investments?);

(ii) The fund's investment in the company (What kind of return does the investor need to make on this investment? When does the investor need to exit from this investment? What if there is no exit event by that date?);

(iii) The investor's other investments (In what companies has the fund made investments? What services, if any, does the investor provide to its portfolio companies?);

(iv) The investor's relationship with management of its portfolio companies (How has the investor handled management changes in the past? Has the fund pushed any entrepreneur out of a company?); and

(v) The investor's relationship with other investors (Is the investor willing to co-invest in the company with other investors? If so, which ones? Has the investor made any distributions or other payments to its fund investors?).

102. See id. at 124-25.
103. See Bagley & Dauchy, supra note 3, at 196; Gladstone, supra note 26, at 164-66.
104. The life of private equity funds usually is seven to ten years. See supra note 19. Given that a fund sometimes does not make an investment in a company until its third year or later, the fund's managers seek to exit from such investment within three to five years after the date of such investment in order to channel the proceeds to the fund's investors on time.
105. See Bagley & Dauchy, supra note 3, at 196; Gladstone, supra note 26, at 164-66.
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The entrepreneur should also talk with the management of the investor’s other portfolio companies and with the investor’s bankers, lawyers, and accountants to determine what kind of partner the investor will likely be.106

2. Key Terms in Term Sheet

After the investor has completed his due diligence examination and has indicated a serious interest in making an investment, the investor (or his attorney) prepares a term sheet to outline the main investment terms. We discuss below some of the most important of these terms. The parties generally may reach an agreement on these terms quickly or realize that an agreement is unattainable. In either case, the parties save time and money by focusing on the major terms first.

a. Type of Security

One of the most fundamental decisions that the investor and entrepreneur make is determining the type of security (common stock, preferred stock, convertible debt, and the like) that the investor will buy from the company. Of course, the type of security that the fund will purchase often depends on whether the fund is investing in a Mexican company or a U.S. holding company. A fund that invests in a Mexican company may accept either equity, debt, or a mixture of equity and debt in exchange for its investment.107 A fund investing in a U.S. holding company, however, generally expects to receive preferred stock in exchange for its investment.108 Naturally, if the U.S. holding company is distressed or it only needs to raise a small amount of money to meet a short-term obligation (such as payroll, loan repayment, etc.), the investor often will make a bridge loan to the company in return for a note that is convertible into either common or preferred stock and warrants to purchase additional stock at a favorable price.109

In contrast to investors, “friends and family” of the entrepreneur typically receive common stock in return for their investment.110 Some angel investors accept common stock for their investment, while others expect preferred stock and many require a bridge note plus warrants.111

106. See Bagley & Dauchy, supra note 3, at 196; Gladstone, supra note 26, at 164-66.
107. For example, in return for its $2 million investment, an investor might receive: (i) a secured note for $500,000; (ii) an unsecured, convertible note for $750,000; (iii) preferred stock worth $400,000; and (iv) 2 percent of the net revenues of the company.
108. See Bagley & Dauchy, supra note 3, at 202; Halloran et al., supra note 43, at 6-7; Mayer, Brown & Platt, supra note 13, at 10.
111. See Halloran et al., supra note 43, at 6-3; Mayer, Brown & Platt, supra note 13, at 10.
Note that the entrepreneur may also want to issue preferred stock to an investor so that the company can sell two different classes of its stock at different prices: the higher priced preferred stock to investors and the lower priced common stock to its employees in the form of restricted stock and stock options.\textsuperscript{112}

b. Valuation

Another important term that the investor and entrepreneur must negotiate is the value of the company. The various methods by which investors determine the value of a company are beyond the scope of this article, but, it suffices to say, the valuation of a company depends on the value of comparable companies (if any), the experience of the company's management team, the size of the market for its goods and services, the viability of the entrepreneur's business plan, the company's stage of growth, what milestones it has attained, what competitors exist, and the amount of revenue and/or profits that the company has.\textsuperscript{113}

The valuation of the company determines the price that the investor will pay for the company's stock and the percentage of the company that the investor will own. That is, once the investor and entrepreneur have negotiated the pre-money valuation of the company (the value of the company immediately before the investor makes its investment) and the investor decides how much money it will invest in the company, the parties can determine the post-money valuation of the company (the value of the company immediately after the investment),\textsuperscript{114} the price per share,\textsuperscript{115} the percentage of the company that the investor will own after the investment,\textsuperscript{116} and the number of shares that the company will issue to the investor in return for his investment.\textsuperscript{117}

\textsuperscript{112} See Halloran et al., supra note 43, at 6-7.

\textsuperscript{113} Interestingly, one prominent investor in Latin America advises investors never to pay more than seven to eight times earnings for a company. See Barham, supra note 37, at 32.

\textsuperscript{114} The post-money valuation is calculated by adding the amount of the investment to the amount of the pre-money valuation. For example, if the amount of the investment is $1 million and the pre-money valuation of the company is $3 million, the post-money valuation of the company is $4 million.

\textsuperscript{115} The price per share is calculated by dividing the pre-money valuation by the number of shares that the company has issued and outstanding before the investment (the outstanding pre-money shares). Using the examples above and assuming the company has six million outstanding pre-money shares, the investor will pay $0.50 per share ($3 million pre-money valuation divided by six million outstanding pre-money shares).

\textsuperscript{116} The percentage of the company that the investor will own after the investment is calculated by dividing the amount of the investment by the post-money valuation. Using the example in note 114 above, the investor will own 25 percent ($1 million investment divided by $4 million post-money valuation) of the company after the investment.

\textsuperscript{117} The number of shares that the company will issue to the investor is calculated by dividing the amount of the investment by the price per share. Using the example in notes 114 and 115 above, the company will issue two million shares to the investor ($1 million investment divided by $0.50 per share). If the entrepreneur knows only the percentage of the company that the investor wants to purchase, he can
In the event that the parties cannot determine the pre-money valuation of the company (or want to postpone making such determination until the company attracts more money or investors), the investor often makes his investment in the form of a bridge loan that is convertible into the type of security (such as preferred stock) issued in a subsequent round of financing. To induce the investor to make such bridge loan, the company will often give the investors warrants to purchase additional stock (usually common or preferred stock) at a favorable price or convert the investor's note at a discount.

Note that the investor who is willing to pay the highest price is not necessarily the best investor for the company. Another investor who is not willing to pay quite as much may be a better partner for growing the business in that such investor's business experience and/or contacts may prove to be more valuable to the company in the long run.\(^{118}\) Also, as discussed in section II.A.3 below regarding price protection anti-dilution rights, getting a high valuation in one round of financing actually can hurt the entrepreneur in a subsequent round of financing if the valuation of the company in the subsequent round is lower than its valuation in the earlier round. For example, after the NASDAQ bubble burst in 2000, many companies could only secure equity financing at a fraction of the valuation that they had obtained before the collapse and consequently the anti-dilution rights that the investors had in these companies severely diluted (and often effectively erased) the ownership interests of their entrepreneurs and other common stockholders in their own companies. In short, it may be in the entrepreneur's interest to negotiate a "fair" valuation of the company instead of the "highest" valuation.

Entrepreneurs also should be aware that certain legal terms might increase the effective ownership percentage that the investor has in the company, which in some cases shifts the effective valuation that the parties have negotiated. The paragraphs below describe these legal rights and section II.A.3 discusses how these legal rights can be used to change the effective ownership percentage and valuation of the company.

c. Preferred Stock Rights

If the fund and entrepreneur agree that the company will issue preferred stock to the fund in exchange for its investment in the company,
the negotiations between the parties then turn to the types of rights that the preferred stock will have. Below is a discussion of some of the most important rights that holders of preferred stock can have. Although Mexican law allows a Mexican company to have different classes of stock (preferred vs. common stock),\textsuperscript{119} many of the rights discussed below may only be available in a U.S. holding company, given certain legal restrictions on the use of such mechanisms by a Mexican company.

(i) Liquidation Preference

A liquidation preference generally provides that, upon liquidation of a company (or when the company sells its assets or stock),\textsuperscript{120} the company must pay any property that it owns after it pays its debts first to the holders of preferred stock and then to the holders of common stock. The amount of this liquidation preference generally is in an amount at least equal to the investor's original investment plus all unpaid dividends,\textsuperscript{121} but liquidation preferences today sometimes allow the investor to receive 150 percent, 200 percent, or more of its original investment (plus unpaid dividends) before the common stockholders receive any money.\textsuperscript{122} Moreover, if an investor holds participating preferred stock, it is entitled to receive its liquidation preference plus its pro rata share of the assets that remain as if the preferred stock had converted to common stock after receiving its liquidation preference (the investor is able to "double-dip" into the company's assets). If the investor holds nonparticipating preferred stock, it must elect either to receive its liquidation preference or convert to common stock and receive its pro rata share of the assets that the common stockholders receive.

Mexican law, however, does not allow stockholders to waive their right to participate in the profits of the company.\textsuperscript{123} This means that stockholders cannot waive their right to receive equity payments in advance. This prohibition, however, does not prevent a Mexican company from issuing preferred stock that has liquidation and dividend rights that might require the company, upon liquidation, to pay all of its equity to the investor and not to any other stockholder. Nevertheless, this limitation on liquidation rights might act as a disincentive to investors interested in making private equity investments in a Mexican company.

\textsuperscript{119} See General Law of Business Organizations, supra note 58, art. 112.
\textsuperscript{120} In private equity financings, the investment documents often provide that the company is deemed to have liquidated if it sells all or substantially all of its assets or the company is acquired by another entity through a merger or consolidation.
\textsuperscript{121} The company may have to pay only dividends that the company declared or it may have to pay dividends that have accrued, regardless of whether the company declared them or not. Bagley & Dauchy, supra note 3, at 116-18, 204. See Mayer, Brown & Platt, supra note 13, at 11.
\textsuperscript{122} Bagley & Dauchy, supra note 3, at 116-18, 204. See Mayer, Brown & Platt, supra note 13, at 11.
\textsuperscript{123} See General Law of Business Organizations, supra note 58, art. 17.
(ii) Dividend Rights

Preferred stock often has dividend rights that require the company to pay any dividend that it declares to the preferred stockholders before it pays any dividend to the common stockholders. In many cases, a fund requires the company to pay a fixed dividend (for example, 8 percent of the investment amount) each year, regardless of whether the company has declared a dividend or not, thus giving investors a right that is similar to an interest payment on debt. In sum, dividend rights require the company to pay only dividends that the company declared or dividends that have accrued, regardless of whether the company declared them or not. If these dividend rights are cumulative, dividends that are not paid to the preferred stockholders in one year are added to the dividend amounts that must be paid to them in subsequent years before any common stock dividend may be paid. Conversely, if these dividend rights are noncumulative, the fixed dividends not paid on the preferred shares in one year are lost and are not required to be added to any dividends that must be paid in subsequent years. A company generally pays cumulative dividends in cash only upon redemption or liquidation of the company, not when the preferred stock is converted into common stock. U.S. law generally allows companies to pay dividends except in limited cases (e.g., the dividend payment defrauds creditors).

Mexican law allows Mexican companies to issue cumulative and noncumulative preferred stock, but a Mexican company cannot pay dividends to its stockholders unless losses in capital from prior years have been made up or the stockholders have approved a reduction in the company's capital and other actions. This is a problem in private equity financings because dividends are an important (and sometimes the only) source of return on the fund's investment.

(iii) Redemption Rights

As discussed above, redemption occurs when a company repurchases its stock from a stockholder. Voluntary redemption rights, also called a put option, allows the investor to require the company to redeem (repurchase) its stock for cash at a specified time and price. Involuntary redemption rights, also called a call option, allow the company to redeem the investor's stock for a specific price upon the occurrence of a certain event. An investor typically does not exercise his put option unless he otherwise cannot exit from its investment. In the United States, private

124. See Bagley & Dauchy, supra note 3, at 118; Mayer, Brown & Platt, supra note 13, at 11.
125. See Bagley & Dauchy, supra note 3, at 118; Mayer, Brown & Platt, supra note 13, at 11.
126. See General Law of Business Organizations, supra note 58, arts. 18, 19.
127. See Bagley & Dauchy, supra note 3, at 118-19.
128. See id.
companies generally may redeem their shares except in limited cases (such as where the redemption defrauds creditors).

Mexican law, however, specifically prohibits private Mexican companies from redeeming their shareholders' stock unless it is judicially ordered for the purpose of satisfying credit obligations. Moreover, Mexican law prescribes that board members and officers who authorize an unauthorized redemption of shares have personal joint and several liability for any damages and lost profits caused to the company and/or to the creditors of the company. When a Mexican company is authorized to redeem shares, it must sell such shares within three months after it obtains title to such shares. If the Mexican company fails to sell these shares within such time period, the shares will be extinguished and the Mexican company's capital will be decreased. During the time the company holds title to its shares, no one can exercise any corporate rights with respect to such shares. Only Mexican companies listed in the securities registry of the National Securities Registry (Registro Nacional de Valores) are exempt from the general prohibition against redemption.

Although the prohibition against redemption may protect minority stockholders in a Mexican company against the majority, it also deprives investors of a critical (and in some cases, the last chance to) exit from its investment. Investors may seek alternative structures to allow for the effective redemption of their shares, such as setting aside a certain percentage of shares in an escrow, using a trust vehicle or forming an offshore holding company (such as a U.S. holding company).

(iv) Conversion Rights

Conversion rights allow the holders of preferred stock to convert their preferred stock into common stock at any time. The ratio at which preferred stock is converted into common stock typically is determined by dividing the initial purchase price of the preferred stock by a number called the conversion price, which is adjusted upon the occurrence of certain anti-dilution events (see anti-dilution rights below). Initially, the conversion price typically is equal to the purchase price of the preferred stock, so the preferred stock converts into common stock on a one-to-one basis.

Mexican law authorizes Mexican companies to issue different categories of stock, including preferred stock, which may be converted into ordi-

129. See General Law of Business Organizations, supra note 58, art. 134; Morrison & Foerster, supra note 3, at 5; Bagley & Dauchy, supra note 3, at 118-19. See also infra notes 220-221.

130. See General Law of Business Organizations, supra note 58, art. 134.


132. See Bagley & Dauchy, supra note 3, at 119-20, 210-11.

133. See id.
When approving the issuance of convertible stock, the Mexican company must issue a sufficient amount of treasury stock (i.e., stock that the Mexican company issues, but which is not subscribed and which is held in the company’s treasury) to be granted to the stockholders upon conversion.

(v) Anti-dilution Rights

Anti-dilution rights protect investors against the dilution (i.e., reduction) of their ownership interest in the company (percentage protection) and the price that the investors paid for their preferred stock (price protection) by adjusting the conversion price at which the preferred stock converts into common stock. These two types of anti-dilution rights are described below.

(a) Percentage Protection

Each time that a company issues stock, the ownership percentage of each of the existing stockholders of the company is decreased. To protect against such dilution, investors often require the company to give them two types of percentage protection: (i) structural anti-dilution protection, and (ii) preemptive rights.

(1) Structural Anti-dilution Protection

In the case of structural anti-dilution protection, if the company issues a stock dividend, stock split, reverse split, or similar recapitalization, the conversion price is adjusted to ensure that the number of shares of common stock issuable upon conversion of the preferred stock represents the same percentage of ownership (on an as-converted basis) as existed prior to the stock dividend, stock split, reverse split, or recapitalization. For example, if there is a four-to-one stock split, the conversion price would be reduced to one fourth of its prior amount. So, if the conversion price was one dollar prior to the split, it would be twenty-five cents after the split; upon conversion the company would issue to the investor four times the number of common shares after the split that the investor would have received prior to the split. In Mexico, structural anti-dilution protection provisions may be included in the extraordinary stockholder’s resolution approving the issuance of the convertible preferred stock since such protection is based on a formula applicable to all stockholders.

134. See General Law of Business Organizations, supra note 58, art. 112 (which specifically authorizes the issuance of different categories of stock, with special rights for each category).
135. See Bagley & Dauchy, supra note 3, at 119, 212.
136. See id. at 212-13.
137. See id. at 212.
138. See id.
139. See id.
Preemptive Rights

If the company wishes to issue stock to someone, a preemptive right gives the investor the right to purchase all or its pro rata share of such issuance so that the investor will not be diluted by such issuance and will maintain at least the same ownership percentage after the stock issuance that it had before such issuance. As discussed above, Mexican law gives preemptive rights to all stockholders. Such rights cannot be waived in advance, thus limiting the ability of the Mexican company to issue stock options and warrants, grant price protection anti-dilution rights and registration rights (discussed below), and implement other mechanisms commonly used in private equity financings. Preemptive rights are not applicable, however, when a Mexican company issues convertible notes.

(b) Price Protection

Price protection protects investors against paying too much for their preferred stock. That is, if a company issues additional shares of common or preferred stock in the future at a price that is less than the investor's conversion price at the time of such issuance, price protection requires the company to adjust the investor's conversion price downward so that the investor obtains the benefit of such lower price when he converts his preferred shares into common shares. Just how downward the investor's conversion price is adjusted depends on whether the investor has "full ratchet" or "weighted average" price protection, each of which is described below. Price protection is based on the theory that the valuation of a company when the investor makes its investment is open to debate, so the investor is entitled to a price adjustment if the company really was overvalued. If overvalued, it is easier for the company to simply adjust the conversion price to give the investor more common shares than to give the investor portion of his money back.

140. See id. at 212-13. Generally, the company will be allowed to issue certain types of stock without triggering preemptive rights, such as issuances of a certain amount of common stock or stock options to employees, directors and consultants, common stock upon conversion of preferred stock, stock dividends, warrants to banks or equipment lessors, stock in mergers or other types of business combinations, and common stock in the company's IPO.

141. See General Law of Business Organizations, supra note 58, art. 132; Morrison & Foerster, supra note 3, at 3.

142. See General Law of Titles and Credit Operations (Ley General de Titulos y Operaciones de Credito), art. 210 bis.

143. See BAGLEY & DAUCHY, supra note 3, at 120, 213-14. Generally, the company will be allowed to issue certain types of stock without triggering price protection anti-dilution rights, such as issuances of a certain amount of common stock or stock options to employees, directors and consultants, common stock upon conversion of preferred stock, stock dividends, warrants to banks or equipment lessors, stock in mergers or other types of business combinations, and common stock in the company's IPO.

144. See id. at 213.

145. See id.
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Below is a brief description of the two basic types of price protection: full ratchet and weighted average.

(1) Full Ratchet Price Protection

Full ratchet price protection is onerous from the company's perspective because if the company issues stock (even just one share) in the future at a price that is less than the conversion price at which the investor’s preferred stock converts to common stock, the investor’s conversion price is reduced to the price at which the company sold such stock. So, if the investor purchases his stock for U.S.$1.00 per share and the company subsequently issues stock at U.S.$0.01 per share, the investor’s conversion price is reduced from U.S.$1.00 to U.S.$0.01, thus greatly increasing the investor's ownership percentage in the company when he converts his preferred stock to common stock.

(2) Weighted Average Price Protection

Weighted average price protection is less onerous from the company’s perspective because if the company issues stock in the future at a price that is less than the investor’s applicable conversion price, the conversion price is reduced to a price somewhere between the applicable conversion price and the lower price at which the company sold such future stock. So, if the investor purchases his stock for U.S. $1.00 per share and the company subsequently issues stock at U.S.$0.01 per share, the investor’s conversion price is reduced from U.S.$1.00 in accordance with the following formula:

\[
\text{Adjusted Conversion Price} = \frac{\text{CP} \times ((\text{CS}_1 + (\text{NP} / \text{CP})) / \text{CS}_2)}
\]

Where:

- \(\text{CP}\) = the investor’s conversion price in effect immediately prior to the issuance of the new, cheaper stock.
- \(\text{CS}_1\) = the number of shares of common stock outstanding (on an as-converted basis) immediately before the issuance of the new, cheaper stock.
- \(\text{CS}_2\) = the number of shares of common stock outstanding (on an as-converted basis) immediately before the issuance of the new, cheaper stock plus the number of shares of new, cheaper stock.
- \(\text{NP}\) = the net proceeds that the company received in exchange for the new, cheaper stock.

Section II.3 below details how these two basic types of price protection can change the effective ownership percentage of the investor in the company.

A Mexican company’s bylaws or shareholder resolution may authorize anti-dilution price protection provisions similar to those discussed above, provided that such provisions do not violate any statutory non-waivable
rights (such as dividend, preemptive, and liquidation rights). Furthermore, Mexican law forbids a Mexican company from issuing stock below its nominal value and provides that any proposal that may affect the rights of any category of stockholders – in this case holders of preferred convertible stock – requires the prior approval of the holders of stock of such category.\textsuperscript{146} Thus, in addition to the two statutory provisions mentioned above, Mexican companies can build into their own bylaws provisions protecting the holders of preferred stock from dilution resulting from subsequent issuances of stock.

3. Terms that Change the Effective Ownership of the Company

The preceding section described the types of legal rights that preferred stock often carries. The next section discusses how these legal rights can be used to change the effective ownership percentage and valuation of the company, allowing the investor to own more of the company than the entrepreneur bargained for (or thought he bargained for).

a. Liquidation Preference

A preferred stock’s liquidation preference can increase the effective ownership that the investor has in the company, and decrease the effective valuation of the company. To illustrate, consider the following three types of liquidation preferences and the effect each has upon the effective ownership and valuation of the company. The three types of liquidation preferences are: (i) standard liquidation preference, (ii) double dip liquidation preference, and (iii) multiple of investment amount liquidation preference. For purposes of this illustration, assume that the company had a $3 million pre-money valuation, the investor made a $1 million investment in the company (giving the company a $4 million post-money valuation), the investor received 25 percent of the company ($1 million investment / $4 million post-money valuation) in the form of two million shares of preferred stock (out of eight million outstanding post-money shares), and the investor is entitled to an annual, accrued dividend equal to 8 percent of its $1 million investment ($80,000 per year).

\textit{(i) Standard Liquidation Preference}

An investor who holds nonparticipating preferred stock\textsuperscript{147} has a standard liquidation preference, meaning that the investor must choose either to receive his liquidation preference or convert his preferred stock to common stock and receive his pro rata share of the assets that the common stockholders receive. That is, when the company liquidates (or is deemed to have liquidated),\textsuperscript{148} the company must pay to the investor, after the company has paid its debts but before it pays any amount to its

\textsuperscript{146} See General Law of Business Organizations, \textit{supra} note 58, arts. 115, 195.
\textsuperscript{147} See section I.A.2.c.1 \textit{supra}.
\textsuperscript{148} See \textit{supra} note 120.
other stockholders, an amount equal to the greater of either (i) the investor’s original investment (in this example, $1 million) plus all accrued and unpaid dividends; or (ii) the investor’s pro rata share of the company’s assets as if the investor had converted his preferred stock to common stock immediately prior to the liquidation. So, if the company is sold for $10 million soon after the investor’s investment, the investor would receive, before any other stockholder, the greater of (i) $1 million (the original investment), or (ii) $2.5 million (25 percent of $10 million). If the investor elects to take the $2.5 million payment, the investor’s effective ownership in the company (25 percent) is the same as his stock ownership (25 percent).

If, however, the company is sold for only $3 million soon after the investor’s investment, the investor would receive, before any stockholder, the greater of (i) $1 million (its original investment), or (ii) $750,000 (which represents 25 percent of $3 million). If the investor elects to take the $1 million payment, the investor’s effective ownership in the company (33 percent) is greater than his stock ownership (25 percent).

(ii) Double Dip Liquidation Preference

An investor who holds participating preferred stock has a double dip liquidation preference, meaning that the investor is entitled to receive his liquidation preference and also his pro rata share of the assets that remain as if the preferred stock had converted to common stock. When the company liquidates, the company must pay to the investor, after the company has paid its debts but before it pays any amount to its other stockholders, an amount equal to both (i) the investor’s original investment ($1 million) plus all accrued and unpaid dividends ($80,000 per year), and (ii) the investor’s pro rata share of the company’s assets as if the investor had converted his preferred stock to common stock immediately prior to the liquidation. So, if the company is sold for $10 million soon after the investor’s investment, the investor would receive, before any other stockholder, both (i) $1 million (the original investment), and (ii) $2.25 million (25 percent of $9 million remaining after paying the $1 million). The investor would receive a $3.25 million liquidation preference, meaning that the investor’s effective ownership in the company (32.5 percent) is greater than its stock ownership (25 percent).

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149. For purposes of this illustration, assume that no dividends have accrued.
150. Thus, $2.5 million liquidation preference divided by $10 million.
151. Thus, two million shares issued to the investors divided by the eight million outstanding post-money shares.
152. Thus, $1 million liquidation preference divided by $3 million.
153. Two million shares issued to the investors divided by the eight million outstanding post-money shares.
154. See section II.A.2.c.1 supra.
155. For purposes of this illustration, we assume that no dividends have accrued.
156. Thus, $3.25 million liquidation preference divided by $10 million.
157. Two million shares issued to the investors divided by the eight million outstanding post-money shares.
If, however, the company is sold for only $3 million soon after the investor's investment, the investor would receive, before any stockholder, both (i) $1 million (the original investment), and (ii) $500,000 (25 percent of $2 million remaining after paying the $1 million). The investor would receive a $1.5 million payment, meaning that the investor's effective ownership in the company (50 percent) is greater than its stock ownership (25 percent).\(^{158}\)

\(\text{(iii) Multiple of Investment Amount Liquidation Preference}\)

An investor might obtain nonparticipating preferred stock that has a liquidation preference that allows them to receive a certain multiple (such as 150 percent, 200 percent, or some other multiple) of its original investment amount (investment amount multiple). At the time the company liquidates, the company must pay to the investor, after the company has paid its debts (but before it pays any amount to its other stockholders), an amount equal to the greater of either (i) a certain multiple of the investor's original investment (e.g., 200 percent of $1 million) plus all accrued and unpaid dividends (in this example, $80,000 per year); or (ii) his pro rata share of the company's assets as if the investor had converted his preferred stock to common stock immediately prior to the liquidation.

Assuming that the preferred stock has a 200 percent multiple, if the company is sold for $10 million soon after the investor's investment, the investor would receive, before any other stockholder, the greater of (i) $2 million (twice its original investment),\(^{160}\) or (ii) $2.5 million (25 percent of $10 million). If the investor elects to take the $2.5 million payment, the investor's effective ownership in the company is 25 percent,\(^{161}\) the same as its stock ownership.

However, if the company is sold for only $3 million soon after the investor's investment, the investor would receive, before any stockholder, the greater of (i) $2 million (twice his original investment),\(^{163}\) or (ii) $750,000 (25 percent of $3 million). If the investor elects to take the $2 million payment, the investor's effective ownership in the company is 67 percent,\(^{164}\) much greater that its stock ownership (which is 25 percent).\(^{165}\)

Note that an investor who wants the company to pay him a multiple of his original investment amount before any other stockholder receives a share effectively is telling the entrepreneur that the valuation of the company is too high and it needs a mechanism (such as the investment amount multi-

\(^{158}\) Thus, $1.5 million liquidation preference divided by $3 million.

\(^{159}\) Two million shares issued to the investors divided by the eight million outstanding post-money shares.

\(^{160}\) For purposes of this illustration, assume that no dividends have accrued.

\(^{161}\) Two million shares issued to the investors divided by the eight million outstanding post-money shares.

\(^{162}\) Thus, $2.5 million liquidation preference divided by $10 million.

\(^{163}\) Two million shares issued to the investors divided by the eight million outstanding post-money shares.

\(^{164}\) For purposes of this illustration, assume that no dividends have accrued.

\(^{165}\) Two million shares issued to the investors divided by the eight million outstanding post-money shares.
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(1) to lower the valuation. By obtaining $2 million for his $1 million investment before any other stockholder receives any money, the investor effectively secures a $2 million pre-money valuation of the company (instead of the $3 million pre-money valuation that the parties originally negotiated).

In contrast, if the investor has participating preferred stock and the company is sold for $10 million soon after the investor's investment, the investor would receive, before any other stockholder, both (i) $2 million (twice the original investment), and (ii) $2 million (25 percent of $8 million that remains after paying the $2 million). Therefore, the investor would receive a $4 million liquidation preference, meaning that the investor's effective ownership in the company is 40 percent, which is higher than his stock ownership of 25 percent.

If, however, the investor has participating preferred stock and the company is sold for $3 million soon after the investor's investment, the investor would receive, before any stockholder, both (i) $2 million (twice the original investment), and (ii) $250,000 (25 percent of $1 million remaining after paying the $2 million). That is, the investor would receive a $2.25 million payment, meaning that the investor's effective ownership in the company is 75 percent, far greater than his stock ownership of 25 percent. This illustrates again how the investor used the investment amount multiple to effectively lower the valuation of the company ($1.75 million pre-money valuation instead of the $3 million pre-money valuation that the parties negotiated).

b. Dividend Rights

The foregoing examples of how a liquidation preference can cause an investor's effective ownership to be greater than his stock ownership (and effectively decrease a company's valuation) did not account for the 8 percent annual dividend that accrued on the investor's $1 million investment ($80,000 per year). If we had accounted for this dividend, the investor's effective ownership would have been even greater (and the company's effective valuation would have been even lower). Consider the following two examples:

Under the assumption that the investor has participating preferred stock with a 200 percent multiple and the company is sold for $10 million one year after the investor's investment, the investor would receive, before any other stockholder, both (i) $2 million (twice his original investment) plus the $80,000 accrued dividend; and (ii) $1.98 million (25 percent of $7.92 million remaining after paying the $2.08 million). That

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166. Thus, $4 million liquidation preference divided by $10 million.
167. Two million shares issued to the investors divided by the eight million outstanding post-money shares.
168. Thus, $2.25 million liquidation preference divided by $3 million.
169. Two million shares issued to the investors divided by the eight million outstanding post-money shares.
is, the investor would receive a $4.06 million liquidation preference, meaning that the investor’s effective ownership in the company is 40.6 percent$^{170}$ (instead of 40 percent when the dividend is excluded).

Now assume that the investor has participating preferred stock with a 200 percent multiple and the company is sold for only $3 million one year after the investor’s investment, the investor would receive, before any stockholder, both (i) $2 million (twice the original investment) plus the $80,000 accrued dividend; and (ii) $230,000 (25 percent of $920,000 remaining after paying the $2.08 million). That is, the investor would receive a $2.31 million payment, meaning that the investor’s effective ownership in the company is 77$^{171}$ percent (instead of 75 percent when the dividend is excluded).

c. Redemption rights

Recall that an investor with redemption rights may require the company to purchase his stock for cash at a specified price.$^{172}$ Redemption rights may require the company to repay the investor’s original investment plus accrued dividends, a multiple (e.g., 150 percent, 200 percent, or other multiple) of the investor’s original investment amount or the company’s appraised value of the investor’s stock. The effect of a redemption right that is a multiple of the investor’s original investment amount is similar to that of the multiple of investment amount liquidation preference discussed above, and may effectively lower the valuation of the company.

d. Dilution Events

(i) Stock Options, Warrants, and Convertible Debt

In determining the investor’s effective ownership in the company, the entrepreneur must account not only for the stock that the company has issued to the investor, but also for any rights that the company has issued to its employees, consultants, investors, and creditors$^{173}$ to obtain stock in the company. These rights include stock options and warrants, which can be exercised to obtain stock in the company, as well as convertible debt, which investors can convert into equity in the company. As discussed in section II.B below, Mexico generally does not permit stock options or warrants, so the discussion below only applies to options and warrants in a U.S. holding company.

Using the example set forth in footnotes 114-117, if the investor invests $1 million into the company in return for 25 percent of the company (giving the company a $4 million post-money valuation), the entrepreneur

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170. Thus, $4.06 million liquidation preference divided by $10 million.
171. Thus, $2.31 million liquidation preference divided by $3 million.
172. See Bagley & Dauchy, supra note 3, at 118-19.
173. In recent years, creditors, such as banks and lessors of real estate and equipment, have required warrants as a condition to extending credit to (or doing business with) a company.
should ask the investor whether this includes or excludes any options, warrants, convertible debt, and other rights that might be outstanding. If the investor's offer includes the reservation of one million shares for convertible debt (in addition to the six million outstanding pre-money shares), then the investor is saying that there are in effect seven million shares outstanding or reserved (not six million shares).\footnote{See Bagley & Dauchy, supra note 3, at 200.} Therefore, using the formulas set forth in the example above, the investor would be entitled to receive \(2,333,333\) shares (not two million).\footnote{The total number of outstanding post-money shares is now \(9,333,333\). Seven million outstanding pre-money shares/(1 minus 0.25), and the company will need to issue \(2,333,333\) shares (\(9,333,333\) outstanding post-money shares minus seven million outstanding pre-money shares) to the investor.}

If the entrepreneur wants the one million reserved shares not to be taken into account in the valuation, the company would issue just two million shares (not \(2,333,333\)) to the investor.\footnote{See Bagley & Dauchy, supra note 3, at 200.} In that case, the company's existing stockholders and the investor holding the two million new shares will jointly bear the dilution for the one million reserved shares in a ratio of 75/25, rather than having the company's existing stockholders bear 100 percent of the dilution.\footnote{See id.}

\subsection*{(ii) Restricted Stock}

As described above, restricted stock is equity that is subject to a vesting schedule and a company can repurchase any unvested restricted stock if the employee leaves the company or is terminated prematurely. Mexico does not permit a private Mexican company to issue restricted stock (since its repurchase constitutes an illegal redemption), so this section only applies to a U.S. holding company. If the company repurchases unvested restricted stock from an employee, the ownership percentage of the departing employee will decrease and each of the other stockholders (including the investor) will increase proportionately.

\subsection*{(iii) Subsequent Financings}

In negotiating the amount of equity that the company will sell in the first round of equity financing, the entrepreneur should be aware that the company may need to sell additional equity in one or more subsequent rounds of financing, each of which will dilute the ownership percentage of the entrepreneur and investor. If, however, an investor has a preemptive right to purchase his pro rata share of any equity that the company issues in the subsequent financing (thus allowing the investor to maintain his ownership percentage in the company after the subsequent financing), the entrepreneur and the company's other existing stockholders will suffer 100 percent of the dilution resulting from such sale. Using the example above, if the entrepreneur owns six million shares (75 percent)\footnote{Six million shares divided by eight million shares.} of...
the company, the investor owns the remaining two million shares (25 percent),\(^{(179)}\) plus a preemptive right to buy his pro rata portion of any new shares that the company issues, and the company wants to sell an additional two million shares to raise more money, the investor would have the right to purchase 500,000 of these additional two million shares (thus allowing the investor to maintain his 25 percent ownership interest in the company),\(^{(180)}\) but the entrepreneur's ownership percentage in the company would decrease from 75 percent to 60 percent. Although an entrepreneur in a Mexican company has a preemptive right under Mexican law that he cannot waive in advance, in practice, he will need to waive this preemptive right in order to sell equity to the investor, thereby diluting his ownership interest in the company.\(^{(181)}\)

e. Price Protection Rights

Recall that price protection anti-dilution rights protect investors against the dilution of the price that they paid for their preferred stock by adjusting the conversion price at which their preferred stock converts into common stock. If the company issues equity in the future at a price less than the investor's conversion price, price protection requires the company to adjust the investor's conversion price downward so that the investor obtains the benefit of such lower price when the investor converts his preferred shares into common shares.\(^{(182)}\) To illustrate, consider the effect of price protection on the investor's ownership percentage in the company in each of the two examples below (one in which price protection is not triggered and the other in which price protection is triggered). For purposes of this illustration, assume that the company had a $3 million pre-money valuation, the entrepreneur owns six million common shares, the investor purchased two million shares of preferred stock for $1 million ($0.50 per share), giving the company a $4 million post-money valuation and giving the investor 25 percent of the company ($1 million investment/$4 million post-money valuation or two million of the eight million outstanding post-money shares).

\[(i) \text{ Price Protection Not Triggered}\]

Assume that the company sold four million additional shares of preferred stock to a new fund for $4 million ($1.00 per share). The original investor's ownership percentage in the company thus drops from 25 percent to 16.67 percent (two million shares out of twelve million total), and the value of the investor's investment increases from $1 million to $2 million ($1.00/share multiplied by two million shares). The sale of additional equity to the fund does not trigger the investor's price protection anti-dilution rights.

\(^{(179)}\) Two million shares divided by eight million shares.
\(^{(180)}\) Thus, 2.5 million shares divided by a total of ten million shares.
\(^{(181)}\) See General Law of Business Organizations, supra note 58, art. 132.
\(^{(182)}\) See Bagley & Dauchy, supra note 3, at 120, 213-14.
(ii) Price Protection Triggered

Now assume that the company sold four million additional shares of preferred stock to a new fund for $1 million ($0.25 per share). The investor’s ownership percentage in the company thus drops from 25 percent to 16.67 percent (two million shares out of twelve million total), but the value of the investor’s investment decreases from $1 million to $500,000 ($0.25/share multiplied by two million shares). The sale of additional equity to the fund triggers the investor’s price protection anti-dilution rights. The effect of such protection depends on whether the investor has full ratchet or weighted average anti-dilution protection.

(a) Full Ratchet Anti-Dilution Protection

As discussed above, if the investor has full ratchet anti-dilution protection, the conversion price at which the preferred stock converts to common stock is reduced to the lower price at which the company sold stock in the subsequent financing. Using our example above, assume that the investor’s original conversion price was 1:1, so that when the investor converts his preferred stock to common stock, he still has 25 percent of the company. Now assume that the investor’s full ratchet anti-dilution rights lowers the investor’s conversion price from 1:1 to 1:2 (from $0.50:$0.50 to $0.50:$0.25 per share), so that when the investor converts its preferred stock to common stock, the company would issue four million common shares to the investor for its two million preferred shares (increasing the investor’s ownership percentage from 16.67 percent to 28.5 percent).\footnote{This assumes that the entrepreneur has six million common shares, the investor has four million common shares (after giving effect to its price protection), and the fund has four million common shares, for a total of fourteen million outstanding common shares. Four million shares divided by fourteen million shares = 28.5 percent.}

(b) Weighted Average Anti-Dilution Protection

If the investor has weighted average anti-dilution, the conversion price at which the preferred stock converts to common stock is reduced towards the lower price at which the company sold stock in the subsequent financing. Using our example above, assume that the investor’s weighted average anti-dilution rights lowers the investor’s conversion price from 1:1 to 1:1.2 (i.e., from $0.50:$0.50 to $0.50:$0.4167 per share),\footnote{\$0.4167 = \$0.50 \times ((8\text{ million} + (\$1\text{ million} / \$0.50))/12\text{ million}). \textit{See} the “weighted average” formula in section A.2.c.5.b.2 \textit{supra.}} so that when the investor converts his preferred stock to common stock, the company would issue 2.4 million common shares to the investor for his two million preferred shares (increasing the investor’s ownership percentage from 16.67 percent to 19.35 percent).\footnote{This assumes that the entrepreneur has six million common shares, the investor has 2.4 million common shares and the fund has four million common shares, for a total of fourteen million outstanding common shares. Two million shares divided by fourteen million shares = 14.2857 percent.}
B. Living with Private Equity (Control)

1. Corporate Governance

In light of the legal, economic, and political risks outlined above, investors sometimes take a majority or controlling stake in the company in which they invest (especially family-owned businesses) in order to protect their investment. As the head of a prominent private equity group notes, "investing as a minority investor is a much bigger challenge than being able to take a controlling stake." Nevertheless, most investors elect to take minority positions in their portfolio companies since majority control requires additional resources, management, and time. Majority control also diminishes the entrepreneur's incentive to grow the company. Below are mechanisms that investors use to protect their minority positions in a U.S. and Mexican company.

a. Litigation

Perhaps the biggest protection that every stockholder of a U.S. company possesses is the ability to sue the company's directors for damages that such stockholder suffers as a result of, among other things, a breach of the fiduciary duty that each director owes to each stockholder of the company as a matter of law and to sue third parties on behalf of the company through stockholder derivative lawsuits and class action mechanisms to enforce rights that the company itself does not enforce. This litigation threat, coupled by the relatively strong enforceability of U.S. court judgments, generally encourages directors to respect minority stockholders and subordinate their own individual interests to the best interests of the company and its stockholders. In Mexico, however, this threat is largely absent.

b. Voting Agreements

To protect themselves against the majority stockholders, investors holding minority positions in U.S. companies often require the major stockholders to enter into an agreement to vote their shares to, among other things, elect certain individuals (including the investor) to the company's board of directors and to force stockholders to sell their shares in the company.

In Mexico, a voting agreement obligating stockholders to vote their shares in a certain way is critical given that stockholders in a Mexican company cannot waive their preemptive rights in advance (thus preventing the Mexican company from issuing future equity pursuant to, among other things, stock options, warrants, anti-dilution rights, and registration total of 12.4 million outstanding common shares. 2.4 million shares/12.4 million shares = 19.35 percent.

186. See Kossick & Neckelmann, supra note 4, at 120.
187. See Fernandez et al., supra note 76, at 160.
188. See id. at 160.
rights). Mexican law, however, zealously protects the voting rights of all stockholders and thus does not allow stockholders in Mexican companies to waive their right to vote or agree in advance to vote in a certain manner. Consequently, investors must find mechanisms other than voting agreements to protect themselves against majority stockholders. One such mechanism is to obligate the major stockholders of the Mexican company to transfer their stock to a voting trust which a fiduciary (such as a bank) manages and instruct the fiduciary to vote such stock in a certain way. Unfortunately, voting trusts are expensive, time consuming, and have their own risks.

c. Board Representation

An investor in a U.S. company typically expects one or more seats on the company’s board of directors in order to better supervise the management and operation of the company, to have access to the company’s financial and other confidential information, and to approve certain fundamental corporate actions. Some investors may be content to attend board meetings as observers who enjoy no right to vote. Many entrepreneurs, accustomed to unlimited control of the company, find such oversight to be burdensome and restrictive, but the services, experience, contacts, and resources that the investor brings to the company are supposed to offset this burden.

The directors of Mexican companies do not hold the similar decision

189. See General Law of Business Organizations, supra note 58, art. 198.
190. Enriquez, supra note 81, at 26.
191. In addition to those corporate actions that article 182 of the General Law of Business Organizations reserves for approval by stockholders at an extraordinary stockholders meeting (see infra note 199), below is a list of corporate actions that investors often want to approve before the company takes such actions. The corporate bylaws of the Mexican company can provide that such actions require either a higher stockholder and/or board vote:

1. Variation of pre-established dividends policy;
2. Purchase, sale, transfer, exchange, or any other disposition of real estate or fixed assets, whose value per item exceeds certain limits;
3. Mortgage or encumbrance of real estate;
4. Obtaining credits, loans, or other financing in excess of certain limits;
5. Granting credits other than in the ordinary course of business;
6. Acting as guarantor or surety for third parties;
7. The execution, amendment, termination, or assignment of contracts or agreements for obtaining or rendering administrative, financial, and other management services, technical assistance, or for the use and exploitation of copyrights, patents, trademarks, or commercial names, other than in the ordinary course of business;
8. Remuneration of directors, officers, and executives;
9. Determination of product lines and scope of business activities;
10. The waiver of any real or personal rights of the company;
11. The appointment and removal of general attorneys-in-fact;
12. Investment in other Mexican entities; and
13. Transactions with persons or entities related to or controlled by shareholders, directors, or employees.

See Fernandez et al., supra note 76, 172-74.
power that directors hold in a U.S. company.\textsuperscript{192} That is, stockholders in Mexican companies exert more influence on directors than stockholders in U.S. companies exert on their directors because the supreme powers in a Mexican company reside in the stockholders meetings.\textsuperscript{193} Moreover, Mexican law accords considerably more rights to majority stockholders, thereby limiting the minority stockholder's influence over the company's management unless the company's bylaws provide additional protection to the minority stockholder.\textsuperscript{194}

To induce entrepreneurs to reach certain goals, some investors require the entrepreneur to relinquish board control (or board seats) if such goals are not met. In Mexico, agreements allowing investors to take over boards are limited and impractical to enforce.\textsuperscript{195} Stockholders elect board members of a Mexican company at stockholders meetings, and the vote of stockholders cannot be controlled through a stockholder voting agreement.\textsuperscript{196} In addition, some grounds that may give rise to triggering a board takeover such as a refusal and/or inability to redeem stock are not allowed under Mexican law.\textsuperscript{197}

d. Veto Rights

Another way that investors in both U.S. and Mexican companies protect themselves against the majority is to obtain the right to approve (or veto) certain fundamental actions that the company may take.\textsuperscript{198} A company may grant an effective veto right to an investor by (i) listing in the company's organizational documents or in a stockholder agreement the specific corporate actions that the investor (either as a director or a

\begin{footnotes}
\item[192] See Fernandez et al., supra note 76, at 163.
\item[193] See General Law of Business Organizations, supra note 58, art. 178.
\item[194] See Fernandez et al., supra note 76, at 163.
\item[195] Besides voting trusts, another way that investors sometimes achieve an effective board takeover and/or replacement of members in a Mexican company is to structure the resolution adopted at a stockholders meeting designating the initial board members and include therein a proviso establishing certain minimum financial milestones for members to continue; if not, their resignation will be automatic, without the need of a stockholders meeting. To avoid a stockholders' voting agreement, such initial resolution must designate the names of alternate members who would take office effective upon resignation of the initial members. The downside of this structure is the weak enforcement mechanism of the judiciary and that alternate members must be designated well in advance. The latter is a process that may not produce the best results when trying to find talent. If no previous designation of alternate members is resolved, then the stockholders must call for a stockholders' meeting to designate substitute members, which may eventually result in a different board composition than the one desired, and the minority stockholders will always be able to exercise statutory board member designation rights.
\item[196] See General Law of Business Organizations, supra note 58, art. 198.
\item[197] See section A.2.c.3 supra.
\item[198] See supra note 190 and infra note 199 listing corporate actions that investors often want to approve before the company takes such actions.
\item[199] In Mexico, investors may list the matters that require their specific approval (that is, their veto rights) in the company's organizational documents (such as bylaws (estatutos)) in a Mexican company, certificate (or articles) of incorporation in a U.S. company or in a stockholders' agreement. Most practitioners in Mexico recommend listing such matters in the company's bylaws.
\end{footnotes}
stockholder) must personally approve; (ii) requiring the company to obtain a super-majority stockholder vote (such as 80 percent) in order to take any important corporate action; or (iii) granting the investor a class of stock (such as preferred stock) that is different from the stock that the majority holds (common stock) and then requiring the company to obtain the consent of the holders of such separate class of stock to approve specific corporate actions. Note that Mexican law provides a list of corporate actions that must be decided at an extraordinary shareholders' meeting. A Mexican company cannot take any action that adversely affects a particular class of stock without the approval of a majority of the stockholders in such separate class.

e. Other Minority Rights under Mexican Law

Below is a brief description of Mexican statutory provisions that address the rights of minority stockholders in Mexican companies. Without the additional protections described above, however, note how these provisions generally do little to protect a stockholder (i.e., an investor) who holds, say, 20 percent of the Mexican company's stock.

(i) Stockholder Meetings

(a) Calling Stockholders' Meetings

Any stockholder (or group of stockholders) holding at least 33 percent of the capital stock of a Mexican company may, at any time, call a stockholders meeting. The same right is available to the holder of at least one share of capital stock if (i) no stockholders meeting has been held for at least two years, or (ii) such meetings have not dealt with the matters to be compulsorily addressed by an annual general ordinary stockholders meeting (i.e., approval of financial statements, appointment and removal of managers, etc.).

200. Article 182 of the General Law of Business Organizations reserves the following actions for approval by stockholders at an extraordinary stockholders meeting:

1. Extension of the duration of the company;
2. Dissolution of the company prior to the term established in its charter and bylaws;
3. Increases and decreases of the company's capital stock;
4. Change in the corporate purpose of the company;
5. Change of nationality of the company;
6. Transformation of the company;
7. Merger of the company with another company;
8. Issuance of special shares;
9. Redemption by the company of its own shares and issuance of redeemable stock;
10. Issuance of bonds;
11. Any amendments to the charter and bylaws of the company; and
12. Any other issues that requires a special quorum in accordance with this charter and bylaws or the General Law of Business Organizations.

201. See General Law of Business Organizations, supra note 58, art. 195.

202. See General Law of Business Organizations, supra note 58, arts. 184, 185. See Fernandez et al., supra note 76, at 164.
(b) Quorums

Two types of stockholder meetings exist under Mexican law: (i) an ordinary stockholder meeting,\textsuperscript{203} and (ii) an extraordinary stockholder meeting.\textsuperscript{204} A quorum at an ordinary stockholder’s meeting called for the first time requires the presence of at least 50 percent of the company’s capital unless the company’s bylaws state otherwise.\textsuperscript{205} If no quorum is reached at the first call those present at the second call, regardless of their number, will constitute a quorum.\textsuperscript{206} In contrast, a quorum at an extraordinary stockholder’s meeting called for the first time requires the presence of at least 75 percent of the company’s capital and 51 percent of the company’s capital at the second call.\textsuperscript{207}

(c) Voting

A majority of the shares present at an ordinary stockholder’s meeting is required to approve a resolution at such meeting, whereas a majority of the total voting stock of the company is required to approve a resolution at an extraordinary stockholder’s meeting.\textsuperscript{208}

(d) Veto Rights at Special Stockholders’ Meetings

In Mexican companies with different classes of stock (e.g., preferred shares or limited voting shares), any proposal that may affect the rights of any such class must be previously approved by the holders of such class in their own special stockholders meeting. The attendance quorum and voting percentages applicable to special stockholders meetings are the same as those required for the adoption of changes to the company’s bylaws, which shall be computed taking into account only the shares belonging to the category being affected.\textsuperscript{209}

(e) Postponing Vote in a Stockholders’ Meetings

Any stockholder (or group of stockholders) holding at least 33 percent of the capital stock of a Mexican company may postpone, for three days, the vote on any resolution or authorization on any matter which such stockholders considers to be not sufficiently informed. This right may only be exercised once for each matter listed in the agenda of a general

\textsuperscript{203} An ordinary stockholders’ meeting must be held annually and will address matters not specifically reserved for extraordinary meetings. \textit{See} General Law of Business Organizations, \textit{supra} note 58, arts. 179, 181.

\textsuperscript{204} An extraordinary stockholder’s meeting is held to address any proposals that the General Law of Business Organizations or the bylaws of the company specifically reserve for such meetings. \textit{See} General Law of Business Organizations, \textit{supra} note 58, arts. 179, 182; \textit{see supra} note 199.

\textsuperscript{205} \textit{See} General Law of Business Organizations, \textit{supra} note 58, art. 189; Fernandez et al., \textit{supra} note 76, at 165.

\textsuperscript{206} \textit{See} General Law of Business Organizations, \textit{supra} note 58, art. 191.

\textsuperscript{207} \textit{See} id. arts. 190-191.

\textsuperscript{208} \textit{See} id. arts. 189-191.

\textsuperscript{209} \textit{See} id. art. 195.
(ii) Challenging Stockholder Resolutions

(a) Challenges by Stockholders Holding 33 Percent or More

Any stockholder (or group of stockholders) holding at least 33 percent of the capital stock of a Mexican company may request a court to vacate any resolution adopted by a general stockholders meeting. With this action, the stockholders may obtain the provisional suspension, pending final judgment, of the challenged resolution. This action may not be filed against resolutions dealing with the liability of managers or statutory examiners.

(b) Challenges by Stockholders Holding Less Than 33 Percent

Any stockholder holding one or more shares of capital stock of a Mexican company may request any court to vacate any resolution adopted in violation of the company's bylaws or the law, with no statute of limitations applicable to initiate such action. However, in this case, the resolution being challenged may not be suspended other than through final judgment (which may not occur for several years).

(c) Challenges by Holders of Special Shares

Holders of limited voting shares, irrespective of the percentage of stock held, shall have the same rights to oppose resolutions adopted on general stockholder meetings granted to stockholders representing at least 33 percent of the capital stock of a Mexican company. Such stockholders may also request the financial statements and corporate books of the company for revision.

(iii) Internal Management

(a) Examining Books and Records

Mexican law requires Mexican companies to disclose balance sheets and other financial information to stockholders before an ordinary stockholder’s meeting.

(b) Information Rights of Holders of Special Shares

Holders of limiting voting shares, irrespective of the percentage of stocks held, may also request the financial statements and corporate books of the company for revision.

210. See id. art. 199.
211. See id. art. 201.
212. See id.
213. See Federal Civil Code (Código Civil Federal), arts. 2224 et al.
214. See General Law of Business Organizations, supra note 58, arts. 112, 201.
215. See id. arts. 172-173.
216. See id. art. 113.
(c) Appointment and Removal of Directors and Statutory Examiners

Any stockholder (or group of stockholders) holding at least 25 percent of the shares of common stock of a Mexican company (or at least 10 percent if the company is publicly traded) may appoint at least one member of the board of directors (provided the board has at least three members) and statutory examiners (comisarios).

(iv) Economic Rights

(a) Liability Claim by Minority Stockholders

Any stockholder (or group of stockholders) holding at least 33 percent of the capital stock of a Mexican company may initiate a claim for civil liability against the company’s managers if: (i) the action comprises all damages caused to the company and not only those caused to the plaintiffs, and (ii) the plaintiffs did not vote in favor of a stockholders’ resolution releasing managers and statutory examiners from liability. Any damages recovered shall benefit the company and not the plaintiff directly.

(b) Right of Withdrawal

When a general stockholders meeting adopts a resolution regarding (i) the change of corporate purpose; (ii) change of nationality; or (iii) transformation of the corporate form, any stockholder who voted against such resolution may withdraw from the Mexican company and may request the redemption of its shares at book value, provided such request is made within fifteen days following the date of the corresponding general stockholders meeting. This right of withdrawal may not be exercised when it has the effect of reducing the Mexican company’s capital below the minimum allowed by applicable law.

(c) Dividend, Preemptive and Liquidation Rights

Each stockholder of a Mexican company has the dividend, preemptive, and liquidation rights previously discussed above, which cannot be waived.

Note that recent legislative developments applicable to companies listed on the Mexican stock exchange (Bolsa Mexicana de Valores) have modified the requirements for minority stockholders to achieve statutory protection. For instance, appointment and removal of directors and statutory examiners, and the request for the call of a stockholders meeting

217. See id. art. 144.
218. See id. art. 171.
219. See id. art. 163.
220. See id. art. 206.
221. See id. arts. 220-221.
222. These developments were introduced via amendments to the Law of Securities Markets.
PRIVATE EQUITY IN MEXICO

requires a share ownership of 10 percent, rather than 25 percent or 33 percent, of the Mexican company's capital stock. These amendments are steps in the right direction, but really do not address the concerns of private equity investors, who usually target non-public companies rather than companies with shares traded on stock exchanges.

2. Stock Transfer Restrictions

In the United States, investors generally require the entrepreneur and other key stockholders of the company to sign a stock restriction agreement (also called a stockholders agreement or share retention agreement) to prevent them from transferring their shares to any third party except in limited circumstances. Typical exceptions allow a stockholder to transfer stock to family members and business affiliates freely and also to third parties once the transferring stockholder has allowed the investor an opportunity to buy the stock first (see right of first refusal and right of first offer sections below). Likewise, entrepreneurs should consider subjecting investors to similar stock restrictions, but most investors resist such restrictions given that they seek to sell their investment in the company within three to five years. The purpose of the stock restriction agreement is to keep the ownership of the company with those that are directly involved in the success of the business, to provide liquidity to investors in certain situations, and to maintain the balance of power among stockholders.223

Stock restriction agreements are uncommon in Mexico. Moreover, although Mexican law allows agreements that restrict the sale of property (such as stock) to a specified third party, agreements preventing the sale of property to any party are null and void.224 Thus, the enforcement of stock restriction agreements in Mexico may be tricky.

a. Right of First Refusal

If a stockholder subject to a stock restriction agreement (such as the entrepreneur) receives (and wants to accept) an offer from a third party to buy his stock, a right of first refusal requires such stockholder to first offer to sell his stock to other stockholders (such as the investors) first on the same terms offered by the third party. If such offerees refuse the selling stockholder's offer, the selling stockholder can then sell his stock to the third party, subject to the co-sale (tag along) rights described below. If the offerees buy some, but not all of the selling stockholder's stock, the third party may not want to buy such shares. For this reason, an entrepreneur should require any stockholder to whom he gives a right of first refusal to buy all (not just some) of his stock as a condition to exercising the right of first refusal.

223. See Bagley & Dauchy, supra note 3, at 92.
224. Federal Civil Code, supra note 213, art. 2301.
b. Right of First Offer

If a stockholder subject to a stock restriction agreement (such as the entrepreneur) wants to sell his stock to a third party (but has not received any third party offer yet), a right of first offer requires such stockholder to offer to sell his stock to other stockholders (or the company itself) and allow such offerees the opportunity to make the first offer to purchase such stock. Again, an entrepreneur should require any stockholder to whom he gives a right of first offer to buy all (and not just some) of his stock as a condition to exercising the right of first offer.

In the United States, rights of first refusal and rights of first offer generally are contained in a stock restriction agreement between the company and the major stockholders of the company. In Mexico, these rights may be included either in the company’s bylaws or in a stockholders’ agreement, although placing such rights in the bylaws may make them easier to enforce. Both the right of first offer and right of first refusal are known in Mexico as the derecho del tanto, which is mandatory (in other words, cannot be waived in advance) for certain types of companies (such as limited liability companies (sociedad de responsabilidad limitada), but not other types of companies (such as sociedad anonima). With respect to capital stock companies, Mexican law permits bylaws to provide that any share transfer requires the approval of the board of directors and the board may deny the approval only if it designates a buyer for the shares at market price.225

In those industries where Mexican foreign investment laws limit the investor’s ability to acquire additional shares pursuant to their rights of first refusal or first offer,226 an alternative is to grant the investor the right to designate a qualified designee to purchase the shares or even the right to have the shares placed in trust until an acceptable buyer is found.

3. Incentives

Investors seek to maximize returns on their investment by using both carrots and sticks to motivate the company’s employees to work hard and efficiently. Below are some of the incentives that investors and entrepreneurs use to motivate their workforce.

a. Stock Options and Warrants

As discussed above, U.S. companies routinely use stock options to attract and retain key employees and consultants, and use warrants inducing investors in the company or third party business.227 That is, companies use the vesting schedule on a stock option to motivate em-

225. See General Law of Business Organizations, supra note 58, art. 130.
226. See section I.D.2.f supra (Regulatory Obstacles - Limits to Foreign Investment).
227. Stock options have the dual purpose of rewarding the employee by allowing him to participate in any increase in the value of the company and ensuring that the employee stays with the company for a certain period of time in order to get such profits. See Morrison & Foerster, supra note 3, at 7.
employees to continue to work for the company by allowing them to purchase more and more stock at favorable prices as their stock options vest over time. In contrast, companies often issue warrants as a "sweetener" to induce investors to make loans or to lower the price at which they purchase equity and to induce third parties, such as banks, lessors, and strategic partners to do business with the company.

Mexico’s current legal framework, however, does not allow a Mexican company to issue such rights. First, if stockholders of a Mexican company can waive their preemptive rights only when the company issues new stock, the Mexican company cannot grant options to acquire its stock in the future unless existing stockholders waive their preemptive rights at the time the option holder exercises such option (which may or may not occur). This leaves employees and investors in a position of legal uncertainty.

Second, even if stockholders of Mexican companies could waive their preemptive rights in advance, Mexican law limits the ability of Mexican companies to hold unsubscribed stock to issue upon the occurrence of a future event, thereby preventing the use of stock options, warrants, and similar rights. To illustrate, a U.S. company may authorize the creation of a pool of shares which have not been issued and subscribed for but which can be issued and subscribed for in the future upon the occurrence of some event (such unissued and unsubscribed shares are referred to as authorized unissued shares). Similarly, a U.S. company can issue shares to its stockholders and subsequently reacquire these shares to hold or re-issue in the future (such issued but not outstanding shares are referred to as treasury shares). When a stockholder or an investor exercises a stock option or warrant (or converts his convertible note into stock), the U.S. company will issue either authorized unissued shares or treasury shares to such stockholder or investor.

Mexican law, however, prohibits authorized unissued shares, thus a Mexican company may issue only the stock that will be subscribed and paid for. A Mexican company cannot issue new shares unless prior issuances are completely subscribed and paid for. Moreover, a Mexican company generally cannot hold treasury shares except in limited cases. Without authorized unissued shares and treasury shares, a Mexican company cannot issue stock options or warrants.

Based on these limitations, the most common way for the entrepreneur, investors, and others to obtain stock options, warrants, and similar rights is to form a U.S. holding company or other offshore company, which may also bring about other benefits as well as additional costs.

228. For example, upon the exercise of a stock option or warrant.
229. See General Law of Business Organizations, supra note 58, art. 133.
230. See id.
231. See Securities Market Law, supra note 131, art. 81 (requires stockholders of a Mexican public company to waive their preemptive rights (derecho de preferencia) in a public offering in order to create a pool of treasury shares that the Mexican company can sell to the public from time to time).
b. Restricted Stock

As discussed above, restricted stock is equity that an employee actually owns in the company but which the company can repurchase from the employee if he or she leaves the company or is terminated prematurely. To motivate the employee to work for the company over a certain period of time (such as four years), the company and employee sign a restricted stock agreement (not a stock restriction agreement as discussed above) that subjects the employee's shares to a vesting schedule. If the employee leaves or is terminated before his or her stock fully vests, the company can repurchase the unvested portion of the shares, thus discouraging the employee from leaving the company.

Since Mexican law generally does not allow redemptions, a Mexican company cannot repurchase any stock of an employee who leaves the company or is terminated prematurely. Mexican law does allow, however, for a Mexican company's charter and bylaws to provide for the issuance of special shares to persons providing services to the Mexican company, including employees. Limited circulation and non-transferability characterize special shares. Unfortunately, the Mexican company may not repurchase these shares if an employee leaves the company or is terminated prematurely, given the express prohibition against redemption in private companies. Once issued and subscribed, special shares belong unconditionally to their holders. These particularities of Mexican corporate law complicate the elaboration of a vesting schedule designed to reward the loyalty and productivity of a Mexican company's employees, reducing the ability of the entrepreneur and investors to encourage employees to continue to work for the Mexican company.

C. Exit from Investment

As mentioned above, investors seek to sell their investment in the company within three to five years after the date of such investment in order to return the sale proceeds to the fund investors within the life of the fund. An investor generally expects to sell his investment in the company either through a private sale to third party, redemption, private sale to stockholder, or a public sale, each of which is discussed below in the context of a U.S. holding company and Mexican company.

1. Private Sale to Third Party
   a. Company Sale

The most common exit strategy in Mexico and throughout Latin
America is for a third party to purchase the assets or stock\textsuperscript{236} of the company in a private sale (company sale). After the NASDAQ crash in 2000, the company sale has also become the most common exit strategy in the United States. A company sale sometimes is called a trade sale or strategic sale. The buyer in a company sale often is a strategic buyer that is either a larger local company that wants to expand its market share or a foreign company interested in entering the local market. A report called “Latin America Private Equity Review & Outlook 2000/2001” establishes that thirteen out of fifteen exits registered in Latin America were carried out through a sale of the company.\textsuperscript{237} Two contractual rights often associated with company sales, drag-along rights and tag-along rights, are permitted in Mexico and are discussed below.

b. Drag-Along Rights

When a third party offers to buy the stock of the company’s shareholders, some shareholders might not want to sell their stock, thereby preventing the third party purchaser from acquiring all (or a certain percentage) of the company’s equity. To prevent this from happening, investors use drag-along rights to require other stockholders (such as the entrepreneur and other key stockholders) to sell their shares to the third party purchaser on the same terms offered to (or negotiated by) the investor or majority stockholders. Drag-along rights allow investors to force (in other words, drag-along) uncooperative stockholders (such as the entrepreneur and key employees) to sell their shares to the third party purchaser. One of the issues that funds consider when deciding whether to invest in a company is whether such a company would be attractive to a third party purchaser. If the entrepreneur opposes the possibility of such a sale (a factor that should be discussed with the fund) the company may not be suitable for private equity financing. Mexico allows drag-along rights, which generally are included in a stockholders’ agreement among the stockholders of the Mexican company.

c. Co-Sale (Tag-Along) Rights

In some cases, a third party offers to buy the shares of the majority stockholders (such as the entrepreneur and key employees) but not others (such as the investor), thereby causing the excluded stockholders to live with new stockholders (a competitor) after such sale. To prevent this from happening, an investor uses co-sale rights (also called tag-along rights) to allow the investor to tag-along in the sale and sell a pro rata portion (or all) of his shares to the purchaser on the same terms and conditions of the offer. This provision aligns the interests of all possible selling stockholders and discourages competition among them for the sale of shares to potential buyers. Co-sale rights may be applicable to the sale

\textsuperscript{236} A third party can acquire the company’s stock either by purchasing it indirectly from the Company through a merger or directly from the stockholders themselves.

\textsuperscript{237} See Morrison & Foerster, supra note 3, at 12.
of the majority or minority of shares. If tag-along rights are only triggered upon the sale of the majority of the outstanding shares, such right prevents a third party from offering to purchase from the majority stockholders at a premium price only that number of shares sufficient to obtain a majority of the board of directors.\textsuperscript{238} Co-sale rights also serve as a defensive mechanism for a fund to avoid being placed in a situation where the fund must maintain an investment while the entrepreneurs withdraw from the company. Mexico allows co-sale rights, which generally are included in a stockholders agreement among the stockholders of the Mexican company.

2. Private Sale to Issuer (Redemption)

a. Put and Call Options

As discussed in section II.A.2 above, a put option (voluntary redemption right) allows the investor to require the company to redeem its stock for cash at a specified time and price.\textsuperscript{239} An investor typically does not exercise his put option unless he otherwise cannot exit from his investment. In contrast, a call option (i.e., an involuntary redemption right) allows the company to redeem the investor's stock for a specific price upon the occurrence of a certain event.\textsuperscript{240} In the United States, private companies generally may redeem their shares except in certain cases (such as the redemption defrauds creditors). Mexican law, however, specifically prohibits private Mexican companies from redeeming their shareholders stock unless it is judicially ordered for the purpose of satisfying credit obligations.\textsuperscript{241}

Investors may seek alternatives to achieve redemption by setting aside a certain percentage of shares in escrow, using a trust vehicle, or forming an offshore holding company (such as a U.S. holding company).

b. Convertible Debt

Before the investor converts his convertible note into equity, the investor has two advantages: (i) the investor can exit from his investment by requiring the company to repay the principal and interest owing on the note; and (ii) upon liquidation, the company must pay the convertible loan before paying any stockholders. Of course, once the investor converts his note into equity, the investor must rely on the other exit mechanisms discussed herein.\textsuperscript{242}

\textsuperscript{238} See Mayer, Brown & Platt, supra note 13, at 16.
\textsuperscript{239} See Bagley & Dauchy, supra note 3, at 118-19.
\textsuperscript{240} See id.
\textsuperscript{241} See General Law of Business Organizations, supra note 58, art. 134. See Morrison & Foerster, supra note 3, at 5. See also supra text accompanying notes 220-221.
\textsuperscript{242} See Alers et al., supra note 37, at 13.
3. Private Sale to Stockholder

a. Negotiated Sale

Another way that investors exit from their investment is to sell their shares to one or more stockholders in the company. The investor can do this simply by negotiating the terms of the sale at the time that the investor wants to exit. The problem with this approach, however, is that it depends on, among other variables, whether (i) the investor has sufficient equity ownership in the company to attract another stockholder to buy it; (ii) other stockholders have the financial ability to purchase the investor's shares; and (iii) other stockholders will pay a fair price for such shares. Thus, the prudent investor will recognize that a negotiated sale is an option but will not rely solely on this mechanism to exit from its investment.\textsuperscript{243}

b. Third-Party Put Options

To secure his exit when the investment is made, the prudent investor may negotiate a third party put option, allowing the investor to require another stockholder to purchase the investor's shares at a specified time and price.\textsuperscript{244} Of course, the crux of these negotiations is determining the time and price at which the investor can "put" his shares to another stockholder.

c. Third Party Call Option

A stockholder might agree to be obligated to buy the investor's shares pursuant to a third party put option in exchange for a third party call option that allows such stockholder to require the investor to sell his shares to the stockholder at a certain time and price. Conversely, an investor may negotiate a third party call option that allows the investor to require another stockholder (such as the entrepreneur) to sell his shares to the investor at a certain price, thus giving the investor greater control of the company. Again, the crux of such negotiations is determining the time and price at which one stockholder can "call" the shares of another.

d. Buy-Sell Option

A buy-sell option incorporates the third party put and call options into one mechanism. That is, a buy-sell option gives a stockholder (such as the investor) the right to give another stockholder (e.g., the entrepreneur) an offer either to (i) buy a certain amount of the other stockholder's shares for a specific price, or (ii) sell a certain amount of his own shares to the other stockholder for a specific price. The stockholder receiving the offer then must either sell his own shares or buy the stock of the offering stockholder in accordance with the terms of his offer.

\textsuperscript{243} See id. at 11.
\textsuperscript{244} See id. at 9.
4. Public Sale

a. Types of Offerings

A Mexican company may sell its stock to the general public by listing its shares directly on the Mexican stock exchange (Bolsa Mexicana de Valores or BMV), directly on a U.S. stock exchange, on NASDAQ, or in the over-the-counter (OTC) or “pink sheet” market, or in the form of American Depositary Receipts (ADRs) on a U.S. stock exchange, on NASDAQ, or in an OTC market. In the alternative, a Mexican company can form a U.S. holding company, which in turn sells its stock to the general public by listing its shares directly on a U.S. stock exchange, on NASDAQ, or in an OTC market. We outline below public sales through direct offerings on the BMV or U.S. public markets and through the use of ADRs.

(i) Direct Offering

(a) Mexican Direct Offering

The BMV does not currently offer entrepreneurs and investors a viable exit opportunity for their stock in a Mexican company. The BMV is small, thinly traded, and generally available only to a handful of top-tier industrial conglomerates, not unknown companies with relatively short performance records. The BMV also has suffered some scandals that have reduced investor confidence (such as unrestricted insider trading that caused prices to fully incorporate the information before its public release). Moreover, OTC trading is almost non-existent in Mexico. The lack of a public market in Mexico reduces the willingness of investors to make private equity investments directly in Mexican companies. However, the Securities Market Law was amended on June 1, 2001 to include a provision under Article 14 Bis-1 that allows companies to register their securities in the Securities Section of the National Securities Registry (Sección de Valores del Registro Nacional de Valores), without a public offering, by requesting authorization from the CNBV. Such registration must comply with the registration terms of Article 14 (applicable for registration for public offerings), provided, however, that a detailed brochure (substituting the public offering prospectus) must describe all the

245. For example, the New York Stock Exchange or American Stock Exchange.
246. See Morrison & Foerster, supra note 3, at 11; Kossick & Neckelmann, supra note 4, at 114-15.
247. The BMV is a minor player among the world’s stock markets, listing only 177 companies as of December 2000. See Roberto Charvel & Juan Carlos de Yeregui, Private Equity in Latin America: The Mexican Case, 6 J. PRIVATE EQUITY 1 (2002).
248. See id. Of the few public offerings on the BMV, the shares of many listed companies are never traded again.
information requested in Article 14, numeral 1 (letter a) (e.g., a legal opinion regarding the standing of the issuer; audited financial statements, etc.). Finally, the Ministry of Finance and Public Credit published in 2002 the Rules Applicable to Certain Acquisitions of Securities and Tender Offers (Reglas Generales aplicables a las Adquisiciones de Valores que deban ser Reveladas y de Ofertas Públicas de Compra de Valores), which seek to enhance transparency and protect minority shareholders deriving from tender offers and transactions involving inside stockholders.

(b) U.S. Direct Offering

The U.S. capital market is one of the most attractive sources of financing to foreign companies because its sheer size offers unparalleled liquidity, an enormous array of financial service providers meet diverse corporate finance needs, and U.S. investors often are more receptive and have a better understanding of companies than investors in the local market. During the internet craze of the late 1990s, a number of private equity supported Latin American companies sold shares through the U.S. public markets. Unfortunately, companies (whether Mexican or U.S.) that seek to sell stock in U.S. public markets subject themselves to U.S. disclosure requirements, accounting standards, legal liability, and other factors that impose significant costs and burdens on the company.

(ii) American Depository Receipts (ADRs)

In addition to a direct offering, a Mexican company seeking to access U.S. public markets can list its ADRs on a U.S. stock exchange, such as NASDAQ, or in an OTC market. ADRs are securities issued by a U.S. bank that represent the Mexican company's ordinary shares held in custody by that bank. The amount of access that a Mexican company gets to the U.S public markets depends on the type of ADR program that it creates. If the Mexican company wants to access the highly liquid U.S. public markets, it can create a Level III ADR program in which the company lists its ADRs on an exchange or NASDAQ as part of a public offering, thus subjecting itself to the full disclosure requirements, accounting standards, and legal liability of U.S. federal securities laws. However, if

251. See Securities Market Law, supra note 131, arts. 14 and 14 bis.
253. Terra Networks, S.A. (a Latin American internet company), El Sitio.com (an Argentine-based internet portal), Impsat (an Argentine internet infrastructure company), and StarMedia Networks, Inc. (a Latin American internet portal) listed their shares on NASDAQ, the active second tier market in the U.S. See Kossick & Neckelmann, supra note 4, at 115-16. See Mailander, supra note 5, at 75.
the Mexican company wants to provide a market for its shares that is more cost-effective and less burdensome from a disclosure, accounting and liability perspective, it can create a Level I ADR program in which the company trades its ADRs in the less liquid OTC markets. As of the date of this writing, twenty-one of the twenty-four Mexican companies listed on the New York Stock Exchange are listed in the form of ADRs. Further, two of the three Mexican companies listed on NASDAQ are listed as ADRs.

b. Registration Rights

Registration rights give the stockholders who have them the right to require the company to register their stock under applicable securities laws so that the stockholders can sell their stock to the general public in a public offering. Investors typically request three types of registration rights: demand rights, short-form rights, and piggyback rights.

(i) Demand Rights

A demand registration right is a right to demand that the company file a long-form registration statement with the U.S. Securities and Exchange Commission (SEC) on Form S-1 (U.S. holding company making a public offering of its stock in the United States) or Form F-1 (Mexican company making a public offering of its stock in the United States). A long-form registration statement is used by a company that is not yet subject to the periodic reporting requirements of U.S. securities laws, or alternatively, is subject to such reporting requirements but is not eligible to use the simpler short-form registration statements. Generally, an investor group will receive only one or two demand rights, with limits on when the rights can be exercised.

In Mexico, however, registration rights are not contemplated in the law. To the extent that a registration right requires a voting agreement among stockholders to approve an increase in the Mexican company's capital to make a public offering and an advance waiver of each stockholder's preemptive rights, such registration rights would be illegal. A provision could be included in the company's bylaws, however, that provides that the corporate purpose of the Mexican company is to become public when certain financial milestones are achieved and that the board of directors of the company is authorized to adopt a resolution to such effect. In addition to enforceability problems, such provisions require

255. See Mailander, supra note 5, at 75, 81; see Saunders, supra note 254, at 50.
258. See BAGLEY & DAUCHY, supra note 3, at 222; Alers et al., supra note 37, at 16-17.
259. See BAGLEY & DAUCHY, supra note 3, at 222; see Mailander, supra note 5, at 77.
260. See Mailander, supra note 5, at 77.
261. See BAGLEY & DAUCHY, supra note 3, at 222; see Mailander, supra note 5, at 77.
language that may not satisfy the Mexican company’s needs or the re-
quirements of the Banking and Securities National Commission (Comis-
tión Nacional Bancaria y de Valores) when going public.

(ii) Short-Form Rights

A short-form registration right is another type of demand right that
allows the investor to require the company to register the investor’s stock
on Form S-3 (U.S. holding company making a public offering of its stock
in the United States) or Form F-3 (Mexican company making a public
offering of its stock in the United States). The Forms S-3 and F-3 are
much simpler, less time-consuming, and cheaper than the preparation of
a Form S-1 or F-1 registration statement. Generally, an investor group
will receive an unlimited number of short-form rights but are limited as to
when the rights can be exercised.262

(iii) Piggyback Rights

A piggyback registration right is a right that allows the investor to in-
clude his shares in a registration statement that the company is planning
to prepare and file with the SEC (or the Mexican CNBV) on behalf of
itself or other stockholders. That is, the investor has the right to “piggy-
back” on the registration statement of someone else in order to register
his own shares. Generally, an investor group will receive an unlimited
number of piggyback rights, but are subject to a cutback or elimination if
the investor’s shares would adversely affect the fund-raising effort.

5. Liquidation

In the event of the company’s liquidation, resulting either from its dis-
solution263 or bankruptcy,264 private equity investors holding ordinary or
limited voting stock, shall hold only a residual claim against the company
for their contributions. In case of liquidation, holders of limited voting
stock shall have a liquidation preference over the holders of ordinary
stock;265 however, holders of both limited voting and ordinary stock shall
be entitled to receive reimbursement on their contributions only after all
of the company’s creditors have been satisfied in full. To compensate for
the lack of flexibility of Mexico’s corporate law in designing structures
reducing the risk of equity investors when liquidation takes place, inves-
tors customarily request the issuance of share convertible instruments,
which, in the event of the venture’s failure, provide the security of having
a preferred credit against the company rather than a residual claim, as is

262. See Bagley & Dauchy, supra note 3, at 222.
263. Recall that the stockholders may decide to dissolve and liquidate their company
upon selling all of the company’s assets to a third party. See General Law of Busi-
ess Organizations, supra note 58, arts. 229, 234, and subsequent.
264. See Bankruptcy Law (Ley de Concursos Mercantiles), art. 167.
265. See General Law of Business Organizations, supra note 58, art. 113.
the case of stock, and, at the same time, provide investors with the option of converting such credit into stock, in the event of the venture's success. Many investors and observers consider the lack of exits to be the single most pressing issue regarding private equity investments in Mexico. In the next couple of years, an important number of funds will try to exit from their current investments. Their success (or failure) will have a direct influence in determining the conduct of funds in the future and the level of private equity money that will be invested in Mexico in the future. For example, the lack of exit options may cause funds to take only majority or controlling interests in a company, which would be unfortunate for smaller companies whose size often would not justify the extra time and resources that a fund would need to spend in taking a majority position.

III. SHOULD A U.S. HOLDING COMPANY BE USED TO ATTRACT PRIVATE EQUITY?

An entrepreneur typically operates his Mexican business in the form of one or more of the corporate structures available under Mexican law (e.g., sociedad anonima, sociedad de responsabilidad limitada). Investors, however, might be reluctant to invest directly in a Mexican company because of the legal, economic, and political risks discussed above. To minimize these risks and attract private equity investment, some entrepreneurs form U.S. holding companies to own the entrepreneur's Mexican company. The next sections discuss the advantages and disadvantages of forming a U.S. holding company to own the Mexican company.

A. Advantages

1. Attract Private Equity
   a. U.S. Legal System

   An entrepreneur might consider using a U.S. holding company to avail investors to the security of the U.S. legal system. A U.S. holding company offers investors and entrepreneurs a wide variety of flexible investment structures that are well-established under U.S. corporate laws and battle-tested in U.S. courts. In contrast, the investment structures that are available to investors and entrepreneurs under Mexican law are limited and their use in private equity investments is not well established. Also, minority stockholder rights are stronger in the U.S. than in Mexico. For example, the ability of a stockholder to sue the U.S. company's direc-

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266. See Morrison & Foerster, supra note 3, at 10.
267. Entrepreneurs from throughout the world, most notably from India and Israel, are forming U.S. holding companies for their business operations in their home country in order to access U.S. capital and U.S. exit opportunities.
tors for damages that the stockholder suffers as a result of any breach of the fiduciary duty that each director owes to stockholders under U.S. law provides investors holding minority positions in U.S. companies with an enormous amount of security in making investments. Minority stockholders do not enjoy such protection in Mexico. In addition, the U.S. judicial system is relatively efficient and accessible and its judgments generally are easily enforceable whereas the enforcement of rights in Mexican courts is more unreliable and slow.

b. Exit Opportunities

An investment in a U.S. holding company generally offers an investor more exit opportunities than an investment in a Mexican company. These exit opportunities include access to the enormous U.S. capital markets (for purposes of a public sale), a large pool of potential acquirors (for purposes of a private sale to third parties), and the ability to sell (or "put") its stock to the company (or redemption). Exits from a Mexican company generally are limited to company sales and private sales to stockholders.

c. Investment Community

The U.S. investment community – investors, entrepreneurs, service providers, government officials – generally is very experienced and offer investors and their portfolio companies an enormous amount of support. In contrast, the Mexican private equity community is relatively undeveloped and does not offer investors and entrepreneurs such support. Such experience and support in the U.S. increases the odds that an entrepreneur's business will be successful.

2. Other Types of Capital

A U.S. company generally can access more government financial assistance (e.g., loans and guarantees from the U.S. Small Business Administration, Overseas Private Investment Corporation, and Export-Import Bank of the United States) than a Mexican company can. Also, once a U.S. holding company receives private equity financing, it can often access loans from U.S. banks. A small or mid-sized Mexican company has little access to bank financing even with venture financing. In short, a private equity investment in a U.S. holding company offers investors and entrepreneurs more flexibility, security, and other benefits than such an investment in a Mexican Company.

3. U.S. Visas

An entrepreneur who owns or works in a U.S. holding company may qualify for a variety of visas allowing the entrepreneur, his family, and key employees to work and live in the United States. These work visas include an employment-based immigrant visa (such as a permanent resi-
dent visa or green card) and various types of non-immigrant visas (such as the E, H-1B, and L non-immigrant visas).

4. Perception

Some entrepreneurs believe that operating their business from a U.S. holding company creates a positive perception of the company abroad, giving the company a competitive advantage. Of course, in some parts of the world (e.g., the Middle East) a U.S. company may be perceived negatively.

B. Disadvantages

1. Cost

Structuring and forming a U.S. holding company and all related entities could initially be costly. For example, designing and forming a tax efficient corporate structure in multiple jurisdictions will generally require substantial legal and accounting work. It is also possible that the transfer of stock or assets from Mexico to corporations in other jurisdictions could subject the entrepreneur and/or the Mexican company to local taxes. However, the overall tax savings are likely to far outweigh the costs of implementation and, thus, the transaction costs generally should not be an impediment to implementing such structure.

Once formed, the administrative costs of operating a company in more than one country and complying with each country's laws can be substantial. Also, the U.S. is a very litigious society, thereby exposing the U.S. holding company to possible legal risks and expenses.

Whether an Entrepreneur should incur such costs (and risks) depends on the size of the enterprise and (perhaps more importantly) its expected rate of growth.

2. U.S. Taxes

While using a U.S. corporation may be very beneficial to facilitate investment, it could create untoward tax consequences to the investors because U.S. corporations are subject to tax on their worldwide income at combined U.S. federal and state rates, which could be upwards of 40 percent. The shareholders are also subject to a second level of tax when dividends are distributed to them. If the entrepreneur uses a U.S. holding company for its non-tax benefits, the entrepreneur should be careful to minimize the U.S. tax impact of the U.S. holding company on the combined operations and the shareholders. The entrepreneur should also be cognizant of the possibilities to maximize foreign tax savings as well. The next section discusses the ability to minimize the impact of U.S. tax in the case where a U.S. corporation is used as the centralized holding company as well as some suggestions at maximizing foreign tax savings.
a. Minimizing the Impact of U.S. Tax

If a U.S. holding company is used to attract venture capital, the formation of a non-U.S. holding company by the U.S. holding company (in a low or no tax jurisdiction), which would own the stock of the operating companies could be advantageous to reduce or, in some cases, eliminate U.S. and possibly foreign tax. The following is a diagram of what the overall holding company would generally look like:

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  U.S. Holdco
    ↓
  Foreign Holdco
    ↓
  Opco   Opco   Opco
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This structure should be beneficial in reducing (although not entirely eliminating) the impact of U.S. tax for two primary reasons. First, it should allow cash from one operating company to be transferred to another operating company without incidence of U.S. tax. This can be done by having the operating company pay a dividend to the non-U.S. holding company which, in turn, would transfer such cash to the operating company in need of it as a contribution to capital. The diagram below illustrates how cash would be moved from one operating entity to another.
The non-U.S. holding company would itself be formed in a jurisdiction with a favorable holding company regime and favorable tax treaties. Consequently, it should not be taxed on the receipt of any dividends and there would generally be little, if any, dividend withholding tax on the payment of such dividends. The result is that there should be little or no tax cost of transferring the cash from one operating company to another and the cash would not come within the U.S. taxing jurisdiction. Without the imposition of the non-U.S. holding company, dividends distributed from an operating company would be received directly by the U.S. holding company and taxable in the United States. In this case, only the after-tax proceeds would be available for use by the operating companies. Dividend withholding taxes could also be incurred upon payment of the dividend. However, all this may be avoided by using a non-U.S. holding company as the centralized holding company.

The second primary way that the non-U.S. holding company will help to avoid the impact of U.S. taxation is with respect to a sale or exit of an investment in one or more of the underlying operating companies. For example, if a sale of one of the operating companies is desired, the non-U.S. holding company would sell the operating company and would not itself be taxed on the receipt of the cash proceeds since it would be formed in a no tax jurisdiction. This should, if managed properly, generally allow for investment of the sale proceeds outside of the United States without the imposition of U.S. tax. Without the non-U.S. holding company as the centralized holding company, the U.S. parent company would have to facilitate the sale of the operating companies and would therefore be taxed on the profit. In this case, only the after tax proceeds would be available for investment outside the United States.

If cash is distributed from the non-U.S. holding company to the U.S. holding company, the proceeds would be taxable in the hands of the U.S. company. However, venture capital investors typically will not allow for the payment of dividends; thus, this is not likely to be a significant tax cost of using the U.S. company. There could be tax costs on exit if exit strategies are not managed properly. For example, if a buyer were to purchase the entire enterprise by purchasing the foreign holding company or the operating companies (but not the U.S. holding company) U.S. tax would be incurred on such sale. On the other hand, U.S. tax could generally be avoided if the buyer were to buy the shares of the U.S. holding company because gain from the sale of stock is generally not taxable in

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269. The non-U.S. holding company would be formed in a jurisdiction with favorable income tax treaties so that dividend withholding taxes would be minimized. If necessary, intermediary holding companies can be used to reduce such tax.

270. Special elections will need to be made for each opco to treat them as flow through entities from a U.S. tax perspective to avoid the U.S. anti-deferral rules.

271. Here again, having the elections (noted above) in place to treat each opco as a flow-through for U.S. tax purposes is necessary to avoid the U.S. anti-deferral rules. It is imperative that these elections be made well in advance of a sale of the underlying companies.
the United States to non-U.S. persons.\(^272\) Therefore, it is possible that any potential tax inefficiencies created by the U.S. holding company could be avoided or minimized if operations are structured properly and careful planning is considered upon exit of the enterprise. It is imperative, however, that all these factors be considered when the entrepreneur is considering using a U.S. holding company.

b. Maximizing Foreign Tax Savings

What should be considered also in the formation and structuring stages is the ability to reduce the overall effective rate of tax of the operating companies. This could generally be done regardless of whether a U.S. holding company is utilized. Because the corporate tax rate in Mexico, for example, or many other countries where the operating company will operate and be subject to tax could be very high (the corporate tax rate in Mexico is approximately 35 percent), it will generally be advantageous to implement tax savings strategies to reduce this tax rate. This article does not discuss all available techniques, but rather one very key planning tool that involves the use of a so-called intangible holding company. If one or more of the operating companies has valuable intellectual property, it may be possible to move this intellectual property to an intangible holding company, which would be formed in a very low taxed jurisdiction. This would effectively shift a large portion of the profits from the higher taxed country of operation to the lower taxed intangible holding company. The intangible holding company would be an addition to the basic overall holding company structure discussed above. Set forth below is a diagram of what the overall structure would look like.

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U.S. Holdco
  ↓
Foreign Holdco
  ↓
Intangible Holdco    Opco    Opco    Opco
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**Example:** Assume that the operating companies have valuable computer software, which they license to end-users/customers. Under the

\(^{272}\) It is possible that the buyer of the shares of the U.S. holding company would be a lower price for these shares than it would pay for the shares of the non-U.S. holding company.
current structure, the operating companies are selling/licensing this software directly to their customers and are paying tax on the profits at regular corporate tax rates of upwards of 35 percent. If ownership of the software were moved to an intangible holding company, the intangible holding company could license this software directly to the customer and could receive the profit directly. The intangible holding company would then pay an arm’s length commission to the operating companies for acting as the sales/marketing agent. Thus, only the commission would be taxable at the higher tax rate in the hands of the operating companies. Alternatively, the intangible holding company could license the software to the operating companies which would in turn license it for a higher price to the customers. In either case, it should be possible to achieve in many cases a much lower tax rate (10 percent or possibly lower) on a large portion of the profits which would ultimately be received by the intangible holding company. In many cases, it may be possible to effectively shift up to 80 percent to 90 percent of the operating profits to the intangible holding company, but this will depend on the specific transfer pricing rules in the applicable operating jurisdictions. Another example where this concept may be feasible is where there is valuable know-how, franchises, or other intellectual capital that the operating companies need to produce their product or continue operating. It may also be possible to transfer ownership of this property to the intangible holding company and license it to the operating companies for their direct use (e.g., each operating company would pay an arm’s length royalty to the intangible holding company), thereby shifting a large portion of the profits to the intangible holding company.

An added planning technique to reduce further the tax rate in the operating jurisdictions would be for the intangible holding company to make interest bearing loans of its cash to the operating companies. The operating companies could then deduct the interest expense, thereby reducing the tax rate in the operating companies and moving the cash to the lower taxed intangible holding company. The profits shifted to the intangible holding company can be moved back to the operating companies by having the intangible holding company paying dividends to the non-U.S. holding company, which would, in turn, contribute the cash to the operating company. This can generally be done without any tax cost as discussed above.

Keep in mind; however, the appropriate jurisdiction will have to be used for the intangible holding company so as to take advantage of favorable tax treaties and the lowest possible tax rates on the profits. Certain countries may also have stringent transfer pricing rules to consider. The overall holding company structure, although very effective in allowing for the savings of significant tax dollars, will take the work of key corporate and tax advisors to implement. Although the basic concept may work for many multinational corporations, every multinational
IV. CONCLUSION

This article provides a description of the current legal framework for the emerging private equity industry in Mexico. For this industry to continue to mature, however, the following issues need to be addressed.

(i) Bolsa Mexicana de Valores (BMV). The current problems that the BMV faces (e.g., being small, thinly traded, and generally available only to a handful of top-tier industrial conglomerates and not to unknown companies with relatively short performance records), do not offer entrepreneurs and investors a viable exit opportunity for their stock in a Mexican company. Moreover, a healthy securities market generally promotes more mergers and acquisitions between companies, since most are done through the securities market or to position a company for a public offering. The absence of a healthy public market and an aggressive mergers and acquisitions market deters investors from making private equity investments in Mexico because it limits the exits that investors can make. One solution lies not only in amending the Securities Market Law to solve the current problems but in making the BMV more attractive to all issuers and investors ranging from institutional investors to individuals. Among the most important legal measures recently adopted is allowing companies to register their securities in the Securities Section of the National Securities Registry to carry out private offerings with the same standards as public offerings.

(ii) Minority Rights. So long as the General Law of Business Organizations does not provide adequate protection of minority rights, institutional investors will be deterred from participating as minority stockholders in new or ongoing ventures. Recent changes have been introduced to the Securities Market Law to enhance minority protection in public companies (such as the right to appoint a member of the board with 10 percent of the common stock or rights arising from tender offers). Minority stockholders in Mexican private companies, however, do not enjoy such protection.

(iii) Flexible Corporate Investment Structures. The General Law of Business Organizations does not provide or allow a variety of investment structures, including voting agreements, redemption of shares by the private issues, issuance of stock options or warrants, or advance waiver of preemptive rights. These are effective tools to align the interests of investors, founders, and employees and promotes the continuous growth of the private equity industry. Recent changes, however, have been introduced to the Securities Market Law allowing the right for listed compa-
nies to purchase their own shares through the BMV.\textsuperscript{273} Recent regulations to the General Dispositions Applicable to Securities Issuers and other Participants in the Securities Market (\textit{Disposiciones de Carácter General Aplicables a las Emisoras de Valores y a otros Participantes del Mercado de Valores}) establish time periods for notifying authorities about certain types of redemptions and the amount of redemptions that may be done in a certain period of time.\textsuperscript{274}

(iv) Legal Institutions. Weak legal institutions lead to fewer projects being financed because they deter many investors from making investments in the first place and increase transaction costs for those who do make investments. Although the Mexican court system has often been characterized as slow and cumbersome, the following events and/or acts have occurred, which are slowly making legal institutions more reliable and trustworthy: (i) the transition to democracy in 2000 resulted in an empowering of the judicial and legislative power, which reflect a better “checks and balances” of the Mexican republican democratic government; and (ii) certain legal reforms including (a) the total reform of the Supreme Court in 1994 that resulted in a reduction from twenty-one to eleven supreme court justices; and (b) the enactment of the Transparency and Public Access Information Law in 2002.

(v) Institutional Sources for Private Equity Capital. There is a lack of domestic institutional sources for private equity capital in Mexico. Pressure has been growing to reform the current legislation to allow pension funds to diversify their investments, but SIEFORES are not yet allowed by law to acquire instruments that may be converted into private company shares. However, insurance institutions now are allowed to invest part of their reserves in private equity funds, SINCAS, as well as trusts designed to increase investment in domestic companies. Private corporate pension funds are an additional important source of private equity capital in Mexico.

(vi) Governmental Entities as Sources of Private Equity Capital. NAFIN (\textit{Nacional Financiera}), BANCOMEXT, and CONACYT are potential sources or catalysts for private equity financing in Mexico. Of these three entities, NAFIN has played an important role in the private equity market in Mexico, financing fourteen of the twenty-nine SINCAS. NAFIN focuses primarily on established companies with proven markets. NAFIN also has played an important role in promoting the creation of a law specifically regulating risk investment (i.e., private equity) as well as devel-

\textsuperscript{273} See Securities Market Law, supra note 131, art. 41 bis-3.

\textsuperscript{274} See General Dispositions Applicable to Securities Issuers and other Participants in the Securities Market (\textit{Disposiciones de Carácter General Aplicables a las Emisoras de Valores y a otros Participantes del Mercado de Valores}), art. 56.
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developing a risk investment market which enhances the modernization and competitiveness of Mexican companies. BANCOMEXT currently no longer is investing in or promoting private equity investment projects given the minimum success achieved in their prior projects. CONACYT, despite assuring future investments in technology oriented projects, is currently in a "waiting" period.

(vii) Tax reform. The tax reform has been on the agenda of the last two administrations, and most certainly it would serve as a booster for, among others, the private equity industry. In this area, double taxation for investors at both the fund level and the target company and lack of transparency constitutes an additional cost that sometimes delays or inhibits the entrance of investment.

(viii) Business Culture in Mexico. The closed business culture in Mexico must evolve into a more open playground where investors and owners are willing to pursue business opportunities with newcomers outside of their family and close circle of friends. NAFTA has slowly permeated into the top-end business playground, but private equity investors should never forget that Mexicans have different customs and values than their U.S., Canadian, and European counterparts, and recognition of and respect for such differences will allow for better partnership relationships.

Each of the issues outlined in this conclusion should help the Mexican private equity industry mature. During this incubation period, domestic and foreign industry players should take into consideration the benefits of using a U.S. holding company to carry out their private equity investments in Mexico. Finally these players must come to terms with the current state of the private equity rules. These rules will evolve, but their evolution will best result by taking into account the size of the Mexican economy and civil law system and by adopting the investment instruments and features of the U.S. and Canadian common law system, which integrate well into the Mexican system.
Due Diligence Checklist

Mr. X
President
ABC, S.A. de C.V.
123 Reforma
01234 Mexico D.F., Mexico

Re: Proposed Purchase of Series A Preferred Stock from ABC, S.A. de C.V.

Dear X:

In connection with the above-referenced transaction and for purposes of our due diligence review, we request copies of materials concerning the items described below for ABC, S.A. de C.V. and its subsidiaries (collectively, the “company”).

1. Corporate Records and Charter Documents
   a. All minutes of directors’ and stockholders’ meetings, and all written consents of directors and stockholders.
   b. Certificate of Incorporation, including all amendments thereto, Certificates of Designation, etc., and Bylaws.

2. Business Plan and Financial Statements
   a. All written strategic, marketing, or business plans.
   b. Financial statements and footnotes for each fiscal year since inception, including balance sheet, income statement, and statement of cash flows (whether audited or unaudited).
   c. Quarterly financial statements for the last three fiscal years and for the period since the latest fiscal year-end.
   d. Management’s operating budget for the last three years and year-to-date, including variances.
   e. All financial projections.

3. Securities Issuances and Agreements Concerning Securities
   a. A list of the company’s stockholders and option holders.
   b. Copies of agreements relating to outstanding options, warrants, rights (including conversion or preemptive rights), agreements for the purchase or acquisition of any of the company’s securities, and agreements relating to the company’s past stock issuances.
   c. Any documents evidencing registration rights for the company’s securities or evidencing any agreements among the company’s stockholders or between the company and its stockholders.
4. Material Agreements and Operating Information
   a. Any agreements, instruments, or proposed transactions to which the company is a party or by which it is bound which involve obligations of or payments to the company in excess of $5,000.
   b. Contracts with suppliers, distributors, customers, or manufacturers upon which the company's business is or is expected to be dependent.
   c. Any personal property leases.
   d. Any agreements concerning the purchase, lease, or sublease of real property.
   e. Any documents evidencing indebtedness for money borrowed, guaranties, equipment leases, or any similar liabilities incurred by the company.
   f. Any documents evidencing any mortgages, liens, loans, and encumbrances with respect to the company's property or assets.
   g. Any documents evidencing any loans, or advances made by the company.
   h. Any agreements, understandings, or proposed transactions between the company and any of its officers, directors, employees, or affiliates, including without limitation, employment agreements.
   i. A summary of insurance policies, or certificates of insurance, with respect to insurance held by the company or of which the company is a beneficiary.
   j. Any employee benefit plans, including, without limitation, stock option plans, pension plans, and insurance plans.
   k. Any judgment, order, writ, or decree by which the company is bound or to which it or any of its officers or directors is a party.
   l. All documents relating to any acquisitions and divestitures, particularly agreements involving covenants by or in favor of the company.
   m. Import and export licenses.
   n. Marketing and sales literature from the past two years through the present, including brochures, advertisements, and industry reports in which the company's promotional materials appear or in which the company is discussed.
   o. Press clippings and releases for the last two years.
   p. Any agreements with competitors, including, without limitation, non-competition agreements.
   q. Partnership, joint venture, association, research and development, and technical cooperation agreements.

5. Information Regarding Intellectual Property
   a. List of principal products (including products being developed) in each line of business, with short descriptions of the products, their respective prices, and their stage of development.
b. All documents relating to company procedures for identifying, harvesting and protecting inventions, including procedures for determining whether an invention should be patented or remain a trade secret, for identifying patentable or inventions made by employees and consultants of the company, for creating and preserving evidence of conception and diligence, for maintaining inventions confidentially and avoiding public uses and sales prior to filing, for making foreign filing decisions, and ensuring the timeliness of patent filings.

c. Any licenses or agreements of any kind with respect to the company’s or others’ patent, copyright, trade secret, other proprietary rights, proprietary information, or technology.

d. Issued patents and patent applications, and information regarding any foreign patent filings.

e. All prior art searches, conclusions, reports, and opinions, whether internal or external, that the company possesses concerning the infringement of third party patents by its products and the validity of such third party patents.

f. All documents relating to all federal, state, and foreign trademark registrations and pending applications used in or associated with the business.

g. All documents relating to all agreements dealing with trademarks, e.g., consent letters, mutual agreements, licenses, or opposition settlement agreements, whether the company is licensor or licensor.

h. All copyright registration records, including title documents and payment of renewal fees (for older copyrights).

i. All documents relating to any restrictions or limitations on the use of the copyright portfolio or third party ownership rights.

j. All agreements dealing with trade secrets, e.g., license, secrecy, or non-analysis, whether the company is licensor or licensee.

k. All claims and legal or administrative actions involving any of the company’s trade secrets.

l. All agreements with any of the Company’s employees and former employees relating to the use of the company’s proprietary information.

m. All value added reseller (VAR), original equipment manufacturer (OEM), and other reseller agreements.

6. Information Regarding Disputes and Potential Litigation

a. Any correspondence or documents relating to any pending or threatened action, suit, proceeding, or investigation, including, without limitation, those involving the company’s employees in connection with their prior or present employment or use of technology.
b. Any correspondence or documents relating to allegations of the company's infringement of the proprietary rights of others.

c. Any correspondence or documents relating to any labor agreements or actions, union representation, strike, or other labor dispute.

d. Correspondence, memoranda, or notes concerning inquiries from federal, state or other government tax, environmental, occupational safety and hazard, or other officials.

7. Audit Information

a. Management letters from auditors concerning internal accounting controls in connection with all audits since the company's inception (including predecessor companies).

b. All letters that have been sent to the company in connection with all audits since the company's inception (including predecessor companies).
Comment and Case Notes