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Mexico: Private Equity

Private Equity Investments in a Mexican “SAPI”: Implications for Shareholder Agreements and Exit Strategies

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The enactment in late 2005 of a new Securities Market Law (*Ley del Mercado de Valores* or “LMV”) in Mexico promises to be an impetus to a greater volume of private equity investments in Mexican companies. The LMV was explicitly designed to reduce or eliminate a number of legal impediments to, among other things: (i) the issuance of preferred stock and warrants, (ii) the grant of registration rights, (iii) the establishment of first refusal, “tag along”, “drag along” and related rights and obligations as to the transfer of shares, (iv) the issuance of stock options and other stock-related incentive compensation, and (v) limiting the liability of directors and providing for indemnification and directors’ liability insurance.

The LMV also authorized the creation of new types of companies, including the [Private] Investment Promotion Company or *sociedad anónima promotora de inversión* (“SAPI”), the Public Investment Promotion Company (the *sociedad anónima promotora de inversión bursátil* or “SAPIB”) and the Public Company (the *sociedad anónima bursátil* or “SAB”). By introducing the possibility of a SAPI transitioning into a SAPIB and then a SAB, the LMV creates an important new process by which a private company can prepare itself for a public offering of shares and thereby enable its investors to carry out an exit strategy.

This article will briefly explore two key issues which must be addressed in the structuring of a SAPI in order to enhance its attractiveness to private equity investors: (i) how to structure the interplay between shareholder agreements and the SAPI’s by-laws (estatutos); and (ii) how to structure the steps to be taken to allow investors to implement their exit strategy.

Shareholders’ Agreements

The principal Mexican corporate law, the General Law of Business Organizations or *Ley General de Sociedades Mercantiles* (the “LGSM”), has traditionally made it difficult for shareholders to enter into binding agreements as to the voting of their shares in favor of particular actions. Article 198 of the LGSM provides that: “Any agreement that restricts the voting freedom of shareholders is void.” This is construed to mean that any shareholders’ agreement that obligates one or more shareholders to take any action that could be the subject of a vote in a shareholders’ meeting is not enforceable. Making the agreement subject to foreign law or to arbitration may not provide sufficient comfort for many investors; and making the relevant shares subject to a stock pledge, guaranty trust or voting trust to achieve the purpose can be a cumbersome, and not entirely satisfactory, approach to the problem, since introducing collateral security devices into the process may not be appropriate for what is essentially an equity (not debt) financing issue. In recognition of the importance of the issue to many investors, Article 16(VI)(d) of the LMV provides that the shareholders of a SAPI may enter into “agreements regarding the exercise of their right to vote in shareholders’ meetings, without being subject to Article 198 of the General Law of Business Organizations”. Thus agreements by shareholders of a SAPI on matters that would otherwise be subject to Article 198 should no longer run the risk of being invalidated by such provision.

Now that such agreements by SAPI shareholders, whether they contain noncompete provisions (for up to three years), share transfer restrictions, “tag along” or

“drag along” provisions, registration rights, or other types of provisions common in such agreements, are unlikely to be invalidated, the issue arises as to whether such agreements should be separate from the SAPI’s by-laws or should be included within such by-laws. Some of the arguments in favor of a separate agreement or agreements are the following:

- (i) Unlike the by-laws, a separate agreement may be governed by foreign law (for example, New York law) and need not be in Spanish, which foreign shareholders may prefer. Since such agreements are often prepared in English by foreign counsel to one or more of the company’s [foreign] shareholders, this may reduce the need to translate the agreement into Spanish and ensure that it is valid under Mexican law and appropriately included within the by-laws. This may be an important advantage if time constraints limit the ability to obtain a reliable translation or to have Mexican counsel thoroughly review and approve the provisions of the agreement.
- (ii) Amendment of the agreement will be governed by the provisions on amendment which the parties wish to include in the agreement, rather than be governed by the provisions on amendment that are contained in the by-laws (which will be subject in part to the LGSM). Among other things, an amendment of the by-laws will (unless approved by the unanimous written consent of all of the shareholders) require the holding of an extraordinary shareholders’ meeting, which will be subject to the quorum and voting requirements set forth in the LGSM and/or in the by-laws. If unanimous attendance at such a meeting cannot be assured, then the call for the meeting must be published and the other timing requirements of Article 186 of the LGSM must be observed. In order for an individual shareholder to be entitled to call such a meeting, such shareholder must own at least 33-1/3% of the outstanding shares of the company (unless a lesser percentage is established in the by-laws).
- (iii) A private shareholders’ agreement is not required to be recorded in the Public Registry of Commerce applicable to the company, and shareholders that wish to avoid disclosure to the public of its provisions can do so by not including the agreement in the by-laws.

However, there are arguments in favor of including such agreements within the by-laws:

- (a) One advantage of including the agreement in the by-laws is to make it more likely that its provisions will be made consistent with the by-laws and enforceable under Mexican law.
- (b) It may be argued that since the by-laws, which have to be formalized by a notary public or public broker (corredor público) and recorded in the Public Registry of Commerce applicable to the company, are more public

than a private shareholders’ agreement, they will appear to have more legitimacy to third parties than would a private agreement. If the SAPI investors wish to attract additional investors, either privately or eventually through a public offering, it may be argued that additional investors will find the company more attractive if it is not subject to private agreements, even during the period prior to the offering.

(c) Many of the provisions that foreign investors may be accustomed to seeing in a separate shareholders’ agreement are capable of being included in the by-laws. For example, most disputes related to the by-laws can be made subject to arbitration rather than litigation in the Mexican courts, to virtually the same extent as the provisions of a separate shareholders’ agreement can be. The same applies even to complex tag-along and drag-along provisions and most other provisions that foreign investors would normally expect to see in a separate agreement. Of course, the lengthier such provisions are, the more time will be required to ensure an accurate translation and competent Mexican legal review.

To the extent that foreign shareholders are involved, whether or not the shareholders’ agreement is incorporated into the by-laws, it may be desirable for a bilingual text of the by-laws to be prepared, to provide easy reference for the foreign shareholders as well as for the Mexican ones.

Given the extent to which the decision as to whether or not to have a separate shareholders’ agreement will affect the process of drafting and negotiation of the documentation for investment in the SAPI, the investors should probably make such decision at an early stage in the process. Otherwise time may be wasted in drafting documents which later turn out to be largely discarded.

Designing a SAPI Exit Strategy

An investor’s options for exiting from a SAPI are essentially of two types, transferring to a private buyer or participating in a public offering. One’s fellow investors may wish to establish strict limitations on the ability to transfer to a private buyer, because they may be concerned about the entry of new investors who do not necessarily share the goals of the original investors. However, once the decision is made to take the company public, such concerns must give way to the goal of creating a larger and more liquid market for the company’s shares.

Private Transfers, Outside of a Public Offering Scenario

Prior to a public offering, each investor’s ability to transfer its shares to third parties may be subject to (i) contractual requirements, which may or may not be included in the by-laws, that it obtain the consent of all or a specified percentage of the other investors before transfer-

ring shares to any buyer, and/or (ii) provisions of the company's by-laws that give preferential purchase rights to the other shareholders based on their respective percentages of the company's shares (although not required by law, the investors may wish to establish such requirements in the by-laws in order to reinforce their control over the disposition of shares by any investor). Under Article 13(I) of the LMV, transfer restrictions "of any nature" may be imposed on the transfer of shares, and such restrictions may be other than those specified in Article 130 of the LGSM (which provides that the by-laws may require Board approval for transfers of shares). Under Article 13(III) of the LMV, it is substantially easier to provide for special or preferred classes of stock, which can be structured as special vehicles for an exit from a SAPI that could have transfer rights different from those that apply to the holders of common shares.

Assuming that a shareholder is able to obtain the consent of the other shareholders to its proposed sale, it may be subject to the additional constraint of "tag along" requirements, in the by-laws or in a separate shareholders' agreement, which entitle the other shareholders to have their own shares included in the proposed sale. If the proposed buyer of shares is prepared to increase the scope of its purchase to include the shares of the "tagging" shareholders, the tag-along provisions may not thwart the sale proposed by the shareholder initiating the exit. On the other hand, if the proposed purchaser is interested in only purchasing the shares initially proposed to be sold, the tag-along provisions will have the effect of curtailing its exit, since such provisions would normally have the effect of allocating the shares of the initiating shareholder and the tagging shareholders to the shares included in the proposed sale, and the initiating shareholder would not be able to thereby make a complete exit.

"Drag along" provisions (which might also appear in the by-laws or in a separate agreement) would normally work to the benefit of the initiating shareholder, and not be a constraint on its exit, since they would usually enable it to expand the scope of the proposed sale to include the shares of the other shareholders as well as those of the initiating shareholder. Both tag-along and drag-along provisions are contemplated by the LMV as being permissible for SAPIs.

Another approach by an investor wishing to have the ability to exit the SAPI prior to it making a public offering of its shares is to limit the "lockup" period, during which its sale of shares would be subject to the consent of the other shareholders or to other restrictions such as mandatory tag along provisions, to as short a period as possible. Such investor may also wish to have the right to initiate the public offering process. The other investors may be willing to accept such a loosening of their control over any individual investor's exit from the SAPI, but even if they share the goal of eventually taking the SAPI public they may have

concerns that the timing be subject to a decision by all or a specified percentage of the shareholders.

Preparing the SAPI for a Public Offering.

The above issues related to the structuring of the rights of investors to exit the company prior to a public offering are comparable to issues faced by private equity investors in other countries and under other legal systems. What makes the SAPI somewhat unusual is the set of requirements for making it a "pre-public" company, and the stages through which it must pass before becoming public.

The requirements for structuring the SAPI seem to be based on the notion that its shareholders must become accustomed to the kinds of requirements that will be applicable to public companies by including them, in whole or in part, in the SAPI's by-laws when it is formed, or is transformed into a SAPI after being originally formed as an ordinary *sociedad anónima* under the LGSM. Most such requirements relate to corporate governance of the SAPI.

For example, under Article 15 of the LMV the by-laws of the SAPI can provide that its management and surveillance functions are structured in accordance with the regime applicable to Public Companies (SABs) except that the SAB requirements for independent directors are not mandatory. Thus instead of providing for a *comisario* or "statutory examiner", as mandated under the LGSM, to be the shareholders' agent of surveillance of the company's financial condition, the SAPI which adopts the SAB regime would have to establish an Audit Committee to perform this function and would be required to hire an independent public accountant to assist in the audit process.

A SAPI must have a Board of Directors and Director General (CEO) and cannot rely on a "Sole Administrator" reporting directly to the shareholders (the alternative organ for company management permitted by the LGSM). Article 28 of the LMV specifies certain functions of the Board which cannot be delegated to the SAPI's officers; such non-delegable functions include (i) establishing general policies and strategies for the company, (ii) overseeing the performance of the company and its subsidiaries, and (iii) approving transactions between the company and its subsidiaries with "related persons" (basically company insiders and shareholders). Article 44 of the LMV has a rather detailed list of the functions that the Director General must perform, which includes reporting to the Board of Directors on his management of the company. The SAPI must also establish a Corporate Practices Committee to ensure that the company follows certain "best practices" established in the LMV; such committee is required to consult with independent experts on certain issues of corporate governance.

Although Article 15 of the LMV allows the SAPI choosing to adopt the SAB regime to disregard the requirements as to independent directors which are applicable to SABs,

the SAPI is free to observe such requirements if it wishes to do so. Article 24 of the LMV requires that at least 25% of the members of the Board of Directors, which may have no more than 21 members, must be independent. This requirement is relatively easy for a SAPI to comply with, but other such requirements are more difficult to follow, for example, the requirement under Article 25 that all of the members of the Audit Committee and Corporate Practices Committee be independent.

A SAPI may also have Board members representing minority shareholders to a greater extent than is provided under Article 144 of the LGSM, which requires only that a "minority" consisting of a shareholder or group of shareholders holding at least 25% of the company's shares has the right to elect at least one member of the Board. Under Article 16(I) of the LMV, the by-laws of a SAPI must provide that each shareholder or group of shareholders representing at least 10% of the voting shares of the company is entitled to elect and replace at least one member of the Board. Of course, the voting power of such member on the Board will depend on the total number of Board members; but the by-laws of the company can provide for weighted voting based on a formula related to the relative number of shares held by the respective shareholders or group of shareholders that has elected the particular Board member.

One issue not expressly contemplated by the LMV is that of the role of an Executive Committee of the Board of Directors. The LMV contemplates that the Director General would report directly to the Board and not to an intermediate body such as an Executive Committee. The LMV does not prohibit the use of an Executive Committee, but in drafting the by-laws of a SAPI it is important to carefully specify the functions of the Executive Committee, taking into account the fact that there are certain functions which under Article 28 of the LMV cannot be delegated by the Board to any other body or to any officer.

Transition of the SAPI to a Public Company

Article 19 of the LMV lays out the process whereby a SAPI can begin the process of becoming a Public Company or SAB. This process entails the shareholders adopting the interim status of a SAPIB, establishing the process whereby the remaining SAB requirements would be adopted over a period not exceeding three years and providing for the elimination during such period of any share transfer restrictions or other provisions of a typical shareholders' agreement that would be permitted for a SAPI under parts I-III of Article 13 of the LMV. Once the SAPI shareholders have taken these actions, they may seek to register the

shares of the SAPIB in the National Registry of Securities and, even before the making of a public offering, list the shares or an instrument convertible into such shares on a stock exchange. However, until the public offering is made, such securities may only be sold to institutional and qualified investors (as defined in the LMV). The purpose of the interim SAPIB phase is to increase the marketability of the company's shares before it takes the ultimate step of transforming itself into a SAB and making a public offering of its shares. As in other countries, the effectiveness of an exit strategy focused on taking the company public will depend greatly on the size or depth of the relevant securities market. The Mexican securities market has expanded rapidly in the last few years, impelled largely by the rapid growth of pension funds, which has in turn been caused by statutory changes which encourage pension fund contributions by employees under the SAR (*Sistema de Ahorro para el Retiro*) regime. However, much of the growth in pension fund investments has been in government debt obligations rather than in shares of privately-held companies. The efficacy of a public-offering focused exit strategy for SAPIs may depend on future statutory or regulatory changes which would allow pension funds to invest in shares of SABs.

Conclusion

The foregoing should give a general idea of some of the implications of the SAPI regime for private equity investors interested in investing in Mexican companies, particularly with respect to the issues of shareholders' agreements and exit strategies. As noted above, one of the key issues with respect to shareholders' agreements is that of whether such agreements should be incorporated, in whole or in part, into the by-laws of the SAPI. With respect to exit strategies, investors must determine to what extent their exit can be effected through the SAPI-SAPIB-SAB steps toward a public offering of shares and, ultimately, whether the Mexican securities market will serve to be an effective market for such shares. In any event, it is clear that the changes embodied in the LMV represent significant steps in the direction of improving the environment for private equity investments in Mexico.

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