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Panel Discussion: A Hypothetical Problem on Securities Law

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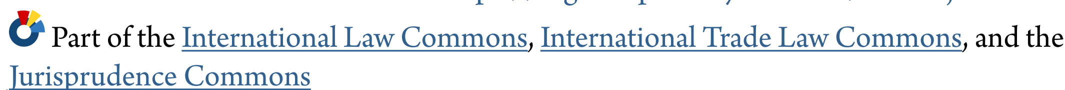

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PANEL DISCUSSION: A HYPOTHETICAL PROBLEM ON SECURITIES LAW

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PANEL MEMBERS: ROBERT L. KIMBALL,**
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THE HYPOTHETICAL PROBLEM

Conflicts Within a Mexican Corporation with Mexican and United States Shareholders About Decisions of the Directors and the Ability of the Shareholders to Initiate and Challenge Actions of Officers and Directors[1]

DRILL-BIT, INC., a Delaware corporation with its principal place of business in Texas, is one of the leading United States companies which manufactures drilling bits for oil and mineral exploration. For some years it sold drilling bits to the Mexican petroleum company, PEMEX. Subsequently it transferred technology to a Mexican company, *Productos Petróleos de México, S.A.* The relationship worked successfully. But a few years ago DRILL-BIT and *Petróleos* decided to establish a voluntary joint equity venture. They formed a Mexican corporation, a S.A. de C.V. It was named PETRO-BITS, S.A. de C.V. DRILL-BIT owns 20% of the shares, *Petróleos* owns 20% and the remaining 60% are owned by the public and traded on the Mexican stock exchange. Formation of PETRO-BITS is governed by the *estatutos sociales*, the Mexican equivalent of the articles of incorporation and bylaws of the company.

PETRO-BITS has three divisions. The first is a small specialty steel mill which makes high quality specialty steel for many uses. About 20% of its production is used by the production division and the other 80% is sold to other manufacturing companies in Mexico. The second division manufactures the drilling bits. The third division is devoted to marketing and distribution.

There are eleven members on the board of directors. Because DRILL-BIT and *Petróleos* are routinely given proxy votes by the publicly-traded shareowners, they have been able to control the board. The board consists of the following:

Roger Smith: Vice-President of DRILL-BIT
Héctor Gómez: Vice-President of *Petróleos*

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** Member of the firm of Vinson & Elkins, Dallas.
*** Member of the firm of Davis, Polk & Wardwell, New York City.
**** Of Counsel, Jauregui, Navarrete, Nader y Rojas, S.C., México, D.F.

1. This problem was prepared by Ignacio Gómez-Palacio and Michael W. Gordon.

Ralph Rogers: President of PETRO-BITS and head of various DRILL-BIT subsidiaries worldwide. He is the only employee from the United States.
Alejandro Rojas: Executive V.P of PETRO-BITS and formerly the vice-president of *Petróleos.*

There are four additional directors: two directors from the United States, Dolores Street and Franklin O. Grace, who both come from the U.S. DRILL-BIT corporation; and two Mexicans from *Petróleos*, Ignacio Esposito and Gloria McCarthy.

The remaining directors are from Mexico and outsiders to PETRO-BITS. They include Jorge Cárdenas, a banker; Juana King, a practicing lawyer and alternate director; and Miguel Romero, an alternate director with long experience in the industry.

For the first two years the company functioned smoothly with little questioning from the public shareholders. But in the past two years, several conflicts have developed:

1. The PETRO-BITS board of directors voted favorably on several issues. The first issue was to have drilling bits shipped to Guatemala for final polishing. This would mean releasing twenty workers at the Mexican plant. The second issue was to sell the specialty steel division. That division represented 10% of the company's assets, 18% of its sales, and 25% of the total company profits. The third board decision was to change the company's accounting firm, and to remove and replace the current stockholders' auditors (*comisarios*).

Shareholders have complained about these decisions. They believe that they ought to vote on each of the three issues. They further believe that the specialty steel division, if it is to be sold, ought to be sold to a different buyer. They have consequently asked the president and the board of directors to call an extraordinary shareholders' meeting to discuss the three issues.

Shareholders are also upset with Alejandro Rojas, an Executive Vice-President and board member, and wish to have him removed both from the board and from his officer position. The shareholders have suggested that his board position be filled with their own nominee, María López.

2. When the board voted to sell the specialty steel division, it conducted a thirty minute meeting. The sale had been the idea of the president, Ralph Rogers. Rogers had been concerned that the company ought to concentrate on the manufacturing and selling of petroleum industry products, and leave the steel business to other companies. Without consulting the board or any officers, Rogers met with José Pritzker, the owner of a Mexican steel company whom Rogers knew socially.

Rogers had previously asked the PETRO-BITS' accountants to prepare an evaluation of the specialty steel division based on adjusted book value. The value was set at 200 million pesos. One accountant, however, noted that the division accounted for considerable profits and the better method to calculate the value might be to capitalize earnings. Pritzker offered to pay the 200 million pesos. Rogers' proposal to sell the division to the board was based on that amount. The board was called to meet in

a special meeting and approved the sale. The meeting was held immediately before the company's annual dinner, which had been scheduled months before, and the members were anxious to complete the board work and get to the dinner.

The shareholders believe that the sale not only should have been shareholder-approved, but that the directors acted improperly. The board did hold a meeting later to address the completed sale in considerable detail and affirmed their earlier decision. Several board members are concerned with being sued individually and propose that the board adopt a resolution to indemnify the directors for any expenses or judgments resulting from their actions, and to obtain insurance for future conflicts.

3. Both Ralph Rogers and Alejandro Rojas have personally acquired some shares of the company over the past year. In response to their inquiries the shareholders learned that Rogers and Rojas would contact individual shareholders and offer to buy their shares. Due to their positions in the company, Rogers and Rojas knew information about the company unknown to the other shareholders, and the offers to buy were based on this inside information. The shareholders believe that Rogers and Rojas have acted improperly in acquiring this additional stock.

4. In considering a suit against PETRO-BITS, the shareholders are concerned that PETRO-BITS does not have a "deep pocket," but that both the parent companies, *Petróleos* and DRILL-BIT, do have "deep pockets." The shareholders would thus like to bring suit against all three companies as well as the individual directors and officers.

The above hypothetical is intended to allow a discussion of some of the relationships between shareholders and directors under Mexican law. Some of the issues to be considered include:

1. What is the legal source of shareholders' rights and directors' responsibilities?
2. When must shareholders be allowed to participate in company decisions?
3. When may shareholders participate in company decisions?
4. Do shareholders have a right to call or demand a shareholders meeting?
5. Do shareholders have a right to remove directors and *comisarios*?
6. Do shareholders have a right to fill director vacancies?
7. Do shareholders have any legal authority in the hiring, or firing of corporate officers?
8. What is the standard for directors' conduct?
9. Do shareholders have a right to challenge the fulfillment of the standard for directors' conduct?
10. Is there an analog to a derivative suit in Mexico?
11. What defenses are available to directors and officers when challenged by shareholders for breach of obligations?
12. May the directors have their actions reviewed by a special committee of directors or outsiders and use a favorable committee conclusion as a basis for ending litigation?

13. May the directors or officers demand indemnification for expenses of litigation if they win or lose?
14. May the corporation insure directors and officers for breach of their obligations?
15. Is there any method to challenge officers and directors who use inside information to trade shares at an advantageous price?
16. Can a Mexican court pierce the corporate veil to reach a parent company, and would the parent's control be sufficient if it had 51% ownership?
17. In the formation of PETRO-BITS, could the parties have included some form of alternate dispute resolution, such as arbitration for any of the aforementioned issues?

THE DISCUSSION

Michael Gordon: This hypothetical involves the Mexican Company Law,[2] which dates from the 1930s. Although NAFTA has no impact on the Mexican Company Law, in the future increased trade may cause Mexico to revise its company law, which may cause United States businesses to look at Mexico's fifty different company laws as a potential trade barrier. We will begin this discussion by asking our Mexican colleagues, "What is wrong with these statutes?"

Ignacio Gómez-Palacio: Whenever structuring a Mexican company, the granting of powers of attorney must be done very carefully. The company laws provide for short, general authorizations, but are not adequate by themselves. When establishing a Mexican company, one must understand the specific powers of attorney for the board of directors, the chairman, the general director, and so forth.

These *estatutos sociales* are neither bylaws nor articles of incorporation. Using the word "bylaws" may mislead a U.S. attorney. The *estatutos sociales* is a document that encompasses both the articles of incorporation and the bylaws, but is different from both. The *estatutos sociales* separate the permanent from the transitory regulations of a company. The permanent regulations include the name, the duration and the purpose of the company, and how the stockholders' meetings are to operate. The transitory articles deal with the first stockholders' meeting which takes place at the time of incorporation and also includes organizational items so the company can operate. The transitory articles also provide for the initial stockholders, and the payments and the number of shares for each subscriber. The stockholders' resolutions cover appointment of a board of directors, an examiner and also cover the approval of general powers of attorney. These transitory articles can be amended either by a decision of the stockholders' meeting or by a decision of the board of directors,

2. *Ley de Compañía [Company Law]*, DIARIO OFICIAL DE LA FEDERACIÓN (July 28, 1934, Aug. 4, 1934, Aug. 28, 1934; as amended Dec. 31, 1942, Feb. 2, 1943, Dec. 26, 1956, Dec. 31, 1956, Jan. 23, 1981) (Mex.).

as sometimes directed by the *estatutos sociales*. In the hypothetical case, the shareholders appointed a board of directors and an examiner.

The hypothetical problem refers to a president who was not appointed. In other words, the appointment of a board of directors and officers of the company is provided for, but there is no provision for appointment of officers. The *estatutos* should have stated that Ralph Rogers is appointed president of the company, although the more common term is "General Director."

Next, the general power of attorney of PETRO-BITS is granted to Rogers and Rojas. A Mexican attorney will also provide a general power of attorney for lawsuits and collections. Next, one would also normally see an accompanying power of attorney for administrative acts, which is a power for representing the company before administrative authorities on specific matters. Finally, there should also be a power of attorney to represent the company before customs.

A Mexican attorney reviewing these hypothetical *estatutos sociales* would next ask, "Now, who is going to represent the company?" Powers of attorney for such matters are crucial and very specific, and express powers should be mentioned for administrative acts, acts of dominion, negotiable instruments, labor matters and the sale of goods to the government. Because PETRO-BITS is going to be selling assets to the government, it would be desirable to have a particular power to that effect. There should also be authority to open bank accounts, to appoint people to sign on the accounts, and the specific power to draw against these bank accounts. These powers should be delegated to the president and perhaps to subordinate managers who carry out the powers in a joint venture. However, the Tenth Article of the *estatutos sociales* delegates authority to the "Sole Administrator or the Board of Directors." The problem with these *estatutos sociales* is that the named person authorized to sign negotiable instruments, bank accounts, labor documents, government procurement documents, and other documents is not specifically provided for.

The board of directors in the hypothetical has eleven members. Three members are representatives of *Productos Petróleos*, five represent DRILL-BIT, and three are outsiders. Article 10 mentions that the chairman of the board of directors has powers for lawsuits and collections and administrative acts. Because Article 10 does grant the authorization to substitute to the board of directors, the board of directors may take action pursuant to its power of attorney. The board would be able to meet immediately and exercise these powers of attorney through delegates.

Robert Kimball: In Delaware, the practice is that a board of directors has all authority over the corporation other than the rights that stockholders have retained under the law or under the charter. Are you saying that under Mexican law the general assembly of stockholders has the full power of the corporation other than powers specifically granted to the board of directors or other administrators?

Gómez-Palacio: Mexican corporations rely more on the stockholders' meeting as the main body of the corporation and the source of the

granting of powers, rather than relying on the board of directors. However, the board of directors can be granted any and all powers. In addition, the *estatutos sociales* may provide for a sole administrator who can act instead of a board, with all the powers of a corporation. *Estatutos sociales* vary depending on the will of the parties. But, generally speaking, in joint ventures the board of directors would not have all of the powers of attorney. Powers would be reserved to the stockholders, which exercise these powers in their meetings. This would be especially true if the board of directors of a joint venture did not have strong veto power designed to protect minority rights. The board of directors, generally speaking, would not be authorized to take acts of dominion so that they could freely dispose of all corporate assets without express authority of the shareholders.

Gordon: In a U.S. corporation, power seems to have shifted not just to the board of directors but to the inside directors. In many cases, the inside officers of the corporation become entrenched. Are you suggesting that there is no similar centralization of power through a proxy system in a Mexican corporation which has broad-based shareholdings?

Gómez-Palacio: To speak generally about Mexican corporations, one would be talking about family corporations, controlled by families and small groups. Mexicans do not have control by officers of the corporation because Mexican corporations do not attain the enormous size of United States corporations. In these very large corporations, there is such a dilution of the power of individual shares that you diminish the stockholders' control. Lately, there is also concern about the use of proxies.

Abdon Hernández: The facts concerning the *estatutos sociales* state that the company is publicly-held. At the time of incorporation, Mexican law requires identification of the shareholders by name, nationality and domicile. Even though the Business Companies Act provides for publicly subscribed shares at the time of incorporation, such a procedure is extremely unusual. Usually, in order to go public, the company is first incorporated. The management subsequently registers the shares for public offering with the *Comisión Nacional de Valores* (CNV).[3] This may be a secondary offering in which the initial shareholders sell their shares or a primary offering resulting from a capital increase.

To protect minority rights, I would recommend the creation of a series of shares so that the series A, or Mexican shares, would appoint a certain number of directors and the series B, or foreign shareholders, would do likewise. In the hypothetical case, a majority of shareholders is authorized to appoint the majority of the directors. Thus, DRILL-BIT might be left without a director if *Productos Petróleos* shareholders and the public shareholders were to combine their votes. Because they would have a majority, the U.S. investor could be outvoted and left without representation.

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3. The *Comisión Nacional de Valores* is the Mexican equivalent of the U.S. Securities and Exchange Commission.

With regard to the general powers of attorney, the document requires that the powers be exercised jointly. Rogers and Rojas would have to exercise the powers of attorney jointly, which is cumbersome.

Gordon: Should the *estatutos* provide for exercising the powers separately?

Hernández: Yes. I would also recommend that the *estatutos* provide for especially high voting requirements for key corporate acts such as major capital investments, divestitures, approval of budgets, and other matters of that nature.

Gordon: Are requirements in the *estatutos* for super-majorities permissible under Mexican law?

Hernández: They are definitely permissible.

Gordon: Is that in the Company Law?

Hernández: No. Even when Mexico had more restrictive regulations supervised by the *Comisión de Inversiones Extranjeros* (Foreign Investment Commission), special voting requirements were allowed. This is permissible so long as the special voting requirements are limited to certain key decisions like appointment of the general manager, director or president, approval of capital investment, budgets, approval of acquisition or sale of fixed assets in excess of a stated percentage of net worth.

Gómez-Palacio: Note that approval is required at two levels, by both the board of directors and the stockholders.

Hernández: Some *estatutos* provide high voting requirements for approval at ordinary shareholders' meetings. The Company Law provides that whenever a high voting requirement is provided in the bylaws, there has to be an extraordinary shareholders' meeting.[4] Another recommendation is that publicly-held shares have limited voting rights, as they are really investor shares and do not require general voting rights for their protection.

Miguel Jauregui: The hypothetical states that increases and reductions of capital stock shall be resolved at a general extraordinary shareholders' assembly. I do not find any provision to eliminate such a requirement for the variable capital. Variable capital in Mexico gives one the ability to increase or reduce capital either by an ordinary general shareholders' meeting resolution, if you are a purist in regard to reductions of capital, or by the board of directors. Because of creditor and third parties rights, there is a debate in the Mexican bar about whether variable capital can be reduced by a resolution of the board without shareholder authority. I hold the position that the board can reduce the capital. Certainly, there is no debate that the board can increase variable capital; however, requiring an extraordinary general shareholders' meeting makes it very expensive. The proceeding will have to be notarized every time and the resolution of the general extraordinary shareholders' meeting recorded in the public record. The charges for recording are a percentage of the amount of capital; thus it is going to be very expensive.

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4. *Company Law*, *supra* note 2, art. 182.

Gómez-Palacio: I agree. In our hypothetical case, we have two 20% shareholders. Many times, matters are sent to an extraordinary stockholders' meeting to protect minority shareholders.

Jauregui: It was suggested that the rights of minority shareholders be protected by requiring a special majority vote or special quorum for special matters at the board of directors meeting. In that case, I would add increases and decreases of variable capital and require a special quorum. Then, if no decision is made in three board sessions, the matter shall be referred to the extraordinary general meeting of shareholders. If no decision can be made at the extraordinary shareholders' meeting, dissolution or a purchase or sale of the shares of the party that did not vote to increase or decrease may be triggered.

Gordon: Is there any body of law in the corporate area about whether or not directors are permitted to increase the variable capital?

Hernández: Article 216 of the Mexican Company Law states, "[t]he articles of incorporation of any company or partnership with variable capital must specify the conditions which govern increases or decreases of capital . . . ."[5] So, normally, it involves two steps. First, one must distinguish between talking about a publicly-traded company and a private, closely-held company. If the company is publicly-traded, such as in the hypothetical, it cannot have unlimited variable capital. Circular 1114 of the National Securities Commission provides that variable capital companies have an upper limit on variable capital of ten times the minimum capital. Within that limit, treasury stock can be created for all of the authorized variable capital. If there is already authorized capital and issued treasury stock, the *estatutos* can provide that the board of directors can offer them for subscription and payment provided the right of first refusal, the preemptive right of existing shareholders, is duly honored. If the company is privately-held, there is unlimited capital, but at any given point in time, one must specify an authorized capital. The practice is to authorize the capital and issue treasury stock. The board then puts it in circulation by offering it for subscription and payment.

Jauregui: In the hypothetical, there is management and administrative authority, but I do not see any authorization for acts of ownership except to acquire and convey real properties. My concern is borrowing money. For example, if acts of ownership are not authorized, most Mexican banks will not lend to a company. In that case, one must revert back to a meeting of shareholders, which might be a serious inconvenience and expense.

Gordon: It seems that one of the most important things in forming a Mexican corporation is to get the general powers straight in the *estatutos* because there is no similar general authorization of powers in the Company Law.

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5. *Id.* art. 216.

Jauregui: That is correct. In a court setting, adversaries will point to a *falta de personalidad*; that is, a lack of authority to represent the company.

Robert Rendell: To repeat Mr. Kimball's question, do all powers have to be specified under Mexican Company Law? Do the officers and directors, or the officers and the board, likely have some residual powers by virtue of the statute that need not be specified?

Jauregui: The law provides that the supreme authority is in the shareholders and that they have all the powers by definition of law. A power need not be specified. The board's powers, however, must be specified to determine the kind of authority that the board can delegate to officers or third parties.

However, I have not seen the fairly new provisions of the Mexican Company Law that allow board of directors' meetings without the personal presence of the directors. The Company Law now permits meetings by exchange of correspondence in writing or by confirmation in writing with the consensus of the directors.

Gómez-Palacio: Article 146 of the Mexican Company Law says, "[t]he managers shall have the powers expressly vested in them; they shall not require special authorization of the . . . board of directors to act in their capacity, and they shall enjoy, within the scope of their responsibilities, the fullest power of representation and of action."[6] Article 146 has never been legally interpreted; thus no one knows what it means. The first part of Article 146 states that "[t]he managers shall have the powers expressly vested in them,"[7] is deemed to be the law.

Bill Kryzda: U.S. attorneys often worry about guarantee clauses, i.e., whether one company can guarantee liabilities of its affiliates or any other third parties, such as a loan to an officer, shareholder or other person. U.S. attorneys generally believe that a prohibition on such liability in the objects clause should be explicitly stated. Thus, if it is not in the *estatutos sociales*, how does one handle the problem of guarantee clauses when it arises?

Hernández: Lenders or banks require that the corporate purposes provision of the bylaws, or the *estatutos*, specifically include the authority to guarantee subsidiary loans. What is normally done is to implement language "to guarantee loans or other credit arrangements with subsidiaries or affiliates with whom the company has business relationships."

Gómez-Palacio: In many instances, a power of attorney is implemented. A Mexican attorney for a bank which is going to authcrize a loan or other action, however, is going to be extremely conservative and would like the action to be clearly authorized. For example, in the hypothetical,

6. *Id.* art. 146.
7. *Id.*

one would ask, "Would this be connected with the company's purpose to manufacture and distribute drills?" Thus, if the company guarantees the acts of a subsidiary which sells toys, for example, it is not connected with the corporate purpose.

Kryzda: Clause XII permits including many matters requiring special shareholder action to protect the foreign investor. How does one justify the requirement for special votes, frequently called the veto powers?

Gómez-Palacio: It should be noted that under Mexican Company Law, there is a large distinction between the ordinary and the extraordinary stockholders' meetings. Ordinary meetings are those that ordinarily take place, usually at the annual stockholders' meeting. Dealing with something of an extraordinary nature, such as an increase of corporate capital or an amendment to the *estatutos*, requires an extraordinary meeting. The former laws and regulations limiting foreign investors to a 49% interest, however, is no longer the law. Nonetheless, joint ventures will still be formed and minority interests may be protected through this vehicle.

Kryzda: Article 181 defines the ordinary stockholders' meeting and Article 182 defines the extraordinary stockholders' meeting.[8] Normally, Mexican counsel provides for a special vote in the extraordinary meeting, but not in the ordinary meeting. This brings up a closely related topic: a number of Mexican lawyers suggest requiring a unanimous vote on all matters in ordinary meetings so that there would be no need for special powers to deal with special matters. The theory is that by requiring a unanimous vote on every matter at the board of directors and shareholders' meetings, the minority will be protected. It is not clear to me whether that is valid under the Mexican Company Law. My personal opinion is that this is contrary to the majority principle as expressed in the law and, therefore, invalid.

That brings me to the second variation of the problem: whether one can limit the ordinary stockholders' meetings to only those matters that are listed in Article 181 and provide that everything else is the subject of extraordinary meetings under Article 182, requiring a special vote. This approach is more sustainable than one where everything would require a unanimous vote.

Kimball: Could you further elaborate on the distinction between the ordinary and extraordinary meeting? The vote or quorum required does not necessarily differ between an annual and a special meeting for a Delaware corporation. It is my understanding, however, that this does make a difference in Mexico and that is why this is an important distinction.

Kryzda: Under Mexican Company Law, there are three types of meetings: ordinary, special and extraordinary meetings. The special meetings usually are those for the same class of shares to determine how they want to vote within their group. If you have class A and B shares, the

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8. *Id.* arts. 181-182.

A shareholders could have a special meeting and the B shareholders could have a special meeting. Ordinary meetings (sometimes called general meetings) are those that are required by law, such as the annual meeting. Shareholders are entitled to one vote for every 100 pesos of capital represented by their shares.[9] There is no special quorum required; a majority of the capital outstanding is a quorum. The majority of those present vote and are sufficient to approve corporate resolutions and other corporate action.

As stated in Articles 78 and 181, shareholders should hold the annual meetings to approve the balance sheet. They may appoint and dismiss directors and officers. That is subject to modification because the law provides that any 25% shareholder group can have the right to at least one director. Thus, the majority of the shareholders in an ordinary meeting cannot just vote on any complete board at their whim. They must respect the right of the minority as provided in the *estatutos*.

The extraordinary stockholders' meeting deals with the matters referred to in Article 182 of the Company Law.[10] These matters can *only* be dealt with at an extraordinary stockholders' meeting. A higher quorum and a higher rate is required for such meetings. At least one-half of the capital stock must be present at any general ordinary meeting,[11] and a majority vote is required for corporate action. At least three-quarters of the capital stock must be represented at special general meetings,[12] but a higher minimum requirement may be required by the *estatutos* to be present and to take corporate actions. The minority is thus protected. Additional matters are imposed on those listed in Article 182 for extraordinary general meetings, and higher percentages are required for corporate actions. Article 194 requires that minutes of the extraordinary general meeting must be recorded before a notary, whereas the minutes of an ordinary general meeting may just be prepared by the corporate secretary and signed by the chairman and secretary.[13]

Gordon: In Mexico, the Company Law tries to foreclose many of these conflicts between shareholders and directors in the corporate documents.

Kryzda: That is a fair statement. Article 198 provides, "[a]ny agreement which restricts the freedom to vote of the stockholders shall be null and void."[14] This article cannot mean what it seems to say. If it were true, all shareholder agreements drafted by Mexican attorneys for years would be invalid for violating the law and none of these agreements would be enforceable. But Mexican counsel avoid challenging the validity of that rule by providing in the *estatutos* for special votes on the same matters

9. *Id.* art. 79.
10. *Id.* art. 182.
11. *Id.* art. 189.
12. *Id.* art. 190.
13. *Id.* art. 194.
14. *Id.* art. 198.

that are covered by the questionable shareholder agreements; this eliminates any potential problems under Article 198.

Gómez-Palacio: Articles of incorporation and bylaws in the United States are more standardized than in Mexico. Each Mexican law firm has its own special form of *estatutós sociales.*

Gordon: Mr. Jauregui noted that Mexican companies have only recently adopted the practice of corporate action by using written consents. In the United States, this is commonly done rather than holding meetings.

Kimball: A review of the minutes books of U.S. corporations reveals that corporate action by the unanimous consent process is, by far, the preferred route for private companies.

The stockholders' agreement is an alternative vehicle of a privately-held company. They are not seen often in public companies except to try to put together a controlling bloc among a few shareholders. As a result, in the United States the board of directors has extraordinarily broad authority. The board has the residual authority of the corporation. Conversely, in Mexico the residual authority is with the meeting of shareholders.

The main issue to resolve in the United States is the separation of ownership and management. That is the core question of U.S. corporate law today. Issues dealt with in corporate law, and increasingly, in federal tax and federal securities law, are beginning to deal with this question. How does one ensure management is representing the interests of the true owners? The Mexican paradigm seems to be to allow the owners, the shareholders, to expressly delineate the authority of management. The United States paradigm seems to give broad authority to management but to provide stockholders, through the charter, with extraordinary voting rights if they have specifically negotiated for them, and also to allow lawsuits for breaches of fiduciary duty. Shareholders may bring legal actions for breaches of the duties of care and loyalty, as well as for corporate waste. A public company also may be liable for failing to make proper disclosures. The federal securities laws try to force better disclosure by management so shareholders can evaluate performance.

Gómez-Palacio: One issue which merits discussion is the issue of control. During the years when the Mexican Foreign Investment Law was strictly applied, interpretation of "control" by the Foreign Investment Commission was unclear.

Even under the current liberalized Foreign Investment Law, there are still provisions limiting foreign investment in some industries to 49% or even a reduced percentage. Thus, in drafting documents, an attorney must scrutinize how much controlling power is given to the minority shareholder, to avoid the issue. In spite of having minority participation, the client may want a controlling interest in the corporation. However, providing for more than the specified percentage of shares may trigger the need for authorization by a government agency.

By using the extraordinary stockholders' meeting as a device to protect a minority shareholder, attorneys may enable the shareholder to protect his interests without bringing the issue to the government. The minority

shareholder effectively acquires "veto rights" because his 49% of the shares can prevent adoption of any proposal in an extraordinary meeting in which more than a majority vote is a condition for corporate action. Ordinary matters can be handled by a majority, so the majority controls the corporation. The idea is that having veto rights on the main matters of corporate decisions does not imply a controlling interest. In the United States, one looks to the shareholders' agreement and at statutes to determine shareholders' rights. In Mexico, there is no shareholders' agreement to look to. An attorney would be much more likely to have considered these issues in the *estatutos sociales.*

One concludes from this discussion that a corporate or individual shareholder seeking to protect its minority interest in the United States would be likely to seek a special agreement among shareholders, whereas in Mexico, the minority shareholders would be more likely to rely exclusively on the *estatutos sociales.* I do not want to leave the impression that in Mexico there is no such thing as a stockholders' agreement. There are a number of agreements and other documents in which stockholders' understandings are put into joint venture endeavors.

Jauregui: I want to caution U.S. attorneys about Article 198, which provides that any agreement which restricts the freedom to vote of the stockholders is null and void.[15] Because this language has not been interpreted definitively, if one really means to control the vote, a voting trust must be established.

Rendell: Can stockholders waive their rights under Article 198?

Jauregui: No. It is public law.

Kryzda: I agree that the control of the company, whether it be by majority, minority or special vote, should be in the charter because otherwise it could be challenged by Article 198.

Gordon: What is the standard of directors' conduct in the United States at this time?

Andrés Gil: In general, directors in the United States assume certain responsibilities to the corporation and to the shareholders and are, under the law, obliged to carry out their functions in various ways. First of all, directors have a duty of care that is fairly broad and encompasses regular attendance at meetings and having adequate information upon which to base their decisions. Directors have the right to rely on others, such as specialized experts, auditors, and legal counsel, but they need to have a reasonable basis for their reliance and they need to keep informed. They have a duty to come forward and inquire, and also have a duty of loyalty to the shareholders and to the corporation. That covers situations where there might be a conflict of interest between the director's own personal position, particularly if he is a member of management, and what is in the best interests of the corporation.

The other area where this comes up is in the area of corporate opportunity. The director has a duty to ensure that business opportunities

15. *Id.*

that arise are taken up by the corporation and not by him or other entities in which he might have an interest.

All of this is tempered by the business judgment rule, which says that if a director makes a business decision, the courts are not going to second-guess that decision. In essence, a director has to ensure that the duties of care are met in order to later protect his decision under the business judgment rule.

Kimball: In general, the decision of the board of directors is given deference by the courts unless the plaintiff sustains the burden of showing that there has been a breach of the duty of care or the duty of loyalty. The courts will give extra scrutiny to the directors' judgment where management is getting some benefit from the transaction different from the shareholders. A third duty, that of fair dealing, requires that disclosures to the stockholders about the matter on which they are voting be fair and adequate. This duty is often encompassed by the overall duty of loyalty.

Gordon: Much of the law regulating directors' liability in the United States is the result of case law. What is the standard, and the source of that standard, in Mexico? Are directors liable for mere negligence?

Gómez-Palacio: Articles 156 to 163 of the Mexican Company Law regulate this matter. Article 157 states that "[t]he directors shall have the liabilities inherent to their office and those derived from the obligations imposed on them by law and by the bylaws."[16] With NAFTA partners coming to Mexico exercising responsibility, there is a likelihood of issues of management compliance with the law being raised. In addition to obligations under the Company Law, there are also obligations of directors under the tax laws.

Jauregui: Mr. Kimball has made the most important distinction between U.S. and Mexican standards. Because Mexican directors do not have as broad a scope of authority as U.S. directors, the authority remains vested in the owners, i.e., the shareholders. This explains why directors do not bear such heavy liabilities and also why the *comisario*, the statutory examiner, carries such a heavy burden. The *comisario* is supposed to guard the owners' property. Therefore, the directors' liability is diminished and is not as substantial as in the United States. I have frequently had difficulty in understanding why the emphasis on directors was so heavy under U.S. corporate laws and why the emphasis was not as heavy in Mexico. The most important reason why Mexico does not have such stringent standards on the behavior of directors as to negligence or gross negligence is because directors have less responsibility in Mexico than in the United States.

Gordon: In the United States, broad powers are delegated to the directors and shareholders are provided with a check on such powers through shareholders' derivative suits. Does Mexico have a derivative suit equivalent to check the power of the directors? Would it be the *comisario*?

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16. *Id.* art. 157.

Jauregui: It is the *comisario* in the private scenario. In the public scenario, it is the *comisario* plus the regulatory authorities.

Gómez-Palacio: When the board in our hypothetical voted to sell the specialty steel division, PETRO-BITS had three divisions: one manufacturing high quality steel, one manufacturing drill bits, and one involved in marketing and distribution. Twenty percent of the corporation is owned by a U.S. company, 20% by a Mexican company, and 60% by the public. It has sold its steel division. Ralph Rogers, PETRO-BITS' president and a board member, believed the company should concentrate on petroleum industry products and leave the steel bit business to others.

Without consulting the board of directors, Rogers met with Pritzker, the owner of a steel company in Mexico, whom he knew socially. Rogers had previously asked the PETRO-BITS accountants to prepare an evaluation of the specialty steel division based on adjusted book value. The value was set at 200 million pesos. One accountant, however, noted that the division accounted for considerable profits and the better method to calculate the value might be to capitalize earnings. Pritzker offered to pay the 200 million pesos. Rogers' proposal to the board concerning selling the division was based on that amount. The board was called to a special meeting to approve the sale. The meeting was held immediately before the company annual dinner, which had been scheduled months before and the members were anxious to complete the board work and get to the dinner. The shareholders believe that the sale not only should have been approved by them, but that the directors acted improperly. The board held a later meeting and gave considerably more thought to the, by then, completed sale. They affirmed their earlier decision. Several board members are concerned with being sued individually and propose that the board adopt a resolution to indemnify the directors for any expenses or judgments resulting from their actions and to obtain insurance for future conflicts.

Gordon: On the basis of the facts in the hypothetical, how would U.S. and Mexican counsel react?

Gil: In looking at the facts of our hypothetical, I would love to represent the plaintiffs in a U.S. court if it were a U.S. company. On the face of it, assets that represent the sole division represent 10% of the assets but 25% of the profits. On the valuation, one looks at book value, and there is an accountant who raises questions about that. It is not pursued. There is no other independent source of information for directors to form an opinion. The fact that they meet for half an hour creates an aura of pushing this thing through. From a U.S. perspective, I view this as a very good case.

Gómez-Palacio: In Mexico, it would most likely be approached from the point of view of gross negligence. In other words, if the value was not 200 million pesos but something really gross, like 800 million pesos. Or if Pritzker and Rogers were related. If I could detect a really fraudulent action on which I could go against the patrimony of the company, I

would definitely try the case. The fact that the directors only met for thirty minutes is an added fact, but not of great concern.

According to the *estatutos*, no officer is expressly authorized to make the sale. However, the board of directors, through authorization by the stockholders' meeting, might have the authority to sell real property.

Gordon: My answer to Mr. Gil is that he had better find and serve these directors while they are in the United States, and try to get them into a U.S. court. His enthusiasm would be diminished if he had to go into Mexico.