Mexico

Negotiated M&A Guide

Corporate and M&A Law Committee

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1. Introduction.

Generally speaking, the Mexican legal framework applicable to agreements that fall within the scope of a merger and acquisition transaction are several; some you would expect from a civil law based legal system (as opposed to common law jurisdictions), and others relate specifically to the industry or sector of the Mexican companies involved in the transaction, whether as purchasers, sellers, targets or affiliates of any of the foregoing.

Just to name a few, practitioners should initially focus on the local Civil Code (*Código Civil*) that applies to the location of the company or assets being acquired, the Code of Commerce (*Código de Comercio*), the General Law on Commercial Companies (*Ley General de Sociedades Mercantiles*), the Securities Markets Law (*Ley del Mercado de Valores*), the National Foreign Investment Law (*Ley Nacional de Inversión Extranjera*) and the Federal Law of Economic Competition (*Ley Federal de Competencia Económica*), as well as any regulations or other provisions hat are related to the foregoing. Naturally, special analysis and consideration needs to be given to applicable tax provisions. For purposes hereof, we will focus on the General Law on Commercial Companies (the "GLCC"), the Securities Market Law ("SML"), the Foreign Investment Law (the "FIL") and the Federal Law of Economic Competition (the "Antitrust Law").

The distinction between commercial and civil transactions must be continually kept in mind. The Code of Commerce contains special rules governing commercial contracts, the principal purpose of which is to simplify the conduct of business. Pursuant to the Code of Commerce the parties to a commercial agreement are bound in the manner and to the terms upon which they appear to have obligated themselves. The validity of commercial transactions does not depend upon the observance of definite formalities and requisites except: (i) where the civil or other commercial laws require the agreement to be in the form of a public document (*i.e.*, articles of association of a corporation or other legal entity, the transfer of real estate assets, long term leases) or where special formalities are required to render the agreement enforceable (e.g., bills of exchange); and (ii) agreements executed in foreign countries, which must comply with the formalities of their country of execution, regardless of whether or not such formalities are required in Mexico. Counsel should take special note that certain provisions of civil law relating to the capacity of parties, exceptions and causes which rescind or invalidate contracts, are also applicable to commercial contracts.

Although civil codes of different States generally follow the Federal Civil Code (*Código Civil Federal*), reference should be made to the civil codes of the local jurisdiction because some provisions of local civil law may be different from those set forth in the Federal Civil Code.

(a) The General Law on Commercial Companies.

The GLCC is a Federal law that describes the rights of shareholders of a corporation. A foreign investor must be aware that several provisions of the GLCC are not the same as provisions applicable to corporations in the common law countries and many other jurisdictions. Accordingly, a foreign investor should be advised by local counsel of the main differences between Mexico and its country of origin. Hereinafter, we provide examples of differences between the US and Mexican legal systems.

Under the GLCC, the holders of the same class of stock have equal rights. Pursuant to the GLCC, the shareholders (and not the board of directors) have the authority to alter the organization, structure, purposes and capital structure of the company. Shares to be redeemed must be (i) redeemed on a pro rata basis for all shareholders, or (ii) selected at random through a formal lottery process. The rules on redemption may only be circumvented by the unanimous consent of all shareholders. Under the GLCC, no resolution may be adopted which is adverse to the shareholders of a given class, without a prior resolution of the holders of that class of stock at a special shareholders' meeting.

If the target company is listed, or it is envisioned that it will be listed in the future, on the Mexican Stock Exchange, then the foreign investor should also pay special attention to the SML which will also apply.

Although the GLCC contemplates six different forms of commercial entities, the most widely used (including for the establishment of joint ventures) are the capital stock corporation (*Sociedad Anónima* or *SA*) and the limited liability company (*Sociedad de Responsabilidad Limitada* or *SRL*). These companies' main characteristics are the following:

(i) both are limited liability entities, insulating their shareholders or partners from liabilities at the entity level.

(ii) the supreme decision making authority of each entity resides with the shareholders or the partners acting through the shareholders' meeting or the partners' meeting.

(iii) management of these entities may be vested in a board of directors or managers; a sole administrator may be designated instead too.

Despite the aforementioned similarities, the corporation (including the new kind of corporation known as *Sociedad Anónima Promotora de Inversión* or *SAPI*), which is a form of entity that places greater emphasis on capital contributions rather than on the identity and continued involvement of those making such contributions, is better suited for investments or joint ventures involving more than two parties, where the parties in question seek to pool capital and financial resources rather than expertise or know-how.

Conversely, where the identity of the partners and their continued participation in the entity is an integral part of the joint venture, the limited liability company would be the ideal vehicle in Mexico, as it is better prepared to deal with transfer restrictions and similar arrangements. Also, with the exception of the SAPI, the limited liability company is generally more favourable for a capital contributing minority partner, than the corporation, to accomplish its negative control objectives. Please refer to paragraph 1(b) below for more information of the advantages in investing through a SAPI rather than in a traditional corporation or a limited liability company.

(b) <u>Securities Markets Law</u>

Before the new SML was enacted in 2005, schemes used in the United States or other countries, such as shareholder agreements, voting covenants, transfer restrictions, cashouts or exchange of common stock for other securities, were limited by the GLCC. Consequently, provisions generally used by private equity investors such as voting agreements, lock-ups, calls, puts, drag-alongs, tag-alongs, registrations rights and squeeze-outs of minority shareholders were difficult to efficiently achieve and enforce in a cost effective manner that carried an acceptable risk to the investor.

Fortunately, the SML contemplates a new type of corporation, the *sociedad anónima promotora de inversion*, or "SAPI," which is designed to accommodate private equity investments, and serve as a transition from a closely-held corporation into a publicly-traded company; although it has also proven to be a very useful investment vehicle for strategic joint ventures. SAPIs are closely-held corporations, and therefore their shares need not be registered before the National Securities Registry (*Registro Nacional de Valores*) or listed on any stock exchange, and they are not subject to compliance provisions or the supervision of the Mexican Banking and Securities Commission (*Comisión Nacional Bancaria y de Valores*).

One of the most important aspects of the SML is that it expressly recognizes the validity and effectiveness of shareholders' agreements among the shareholders of a SAPI. This allows the shareholders to establish their arrangements without the need to replicate the relevant agreements and undertakings in the SAPI's by-laws, which is a publically registered document.

Moreover, the SML exempts SAPIs from the application of certain restrictive provisions of the GLCC allowing their shareholders to execute shareholders' agreements wherein they freely negotiate

investment and governance arrangements which are otherwise prohibited or limited under the GLCC. Specific exemptions to the GLCC include:

(i) *Classes of Shares*. SAPIs may issue common shares, shares with limited or no voting rights (without the need of granting the holders of the latter a preferential right to receive distributions), preferred shares and shares granting preferential voting or other rights to their holders. In this respect, the SML has given investors a tool that acknowledges that different shareholders have different needs, objectives and expectations for managing their investment and its return.

(ii) *Voting Restrictions*. Shareholders may establish voting restrictions otherwise prohibited under the GLCC. Hence, the SML allows shareholders to covenant to vote, or abstain from voting, on certain matters or under certain circumstances. Likewise, shareholders of SAPIs may assign their voting rights.

(iii) *Preemptive Rights*. Shareholders may waive or assign their preemptive rights to subscribe for shares and/or pay capital increases, even prior to the adoption of the shareholders resolution approving the relevant capital increase. The relevant provisions also allow for the implementation of punitive dilution and other remedies for shareholders defaulting on their capital commitments or capital calls.

(iv) *Transfer Restrictions*. The SML specifically contemplates the right of shareholders to establish lock-up periods, rights of first refusal, rights of first offer, as well as tag-along and drag-along rights.

(v) *Liquidity/Exit*. SAPIs are not restricted from repurchasing their own shares, which in terms of liquidity or exit allows the shareholders to put their shares to the actual SAPI. In addition, shareholders of a SAPI may establish specific registration rights designed to take the SAPI public, as well as put and call mechanisms among the shareholders.

(vi) *Non-Compete*. Subject to the Antitrust Law and its regulations (and other enforceability questions under the Mexican Constitution), shareholders of SAPIs may establish non-compete provisions or exclusivity covenants.

(vii) *Dispute Resolution*. The shareholders of a SAPI may establish dispute resolution mechanisms, including mechanisms triggered by fundamental business disagreements that trigger buy-sell schemes.

In terms of minority rights, the SML establishes minority rights and protections for SAPI's shareholders that are similar to those that apply to publicly-traded companies. Among other rights, the SML lowers thresholds for the appointment of directors and statutory auditors from 25% under the GLCC, to 10%.

SAPI's are given the option to adopt (even gradually) the corporate governance provisions applicable to publicly traded companies. SAPI's that elect to adopt the corporate governance standards of listed companies will be subject to the more stringent governance schemes. Among others, in terms of corporate governance the SML specifies the authority and duties of the board of directors and the chief executive officer of a listed company, and contemplates certain standards that are novel to Mexico, such as the standard of loyalty, the standard of diligence and the business judgment rule.

Finally, when considering a minority investment in Mexican companies or a joint venture with a Mexican group of shareholders, foreigners should note that the GLCC imposes very limited obligations on a Company to prepare and deliver financial and operating information to the shareholders or partners. Shareholders or partners have a statutory right to inspect the financial statements just before the fiscal year's results are to be submitted to them for approval or at the annual shareholders' or partners'

meeting. Accordingly, any person negotiating a joint venture in Mexico should place great emphasis on specifically outlining in the by-laws (and/or in the shareholders' agreement) not only the nature of the information that the investment vehicle should produce and deliver, but also the process that must be followed by the parties in order to inspect books and records and to access the company's facilities and management, so as to ensure that it will have full access to the company's information.

(c) Foreign Investment Law

The FIL governs domestic and foreign investment in Mexico and imposes certain limitations and restrictions on the percentage of the voting capital stock of Mexican corporations or assets which may be owned by non-Mexican nationals, depending on the industry and business sector in which such companies are involved or in which the assets are used. The Foreign Investment Commission (the "FIC") is the administrative body in charge of enforcing the FIL.

For the purposes of the FIL, an investor will qualify as a "Mexican investor" if he/she is a Mexican national or an entity incorporated and existing in accordance with the laws of Mexico, of which at least 51% of the voting stock or capital is owned by Mexican nationals.

In general, under the FIL, foreign investors may invest in both listed and unlisted Mexican companies, subject to a limited number of restrictions on investment in certain economic sectors (including national air transportation, telecommunications, shipping and insurance and bonding) which are, under the law, specifically reserved to Mexican nationals and/or the Mexican government. Activities such as petroleum, basic petrochemicals and electricity are reserved to the Mexican government and other areas, such as radio, television and transportation, are reserved to Mexican investors exclusively.

The FIL allows foreigners to either own majority economic interests in Mexican companies operating in sectors or industries where foreign investment is restricted, up to certain specified maximum aggregate percentages, or to obtain funding from foreign sources in the form of new equity without exceeding the applicable foreign investment thresholds and without forfeiting Mexican control of the company in question. It does so through a concept known as "neutral investment" (*inversión neutra*) or "neutral shares" that are specifically provided for and governed by the FIL and its regulations (*Reglamento de la Ley de Inversión Extranjera*). "Neutral investment" is defined as the investment made in a Mexican company or trust which is not computed for purposes of determining the percentage of foreign investment in the equity of the company.

A Mexican company may only issue non-voting or limited-voting shares which qualify as neutral investment ("Neutral Shares") with the prior authorization of the *Secretaría de Economía* (Ministry of the Economy) and, where the issuer of the Neutral Shares is or will be a public company under applicable securities laws, the Banking and Securities Commission (*Comisión Nacional Bancaria y de Valores*). To obtain such an authorization, the Mexican company, that is, the issuer of the Neutral Shares, must file a written application before the Ministry of the Economy, specifically referring to the sector in which the company operates, and stating the business rationale for having Neutral Investment, as well as the rights and obligations which will attach to the Neutral Shares (*e.g.*, matters with respect to which the shares would be entitled to vote, if any, preferred distributions; etc.).

The FIL and the Regulations do not specifically provide for a maximum or minimum percentage of Neutral Investment. Hence, the Ministry of the Economy has discretionary authority to determine, on a case by base basis, the aggregate percentage of Neutral Shares that may be issued as a percentage of total equity represented by common stock (*acciones ordinarias*). In considering applications, and specifically the reasonableness or appropriateness of the percentage of Neutral Investment requested in any given application, the Ministry of the Economy will take into account, among other factors, whether the Neutral Shares will be non-voting or limited-voting. To the extent that Neutral Shares will be non-voting shares, the Ministry of the Economy has generally authorized a larger proportion of Neutral Investment. During the application process, the Ministry of the Economy will request the opinion of the industry regulator to determine the appropriate and permissible level of Neutral Investment.

(d) Federal Law of Economic Competition

Mexico undertook a commitment to implement a real competition policy when entering into the North American Free Trade Agreement (NAFTA). The Federal Competition Commission (the "FCC") is the independent administrative body of the Federal Government in charge of enforcing the Law and its regulations, and in doing so preventing and investigating monopolistic practices, including concentrations, whose purpose or effect is to diminish or impede free competition with respect to similar or substantially related goods. The following sectors are not considered monopolies under the Antitrust Law: strategic areas (i.e., postal service, generation of nuclear energy, petroleum and hydrocarbons, electricity); activities of the Central Bank of Mexico; unions; and privileges derived from intellectual property rights and copyrights.

The Antitrust Law addresses merger review under the name of concentrations (*concentraciones*), which not only involve mergers but also acquisitions or any other similar act that combines corporations, associations, partnerships, shares of stock, assets or trusts between competitors, suppliers, customers or any other economic agents. In view of the foregoing, foreign investors must take note that the FCC may block any given transaction if it "creates or strengthens a dominant position as a result of which effective competition would be significantly impeded in the Mexican market or in a substantial part of it". Although all concentrations which occur in Mexico or have effects in Mexico are subject to the Antitrust Law and may be investigated by the FCC, the Antitrust provisions sets forth the following notification thresholds (pre-merger fillings) which trigger the obligation of economic agents to notify concentrations before they are undertaken:

(i) If the transaction or series of transactions originating them, represent within Mexico, directly or indirectly, a value greater than MX$1,034,280,000 Mexican pesos (approximately US$76,613,333);

(ii) If the transaction or series of transactions originating them, result in the acquisition of 35% or more of the assets or shares of an economic agent whose assets or annual sales originated in Mexico are worth more than the equivalent MX1,034,280,000 Mexican pesos (approximately US$76,613,333); or

(iii) If the transaction results in (1) an accumulation within Mexico of assets or capital stock in excess of the equivalent of MX$482,664,000 Mexican pesos (approximately US$35,752,888), and (2) two or more economic agents are involved in the concentration and their assets or annual volume of sales, jointly or separately, are worth more than the equivalent of MX$2,758,080,000 pesos (approximately US$204,302,222).

It is important to point out that a transaction will be subject to a pre-merger filing by reaching at least one of the abovementioned thresholds. Likewise please note that if the thresholds are not met, the FCC may still have the right to analyze the transaction.

Where a merger notification is required, it is strictly prohibited to implement the transaction prior to the corresponding waiting period elapses or until receiving clearance. Counsel should begin by analyzing (and considering for purposes of the envisioned transaction) that obtaining the FCC's approval will be required prior to completion of the relevant acquisition.

2. Structure of the Transaction

Generally speaking, a buyer of a business in Mexico has two options: stock acquisition and asset acquisition. There is no specific rule of thumb as to what is more convenient, because both structures have their specific issues that need to be addressed prior to and during the negotiation process. The convenience of one form of acquisition over the other depends mainly on four factors: (i) confidence in, and reliability of, the information supplied or to be supplied by the sellers and the target company, particularly as it relates to liabilities and contingencies; (ii) scope and accuracy of the sellers'

representations and warranties; (iii) creditworthiness of the sellers as indemnifying parties under the purchase agreement; and (iv) the business sector and industry in which the target and its subsidiaries operate and the nature and number of the assets which comprise the target's business.

To the extent the buyer has confidence that the information supplied by the sellers and the target is reliable and the buyer is accorded the right to thoroughly investigate such information and any liabilities of the target, a *stock purchase* will be the faster and preferred way to acquire existing businesses in Mexico. However, due note should be taken that an asset purchase transaction will allow the buyer, unless otherwise agreed to in the asset purchase agreement, to acquire the assets free and clear of any liabilities, except for those relating to tax and labor, which liabilities follow the assets.

As you will see in the list below, issues that arise from an acquisition in Mexico are generally the same as those in other jurisdictions. The following are the relevant issues that arise in a stock and/or asset acquisition in Mexico:

(i) *Political Issues / Public Opinion*. Although steps have been take in the right direction since the mid 1990's, many sectors and industries are still politically charged and, accordingly, subject to public opinion which may increase national pride or other political issues when it is known that the control and operations of target will be assumed by a foreign company. Possible problems where direct lobbying could prove useful include issues with raw material suppliers and service providers, unionized employees, officials of all levels of government, industry chambers, etc.

(ii) *Regulatory Permits*. Another important consideration when deciding upon an asset acquisition versus a stock acquisition are the regulatory aspects of the target's businesses. Many permits, licenses, concessions and authorizations granted by the Mexican governmental authorities are non-transferable. Thus, buyers of a target's assets (rather than its shares) whose business activity is highly regulated, should take into consideration the timing issues, complexity and additional costs of obtaining the necessary permits and authorizations to carry on the business once the asset acquisition has been agreed upon and/or completed. Considering that obtaining such regulatory permits and authorizations are a standard condition to closing of any buyer in an asset acquisition, it is in the best interests of both parties to jointly collaborate during the pre-closing period to not only manage public opinion but also to obtain the consents of the granting authorities to carry out the transfer of permits and other regulatory approvals.

(iii) *Antitrust Approval*. As discussed in 1(d) above, under any of the two alternative structures, the prior approval of the FCC may be required to the extent the transaction (or series of transactions) or the parties thereto fall within the thresholds set forth in the Antitrust Law.

(iv) *Control/Minority Shareholders*. A stock purchase acquisition provides a higher degree of control subject, principally, to any minority shareholdings and the terms of any third party contracts. Clearly, the higher the minority interests, the greater will be the limitations on control, so minority rights and their implications to each scenario are important to determine once counsel knows the nature of the provisions and rules applicable to their participation. Although minority rights play a much smaller role in an asset acquisition, third party contracts together with the political/regulatory issues discussed in paragraphs (i) and (ii) should be carefully considered before deciding on the best approach. For example, in the context of an asset acquisition, if such assets include contractual rights (e.g., suppliers, lease agreements, etc.), then the prior consent of the relevant third parties will generally be required, as is the case with third party contracts with change of control provisions that would apply in a stock acquisition.

(v) *Balance Sheet and Income Statement Effects*. Important differences exist in the balance sheet and income statement effects applicable to a stock acquisition and an asset acquisition, among others, please note the following:

(1) *Balance Sheet*. In the former, the buyer assumes all liabilities (including balance sheet, labor, covenants, contractual rights and obligations, etc.) and net operating losses and generally other tax attributes of the target will remain. On the other hand, in an asset acquisition tax and labor liabilities (and claims) follow the assets, to the extent the acquisition involves substantially all of the assets of the relevant business (or going concern). An important consideration to certain strategic buyers is that net operating losses and other tax attributes of target are not transferable in an asset acquisition.

(2) *Income Statement*. A stock purchase made by a Mexican holding company which determines its tax or a consolidated basis, will give the buyer consolidation of the tax result of the target company and its subsidiaries (that comply with the requirements applicable to the consolidation regime). Under newly enacted tax provisions related to consolidation, companies that consolidate their tax results will have to recapture tax benefits every five years; that is, these provisions set forth a five year deferral in the payment of the relevant taxes. In any event, under both scenarios the buyer will be able to depreciate the value of all assets owned by target.

(vi) *Liabilities*. In the stock acquisition, the buyer indirectly steps into all of target's liabilities (whether contingent or otherwise) limited, of course, to its resulting equity interest in the target as of the closing date. On the other hand, the buyer in an asset acquisition will purchase the assets with existing liens and encumbrances (unless otherwise released on or before the closing takes place), but all liabilities of the seller, such as its covenants, contractual rights and obligations, remain with the seller, other than certain tax, environmental or liabilities that will follow the assets, for example (i) payment of any due and outstanding amount related to property tax, (ii) owners and possessors of contaminated sites are responsible for their cleanup regardless of the liability of the contaminating party, and (iii) ´payment of due and outstanding water extraction duties.

(vii) *Bankruptcy Risk*. Depending on the current financial condition of the seller at the time of execution and until closing, stock and asset purchase transactions must be carefully analyzed from a fraudulent conveyance point of view, as there may be certain limitations or principles to comply with under the applicable Mexican bankruptcy statutes that could affect the timing and enforceability of the transaction.

(viii) *Tax Considerations*. Important tax effects (and transaction costs) applicable to a stock acquisition and an asset acquisition are very different, and a tax specialist should be consulted in this regard.

Finally, it is important to note that when acquiring the assets of an ongoing business concern, it is common practice in Mexico to execute a master asset purchase agreement that has ancillary conveyance documents, wherein all the necessary formalities to execute and enforce the transfer of the different assets of the business are duly and timely taken. For example, to the extent real estate assets are involved, a separate agreement formalized before a notary public in Mexico and registered in the applicable Public Registry of Property would be required. In addition to real estate, certain formalities must be followed when interests in long-term lease agreements or other contracts are being transferred or assigned. Likewise, assets subject to liens may require separate documentation for the release (total or partial) and the subsequent transfer. As a result of the foregoing, due note should be taken that asset purchases (specifically those covering a business concern) do commonly entail more transaction documentation than a stock purchase and may delay the drafting and negotiation phases.

With regard to a stock purchase transaction, the documentation is generally simpler and, depending on the type of entity that is the target (corporation, limited liability or SAPI), counsel to the buyer should focus on the ancillary documentation and corporate authorizations that, by statute or pursuant to the by-laws, should be executed and delivered to obtain an enforceable purchase of the equity interest. Such may include: required shareholder or partner approval, the approval of the board of directors or managers and the waiver by existing shareholders of any right of first offer or similar right they

may have. The acquisition must be recorded in the stock registry book of the company and the purchaser must receive original share certificates, duly endorsed in property in favor of the acquiring party.

3. Pre-Agreement

(a) Preliminary Agreements

The execution of documents aimed to evidence the preliminary agreements of the parties and to build-up the framework in which the preparation and negotiation of a definitive agreement will be structured are common practice in Mexico.

The agreement whereby the parties agree to execute a definitive agreement is called a "Promise Agreement". Pursuant to the Federal Civil Code, a Promise Agreement is an agreement evidencing the agreement of the parties to execute a future agreement. The formalities of a promise of purchase and sale agreement are that (i) it be in writing, (ii) the basic elements of the definite contract shall be set forth (in our case, a clear identification of the asset being sold and a determined purchase price) and (iii) the parties have agreed on a specific term in which the definitive agreement will be executed.

The following provisions are commonly seen in most preliminary agreements:

(i) *Due Diligence Clause.* The representatives and advisors of the parties will review, analyze and investigate relevant information and documentation pertaining to the company, its business, assets and liabilities. In most cases the buyers will ask for reasonable access to the necessary books and records of the seller parties, the facilities and management, without interfering with the daily operations of the target company and its affiliates. It is common for due diligence tasks to be limited by the sellers to a certain period of time that is commonly tied to the exclusivity period to which reference is made below.

(ii) *No-Shop Clause*. The sellers assure the buyer that there is no other on-going negotiation or existing agreement or undertaking of any kind between the seller parties and any other person with respect to the target company or its assets. Moreover sellers generally agree to give the buyer an exclusivity period that is generally concurrent with (or longer than) the period granted to the buyer to carry out its due diligence and in which it will not make or take any competing offer or engage in negotiations of any kind with another person in connection with the company, its business or assets.

(iii) *Confidentiality Clause*. The parties agree on the treatment that they will reciprocally give to the other party's information or documentation they receive from the beginning of the due diligence process and during negotiations. Its important that executives and officers of both parties understand that all information and documentation received during the process is confidential and that the company providing such information may have a claim against the receiving company if any unauthorized disclosure of such information occurs.

(iv) *Binding Effect Clause*. Preliminary agreements do not necessarily create a binding legal obligation to carry out the transaction therein contemplated; in most cases the documents expressly state that its content is merely an expression of mutual interest by the parties to carry on with negotiations (and the time, effort and expense of a due diligence process, in the case of the buyer) and, if applicable, execute a definitive agreement. As a general rule, parties in Mexico tend to execute preliminary agreements of a non-binding nature wherein the only binding provisions include the confidentiality clause, the no-shop agreement and the due diligence section.

Special care will need to be taken by counsel for both parties to specifically set forth the intent of the parties as to the non-binding nature of the agreement and that it is only a preliminary agreement not intended to be construed or interpreted as the definitive agreement. This is especially true when the

preliminary agreement has most, if not all, of the covenants and agreements of the parties that a third party would expect to find in a definitive agreement.

(b) Lock-up Provisions and Voting Agreements

As discussed in Section 1(b) above, lock-up and other voting agreements between shareholders are permitted by the SML, with respect to the voting rights of any shareholder of a SAPI. Such voting arrangements between shareholders are very useful in the context of a private equity investment where the investor is acquiring a portion of the target company and will have other shareholders (whether controlling or not) whose participation the investor may want to retain (by imposing transfer restrictions on their equity interest) as part of its integral exit strategy.

4. Acquisition Agreement

For the last ten years, Mexican commercial practitioners involved in cross-border transactions have undoubtedly been influenced by foreign buyers that like to see agreements that "look and feel", in many respects, as those used in other jurisdictions, but that comply with the particular formalities that need to be followed in order to execute a valid and enforceable agreement in Mexico. The following list is not intended to cover all provisions seen in an acquisition agreement, it is only a general guideline of the provisions that are common in Mexican corporate practice. Thus, counsel to the buyer (or the seller) will need to take into account the particularities of the transaction, the parties' business and industry sector in order to determine whether other provisions should be considered for the proper protection of their client:

(a) Purchase Price, Holdback and Escrows

Although it is common practice to negotiate a purchase price in a foreign legal currency (typically United States dollars), foreign investors should take note that the Monetary Law (*Ley Monetaria*) provides that debtors of obligations agreed to by the parties in a foreign currency and payable in Mexico may discharge such obligations in Mexican pesos at the rate of exchange published by the Central Bank of Mexico (*Banco de México*) on the date when payment is made. Accordingly, it is common practice for the parties to clearly set forth not only the specific method and location of payment, but also the source that shall be taken and the method to be used in calculating the applicable foreign exchange rate of the purchase price.

Holdbacks, carve-outs, cash-outs and escrow arrangements are all agreements commonly used in Mexican practice to adjust the purchase price and give the necessary certainty to the purchaser and the seller (as applicable) that: (i) sufficient funds to pay the purchase price exist, (ii) it will receive the purchase price, or (iii) it will be indemnified in a timely manner from any losses or purchase price adjustments.

Provisions on price adjustments are carefully drafted to provide that a post closing audit of the target company, its business or assets will be carried out, including a financial review to confirm the valuation agreed to by the parties or the existence and compliance by the target company of certain accounts set forth in its budget or business plan (cash availability, working capital, among others). It is important for the methodology of the valuation and any applicable adjustment to be clearly agreed to by the parties in the transaction documents; generally a formula is agreed to adjust the price that has been paid by the purchaser, based on a post closing audit of all or a part of the business or its assets.

In some cases, a portion of the purchase price is retained in an escrow-type arrangement in Mexico, or through an escrow agreement executed in another jurisdiction, so that the buyer has free access to funds to cover a price adjustment resulting in a reduced purchase price or any losses that could result in an indemnity payment under the acquisition agreement. Likewise, with the escrow in place the seller has certainty that the funds to pay the remaining purchase price exist and have been allocated specifically for such purpose, subject, of course, to any adjustment in the purchase price or indemnity right that the buyer may have.

(b) Representations and Warranties

It is a general practice to perform a complete legal, financial, operational and environmental due diligence of the target company, before structuring the investment and closing the transaction. Even if a complete due diligence is performed, it is essential for the buyer to request extensive representations and warranties from the seller, as well as for the seller to assume the obligation to indemnify the buyer in the event of an inaccuracy of any representation.

The legal due diligence and the representations of the seller and/or the target company should cover the following areas:

(i) Corporate, including (1) due incorporation of the target company and its subsidiaries, (2) compliance with requirements for its operations and to conduct its business, (3) the existence of appropriate and updated corporate books and records, and (4) status of powers of attorney granted to officers and other employees involved in the company's daily activities and, specifically, of the person that is representing the sellers and/or the Company in the transaction documents.

(ii) Outstanding shares, including (1) compliance with legal requirements of all capital increases or decreases, (2) due issuance of outstanding shares, (3) evidence that the seller has title to the shares to be acquired by the investor, (4) nature of the shares to be acquired (common, preferred, non-voting, etc.), (5) existence of liens, charges or encumbrances on the shares to be acquired, (6) existence of outstanding options, rights, trust agreements, escrow arrangements or other agreements, which limit the transferability of the shares, and (7) status of dividends paid and payable on the shares.

(iii) Assets, including (1) title, (2) liens, charges, encumbrances and security interest, (3) compliance with applicable laws with regard to real estate, including environmental compliance and zoning and permits compliance, (4) existing leases, (5) fees, charges, taxes, assessments or other accounts payable by the owners, or for use of the real estate properties, (6) evidence of proper permits or authorizations from the governmental authorities, and (7) status of insurance arrangements covering the businesses' assets.

(iv) Loans and indebtedness, including (1) all existing loan agreements and other financing schemes entered into by the target companies, as lender or guarantor, (2) all credit instruments, such as promissory notes issued by the target company, (3) stand-by or other letters of credit from which indebtedness may arise, and (4) purchase agreements providing for deferred payments or retention of title.

(v) Taxes, including provision and annual payment of (1) income tax or alternate income tax (also known as IETU), (2) value added tax, (3) asset tax, (4) special taxes on production and/or services, (5) local taxes on real estate and payroll and (6) other duties, such as import duties or water extraction duties, social security payments (IMSS), housing development contributions (INFONAVIT) and savings funds (SAR).

(vi) Transactional matters and day to day operations, including (1) all agreements entered into by the target company, (2) major negotiations from which obligations or liabilities may arise, (3) potential events of default incurred by the target company, (4) all relevant operational permits, authorizations and concessions (including extraction water rights), and (5) official communications from governmental authorities giving notices on irregularities or imposing fines or sanctions.

(vii) Industrial and intellectual property, including (1) trademarks, patents and trade names, (2) registrations or licenses granted thereto, (3) franchise agreements and (4) know-how and technology transfer agreements.

(viii) Environmental matters, including all applicable permits and filings and implementation of required environmental protection measures, such as (1) hazardous waste, its handling, collecting, storage, reusage, treatment and final disposal, (2) waste waters, (3) solid and liquid emissions into the atmosphere, (4) open sky combustion, (5) vehicles transporting waste, (6) independent contractors handling waste, (7) notice of emissions and water treatment.

(ix) Labor matters, including (1) collective bargaining agreements, (2) individual labor contracts, (3) executive compensation arrangements of any kind, (4) maintenance of appropriate joint commissions records and (5) labor inspections.

(x) Disputes, including (1) actual, pending or threatened claims involving the target company, whether in judicial proceedings, administrative proceedings or other dispute resolution mechanisms, such as arbitration, (2) existing court orders or arbitral awards, and (3) settlements.

When possible representations and warranties should not be in lieu of the due diligence review. As in other jurisdictions, the representations and warranties must be drafted based on the results of the due diligence carried out by the buyer.

Sellers should seek that representations and warranties from the buyer that focus on the capacity of the buyer or its affiliates to assume its obligations under the transaction documents and to perform them accordingly, including the buyer's financial capacity to pay the purchase price at closing (whether with its own funds or through financing commitments).

The survivability of the representations and the corresponding indemnities given by the seller to such representations are generally framed to cover a convenient period of time, in some cases to cover the statute of limitations (applicable to matters that relate to title of the assets being sold, capacity of the parties, as well as labor and tax matters) and in other cases with a survivability that ranges between one and two years after closing.

(c) Pre-Closing and Post-Closing Covenants

Pre-closing and post-closing covenants of the parties in a Mexican transaction are the same as those commonly used in other jurisdictions.

Prior to closing, the parties should focus on covenants aimed to assure that the parties will collaborate and take all necessary steps required to obtain and fulfill closing conditions. More importantly, stand still provisions regarding the conduct of business between signing of the acquisition agreement and closing of the transaction are common practice. In these provisions, buyers request to be notified of certain business activities or transactions that the target company wishes to undertake that are beyond the business' common past practice or that exceed predefined thresholds. The scope of these stand-still covenants will depend on the industry and sector of the target, and they are used in both asset and stock transactions.

Post-closing covenants are generally driven by the closing conditions agreed to by the parties. A specific post-closing covenant found in Mexican stock purchase agreements is one related to the income tax payable by the seller on the purchase price. This is of particular interest to the buyer since the target company (the issuer of the sold shares) may be held jointly liable with the seller for any income tax payable by the seller on the sale of its shares. To such effect, it is common to include a post-closing covenant whereby the seller agrees to deliver a copy of the tax documentation evidencing the payment of income tax on the sale of stock, including the corresponding tax return and any ancillary documentation filed with the Mexican tax authorities.

(d) Conditions to Closing

In most cases, an acquisition is carried out first by executing a stock purchase (or subscription agreement) or the asset purchase agreement, followed by a closing at which the buyer will pay the purchase price and receive the purchased assets or share, but only if certain closing conditions are met.

It is common for Mexican company's by-laws to require previous corporate authorizations from the shareholders' or its board for a company to sell its assets that conform a business. The same is sometimes true for the sale by shareholders or partners of their interest in the business entity. In addition, when contemplating a stock purchase, the parties should review whether or not the existing shareholders or partners need to waive any right of first refusal or right of first offer. Furthermore, certain formalities regarding the conveyance of shares in a corporation or a limited liability company will need to be included as a closing condition, such as the registration of the transfer in the entity's corporate books and, in the case of a corporation, the delivery of endorsed share certificates to the buyer.

If, as a result of due diligence, problems are identified, corrective measures may sometimes need to be taken before closing. Such provisions generally take the form of conditions to closing, so that at the time of closing the acquisition such problems are resolved or the correction measure is waived by the buyer. Special care should be taken when drafting conditions to closing to ensure that they are valid and enforceable under Mexican law.

In both stock and asset acquisitions, additional closing conditions may include: the buyer completing its due diligence process; the accuracy of representations and warranties made by both parties; the parties obtaining antitrust approvals; third party consents (from clients or suppliers) and other governmental approvals; and the execution of other transactional agreements (*i.e.*, shareholders' agreements, stock options, license agreements, services agreements, and transition agreements).

(e) Indemnification Provisions

Indemnification provisions are common practice in Mexican transactions. Generally, such provisions set forth the parties' right to be indemnified for damages and lost profits (*daños y perjuicios*) arising from (i) any breach of the representations contained in the agreement, (ii) any breach of the covenants set forth in the agreement, and (iii) specific relevant issues not covered by the representations or that may require a particular indemnity provision (*i.e.,* resolution of pending legal proceedings, tax and environmental issues identified during due diligence). An important basic concept to seek indemnification in Mexico is that damages and/or lost profits must be a direct and immediate consequence of the other party's breach in its obligation. Since not every breach of an obligation results in an immediate damage or loss, not all breaches may be indemnified.

As in other jurisdictions, the indemnification clause is usually one of the most important provisions of any acquisition agreement and frequently results in intense negotiations between the parties; hence, no standard indemnity provision exists for Mexican acquisitions. Accordingly, please note that *deminimis* amounts or deductibles (*i.e.*, a minimum amount that must be exceeded before any indemnification right is owed by the indemnifying party) and capped indemnities (*i.e.*, a maximum amount to be indemnified) are common practice in Mexico.

Finally, with respect to indemnification provisions, counsel should keep in mind that these provisions are a fundamental requirement because Mexican statutory dispositions do not provide suitable protection in the event of a breach of the representations in an agreement subject to Mexican Law.

(f) Dispute Resolution

Parties are allowed to submit the stock or asset acquisition agreements to a foreign law, however, the following restrictions should be taken into account: (i) the foreign law will not be applied in Mexico if its provisions are contrary to Mexican public policy (*orden público*); (ii) the foreign law agreed between the

parties will not be applied in Mexico if the parties have selected the applicable law in order to avoid general principals of the Mexican Law; and (iii) real estate properties will be governed by the applicable law of their location.

With respect to jurisdiction, parties have the option to either submit to Mexican courts or agree to refer all disputes to binding arbitration. Mexican law permits disputes among the parties to be solved through arbitration, which in most cases is a more expedient procedure than submitting to the Mexican judicial system. Under arbitration, the parties may waive any rights to appeal and consequently the procedure may be quite expedient. Finally, it is important to consider that any order of a foreign court must fulfill certain requirements specifically set forth in the Code of Commerce to be enforced within Mexico.

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