Practices for a Good Corporate Governance in Mexican Startups

Eugenio Dávila, Santos-Elizondo, S.C., Monterrey, Nuevo León, Mexico

Unlike other countries, in Mexico the Boards of Directors of private companies rarely functions and their relevance in the company is minimal. However, with the growth of the entrepreneurial sector in the country, the role of said Board in early-stage companies with venture capital known as "startups" has become extremely relevant. Although this figure is not widely regulated for private companies as it is for public companies whose securities are listed in the stock market, the General Law of Business Corporations (the "Law") and the Code of Principles and Best Practices of Corporate Governance (the "Code of Best Practices") published by *Consejo Coordinador Empresarial* establish different provisions regarding the operation, powers and responsibilities of the Board, although the latter is not a mandatory regulation for companies, it provides recommendable principles and practices to be followed by all companies. The purpose of this essay is to briefly summarize the attributions and responsibilities of the Board as well as suggest practices to be implemented for a good corporate governance.

Form of Administration.

Mexican startups favor two main types of incorporation, the most common one is the S.A.P.I. (*sociedad anónima promotora de inversión*) and the other one is S.A. (*sociedad anónima*), both of them provide for the company to be managed by a Board of Directors, in the latter having the possibility of appointing a Sole Director instead.

Such Board is appointed by the Shareholders' Meeting, and for all companies incorporated as a S.A. the shareholders owning at least 25% of the outstanding shares will have the right to appoint one of the members in the event that the Board has three or more members. On the other hand, in the S.A.P.I., shareholders owning at least 10% of the outstanding shares will have the right to appoint one of the members.

In both cases, the positions of the Board are personal and cannot be executed by proxies or agents. However, the Shareholders' Meeting may appoint alternate members for each director.

Powers and Responsibilities.

Pursuant to the Law, the Board has the power to appoint one or more General Managers of the company. Such appointments may be revoked by the same Board or by the Shareholders' Meeting. This provision establishes the hierarchy of companies, where the Board of Directors is below the Shareholders' Meeting and is not necessarily considered as a counterweight to it. In addition to such attribution, the Law provides that the Board may, within its powers, grant powers of attorney on behalf of the company to any individual. Apart from these provisions, the Law does not provide any additional attribution to the Board.

Furthermore, regarding the responsibilities of the Board, the Law provides that the directors who have a conflict of interest with the company must abstain themselves from deliberating and adopting resolutions in the meetings with respect to any act that originates such conflict of interest. If the director in question fails to comply with this provision, he/she will be liable for any damages caused to the company in question. Notwithstanding the foregoing, the Law does not make it clear

whether or not the director with a conflict of interest must appear at the meeting, it only states that they must abstain from deliberating and adopting resolutions on the matter. Our courts have resolved this issue through caselaw stating that all directors must be summoned to the meetings and it is their duty to abstain themselves from deliberating and adopting any resolution where they may have a conflict of interest.

Additionally, the Law states that the directors have the responsibility natural to their mandate and the one derived from the obligations that the law and the bylaws impose on them.

First, we have the responsibility natural to their mandate, our courts' caselaw states that, said responsibility refers to the acts executed by a director with express instructions given by the principal (in this case the Shareholder's Meeting), and in case of lack thereof, the director must consult the principal or, failing to do so, must act prudently. This first provision is practically impossible to comply with during the ordinary course of business of a company, where directors must take action in day-to-day operations which would be obstructed if they have to consult with the principal for every decision, so the directors must resolve matters acting prudently. However, said caselaw states that the violation of the duty of prudence and care of the directors will be unlawful and will give rise to a civil liability claim against the directors when their conduct causes damages to the assets of the company.

Moving on to the responsibilities derived from the law, the Law states that directors are jointly and severally liable with the company, for: (i) the reality of the contributions made by the shareholders; (ii) the compliance with the legal and statutory requirements established with respect to the dividends paid to the shareholders; (iii) the existence and maintenance of the accounting, control, registration, filing or information systems provided by law; and (iv) the exact compliance with the resolutions of the Shareholders' Meetings. Taking as an example Section I which establishes that directors will be jointly and severally liable for the contributions made by the shareholders, this means that if a shareholder defaults in his/her obligation to make a contribution to the company and the directors register him/her in the share registry book, they will be liable before the company for the contribution of such shareholder.

Finally, one of the most delicate responsibilities for directors found in the Law is related to the matters resolved by previous directors. The Law provides that a director is jointly and severally liable for the irregularities incurred by the previous directors. Therefore, it is of utmost importance that a new director, prior to accepting his position, analyzes the situation of the company and the actions previously taken by the Board.

Liability Action.

Having reviewed the responsibilities of the directors, our next point covers the manner of exercising a liability action against directors. The Law provides that all liability actions must be exercised by the Shareholders' Meeting through the person appointed by such meeting. Notwithstanding the foregoing, there is an exception to this rule, as a minority right for shareholders, whereby in the S.A., shareholders representing 25% of the capital stock may exercise a liability action directly, without the need of a prior favorable resolution of the Shareholders' Meeting. For the S.A.P.I. said percentage is reduced to shareholders representing 15% of the capital stock. This exception is applicable when two requirements are met, the first one is of a

procedural nature regarding the requirements that must be included in the claim, which is to say, to include the amount of the liabilities claimed by the company and not only the personal liabilities claimed by the shareholders. The second requirement to be met is that such shareholders have not voted in favor of not exercising the liability action at the Shareholders' Meeting. From the interpretation of this last requirement, we understand that prior to the exercise of the action directly by the shareholders, the matter must be discussed in a Shareholders' Meeting.

Relevant Corporate Scandals.

Having reviewed the powers of the Board of Directors, the responsibilities directors undertake when taking on their roles, and the liability action that the Shareholders' Meeting might exercise against them, it is relevant to mention a couple of scandals caused by mismanagement of the Board of Mexican companies. Although the cases to be mentioned are of public companies whose shares are listed on the stock market, the same could have happened in private companies.

Comercial Mexicana

Comercial Mexicana is a Mexican supermarket chain that during the 2008 crisis reported large losses compared to the profits it had been reporting in previous years. These losses were directly caused by the treasury director of this company, who since the late 1990's, entered into various derivative transactions without disclosing the same to the Board of Directors.

The mismanagement of the Board of Directors in this case was not the approval of such operations, since they were never aware of them. The fault here was precisely that they did not have knowledge of such operations, they were not careful to have a structured delegation of powers so that this type of operations would require the prior approval of a certain number of directors.

As a result of this mismanagement, Comercial Mexicana's shares plummeted 94% in the market and Mexican Securities Law was amended to require public companies to disclose their derivative transactions to the general public.

TV Azteca

TV Azteca is a company from Grupo Salinas that was involved in a scandal in the U.S. when UNEFON, a subsidiary of TV Azteca, had a debt of around USD $325,000,000 in favor of Nortel, a Canadian telecommunications company. This debt was settled after several negotiations for about USD $150,000,000 paid mostly by a third company called CODISCO, owned by Ricardo Salinas and Moises Saba, the former owner of TV Azteca and the latter chairman of the Board of Directors of UNEFON. The irregular conduct came later when UNEFON paid CODISCO the total amount of the debt, that is, the amount of USD $325,000,000, making Ricardo Salinas and Moises Sada a profit of around USD $218,000,000.

All this came to light when the U.S. law firm Akin, Gump, Strauss, Hauer & Feld, LLP, which represented TV Azteca in the U.S., under the SOX Law, condemned and resigned to continue representing said company.

This caused TV Azteca to be delisted from the New York Stock Exchange, as well as the resignation of independent directors and the fall of 20% of TV Azteca's shares in the Mexican stock market, among others.

Practices for Better Corporate Governance.
With the rise of venture capital funds being invested in Mexican startups and the lack of legislation regarding the attributes of the Board, it is important for early-stage companies to set up a good corporate governance strategy before it is too late.

Having clear attributions of the Board reduces the risk of its members causing a detriment to the company's assets and/or reputation. An excellent guide to implement good corporate governance within a company can be found in the Code of Best Corporate Practices (*Código de Mejores Prácticas Corporativas*) published by *Consejo Coordinador Empresarial* in 2018. Although this code is not enforceable and is more applicable to publicly traded corporations, some of its practices can be implemented in all S.A. and S.A.P.I. private companies in order to protect its shareholders. The following are some of the practices and principles provided by said code as well as personal suggestions to implement a good corporate governance.

1. Equal treatment and respect for and protection of the interests of all shareholders.

This first principle seeks to protect all shareholders equally, regardless of their stake in the company. This is due to the fact that the current laws do not really protect those of interests of minority shareholders who in many early-stage companies, tend to be venture capital funds or angel investors providing the company with funds to execute their vision.

2. The generation of economic and social value.

All good corporate governance must ensure the generation of economic value for the company. However, generating social value is a key aspect, which is becoming more and more relevant as our environment changes. A good corporate governance must generate social value around it, such social value is not only generated by doing good deeds but also by omitting to do acts that could mistreat or harm the environmental, social or economic environment around the company.

3. The disclosure of information, as well as transparency in management.

This third principle is of utmost importance. Today, the disclosure of information and transparency within inside a company and with the shareholders of the same is very relevant in terms of the responsibilities of both the directors and the shareholders. Let us remember that the directors and shareholders may be jointly and severally liable with the company in some cases, so it is extremely important for them to be aware of what is going on within the company.

4. Disclosure of wrongdoing and protection of whistleblowers.

Protecting whistleblowers is extremely important in companies with operations in different cities where it is impossible for management to have control over operations in all locations of the company. A whistleblower helps the company react in time to conflicts that may arise and even in some cases to prevent the company from committing illegal acts, which could affect both its reputation and its assets. In the same way, it is essential to have protection mechanisms so that

employees who report such acts are not affected, as this encourages them to continue reporting any wrongdoing.

5. The Board of Directors should include in its annual report the relevant aspects of each intermediate body.

This practice would avoid having a case like that of Comercial Mexicana mentioned above. By including in the annual report, the activities of each area, all areas of the company would be obliged to make an annual report to the Board, where they would have to disclose any ongoing operations.

6. Suggest that the functions of the Board of Directors should not include the activities of the General Management and its team.

The division of powers, if we could call it that way, within a company is as important, as it is in our government. Having well-defined attributions for the Board and for the General Managers is essential to the proper functioning of the business. If the Board is involved in most of the decisions of the Management and does not give them the freedom to operate, we will have a company with a slow, bureaucratic operation, where every decision goes through a long process to be approved.

7. Avoid appointing alternate directors.

It is common for the Shareholders' Meeting itself to appoint the proprietary directors and their alternates. The best practice, if alternates are to be included, is for them to be appointed by the proprietary directors so that they can form a team and the alternate can participate more effectively when necessary.

8. Forms containing detailed information and voting alternatives on the matters to be discussed at the Shareholders' Meeting.

It is very common for startups to send documents to be signed by their foreign investors without any indication of what is being approved and sometimes even without any translation of the documents to be signed. There will be investors who have no problem and blindly trust the company, but a good practice would be to send a form detailing the reasons for each proposal and the alternatives for voting on it, accompanied by a translation for the foreign investor.

I personally find the above points to be the basic principles and practices that should be adopted by early-stage companies seeking to form a good and solid corporate governance to avoid any corporate scandal and/or the detriment of the company's assets and reputation. As has been demonstrated, having a good and structured corporate governance is attractive to a company's shareholders and facilitates the generation of trust with investors by providing certainty about the company's direction.