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Cover Page Footnote
Member of the New York bar

COMMENTS ON THE MEXICAN DECREE OF DECEMBER 28, 1962, PERMITTING THE ISSUANCE AND SALE OF CONVERTIBLE DEBENTURES

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I. INTRODUCTION

THERE is little question that the privilege of conversion permitting an exchange of bonds or debentures for preferred or common shares of a corporation offers considerable attraction to investors. The ability to convert debt to equity investment, or more succinctly, to be able to exchange the status of creditor for that of owner, provides a definite lure to the potential lender who has faith in the enterprise and is prepared to speculate to a limited extent on the results which may be produced by his contribution and that of others to its working capital.

The unprecedented economic expansion of the United States in the latter part of the nineteenth and well into the twentieth century, with its consequent urgent need for capital in amounts which required volume investment, provided a sufficient incentive to the businessman and his legal advisor to seize upon and develop the exchange or conversion device. Thus, today exchange or conversion privileges more frequently than not appear in corporate charters. Conversion privileges are not limited to the conversion of debt obligations into stock, but include as well the right to exchange preferred stock for common stock,[1] or to convert shares of stock into bonds or other credit obligations.[2]

The commercial laws of the Latin American jurisdictions do not in the main provide great flexibility in the type and form of corporate securities. No doubt the disinclination of investors in such jurisdictions to invest in securities or other personal property, and the relative absence, until comparatively recently, of an enlightened realization of the necessity for rapid economic expansion, did not provide a suitable climate to encourage the public solicitation of corporate investment. Accordingly, there was no pressing necessity to tailor the form of securities by amendment or modification of relatively antiquated commercial codes to attract mass individual investment.

It was thus a distinct legal innovation when, on December 28, 1962, the Mexican Congress promulgated the Decree[3] amending Article 210

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1. See generally 11 Fletcher, Private Corporations § 5306 (perm. ed., Wolf rev. 1958).

2. Id. §§ 5314-15. The latter privilege of conversion would appear to be nothing more than a purchase by a corporation of its own shares.

3. Decree of December 28, 1962 [hereinafter cited as the Decree], Diario Oficial, Dec. 29, 1962.

of the General Law of Negotiable Instruments and Credit Operations,[4] permitting corporations to issue securities convertible into stock. This legislation was clearly designed to attract foreign investment to Mexico. No other Latin American jurisdiction has thus far expressly permitted the issuance of convertible securities, and, as will be seen from the following discussion, it is questionable whether securities convertible into stock may be validly issued under the general provisions of commercial codes similar to that of Mexico, without special enabling legislation.[5] The Decree and an English translation appear in the annexed appendix.[6]

II. THE TERM *Obligaciones*

It is important to note at the outset that the Decree does not expressly describe the specific type or form of securities that may be made convertible into stock. In providing that corporations (*sociedades anónimas*)[7] may issue securities convertible into stock under the conditions set forth in the Decree, the term *obligaciones* is used.[8] Article 210-bis added by the Decree to the General Law of Negotiable Instruments falls within Chapter V thereof, entitled *De las Obligaciones*. Literally translated, the word *obligación* means "obligation" in the contractual sense. In relation to securities, however, while most of the Latin American commercial codes contain the term, no precise and exclusive definition is set forth. As a result, the exact meaning of the term has been open to question.[9] For example, does the term include debt securities, such as bills of exchange or promissory notes, issued in the ordinary course of business?[10] Does the term refer to credit instruments evidencing both short-term or long-term debt? Is the fact that the corporate debt obligations are publicly offered or privately placed significant in determining

4. Ley General de Títulos y Operaciones de Crédito, Aug. 26, 1932 [hereinafter cited as Gen. Law of Negotiable Instr.], Diario Oficial, Aug. 27, 1932.

5. Compare Law No. 8875, February 23, 1912 (called the Law of Debentures), 17 Leyes Nacionales 582 (art. 1918), representing special regulations amending articles 365 through 368 of the Código Comercial of Argentina to liberalize the issuance of corporate debentures, but without providing for the issuance of convertible debentures.

6. The annexed English translation, as well as other such translations appearing herein, were prepared by the author and are, of course, unofficial.

7. The word "corporation," as used herein, refers to the civil law sociedad anónima ("S.A.") or the compañía anónima ("C.A."), which are used interchangeably to mean the commercial association having the particular legal characteristics of the Anglo-American business corporation.

8. Gen. Law of Negotiable Instr. art. 210-bis.

9. Gen. Law of Negotiable Instr. art. 208 provides as follows: "Corporations may issue obligaciones which represent the individual participation of the holders thereof in a collective credit ('crédito colectivo') chargeable to the issuing corporation."

10. The Venezuelan Commercial Code, for example, in providing that obligaciones may not be issued by business associations in excess of its paid-in capital, expressly excludes from such limitations bills of exchange and certificates of deposit. Código de Comercio art. 300 (Andrés Bello ed., Caracas 1956) [hereinafter cited as Ven. Com. C.].

whether the special provisions applicable to the issuance of *obligaciones*, such as those set forth in Chapter V of the General Law of Negotiable Instruments Operations, hereinafter discussed, must be met?[11]

Most commentators describe the *obligación* as a unitary "collective credit," created by a single voluntary legal act of the issuing corporation, such collective credit being established in a determined aggregate amount, divided into a fixed number of equal undivided parts.[12] The collective credit aspect of the *obligación* is said to be evidenced by the fact that there exists a direct relation between the creditors, who are in effect jointly making the investment or loan, and thus constitute an associated group with common representation,[13] and who act in concert with respect to all major matters concerning them through general meetings.[14]

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11. Under the provisions of Article 208 of the General Law of Negotiable Instruments, only corporations may issue obligaciones. Compare Ven. Com. C. art. 300, providing that obligaciones may be issued by compañías without any designation as a "C.A." or "S.A." The Spanish word "compañía" would include various forms of business organizations and is not limited to corporations.

In order to qualify as an obligación, the security must be negotiable in the technical sense. This requirement is established by reading Article 209 of the General Law of Negotiable Instruments, together with articles 18, 25, 26, 60 and 70 thereof. Article 209 provides that obligaciones may be in registered or bearer form. Article 26 states that securities in registered form are transferable by endorsement, and article 70, that those in bearer form are transferable by simple delivery. Article 18 establishes that the transfer of a credit instrument "implies the transfer of the principal right created thereby, and, in the absence of a stipulation to the contrary, the transfer of the right to accrued interests and dividends, as well as to guaranties and other accessory rights." Article 25 provides that credit instruments in registered form are understood to be issued "to order," unless the contrary is expressly stated. On the basis of such construction of these articles, the Mexican text writers take the position that unless the obligación is "payable to order" it does not conform to article 209 and hence is not an obligación. 2 Rodríguez, Sociedades Mercantiles 211 (Porrua ed. 1959). In this connection it should be noted that under the provisions of Article 24 of the General Law of Negotiable Instruments, where the instrument itself, or the applicable law, requires that the rights represented thereby be "inscribed" on the records of the issuer, the issuer is not obligated to recognize as legal holder any person not so registered; and no act affecting the rights represented by such instrument will be effective as against the issuer or third parties, which has not been so inscribed.

12. 2 Rodríguez, op. cit. supra note 11, at 213.

13. Gen. Law of Negotiable Instr. art. 216 provides that a representative shall be designated to represent the holders of obligaciones, who may resign for grave cause certified by a court. The designation of such representative is made by the issuing corporation. Art. 213, para. I(c). Provision is made, however, for his substitution by the holders of the obligaciones and for his removal by the affirmative vote of 75% thereof, at a general meeting called for such purpose. Art. 220. His general duties are to survey the activities of the issuing corporation by attendance at stockholders' meetings, and to obtain information concerning the issue relevant to the rights of the obligación holders. He also calls and presides at the general meetings of such holders, and is authorized to deal on their behalf with the issuer. Art. 217.

14. General meetings of the holders of obligaciones may be held at any time when

Each holder of an *obligación* has precisely the same rights as his other associated debtors.[15] It is important to note in this connection that the plurality of debtors is not an essential element of the nature of the *obligación*. All of the *obligaciones* may be in the hands of a single person. What appears to be the determining characteristic of the *obligación* is the fractionation of the single credit into equal parts, each of which may be represented by a separate certificate or other evidence of ownership. Thus, the basic legal characteristics of the *obligación* would appear to be: (1) the single and voluntary legal act of issue;[16] (2) the unitary credit obligation, in a determined aggregate amount, represented by a fixed number of parts;[17] and (3) the equality of rights in the legal sense of the various parts or fractions of the collective credit.[18]

It would seem, on the basis of this typically civil law conception, that it is immaterial whether the *obligación* is short-term or long-term, or whether it is publicly or privately offered. In addition, credit instruments such as bills of exchange and promissory notes issued by the corporation in the ordinary course of business would seem to be excluded, since they represent an independent debt obligation of the corporation, circulating entirely without reference to other such outstanding instruments. Such commercial credit obligations represent a separate and distinct debt, and not a fractionated portion of a so-called unitary collective obligation. Thus the most accurate English translation of the word *obligación* would therefore appear to be "debentures," and such translation is hereafter used.

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called on notice by the representative of such holders, by the holders of 10% of the outstanding obligaciones, or by a court of competent jurisdiction. Gen. Law of Negotiable Instr. art. 218. Action may be taken at such meetings by majority vote of those present and constituting a quorum, except with respect to a proposal to remove the common representative. Art. 219. The holders of obligaciones may act individually only for the purposes of (a) attacking the validity of the issue, or of resolutions adopted at a general meeting; (b) suing for payment of interest or principal; (c) forcing the common representative to perform his legal duties; and (d) seeking redress against the common representative for his failure to perform. In any event, no individual action of the holders of obligaciones may be taken when similar action has already been initiated by the common representative, or which is incompatible with any resolution adopted at a general meeting of obligación holders. Art. 223.

15. Gen. Law of Negotiable Instr. art. 209.

16. Gen. Law of Negotiable Instr. art. 213. See also the Nueva Ley General de Instituciones de Crédito y Organizaciones Auxiliares, May 3, 1941 [hereinafter cited as Law of Credit Institutions], Diario Oficial, May 31, 1941.

17. Gen. Law of Negotiable Instr. art. 210, para. III, art. 213, para. II. See also Law of Credit Institutions art. 123, para. VI.

18. Gen. Law of Negotiable Instr. arts. 208-09, 210, para. III. See also Law of Credit Institutions art. 123, para. VI.

III. Conditions Required for Issuance of Convertible Debentures

The Decree provides a number of conditions which must be observed (some of which are self-executing), in order for a corporation to issue debentures convertible into shares of stock.[19] These are:

(1) The corporation must "take the necessary steps" to issue and to hold in its treasury (*en tesorería*) a sufficient number of shares of stock to cover the conversion requirements of the debentures.[20]

(2) The pre-emptive rights of existing stockholders of the issuing corporation are expressly declared to be inapplicable with reference to the "treasury" shares referred to in (1) above.[21]

(3) The resolution authorizing the issuance of the convertible debentures must establish a period, following the date on which the debentures have been sold (*colocadas*), during which the right of conversion shall be exercisable.[22] The Spanish word *colocada* literally means "placed." It would seem, however, in this context to mean "sold." It is not entirely clear from the language of this provision whether the convertible debentures must be sold on the same date, as would be the case, for example, of an underwriting purchase; or whether the debentures may be sold on successive dates, with a fixed date on which the right to convert vests; or whether they may be convertible on successive dates measured by fixed or varying periods from the date of sale of each debenture. On principle, taking into account the fact that conversion is, in a sense, prepayment of the convertible obligation through the purchase of shares of the issuing corporation, it should not be objectionable to provide for differing periods of conversion. On the other hand, it would be inequitable to convertible debenture holders to permit conversion during different periods, when the value of the shares of stock to be acquired upon conversion may differ radically. It is the view of the writer that the intention of this provision is that all of convertible debentures are to be sold on the same date, and that the authorizing resolution may establish a conversion period during which any debenture holder may exercise his privilege of conversion. Nevertheless, it is believed that sales of the debentures could be accomplished successively without violating the said provision, provided that the enabling resolution establishes a fixed period during which the conversion rights of all of the debentures would be available.

(4) Convertible debentures may not be sold below par, and the expenses of the issuance and sale thereof must be amortized over the period

19. Art. 210-bis, paras. I-IX.
20. Art. 210-bis, para. I.
21. Art. 210-bis, para. II.
22. Art. 210-bis, para. III.

of the life of the debentures.[23] It is to be noted that the Decree establishes no conditions regarding the determination of a conversion price. It is clear, however, that such price may not properly be established below the par value of the stock acquired upon conversion. Article 115 of the *Ley de Sociedades Mercantiles y Cooperativas*[24] expressly provides that corporations may not issue their shares for less than their par value. Accordingly, to permit acquisition by conversion of shares at a price below their par value would appear to constitute a violation of article 115. In view of paragraph I of the Decree requiring the issuing corporation to have in treasury sufficient shares to fulfill the requirements of conversion, it would seem that the aggregate par value of such treasury shares must necessarily equal the aggregate par value of the convertible debentures issued and sold. Therefore, if convertible debentures were offered at less than their par value, and convertible at a price which in the aggregate would be less than the total par value of the shares so acquired, such shares would have been issued in contravention of the provisions of article 115.[25]

(5) The conversion of the debentures into shares must be effected by a request presented by the debenture holders within the period set forth for such purpose in the authorizing resolution.[26] It is not entirely clear from the wording of this provision whether the conversion must be effected jointly by the debenture holders acting through their representative or by agreement at a general meeting, or whether any debenture holder may convert its debentures at any time within the permissible period, without concurrence on the part of the other holders.

In the light of the provisions of paragraph II of Article 223 of the General Law of Negotiable Instruments permitting the debenture holder individually to call for payment of debentures held thereby,[27] and bearing in mind the apparent intent of the provisions of paragraph III of the Decree to permit successive conversions during an established conversion period, it would seem that the latter construction would most appropriately represent the meaning of this requirement. In addition, the debentures are negotiable, and it would appear that a requirement of joint action might destroy negotiability, since the right to convert, viewed as a method of payment at the option of the holder, would be contingent upon the action of other debenture holders.

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23. Art. 210-bis, para. IV.

24. Ley General de Sociedades Mercantiles, Aug. 28, 1934 [hereinafter cited as Company Law], Diario Oficial, Aug. 28, 1934.

25. Compare Brockett v. Winkle Terra Cotta Co., 81 F.2d 949, 959 (8th Cir. 1936), prohibiting a corporation from evading statutory provisions forbidding sale of stock below par by issuing below-par bonds convertible into stock at their par value.

26. Art. 210-bis, para. V.

27. See note 14 supra.

(6) During the life of the convertible debentures, the issuing corporation may not take any action which might prejudice the rights of the debenture holders to convert.[28]

The general language of this provision is disturbing, as it is difficult to assess with any degree of certainty what corporate action might be deemed "prejudicial" to conversion rights. The issuing corporation might be vulnerable to attack on the ground of the violation of this provision, by the taking of such ordinary corporate action as the declaration of dividends, or perhaps by borrowings or undertaking guaranties. Clearly more fundamental corporate action such as a recapitalization, increase or decrease of capital, merger or sale of assets should not be accomplished without the concurrence of at least a majority of convertible debenture holders.[29]

(7) Where the issuing corporation uses the designation "authorized capital," with reference to the shares held for conversion, it must be accompanied by the phrase "for conversion of debentures into shares." In addition, the paid-in capital must be mentioned.[30]

(8) Each year, within the first four months following the close of the fiscal year of the issuing corporation, its board of directors must by formal declaration, inscribed in the competent Commercial Registry, indicate the amount of capital subscribed by the conversion of debentures.[31]

(9) The "treasury" shares not acquired upon the expiration of the conversion rights applicable thereto must be cancelled. For this purpose the board of directors and the common representative of the debenture holders must appear before a notary public and make an appropriate declaration to such effect, which will be filed in the competent Commercial Registry.[32]

IV. Corporate Procedures Necessary for the Issuance of Debentures

Under the Company Law, a proposed issue of debentures must be approved by the stockholders of the corporation at a special meeting called for such purpose.[33] Article 182 of the Company Law provides that "special meetings of stockholders are those which are called to con-

28. Art. 210-bis, para. VI.

29. Gen. Law of Negotiable Instr. art. 212 provides that the "issuing corporation may not reduce its capital except in proportion to the payment of its debentures, nor change its purposes, domicile or name, without the consent of a general meeting of debenture holders."

30. Art. 210-bis, para. VII.

31. Art. 210-bis, para. VIII.

32. Art. 210-bis, para. IX.

33. Gen. Law of Negotiable Instr. art. 213.

sider any one of the following matters . . . X. the issuance of bonds."[34]

Under Article 190 of the Company Law, unless the charter provides for a greater number, a quorum for a special stockholders' meeting must be at least three quarters of the issued capital, and resolutions must be adopted by those shares representing fifty per cent of the capital. If no quorum appears on the date on which the meeting is to take place, a second meeting is called so indicating, and the quorum requirement for the second meeting is satisfied regardless of the number of shares represented, except that in the case of all special meetings, although held on second call, the favorable vote of at least fifty per cent of the outstanding capital is necessary to adopt any resolution.[35] Thus, in any case, approval of an issue of debentures requires the approval of at least fifty per cent of the outstanding capital.

The stockholders' resolution authorizing the issuance of debentures must contain the following:[36]

(1) The aggregate principal amount of the issue, and the number and par value of the debentures to be issued;

(2) The rate of interest to be charged;

(3) The interest payment dates, and the dates of maturity of the debentures, as well as the conditions under which the debentures are to be paid;

(4) The place of payment;

(5) A description of the conversion rights, and the period within which the rights to convert may be exercised;

(6) The name of the common representative of the debenture holders; and

(7) A description of any special guaranties, specifying the legal requirements necessary to constitute same.

Following stockholders' approval, the board of directors must meet to implement the resolution of issuance adopted at the stockholders' meeting. At this meeting, the board must designate the persons required to appear before a notary public to execute the deed of issuance on behalf of the issuing corporation,[37] and must appoint the person or persons who are authorized to execute the debentures.

The deed of issuance must contain the following:[38]

(1) The name of the corporation, its purposes and its domicile;

(2) The amount of the paid-in capital of the issuing company, and

34. The Mexican commentators regard the word "bono," meaning "bond," as synonymous with "obligación." 2 Rodríguez, op. cit. supra note 11, at 217.

35. Company Law art. 191.

36. Gen. Law of Negotiable Instr. art. 213.

37. Ibid.

38. Gen. Law of Negotiable Instr. arts. 210, 213.

the value of its assets and liabilities in accordance with the balance sheet prepared for the purpose of issuing the debentures;

(3) The aggregate principal amount of the issue and the number and par value of the debentures to be issued;

(4) The rate of interest to be charged;

(5) The interest payment dates and the dates of maturity, as well as the conditions under which the debentures are to be paid;

(6) The place of payment;

(7) A description of any special guaranties;

(8) A description of the conversion rights, and the period during which such rights of conversion may be exercised;

(9) The persons authorized to sign the debentures;

(10) The name of the common representative of the debenture holders;

(11) The purpose for which the proceeds of the sale of the debentures are to be used, if such proceeds are to be utilized to acquire property or for construction purposes;

(12) A representation by the common representative of the debenture holders to the effect that he has satisfied himself as to the value of the assets of the issuing corporation; and, in the event the debentures are secured by mortgage or other collateral, the existence and value of the properties offered therefor; and finally, that such representative will act as depository of the proceeds of the sale of debentures in those cases where such proceeds are to be utilized for the acquisition of property or for construction.

Aside from the foregoing questions of construction of certain provisions of the Decree with respect to the conditions to be observed by corporations issuing convertible debentures, a number of fundamental legal questions are raised as to the effect of the provisions of the Decree on existing provisions of law. It is a generally recognized principle in civil law jurisdictions that prior laws may be repealed or modified by subsequent legislation which expressly purports to do so, or which contains provisions which are incompatible with such prior laws.[39] Only one provision of the Decree purports expressly to suspend, to a limited extent, the operation of a prior statutory provision, while, as will be seen from the following discussion, others appear to be fully incompatible with certain pre-existing code provisions. In case of an express abrogation of the application of a prior law, however limited in effect, a question is necessarily raised as to the constitutionality of the subsequent

39. Código Civil para el Distrito y Territorios Federales art. 9 (11th ed. Andrade 1958), effective October 1, 1932 [hereinafter cited as Fed. Civ. Code], provides that "only those laws are derogated or repealed by subsequent legislation which expressly so declares, or which contains provisions totally or partially incompatible with such prior laws."

enactment. In the latter cases, however, the problem is to determine whether the Mexican Congress, in promulgating the Decree, had in contemplation the prior legislation affected, to the extent that it may be said that such prior legislation had been superseded by the Decree through the application of the aforementioned principle. There appears below a brief discussion of some of these problem areas.

V. Effect on Pre-emptive Rights of Existing Shareholders

As has been noted above, by the express terms of the Decree, the pre-emptive rights of stockholders of the issuing corporation are stated to be inapplicable with respect to the shares of the issuing corporation available for conversion.

Article 132 of the Company Law provides as follows:

> Shareholders shall have the preferential right in proportion to the number of their shares, to subscribe to those issued upon an increase in capital. This right must be exercised within fifteen days following publication in an official newspaper of the domicile of the corporation of the resolution of the shareholders increasing the capital.

This article grants to existing shareholders the opportunity to maintain their proportionate interest in the corporation in the event of an increase of capital. The recognition by Mexican text writers[40] of the transferability of pre-emptive rights has enabled corporations to make distribution to shareholders other than in the form of dividends. The issuance of shares at a price below fair market value permits the shareholder with pre-emptive rights to sell such rights for cash or acquire such shares at a discount through the exercise of such rights, thus increasing his possible future yield. The pre-emptive rights granted expressly by article 132 is clearly a valuable one, and by such provision becomes an essential right inherent in share ownership. The existence of such right to subscribe to additional shares of the corporation undoubtedly contributes to the establishment of the value of existing shares, and the removal thereof would seem necessarily to decrease such value. There are other shareholder rights not directly affecting value, the maintenance of which may also depend on the existence of pre-emptive rights. For example, under Article 134 of the Company Law, twenty-five per cent of the outstanding shares of a corporation have the right to name one director, if the board of directors consists of three or more members. The inability of an existing shareholder to retain his proportionate interest in the share capital of the corporation might well affect his right granted under article 144 to assure such shareholder of board representation.

It is to be further noted that Article 132 of the Company Law does not permit the removal or suppression of pre-emptive rights by appro-

40. 2 Rodríguez, op. cit. supra note 11, at 180-81.

priate provision in the charter of the corporation or in fact by shareholders' action.[41] In fact, Mexican attorneys differ as to whether or not an individual stockholder may voluntarily waive his rights in advance of their vesting, on the theory that such rights are granted as a matter of public policy, and thus, in accordance with generally accepted civil law doctrine, cannot be waived, since only those private rights may be waived which do not directly involve the public interest.[42]

The question arises whether, with respect to corporations existing at the time of the promulgation of the Decree, the express suspension of pre-emptive rights granted under article 132 with respect to the shares to be available for delivery upon conversion, has retroactively divested such shareholders of vested property rights, contrary to Article 14 of the Mexican Constitution. Article 14 provides that no law may be given retroactive effect so as to deprive persons of their property or property rights.[43] Some argument can perhaps be made that inasmuch as the pre-emptive rights of existing shareholders do not become effective until a resolution authorizing an increase in capital of the corporation has been duly adopted by the shareholders, the Decree operates only prospectively. Under this theory, the suspension of pre-emptive rights would occur only after they have vested, that is, following approval of a proposed increase in capital occurring subsequently to the effective date of the Decree. The Supreme Court of Mexico has held, however, that pre-existing rights, although not vested, cannot retroactively be affected by the enactment of a subsequent law.[44] In this connection it is interesting to note that, with respect to corporations of "variable capital," referred to below, which may have authorized but unsubscribed shares "in treasury," a leading Mexican commercial law commentator has taken the position that upon a pre-authorized increase in capital represented by such unsubscribed shares, existing shareholders have pre-emptive rights to subscribe to such shares before they may be offered for subscription to third parties.[45]

41. Id. at 173-76. Compare Company Law art. 72, permitting the suppression of pre-emptive right to subscribe proportionately to increases in capital of limited liability companies (Sociedad de Responsabilidad Limitada).

42. Fed. Civ. Code art. 6 provides: "The observance of the law may neither be altered or modified by the desire of private persons. Private rights may only be renounced which do not directly affect the public interest, when such renouncement does not prejudice the rights of third parties."

43. Constitución Política de los Estados Unidos Mexicanos, May 1, 1917, as amended (4th ed. Andrade 1941).

44. Lagunas Francisco y Coags, La Suprema Corte, Aug. 5, 1953, [1953] 117 Semanario Judicial de la Federación I. 550.

45. 2 Rodríguez, op. cit. supra note 11, at 181. Compare Wall v. Utah Copper Co., 70 N.J. Eq. 17, 62 Atl. 533 (Ch. 1905), holding that a shareholder having pre-emptive rights to subscribe proportionately to an increase in capital stock of the corporation may enjoin

The writer believes that there is indeed a serious question as to whether paragraph II of the Decree is unconstitutional as a violation of Article 14 of the Mexican Constitution; and accordingly, that a stockholder may seek relief in the courts (a) by way of injunction to prevent the issuance of the convertible debentures, or (b) by seeking a judgment declaring invalid the resolution of stockholders authorizing the issue, or (c) by way of *amparo*, a form of action permitted in Mexico to protest against a law or regulation or any act of a governmental authority alleged to be unconstitutional or otherwise illegal.[46]

If the aggrieved shareholders owned thirty-three per cent of the outstanding stock of the issuing corporation, such shareholders may immediately petition a competent court for an injunction against the implementation of the enabling resolution adopted at the special stockholders meeting, or petition such court for a judgment of invalidity of such resolution, or possibly demand that the court enforce their pre-emptive rights with respect to the securities reserved for conversion. Such a

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the issuance of convertible bonds, when his right to share ratably in the corresponding increase in capital was not provided for. There is some authority in the United States for the proposition that pre-emptive rights do not attach in favor of existing stockholders to a new issue of previously authorized shares, unless the proceeds of such issuance are to be utilized for capital investment to fulfill the needs of future expansion of the enterprise, on the theory that the original subscribers have impliedly agreed that the authorized stock not initially subscribed may be offered from time to time for working capital. 11 Fletcher, op. cit. supra note 1, § 5136.1. There is similar United States authority to the effect that, unless otherwise provided in the certificate of incorporation, pre-emptive rights do not extend to the reissue or resale of treasury shares. This position is based on the same theory that the very nature of treasury shares implies the understanding that they may be sold from time to time; and further, that with respect to the reissuance and resale of stock acquired by the corporation and held in its treasury, the value thereof has not changed in so far as the original holders are concerened. 11 Fletcher, op. cit. supra note 1, § 5136.2. See also N.Y. Bus. Corp. Law § 622(b) protecting the pre-emptive rights of existing shareholders with respect to shares issuable upon conversion of other securities. In a recent decree amending the Mexican investment company law, it is expressly provided that in the case of increases in capital, the shares representing any such increase may be issued without reference to the pre-emptive rights provided for in Article 132 of the Company Law. Decreto que Reforma y Adiciona la Ley de Sociedades de Inversión, Dec. 31, 1963, Diario Oficial, Dec. 31, 1963.

46. Nueva Ley de Amparo, Dec. 30, 1935, arts. 82-93, Diario Oficial, Jan. 10, 1936. Amparo would have to be asserted within 15 days after the shareholder had notice that the resolution of issuance was adopted, and be based on the theory that through such action the shareholder was retroactively deprived of his pre-emptive rights granted under Article 132 of the Company Law. The remedy of amparo might also be utilized within 15 days from the first act of a public authority which resulted in the retroactive loss of the shareholder's pre-emptive rights—for example, a court order denying him injunctive relief, or a court decision that the issuing resolution was valid and that para. II of the Decree was constitutional, or the recording of an amended charter in the Commercial Registry, or the approval of the issue of the convertible debentures by the National Securities Commission of Mexico (Comisión Nacional de Valores).

petition would have to be presented with fifteen days following the adjournment of the special stockholders' meeting at which the resolution of issuance was adopted.[47]

If the complaining shareholder proceeded by way of injunction prior to the issuance of the securities, their issuance might be withheld, unless pre-emptive rights were granted to such shareholder. In the event the complaining shareholder proceeded by injunction following the issuance and sale of the debentures, the probability is that the debentures would be held validly issued, but the issuing corporation might be required to offer the complaining shareholder pre-emptive rights to the securities reserved for conversion, or possibly offer him for sale the principal amount of debentures, which upon conversion would entitle him to receive shares of stock proportionate to his stock interest in the corporation.

In order to avoid any difficulty in this connection, it is suggested either that the resolution authorizing the issuance of convertible debentures offer to existing shareholders rights to subscribe to the convertible debentures in proportion to their respective stock interests, or alternatively that an express waiver of such pre-emptive rights be obtained following approval by the required number of shareholders of the resolution of issuance.

Clearly, if the resolution authorizing the issuance of the convertible debentures is approved by all of the shareholders, no difficulty should arise on the basis of any illegal suspension of the pre-emptive rights.

It should perhaps be noted that under the French law relative to the issuance of securities convertible into stock, it is required that the stockholders expressly renounce their preferential rights to subscribe to the shares to be issued upon conversion.[48]

VI. The Problem of "Treasury" Shares

It will be recalled that Article 210-bis, paragraph I, of the Decree provides that the corporation issuing the convertible debentures must "take the necessary steps" to issue and hold in its treasury (*en tesorería*)

47. Company Law arts. 201-02. Under article 201 a competent court may suspend the implementation of a resolution of shareholders attacked as invalid by the holders of 33% of the outstanding capital stock of a corporation, provided that the action is commenced within 15 days following the adjournment of the stockholders' meeting at which the resolution was adopted, and provided further that the complaining shareholders were not present, or, if present, voted against such resolution. Article 202 requires the moving shareholders to post a bond sufficient to cover damages which may result to the corporation by reason of the nonexecution of such resolution in the event its validity is upheld. Article 200 provides that resolutions of the shareholders duly adopted bind all shareholders whether or not present, even those who dissent, except with respect to the right to oppose such resolutions as set forth in articles 201 and 202.

48. Décret du 3 septembre 1953 (Fr. 60th ed. Petits Codes Dalloz 1964). See also Loi du fevrier 1953 (Fr. 60th ed. Petits Codes Dalloz 1964).

sufficient shares to meet the requirements of conversion. The Anglo-Saxon concept of treasury shares is somewhat alien to the civil law. Under the Anglo-Saxon practice, treasury shares are recognized and are regarded as issued but not outstanding. They are treated as an asset of the company or as a reduction from surplus. Such shares may not be voted, nor may they participate in dividend or capital distributions. No reduction in capital occurs, however, until such shares are in fact cancelled.[49]

As in most Latin American jurisdictions, the concept of authorized but unissued and unsubscribed shares does not exist in Mexico, except under the provisions of the Company Law, relating to so-called companies of "variable capital,"[50] and under certain special laws relating to banking and insurance corporations.[51]

Under the so-called "variable capital" arrangement, the charter of the company in effect establishes an authorized capital with maximum and minimum limits. The capital may be increased by subsequent contributions of the shareholders, or reduced by the withdrawal of capital, without the usual formalities established for an increase or reduction of capital requiring an amendment of the charter provisions. Article 216 of the Company Law provides in part that "the shares issued and not subscribed . . . shall be held in the custody of the company to be delivered when subscriptions have been effected."

This concept of treasury shares differs somewhat from the type of treasury shares customarily designated as such under United States corporate practices, that is, shares of a corporation which have been issued and outstanding shares, which are purchased subsequently by such corporation and held in its treasury. Under Mexican law, a corporation is expressly prohibited from acquiring its own shares, unless done pursuant to a court order for the purpose of the payment of outstanding debts of the corporation. In such event, however, the corporation must sell such shares within three months following their acquisition, and, if such sale does not occur, the shares must be cancelled and the capital accordingly reduced. The shares so purchased may not be represented at a stockholders meeting.[52] The commercial codes of many Latin American jurisdictions permit a corporation to acquire its own shares out of earnings or other special funds not constituting legal reserve.[53]

49. See generally 11 Fletcher, op. cit. supra note 1, § 5088.

50. Company Law arts. 213-21.

51. The concept of issued but unsubscribed shares is also seen in the Ley que Reforma la Orgánica del Banco del Pequeño Comercio del Distrito Federal, Dec. 29, 1948, Diario Oficial, Jan. 3, 1949. Under this law the bank is created as a corporation of "variable capital." Article 8 provides that "the bank may issue shares corresponding to Series C of its capital, and shall conserve same in its treasury (en tesorería) until such shares are subscribed and fully paid."

52. Company Law art. 134.

53. Ven. Com. C. art. 263 provides that "the administrators may not acquire shares of

A problem raised by the provisions of paragraph I of the Decree results from the fact that under the Company Law, all of the stock of a corporation must be subscribed, and at least twenty per cent of the par value of each share paid in.[54]

Thus, the question is whether, under the doctrine of implied repeal of inconsistent prior legislation, referred to above, paragraph I of the Decree is intended to provide an exception to this requirement, although not expressly so indicated. If so, it may well be that the issuance of treasury shares for the purpose of conversion under the Decree is an exception to the requirement of paragraph III of Article 89 of the Company Law that all shares of a corporation must be fully issued and subscribed and partially paid. On the other hand it may be possible to make the argument, in support of the validity of the issuance of the treasury shares, that they are not fully issued until delivered against the conversion price upon conversion. Upon the happening of the event of conversion, such shares would be fully paid. The language of paragraph I of the Decree is not helpful in this connection, since it provides only that the corporation shall "take the necessary steps" to have available in its treasury, shares sufficient to meet conversion requirements. It does not attempt to define whether such shares are in fact "issued"—as does, for example, the provision of Article 216 of the Company Law with respect to the treasury shares of a "variable capital" company referred to above—or whether they may be regarded only as having been authorized for issuance against conversion.

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the corporation for its own account, except in those cases where the acquisition was authorized by the stockholders, and is accomplished with amounts derived from regularly obtained earnings of the company as reflected in its balance sheets . . . ." Código de Comercio art. 103 (ed. Jurídica 1949) of Chile also permits a corporation to acquire its own shares subject to stockholders' approval, and that of the superintendencia, with earnings or special funds not constituting legal reserve. The question arises in these jurisdictions as to the status of such shares following acquisition. There appears to be authority that upon purchase by a corporation of its shares such shares are automatically cancelled. For example, it has been stated: "The purchase by a corporation of its own shares may have as a result the pure and simple cancellation of such shares thus returned to the patrimony of the corporation; such purchase may not be considered in any other manner than as effecting a corresponding and open deliberate reduction of capital. In our view this is the only juridical solution which is acceptable: the share is concrete evidence of the right of the shareholder, that is to say, a right of credit against the corporation. Thus, if the latter becomes owner of such credit right, a fusion has been produced in accordance with Article 1665 of the Civil Code [of Chile]." Herrera-Reyes, Sociedades Anónimas 130 (Chile ed. 1935). Article 1665 of the Código Civil (ed. Jurídica 1953) of Chile, referred to, provides that where the status of creditor and that of debtor are merged in the same person, the debt is extinguished and produces the same effect as payment. See also 2 Cooper-Royer, Traité des Sociétés Anonymes 635 (1926), to the same effect under the French law. Compare 3 Encyclopedia Dalloz (1958), Droit Commercial Sec. Action para. 462, p. 32. There is certainly a question whether it is proper to regard a share of stock as a debt obligation within the provisions of Article 1665 of the Código Civil of Chile.

54. Company Law art. 89, para. III.

Another problem arises in this same connection in the light of the provisions of Article 133 of the Company Law. This article provides that new shares may not be issued unless existing shares have been fully paid. Assuming that the treasury shares available for conversion pursuant to paragraph I of the Decree have been issued, but remain unsubscribed, it would seem necessary for the holders of existing shares not fully paid to pay the balance of their subscriptions prior to the issuance of the convertible debentures. If, on the other hand, the treasury shares available for conversion under the Decree are regarded as merely authorized for issuance upon conversion, such existing shareholders would be required to pay the full amount of their subscriptions at the time the treasury shares were issued against conversion. Here again, however, it may be possible to make the argument that the provisions of article 133 have been implicitly repealed by the apparently inconsistent provisions of paragraph I of the Decree.

VII. Problem of the Limitation on the Issuance of Debentures

Under the provisions of Article 212 of the General Law of Negotiable Instruments, a corporation is prohibited from issuing debentures for an aggregate principal amount in excess of its "net worth" as reflected in its balance sheet, prepared to support the issuance of the debentures as required by paragraph II of article 210 of the said law. Article 212 provides further that where the proceeds of the issue of debentures will be utilized to acquire assets or for construction purposes, the net worth may include "the value or price" of the assets or construction contracted for, in order to meet the capital limitations test prescribed in article 212.

Once again, the question is presented as to whether the Decree repealed or modified by implication the provisions of article 212, to the extent of eliminating the limitations imposed thereby in so far as the issuance of convertible debentures is concerned. Bearing in mind that the Decree adds a new Article 210-bis within the chapter of the General Law of Negotiable Instruments dealing with debentures, a strong argument may perhaps be made to this effect. It is certainly conceivable that the Mexican Congress intended to permit the issuance of convertible debt obligations in excess of the limitations established by article 212 on the theory that convertible debentures, although debt obligations in form, were in substance equity investment. In any event, it seems clear that the shares available for conversion, whether they be regarded as issued and unsubscribed or merely authorized for issuance, could not properly be taken into the capital account at the time of issuance for the purpose of determining whether the debenture issue met the requirements of article 212. Only upon conversion, resulting in the capitalization of the debt represented by the converted debentures, would the shares acquired properly represent capital.

VIII. Problems as to the Content of Stock Certificates

Paragraph IV of Article 125 of the Company Law provides that stock certificates must state the amount of the corporate capital paid in, and the total number and designated par value of the shares of the corporation. Inasmuch as the total number of shares outstanding, as well as the amount of capital paid in, will vary in accordance with the exercise of conversion rights, it is difficult to see how either the certificates representing existing shares, or those issued to represent the shares delivered upon conversion, can comply at all times with these requirements.

Similarly, Article 140 of the Company Law provides that in the event of any changes in a stock certificate, other than with respect to the statements as to capital and total number and par value of the shares required under the aforementioned provisions of article 125, all previously issued certificates must be cancelled and new certificates issued, or appropriate notification made on the prior certificates, accompanied by a notarial certification or that of a registered public broker. Thus, any such changes in the certificate—such as, for example, the requirement contained in paragraph VII of the Decree requiring a statement that authorized capital be designated as "for conversion of debentures into shares"—might run afoul of the requirement of article 140. In both of these instances, the question is again presented as to the extent to which the Decree has repealed these provisions.

IX. Conclusion

In addition to the constructional problems mentioned above regarding the meaning of certain provisions of the Decree, it seems clear that at least four major issues of law are raised as to the effect of the Decree on existing statutory provisions.

With respect to the pre-emptive rights of existing shareholders, the Decree expressly states its intention of rendering inapplicable the exercise of such rights as to shares of the corporation available for conversion. The only question is, therefore, whether it is constitutionally permissible to do so. While, as has been indicated, an argument can be made to support the prospective, rather than retroactive, operation of the Decree, it would seem inadvisable to rely wholly upon such an argument. Several methods have been suggested to avoid the constitutional problem, the feasibility of which would, of course, depend on the particular circumstances involved. Suffice it to say that a serious problem exists in this regard, which should be taken into account by any attorney charged with the responsibility of delivering a validity opinion relative to any issue of convertible debentures under the Decree.

With respect to the question as to whether the statutory capital limitation on the issuance of debentures remains applicable to the issuance of convertible debentures under the Decree, in the writer's view the answer

must be affirmative. The Decree merely adds an additional provision to those already existing in Chapter V of the General Law of Negotiable Instruments, and thus the new article 210-bis merely becomes a part of the legislation applicable to the issuance of debentures. The failure to again set forth the capital limitation cannot properly be regarded as an affirmation of its nonapplicability.

With respect to the proper issuance of treasury shares for conversion purposes, the matter is somewhat more in doubt. It will be recalled that the Company Law requires that no new stock may be issued unless all previously issued stock has been fully paid. As a practical matter, the issuance of convertible debentures representing any sizable principal amount, in the light of an already existing source of capital in the form of unpaid stock subscriptions, seems unlikely. Depending, of course, on the circumstances, it would appear advisable to call unpaid subscriptions before the stockholders are asked to approve the issuance of convertible debentures. This would, of course, avoid any difficulties as to the validity of the delivery of stock upon the exercise of conversion rights.

As to the possible violation of the statutory provisions requiring that all shares of a corporation be issued and at least twenty per cent paid, it would seem that the position must be taken that the Decree has, in fact, rendered inapplicable these requirements with respect to the "treasury shares" available for conversion. As has been seen, there is already existing statutory authority for the issuance of unsubscribed treasury shares under the provisions relating to corporations of "variable capital."

Finally, when the dictates of practicability prevent literal compliance with the provisions of the Company Law applicable to the contents of share certificates, the position of implied repeal of such provisions by their apparent inconsistency with the Decree would be available and seems to be a reasonable one.

APPENDIX A

Parte Pertinente del Decreto Publicado en el *Diario Oficial de los* Estados Unidos Mexicanos, el 29 de diciembre de 1962.

DECRETO:

El Congreso de los Estados Unidos Mexicanos, decreta:

SE ADICIONA LA LEY GENERAL DE TITULOS Y OPERACIONES DE CREDITO.

ARTICULO UNICO. Se adiciona la Ley General de Títulos y Operaciones de Crédito con un artículo del tenor siguiente:

Artículo 210-bis.—Las sociedades anónimas que pretendan emitir obligaciones convertibles en acciones se sujetarán a los siguientes requisitos:

I—Deberán tomar las medidas pertinentes para tener en tesorería acciones por el importe que requiera la conversión.

II—Para los efectos del punto anterior, no será aplicable lo dispuesto en el artículo 132 de la Ley General de Sociedades Mercantiles.

III—En el acuerdo de emisión se establecerá el plazo dentro del cual, a partir de la fecha en que sean colocadas las obligaciones, debe ejercitarse el derecho de conversión.

IV—Las obligaciones convertibles no podrán colocarse abajo de la par. Los gastos de emisión y colocación de las obligaciones se amortizarán durante la vigencia de la misma.

V—La conversión de las obligaciones en acciones se hará siempre mediante solicitud presentada por los obligacionistas, dentro del plazo que señala el acuerdo de emisión.

VI—Durante la vigencia de la emisión de obligaciones convertibles, la emisora no podrá tomar ningún acuerdo que perjudique los derechos de los obligacionistas derivados de las bases establecidas para la conversión.

VII—Siempre que se haga uso de la designación capital autorizado, deberá ir acompañada de las palabras "para conversión de obligaciones en acciones."

En todo caso en que se haga referencia al capital autorizado, deberá mencionarse al mismo tiempo el capital pagado.

VIII—Anualmente, dentro de los primeros cuatro meses siguientes al cierre del ejercicio social, se protocolizará la declaración que formule el Consejo de Administración indicando el monto del capital suscrito mediante la conversión de las obligaciones en acciones, y se procederá inmediatamente a su inscripción en el Registro Público de Comercio.

IX—Las acciones en tesorería que en definitiva no se canjeen por obligaciones, serán canceladas. Con este motivo el Consejo de Administración y el Representante Común de los Obligacionistas levantarán un acta ante Notario que será inscrita en el Registro Público de Comercio.

TRANSITORIO

UNICO—El presente Decreto entrará en vigor tres días después de su publicación en el "Diario Oficial" de la Federación.

APPENDIX B

Unofficial Translation of Relevant Part of Decree Published in *Diario Oficial* of the United Mexican States, December 29, 1962.

DECREE

The Congress of the United States of Mexico decrees:

An amendment to the General Law of Negotiable Instruments and Credit Operations.

Article I—The General Law of Negotiable Instruments and Credit Operations is amended by the addition of the following article:

Article 210-bis. Corporations [*sociedades anónimas*] which intend to issue debentures that are convertible into shares of stock will be subject to the following requirements:

I—They will have to take the necessary steps to have in their treasury [*en tesoreria*] sufficient shares to meet the requirements of conversion.

II—For the purposes of the above provision, Article 132 of the General Law of Business Associations will not be applicable.

III—The resolution authorizing the issuance will provide for the period within which, following the date of sale, the right of conversion must be exercised.

IV—Convertible debentures may not be sold at less than par. The expenses of issuance and sale thereof are to be amortized over the life thereof.

V—Conversion of debentures into shares will always be effected by means of an application presented by the holders of the debentures within the period for conversion set forth in the resolution of issuance.

VI—While the debentures are outstanding, the issuing corporation may take no action that would prejudice the rights of the holders established as the basis of conversion.

VII—Whenever the term "authorized capital" is employed, it must be accompanied by the words "for conversion of debentures into shares."

Whenever reference is made to "authorized capital," "paid-in capital" must be mentioned at the same time.

VIII—Every year, within the first four months following the close of the corporation's fiscal year, the Board of Directors will set forth in an instrument, which will be protocolized and immediately inscribed in the Public Commercial Registry, the amount of capital subscribed by means of the conversion of the debentures into stock.

IX—Treasury stock which finally will not be exchanged for debentures will be cancelled. To carry out that purpose, the Board of Directors and the General Representative of the holders of the debentures will execute an instrument to that effect before a Notary, which instrument will be registered in the Public Commercial Registry.

TRANSITORY

The present decree will enter into force three days after its publication in the *Diario Oficial* of the Federation.