Market Entry Vehicles and Agreements

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In defining a market entry strategy, U.S. exporters should evaluate both the risks and potential rewards associated with each available option. Although some market entry vehicles may involve less risk—both legal and commercial—these strategies also tend to offer the lowest potential returns and market staying power.

Oftentimes, companies will choose a hybrid strategy, depending on the nature of the opportunity at hand. Others choose to start with a less risky approach, which may become more aggressive as they build the business. One strategy may be more appropriate for a service provider, while another, for an equipment supplier. Some of the more common approaches (from low to high risk) employed in Mexico are:

(1) Direct exports

(2) Manufacturers' representatives and agents

(3) Local distribution

(4) Subsidiary sales office

(5) Licensing and franchising

(6) Partnerships and joint ventures

DIRECT EXPORTS

Direct exports are the sale of goods from a seller in one country directly to a buyer in another country, without the involvement of intermediary resellers. Direct exporting is often the preferred strategy for exporters because it involves little risk and no mark-up by the distributor or reseller.

Before deciding on direct exporting as a vehicle, however, suppliers are advised to consult with their customers to make sure they are willing to take care of all product importation requirements **(see report on Import Procedures)**. Companies must take into account that under Mexican law, only Mexican companies or individuals with a Mexican taxpayer ID number and enrollment in the Mexican Importers' Registry may legally import merchandise into Mexico. If the customer is willing to handle importation, sellers will typically deliver merchandise to their buyer at some port of entry prior to passing through customs (e.g., "FOB Laredo, Texas").

If your customer is not willing to assume importation responsibilities, companies referred to as *comercializadoras* will take charge. Your customs broker or logistics company will often double as a *comercializadora*, and if not, can probably recommend one. Keep in mind, however, that these intermediaries must first take title to the goods upon importation and pay all applicable duties and VAT tax **(see report on Tax)**, before transferring the VAT tax and title to the final customer by issuing a Mexican invoice. As a result, extra cost and taxes will usually be added to the final sale price. Therefore, before choosing this route, exporters should calculate and factor in these added costs to ensure that the final price is still competitive.

Purchase and Sale Agreements and Securing Payment

When selling to Mexican buyers it is very important to document the transaction with a purchase agreement **(see report on Payment and Collections)**. Without such an agreement, you will have little legal recourse if your customer fails to pay for an order or otherwise does not fulfill his end of the bargain.

Some of the most important provisions of a purchase agreement include:

- The law and courts that govern the agreement. In other words, the contract should clearly spell out (i) under what law and (ii) in which courts (two distinct, but related concepts) controversies are to be heard. If the sale is to be consummated on the U.S. side of the border (i.e., delivery, payment in full, and transfer of title occurs prior to importation), then the seller should feel free to insist that U.S. law and courts govern. If, however, the seller is required to import and deliver in Mexico or if payment terms or financing is provided, then exporters are in most cases advised to insist that Mexican law and courts apply. (If you have to repossess the goods or sue for non-payment, doing so from a U.S. jurisdiction where the buyer has no legal address and conducts no business will be very difficult. And even if you are successful in such a claim in the U.S., if the buyer has no assets in the U.S., any judgment to collect will have to be executed and enforced in Mexico.) Parties should also be aware of the **International Convention on the Sale of Goods**, a multilateral treaty to which Mexico and the U.S. are parties, which sets forth the rules of the game for international purchase agreements between entities from countries that have ratified the treaty.

- Contract price and payment terms

- Description of the goods sold

- Delivery terms

- Term or duration of the contract

- Grounds for termination

- Confidentiality, non-disclosure, and other provisions to protect the parties' know-how and intellectual property

Exporters that give their buyers "terms", which allow for deferred payment (in whole or in part) within a specified period of time following the signing of the contract and the delivery of the merchandise, are strongly advised to require their customers to execute a **promissory note, standby letter of credit or similar security device to ensure payment**. Without such security—and even with a signed purchase agreement—collecting from a defaulting buyer is very difficult at best.

MANUFACTURER'S REPRESENTATIVES AND AGENTS

As discussed above, a foreign vendor can sell goods or services in Mexico directly. However, a vendor may decide, for various reasons, to use other methods to market and sell his merchandise in Mexico, such as independent agents or manufacturer's representatives in Mexico. Agents offer their foreign principals local know-how and contacts without having to open a local office.

Such a relationship is usually documented by a service agreement (your representative is providing you the service of marketing and selling the goods or services on your behalf) or by a commission agreement.

Under a commission agreement, the agent is paid a commission on sales made directly by the foreign company deriving from contracts and sales brought by the agent. Under a service agreement, the agent/service provider's compensation may depend on sales (results) but also may involve a fee payable independent of the results.

Mexican law does not regulate the amount to be paid as a commission; however, for tax purposes the agent's commission will be considered regular income. The agent's obligations will typically include marketing and promoting the sale of the company's products in accordance with the company's policies. Agents do not assume the risk of product loss nor do they acquire title to the seller's goods or keep inventories. The commission agreement must also specify if the agent may act on behalf and in the name of the company. Other clauses that may be agreed upon by the parties include: exclusivity, territory, intellectual property, payment conditions, labor relations, choice of law and jurisdiction, term and termination.

"Permanent establishment" issues **(see report on Tax Law)** may arise and should be addressed. Under Mexican and international tax law, a "permanent establishment" is a fixed place of business through which the business of an enterprise is wholly or partly carried out. Branches, agencies, offices, factories, and workshops are deemed permanent establishments. If your Mexican agent is not considered under law to be "independent" (e.g., he works only for you, takes orders from you, etc.), then you will have a permanent establishment in Mexico with respect to the activities the agent carries out on your behalf.

Another "red flag" associated with using an agent in Mexico is Mexican employment law **(see report on Labor Law)**. This law will typically apply only if your agent is an individual rather than a company. Therefore, the easiest way to avoid having to deal with employment law is to hire a company rather than an individual as your agent. Even still, it is important to ensure that the contract signed with the company clearly indicates that the agent's/company's employees are not your employees, and that in the event they sue you as their employer, the agent must indemnify you.

DISTRIBUTION

Distributors are independent vendors who purchase products from the foreign seller then resell them to Mexican buyers. In other words, the distributor will purchase, take title, import and resell the exporter's goods in a defined territory. Distributors may or may not keep inventories of the seller's product. Distributors, unlike commission agents, derive their income from the difference between the wholesale price at which they purchase, and the retail price at which they sell. The risk of loss is assumed by the distributor upon accepting or receiving the goods sold. With the exception of clauses related to purchase and sale, distribution agreements typically include the same provisions found in agency agreements.

SUBSIDIARY SALES OFFICE

Opening a Mexican subsidiary sales office will enable U.S. exporters to import products and deliver directly to their Mexican customers without the use of costly intermediaries. A subsidiary office will also enable exporters to employ exclusive sales representatives rather than having to rely on independent agents who may not fully represent exporters' interests.

The establishment of a subsidiary **(see report on Incorporation Procedures)** in Mexico requires incorporating a Mexican company, registering it in the National Foreign Investment Registry, and obtaining a Mexican taxpayer ID number (RFC). Other required steps will depend on the company's proposed activity or purpose and the state in which it is incorporated.

A subsidiary office is different from a branch office in that a subsidiary is a separate legal entity from the parent company. Thus, a subsidiary shields the parent company from liability in Mexico while a branch does not.

LICENSING AND FRANCHISING

“Licensing and franchising” may apply to many different types of businesses, from manufacturing to software, to retail stores. A common denominator in all cases, however, is that the U.S. licensor/franchisor is granting to its Mexican counterpart the right to use and exploit intellectual property, know-how, or a trade secret in a defined jurisdiction.

For example, U.S. exporters may wish to establish a permanent, on-the-ground presence in Mexico but prefer not to run the risk of starting up their own facility in a foreign jurisdiction. In the case of equipment manufacturers, the U.S. supplier may choose to license specific technology and know-how (patents, trademarks, trade secrets and industrial secrets[1] such as design and manufacturing processes, etc.). Through the transfer of technology and license agreements, the licensee pays the licensor a royalty equal to a certain percentage of the sales produced by the licensor’s technology, as well as technical assistance agreements and service contracts. License agreements are also an essential part of any software distribution agreement.

If your “know-how” relates to the way you sell or market your goods or services in a uniform manner and depends on a certain image, then the appropriate vehicle may be a franchise agreement. Mexican law establishes that a franchise exists “when, along with the license to use a trademark, technical knowledge is transferred, or technical assistance is granted, to produce, sell goods or render services in a uniform manner and with the same commercial, administrative and operative methods established by the owner of the trademark, with the purpose of maintaining the quality, prestige and image of the products or services therein distinguished.”

JOINT VENTURES

A joint venture can be defined as the association of parties (individuals or legal entities), for a limited period of time, in which the parties jointly undertake a specific business enterprise. A joint venture can take any form agreed upon by the parties to develop the business, usually a joint venture agreement or joint venture entity.

All joint ventures involve a common denominator: the sharing of risk and reward. In the manufacturing arena, a joint venture will typically take the form of an equity arrangement whereby both the foreign and local partners share ownership of a new or existing manufacturing operation held by a joint venture entity. In sales and services, a joint venture may also be carried out through a joint venture company, but oftentimes the parties will prefer to formalize more of a “strategic alliance” through a joint venture agreement or similar accord in which the parties define the terms of their venture.

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[1] Industrial secrets are defined as “any information capable of industrial application maintained in confidence which may be useful to obtain or to maintain a competitive advantage in the performance of economic activities, which confidence the owner has taken measures to preserve, by labeling information as ‘confidential’, ‘secret’, or in a similar manner.” An industrial secret must necessarily relate to the nature, characteristics or purposes of products, production methods or processes, or to the means or forms of distributing or marketing products, or rendering services.

i. Joint Venture Agreements

Mexican law provides for a specific type of contractual joint venture referred to as an "*asociación en participación*". Under this type of joint venture agreement, the parties join efforts for a specific purpose or job: one partner (the active partner) assumes all contractual responsibilities and liability before third parties and the other partner (the silent partner) assumes responsibility only for providing services or capital to the joint venture. Upon completion of the defined job or objective, the agreement will terminate. The joint venture agreement will include the standard provisions discussed above. Other key provisions of joint venture agreements include sharing in profits or losses, indemnity, and rights and responsibilities of each party. The *asociación en participación* is not widely used in Mexico outside of construction contracts or other joint ventures in which one party provides the capital and the other performs the business.

In contrast, joint venture agreements of strategic alliance are much more widely used than an *asociación en participación* and offer the parties more flexibility in defining and tailoring the terms of their understanding. As another option, when the terms of your joint venture are not yet clearly defined, an MOU (memorandum of understanding) is a common and very useful way of formalizing an understanding with your Mexican counterpart to conduct jointly a specific business or project. Many parties will also execute a joint venture agreement as a complement to their joint venture company, to serve the purpose of establishing the broader rights and responsibilities of the parties.

ii. Joint Venture Companies

Many U.S. companies looking to develop and carry out a specific business in Mexico with a given Mexican partner choose to create a joint venture company. The most important aspect of the joint venture company that you must negotiate with your Mexican partner is the bylaws or "*estatutos*" of the entity. The bylaws spell out the framework and "rules of the game" of the joint venture and address issues such as corporate governance, ownership percentages, deadlock provisions, transfer of shares, withdrawal, increasing and decreasing capital, buyout provisions, the distribution of profits and losses, minority rights, calling, convening and taking resolutions at shareholders and board meetings, as well as dissolving the company, among other important matters. Joint venture companies can also be created by the U.S. partner purchasing a percentage of the shares in an existing company previously held only by the Mexican partner (i.e., an acquisition). Whatever the approach, the joint venture company will exist validly under Mexican law, and will therefore be obligated to pay taxes and comply with other requirements established by Mexican law. The advantage of a joint venture company as opposed to a simple joint venture agreement is that the former is more effective in protecting the investment of the U.S. investor.

As a final note, regardless of the type of joint venture used, before entering into the venture, U.S. companies are advised to perform legal, financial, and reputational due diligence on their Mexican partner. Indeed, a lack of proper due diligence on partners during the initial stages may result in much more serious legal and operational problems in the future.

QUESTIONS & ANSWERS

Question: when hiring a Mexican agent, will the individual be considered an employee?

Answer: **It depends on whether the agent is "subordinate" to the principal or "independent" (i.e., represents others in addition to you).**

When dealing through an agent, U.S. exporters should be careful to specify that the agent shall be considered an independent contractor, and not an employee. Otherwise, the agent could claim that a labor relationship exists under Mexican law for services while in Mexico, regardless of the nationality or residence of the employer, and request entitlement to the employee benefits provided by law. Furthermore, it is important to keep in mind that Mexico's Federal Labor Law states that any person conducting sales, subject to direct supervision, is considered an employee of the entity for which the sales are being made.

Question: are there any specific restrictions when entering into a franchise agreement?

Answer: **No.** The parties to a franchise agreement enjoy full contractual freedom. Their respective obligations include, among others, the granting of a trademark license and technical assistance, protection of confidential information, compliance with quality and operational standards, payment of royalties, and access to the franchisor's system of operation.

Additionally, franchise agreements are not subject to governmental approval. As stated in Mexico's Intellectual Property Law, franchisors must deliver to potential franchisees, before execution of the franchise agreement, the technical, economic, and financial information regarding the franchise and its system.

Question: when is "confidential" information not considered an industrial secret?

Answer: Information in the public domain, information that may be obvious to an expert, or information that must be disclosed by law or court order, shall not be considered an industrial secret. Confidential information is not in the public domain if it is disclosed to an authority for the purpose of obtaining permits, registries, or authorizations.

Question: how are the parties of an asociacion en participacion taxed?

Answer: The active partner shall comply with the tax obligations of the common operation, including registration in the Taxpayers' Registry and provisional tax payments. Each fiscal year, both the active and silent partners are required to report their income from the venture, by indicating their taxable profit.