Guide Through The Mexican M&A Labyrinth: Top 10 Labor and Employment Considerations for Foreign Investors

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For foreign companies contemplating a merger with or acquisition of a Mexican company, understanding the labor landscape is crucial. Mexico's labor laws, particularly the Federal Labor Law (*Ley Federal del Trabajo*, or FLL), provide strong protections for workers, which become highly relevant in M&A scenarios. This Insight aims to outline the top 10 key labor considerations involved in such transactions, helping foreign investors navigate the complexities of Mexican labor regulations.

Understanding Mergers and Acquisitions in Mexico

Before diving into labor-specific issues, it's important to grasp the general framework governing mergers and acquisitions in Mexico.

M&A transactions in Mexico are regulated by several laws including the General Business Corporation Act (*Ley General de Sociedades Mercantiles*), the Securities Market Law, the Antitrust Law, the Foreign Investment Law, and crucially, the Federal Labor Law. Foreign investors should also be mindful that the Foreign Investment Law generally allows 100% foreign investment and the transfer of funds, offering favorable conditions for international business, but certain restrictions remain for strategic industries mostly related to oil and gas as well as terrestrial and aerial transportation.

In Mexico, mergers can take two primary forms: a merger by incorporation and a classic merger.

- In a merger by incorporation, one of the merging companies absorbs the assets and liabilities of the other(s), which then cease to exist.
- Conversely, a classic merger involves the dissolution of all merging companies to form a new entity.

Although both types are recognized by Mexican law, the classic merger is less frequently utilized in practice.

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The General Business Corporations Act requires that the merger be approved by the shareholders' or partners' meetings of the involved companies. The merger agreement, detailing the terms of the merger such as the exchange ratio of shares and the management structure of the new entity, must be registered with the public registry of commerce.

Additionally, each company involved must publish the merger resolutions and balance sheets in the electronic system established by the Ministry of Economy, and a plan must be published to address outstanding liabilities. Creditors have a three-month period to oppose the merger if their rights are affected, though the merger can take effect at the time of registration if payment of all the debts of the merging companies has been agreed, or if the amount thereof has been deposited in a credit institution, or if the consent of all the creditors has been obtained.

Top 10 Labor Considerations in Mergers and Acquisitions

When it comes to labor issues in M&A transactions, the implications can vary significantly depending on whether the acquisition involves purchasing shares or assets. Here are the top 10 labor and employment considerations to take into account.

1. Purchase of Shares

Acquiring shares in a Mexican company does not typically impose additional labor obligations on the acquiring company. In this scenario, the local company continues as the employer, maintaining its existing employee relationships and union affiliations. This means that collective bargaining agreements and labor contracts remain intact, and the acquiring company inherits the existing labor framework without triggering special rights for unions due to the change of control. However, it's crucial to review any collective bargaining agreements to ensure there are no clauses that might give rise to additional obligations or rights upon a change in ownership.

2. Purchase of Assets

In contrast, when a foreign company acquires the assets of a Mexican company or engages in a merger, it becomes necessary to evaluate whether existing labor relationships and associated rights and obligations will be preserved or if they will be renegotiated. If the acquiring entity or the resulting company from the merger does not wish to assume the existing labor obligations, the local company may need to terminate these relationships, which may be very costly. This could involve severance payments and addressing potential liabilities such as unpaid social security contributions. A thorough due diligence process should include a review of employee registration with the Mexican Social Security Institute (IMSS), individual and collective labor agreements, and any issues related to employees working without formal agreements. The acquiring company might face significant costs related to severance and potential claims if the labor situation is not rectified before the transaction.

3. Substitution of Employer

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The FLL provides for the automatic transfer of labor obligations through a legal mechanism known as the substitution of employer (*sustitución patronal*). Under Article 41 of the FLL, this mechanism ensures that the new employer assumes the labor obligations of the previous employer when the business is transferred as an economic and legal unit. This includes transferring employees with their acquired rights, such as seniority and negotiated conditions. The original employer remains jointly liable for any labor obligations incurred up to six months after the transfer.

This means that the acquiring company only needs to notify employees of the change in employer, and employees do not have to consent or receive severance pay, as their rights and conditions remain unchanged. However, the union must be informed of the acquisition, and obtaining its approval early in the transaction process is crucial to avoid complications at closing.

4. Unions

Unions in Mexico can significantly impact M&A transactions. Purchasers together with the target company should approach the existing union to avoid conflicts. The FLL mandates that unions and employers must protect democratic structures and allow employees to freely choose their unions.

The legal landscape now enforces independent unions and more transparent and democratic practices within them, which should be factored into any M&A strategy.

5. Social Security

Mexican social security laws also recognize the substitution of employer, extending joint liability for social security obligations to both the old and new employers for six months after the transfer. The statute of limitations for these liabilities is five years. To avoid inheriting social security liabilities, companies might consider structuring employment through outsourcing arrangements. However, this can lead to shared liabilities between the outsourcing company and the operating entity, with the old employer remaining responsible for pre-transfer obligations.

6. Due Diligence Review

When negotiating an acquisition in Mexico, it is crucial to conduct a comprehensive due diligence review, focusing specifically on the labor and social security liabilities of the target company. Pay particular attention to potential risks related to ongoing litigation and social security issues. For instance, if employees have been exposed to hazardous noise levels without adequate protective equipment, they may suffer from hearing loss over time, which could be classified as work-related illness or injury. This situation could lead to increased social security premiums and liabilities.

7. Representations and Warranties

Given that due diligence cannot uncover every potential liability, it is important to establish a robust set of representations and warranties. These should aim to address potential future liabilities, such

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as those related to hazardous working conditions, for a period extending beyond the statutory six-month joint liability period typically associated with mergers.

8. Termination of Employees

Mexican labor laws regulate employee terminations stringently. Terminations without payment of a severance must be based on grounds specified in the FLL, such as misconduct or violation of company policies. Be aware that the concept of payment *in lieu* of notice is not known to Mexican labor law. Instead, the employee can be terminated immediately with payment of a severance if no legal cause for dismissal exists. Employers must provide written notice of termination and may face substantial financial liabilities if the dismissal is deemed unjustified. This includes severance pay, which comprises three months of integrated salary, which consists of the daily base salary and proportional parts of benefits, plus additional compensation based on years of service. To avoid protracted legal disputes, it is common for employers to add to the package 20 days of integrated salary per year of service and negotiate terminations by mutual consent, offering a severance package that aligns with statutory requirements.

9. Profit Sharing

Mexican law mandates that employers share 10% of their annual profits with employees (PTU). Eligible are all employees except for directors and general managers. The amount is now capped at either the total of three months of the employee's salary or the average amount received for PTU during the last three years, choosing the option that most benefits the employee. Newly established businesses are exempt from this obligation in their first year of operation, which starts when the company is registered at the tax authority (SAT) obtaining its tax ID number (RFC). During an M&A transaction, profit-sharing obligations may need to be calculated and priced in.

10. Statute of Limitations

Labor claims in Mexico are subject to varying statutes of limitations. Generally, actions regarding employee rights are subject to a one-year limitation period, e.g. to claim salary, PTU, benefits, with shorter periods for some claims related to unjustified dismissal (two months) and longer periods for claims related to work-related injuries or enforcement of labor tribunal judgments.

Conclusion

Navigating labor issues in Mexican M&A transactions requires a comprehensive understanding of local laws and regulations. Foreign investors should conduct thorough due diligence to address potential labor obligations, union considerations, and social security liabilities. By carefully managing these factors, investors can mitigate risks and enhance the likelihood of a successful transaction.

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