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GUIDE ON AGENCY AND DISTRIBUTION AGREEMENTS IN MEXICO

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AGENCY

Preliminary considerations surrounding Agency and Distribution Agreements in Mexico.

Mexico as a Civil Law jurisdiction regulates the legal institutions adopted primarily from the Corpus Iuris Civilis (of roman origin) and the Napoleonic Code. In view of the foregoing, the Commercial Code regulates the sale and purchase agreement, the consignment agreement, the deposit agreement, among others. On the other hand, due to the international trading and global economics ensuing from the Free Trade Agreements to which Mexico is a party, the latter has been adopting foreign legal institutions of Anglo-Saxon origin such as the agency and distribution agreements. The first problem that arises is the assimilation of such legal institutions. The Mexican Congressmen in light of the globalization and eminent opening of the economies, decided to regulate some of the aforementioned Anglo-Saxon legal institutions, such as the trust, or the financial leasing agreement. However, some other agreements like the agency and distribution, lack legal customized regulation and are therefore considered as atypical and innominated contracts.

The Commercial Code does not foresee the theory of atypical and innominated contracts¹, but such Code remits supplementary to the application of the Federal Civil Code, hereinafter the “Civil Code”. Article 2 of the Commercial Code states: “Failing provisions of this ordinance and the other mercantile laws, those of civil law contained in the Civil Code applicable to federal matters shall be applicable to commercial acts”. Furthermore, the Civil Code follows the theory of Messineo (Italian legal author) in Article 1858 regarding atypical contracts: “Contracts which are not specifically regulated in this Code shall be governed by the general rules of contract law, by the stipulations of the parties, and in so far as these lacking, by the provisions of the contract with which they have most analogy amongst the contracts regulated in this Code”

¹ The agency and distribution agreements according with Article 75 subsections I and X of the Commercial Code are considered as acts of Commerce. Notwithstanding the aforementioned, the Commercial Code does not specifically regulate the agency and distribution agreements, but said Code recognizes the existence of such legal figures as commercial acts.

Said Article provides that the non-regulated contracts will be governed by: (i) the general rules of contract² law; (ii) the stipulation of the parties³ (as foreseen by Article 1796: “Contracts are perfected by mere consent, except those which must appear in a form established by law; from time to time they are perfected and bind the contracting parties not only for compliance with what was expressly stipulated but also for the consequences which, according to their nature, are required by good faith, use or law”). The limitation provided by Article 1796 is also established in Article 6 of the Civil Code: “The will of parties cannot exempt them from the observance of the law, nor alter or modify it. Private rights which do not directly affect public interests may be waived only when the waiver does not impair rights of third parties”); and (iii) the rules of the contract with which they have most analogy. For example, for the distribution agreement some dispositions regarding the sale and purchase agreement are applicable, because of the transfer of the property encompassed in both agreements.

Regarding commercial agreements the regulations applicable are as follows:

1. The provisions of the special Mercantile Laws; in the absence thereof, by;
2. The general Mercantile Legislation (Commercial Code); in the absence thereof, by;
3. The banking and mercantile usage; and, in the absence thereof, by;
4. The Federal Civil Code.

Under Mexican law agency and distribution agreements are considered as atypical an innominated contracts. Since no jurisprudence, court practice or legal dispositions regulate these agreements, the legal analysis set hereof is based on the common commercial practice and Mexican doctrinal reference.

1. THE AGENCY AGREEMENT.

1.1. *Agency, Agent and the Agency Agreement.*

For the correct study of the agency agreement, distinction must be made between three concepts: the agency as establishment, the agent and the agency agreement.

a) The agency as establishment is referred to in many statutes within the Mexican legal system. For example: Article 75, subsection X, of the Commercial Code establishes: “Undertakings for commission agents, agencies, houses for commercial business and establishments and offices for sales at public auction”. Also, the Commercial Code⁴ considers as business entities: (i) Foreign companies, or their agencies and branches. For income tax purposes the term "permanent establishment" means any place in which business activities or personal services are wholly or partially carried on. The term incorporates

² Said rules are regulated by the Civil Code from Article 1792 to Article 2242.

³ Also known as ‘free will principle’.

⁴ Article 3 of the Commercial Code.

branches, *agencies*, offices, factories, workshops, installations, mines, quarries and any other place of exploration or extraction of natural resources.

b) The agent as a person or entity acting on its own is also referred to in many regulations. For example: (i) the maritime agent is the person or corporate entity acting on behalf of the maritime company as commissioner or agent⁵; (ii) the insurance agents are the persons or entities that intervene in the insurance contracting⁶; (iii) the surety agent is the person that intervenes in the surety contracting⁷; (iv) the customs agent has the function to promote the importers' and exporters' dispatch of merchandise⁸; finally (v) the Labour Law regulates the commercial agents (insurance, salesmen, travelers, advertisers or sales promoters) and considers them as employees of the company when laboring permanently and under a dependency relationship with the employer⁹.

The common underlying element in the above mentioned examples regarding the different types of agents is that they act on their own, independently if there is representation or not.

c) As mentioned above, the agency agreement has a commercial nature when entered into by independent business entities and there is no subordination between the agent and the business entity. In the Income Tax Law, Article 14, subsection IV, provides that the independent performance of services applies to the commission, *agency*, and representation.

The Agent as one of the parties in the commercial agreement is by general rule a business entity. However, there may be different kinds of agents and different relations of these with the businessmen. Under certain circumstances this relationship has a labour nature (see section 1.4.).

1.2 *Definition.*

Under Mexican law a commercial agent is considered a business entity or person that enters into a commercial agency agreement, acting independently, developing the businesses of one or more companies.

1.3 *Types.*

The agent of commerce is a business entity, as it performs qualified acts of commerce; due to its continued and steady activity and the independence requirement, generally has the condition of a Business Company.

The agent of commerce may or may not have authority to represent and act on behalf of the business entity, as it is not

⁵ Article 19 of the Navigation Law.

⁶ Article 23 of the Insurance Law.

⁷ Article 87 of the Surety Law.

⁸ Article 26 of the Customs Law.

⁹ Article 285 of the Federal Labour Law.

inherent to the function of acting in name of the principal (*mandante*). In Mexican Law, most of the agents do not have the implied authority to represent the principal.

It is possible to distinguish the agent of commerce with representation of its principal, from that acting without it. In view of this, there are representative agents and agents without representation. The agent of commerce may be or may not be exclusive, depending on the terms of the agreement. For this reason there are exclusive agents and agents without exclusivity or non-exclusive.

There are other types of agents that tend to create confusion, i.e. the traveler agents and the sales agents, in contrast with the commercial agents. The sales agents have their mission circumscribed to a certain territory and the travelers as indicated by its name, travel through one or more territorial zones and even the whole country. The functions of the sales and travel agents are more limited than the commercial agent. The former tend to reduce their activities to visit clients, foment their offers and pick up the orders and transport them to the Business Company which they are representing; customarily they are empowered to enter into agreements. Their authority and even the way they are reattributed depend on the nature of the activity developed. There is a reference in the Commercial Code to the travel agents¹⁰: “Traveling employees authorized by letters or other documents to undertake business, or effect trading operations, shall bind their principal within the scope expressed in the documents authorizing them”; the description of this agents may be found in the Labour Law¹¹.

1.4. *Labour Aspects.*

An issue of great importance in the relation between agent and principal is to determine in which cases a commercial agreement may be deemed as a labour relationship. The Mexican Federal Labour Law contains a whole chapter dedicated to the agents of commerce and other similar business persons and in Article 285 of said legal disposition it is established that: “The agents of commerce, of insurance, sales, travelers, propagandists or sales promoters and other similar, are employees of the Company or Companies when their activity is permanent, except when the activities performed are isolated or not executed personally”.

The jurisprudence and doctrine have analyzed this legal disposition. Even though the Labour Law utilizes the most ample expressions to describe the agent, the criterion seems to be clear.

The Supreme Court of Justice interpreted in 1975 Article 285 of the Federal Labour Law declaring: “The agents of commerce and insurance are employees of the company to which they render services, with the exceptions that Article 285 foresees: (i) that they do not execute the work personally; or (ii) intervene in isolated operations. If the labour relationship is denied by the employer questioning that the agent is not an employee, then the defense would prevail if the employer proves the exceptions

¹⁰ Article 323 of the Commercial Code.

¹¹ Article 285 of the Federal Labour Law.

provided for in Article 285”.

Notwithstanding the aforementioned, the Federal Courts have recently established (2003) a new jurisprudential thesis, in opposition to the precedent set by the Supreme Court: “AGENTS OF COMMERCE. THE ESSENTIAL ELEMENT TO DEMONSTRATE THE EMPLOYER-EMPLOYEE RELATIONSHIP IS THE EXISTENCE OF SUBORDINATION. The agents of commerce described in Article 285 of the Federal Labour Law, are the persons that acting in a permanent way following the instructions imposed by the companies, are dedicated to offer to the general public merchandises, values or insurance policies, and for said work they receive a prime calculated over the income of the operation in which they intervene, giving it the name of salary or commission. In light of this, the essential element for an agent of commerce to be considered an employee is the existence of subordination of the employee towards the employer, even though apparently this element is substituted by the mentioned Article 285 by the permanency of the relationship; however, due to the special characteristics of the agents of commerce, the subordination is still the essential element and the permanency is an element that presumes its existence”.

This thesis is an isolated precedent, not obligatory like the one set in 1975 by the Supreme Court, and has brought great controversies and as of this date the issue at hand has not yet been resolved otherwise.

1.5. *Definition.*

The agency agreement is a commercial relationship whereby one person called agent, acting as an independent intermediary, in a permanent and steady way, is compelled to promote or in its case conclude the negotiations on account of the business corporation or principal, in exchange of a compensation generally linked to the results.

1.6. *Elements.*

The parties that intervene in the agreement are called agent (also representative or commission agent) and principal (also business corporation, entity or person).

The principal or business entity is in most cases a business corporation. Said entity must have the general contracting capacity. The agent must have this capacity as well. It is important to analyze the nationality of the agent, to determine if there are any legal limitations to act as an agent.

The basic elements of this agreement are basically:

- a) *The activity of the agent.* The agency agreement may be distinguished from the mandate agreement exclusively in the following sense: the agent in the mandate agreement commits to enter into agreements, not to obtain contracting parties (clients). The primary characteristic of the agent's activity is the promotion or the conclusion of the deals or agreements on account of the business entity.

The content of the activity to develop may be very ample. Normally, the agreements promoted by the agent are sale and purchase, but it is clear that the purpose of the agency agreements is not limited to this type of contracts. In concordance with the aforementioned, the French law which is similar to Mexican law regarding commercial agents states the following: "the agent negotiates and eventually concludes sales, purchases, leasings, rendering of services in name and on account of the producers, industrials and business entities".

- b) *The remuneration.* The compensation received by the agent is the so-called commission, award or compensation which may be in money or in kind. It is common to remunerate the agent by fixing a percentage of the concluded agreements or purchase orders. When the remuneration is not set contractually by the parties, Article 304 of the Commercial Code is applicable by analogy, regarding the commission agreement.

1.7. *Formalities.*

As an atypical agreement, not expressly regulated by any law in Mexico, there are no mandatory formalities that the agreement must meet to be legally valid and binding. Therefore, the general rule of contractual consensuality applies¹².

The written form of the agency agreement is *ad probationem*, to probe the will of the parties, but it is not an element of existence or validity. However, in light of the resemblance to the mandate and commission agreements, the legal dispositions of said contracts as to formalities may apply. In connection with the foregoing, we are of the opinion that no formality is required for the agency agreement, except when representation is granted to the agent.

1.8. *Main obligations of agent.*

- a) Promote or conclude negotiations on behalf of the business entity.

This obligation may be expressly agreed in the corresponding agreement, regarding the activities that must be performed by the agent and the promotion and sale proceedings. The activity of the agent is delimited to instrumental tasks destined to stimulate the will of third parties, to enter into agreements with the principal. In this sense, the agent does not perform legal acts, but procures negotiations, except in the case of the agent with representation.

- b) Cooperate for the conclusion and fulfillment of the negotiations with third parties.

¹² Article 78 of the Commercial Code.

This obligation is not indispensable. Its existence will depend on the conditions set forth in the agreement. An example of this obligation is the delivery of the merchandise to the client, and the post-sale services, amongst others.

c) Follow the instructions of the principal.

The agent is obliged to execute the conferred task following at all times the instructions received and procuring the faithful tutelage of the interests that it represents. The characteristic is to let the agent decide how it is going to perform its activities. This obligation is similar to that of the mandate and commission agreements. Due to the broad scope of the activities of the agent, the instructions of the principal are most of the time facultative.

d) Inform the principal.

The agent is obliged to convey to the principal, the information regarding the market conditions in the geographical zone assigned; including any other useful information to value the importance or convenience of the negotiations. It is also obliged to inform about the solvency of the third parties with which exist pending operations or negotiations. The duty to inform must be satisfied periodically during the term of the agreement. At the end of the agreement the agent must render the accounts of its activity.

e) Execute the agreement by itself.

In order to enter into sub-agency agreements, the agent needs express authorization from the principal. Article 280 of the Commercial Code applies analogically to said obligation. As expressed in said Article, the agent may utilize dependents, which do not exempt it from its responsibilities with the principal.

1.9. *Main obligations of the principal.*

a) Pay the remuneration or commission in the agreed terms.

The amount of the remuneration must be agreed by the parties, consisting generally, in a percentage over the value of the negotiations executed by the agent. Some times several percentages are set for different products, volumes or clients. A fixed amount may be set as a minimum or a percentage that varies according with the achieved negotiations. When there are no grounds to determine the amount of the agent's compensation, the mercantile usages apply. The agent is entitled only to the commission of the originating from concluded negotiations. In concordance with this, the agency agreement is considered of 'results' and not 'of means'. The partial performance of the agreement imposes a proportional remuneration.

The agreement must perfectly state the time when the agent has the right to collect its commission. If the agreement is silent, the following criteria applies:

- i. If the obligation of the agent is limited to obtain orders, it has the right to the remuneration, at the time said orders are confirmed.
- ii. If the agent must deliver the merchandise on account of the principal as an additional collaboration obligation, the agent may collect its remuneration, when said merchandise is delivered.
- iii. Finally, if agreed that the agent must collect the amounts owed to the client, its commission will accrue when said client pays the amount owed to the principal.

Another relevant aspect to consider in the agreement is to determine the time when the commissions become due and payable. Even when the agent is entitled to them, the principal must pay them within a certain given period. It is common practice to stipulate that periodically or from time to time, the agent informs the principal of the concluded negotiations, and thirty or sixty days later the principal pays the commissions.

- b) The reimbursement of operating expenses to the agent.

The agent as a general rule does not have the right to the reimbursement of expenses, even though the parties expressly agree otherwise. The main reason is that the agent is an independent commercial entity and with the remuneration so paid, it must pay its own operating expenses. This is a distinctive element of the commission agreement.

- c) Assist the agent in the development of the activity.

This extensive obligation includes acts such as supply the agent with catalogs, costs lists, discounts, and assistance or sales techniques. The scope of this obligation must be convened by the parties, even when the commercial usage of the principal in other analog and different agreements may be of help to interpret its limits.

- d) Rights of the principal and the agent to inspect.

The principal is authorized to inspect and be acquainted with the accountancy and administration of the agent. This has the purpose of corroborating that the paid commissions, come from the concluded negotiations and have been calculated according with the agreed percentages. However, the principal must not interfere with the agent's operations.

1.10. *Types of agency agreements.*

- a) *The representative agency agreement.* The agency agreement as well as the commission and mandate agreements may be representative or non-representative. Regarding the representative agreement, the agent acts on behalf and on representation of the principal. Under the non-representative agreement the agent acts on behalf of the principal, but without representing it. According to Mexican law when the agency agreement is representative, the agent requires to have the express authority to represent the principal and following the formalities prescribed by law. The representation granted to the agent is ruled by the legal dispositions governing the mandate agreement¹³.
- b) *Guarantee Clause.* It is valid to agree in the agency agreement the obligation of the agent to respond and guaranty the obligations contracted with third parties. This provision must be included in the agreement and presumes and additional remuneration. The agent may guarantee the total amount of the operation or part of it.
- c) *Sub-agency.* This figure is recognized in the common commercial practice as an instrument of commercial organization, through the subcontracting performed by the agent, as principal with the subagents. It must be differentiated the subagents as commercial auxiliaries or independent business entities from the factors, dependants or traveler linked to the agent by a labour relationship.
- d) *Agency-Distribution.* In some agency agreements, the agent has the right to acquire from the principal, the merchandise subject matter of the agreement. The agent does not lose its quality and may ask from the principal certain operations and the purchase of the merchandise under certain profit conditions. The agent that purchases to resell on its own, becomes a distributor of the principal over said purchased merchandise.
- e) *Agent-Consignee.* In similar terms to the type explained in the preceding paragraph, the agent may also be a consignee of the merchandise property of the principal. An agreement of this nature must include the covenants regarding the sales condition, estimated price, terms which the merchandise will be consigned and the agent-consignee's retribution, amongst others. The primary element of distinction between the agency-distribution agreement and the agent-consignee is the transfer of the title to the stored merchandise.

1.11. *Exclusivity Clause.*

It is frequent to find in agency agreements exclusivity covenants for the benefit of the agent, the principal or both parties. These covenants must be expressly agreed in the agency agreement. The exclusivity clause has two basic requisites: (i) a geographical zone must be determined; and (ii) be subject to a term. The zone is usually the area exclusively assigned to the agent and the duration is the same as the one set in the agreement. The principal that granted the exclusivity to the agent may reserve for itself certain privileges to promote and conclude negotiations directly.

If the agent breaches the exclusivity covenant and concludes negotiations with third parties outside the agreed territory or commercial zone, the concluded negotiations are valid, as the exclusivity covenant is not enforceable against third parties, only to the agent and the principal.

¹³ Article 285 of the Commercial Code.

1.12. *Non-competition after termination.*

There are no legal non-compete clauses after termination; however it is common practice to establish these types of restrictive clauses in the agency agreements, in order to prevent the agent from benefiting from prior businesses engaged in name of the principal.

1.13. *Termination.*

- a) *Natural termination of the agreement.* The agency as a continuous performance agreement pretends a steady and permanent relation between the parties. Regarding the duration, the agency agreement may be for a fixed term of duration or for an indefinite term. When the agreement has a fixed duration period, the termination extinguishes the contractual relation when said period comes to an end.
- b) *Unilateral termination.* By general rule the principal cannot reverse the agreement unilaterally, if said termination method was not agreed. The principal that unilaterally terminates the agreement must indemnify the agent, according with Article 2596 of the Civil Code, applied by analogy.
- c) *The resignation of the agent.* In the mandate agreement not in the commission one, the resignation of the agent is set as cause of termination (Article 2595 subsection I of the Civil Code). In some agency agreements it is common practice to agree that the agent may resign at any time and terminate the agreement, without the obligation to indemnify the principal.
- d) *Death or inability of the agent.* Since the agency agreement is created by an *intuitu personae* relation, the death of the agent is a contractual cause of termination. On the other hand, the death of the principal is not a cause of termination of the agreement, if said principal is a commercial entity and subsists. When the agent is a business corporation, the change in the management, stock control or any other event, does not trigger termination, except when agreed in the respective agency agreement.
- e) *Bankruptcy.* The Business Reorganisation Law establishes for the mandate and commission agreements by general rule that the bankruptcy of any of the parties will not be a cause of termination, except when determined by the conciliator; this disposition applies to the agency agreement by analogy¹⁴.

1.14. *Indemnity in case of rescission.*

The parties may agree in the agreement an indemnity in favor of the agent in the cases in which the agreement is rescinded by default of the principal.

¹⁴ Article 100 of the Business Reorganisation Law.

The indemnity provision is known in Mexico as “*pactum commisorium*”. In contract law, the agreement contained in all reciprocal obligations whereby the nondefaulting party is entitled to demand specific performance or the termination of the agreement from the defaulting party, and in both cases, the payment of damages. It is common practice to include in the agreement the liquidated damages clause in order to avoid the quantification of the damages or civil liability in Court. Also, moral reparation may be paid, even amongst corporations. This term has no identical concept under U.S. or British laws and means the harm that a person or corporation suffers in its honor, dignity, as well as the image that the person or entity has before the rest of the persons or entities. The legal claims containing this kind of provisions are enforceable and very common. The damages in civil law jurisdiction must be a direct effect from the default of the obligation, in light of this; consequential damages, incidental damages, indirect damages and torts are not foreseen by Mexican legislation as they are common law concepts.

In order to avoid the liquidation of damages it is common practice to include in the agreements a clause in the agreements known as “conventional penalties” or “liquidated damages clause”. The amount charged in said clauses can not exceed the principal amount or value of the obligation. If the obligation be executed in part, the penalty shall be reduced in the same proportion. In demanding the penalty, the creditor is not obliged to prove that he has suffered losses, nor can the debtor exempt himself from satisfying the penalty by proving that the creditor has suffered no loss.

1.15. *Tax considerations.*

The tax imposition criterion in Mexico for income tax purposes is the residence. Therefore a Mexican resident may be engaged as a non employee agent or sales representative for a resident abroad and the consequences are the following:

According to Article 2 of the Mexican Income Tax Law, an independent agent may act for an entity resident abroad, without being considered a permanent establishment for said entity, as long as such agent acts in the ordinary course of his business. For said purposes, it will be considered that the agent does not act in its ordinary course of his activities, when he:

- (i) Possesses goods or merchandise to deliver to clients in the name of the foreign entity.
- (ii) Assumes risks corresponding to the entity resident abroad.
- (iii) Acts subject to detailed instructions or subject to general control of the resident abroad.
- (iv) Performs activities that economically correspond to the resident abroad and not to his own activities.
- (v) Obtains his consideration regardless of the results of his activities.
- (vi) Performs transactions with the resident abroad using prices that differ from those generally agreed to by independent parties in comparable transactions.

In the terms of the Treaty to Avoid Double Taxation between Mexico and the United States¹⁵ ('the Treaty') an entity shall not be deemed to have a permanent establishment in a Contracting State merely because it carries on business in that State through a broker, general commission agent, or any other agent with an independent status, provided that such persons are acting in the ordinary course of their business and that in their commercial or financial relations with the entity, conditions are not made or imposed that differ from those generally agreed to by independent agents.

Notwithstanding the foregoing, according to the provisions of the Treaty, a representative in Mexico may possess goods or merchandise to be delivered to clients in the name of the resident abroad without being considered a permanent establishment as long as the other previously mentioned conditions are met.

According to the provisions of the Mexican Income Tax Law and the Treaty, the consideration obtained by an independent agent must depend on the results of its activities, and therefore it can not be a base salary.

It is important to mention that if the representative sells goods in Mexican Territory in the name or for account of the entity residing abroad, it will be considered a permanent establishment for the foreign company, since the said company is performing a commercial activity in Mexico through the agent.

The commentaries to the model tax convention on income and capital by the OECD Committee on Fiscal Affairs, provide that when a commission agent habitually acts, in relation to certain foreign entity, as a permanent agent having an authority to conclude contracts, said agent would be deemed in respect of this particular activity to be a permanent establishment, since he is thus acting outside the ordinary course of his own trade or business (namely that of a commission agency).

Said commentaries are a source of interpretation of the treaties to avoid double taxation signed by Mexico, and as a consequence, we consider that with said manner of operation there is a high exposure to be deemed as a permanent establishment.

According to this, it is advisable that the agent in Mexico does not conclude contracts in the name or for account of the entity residing abroad.

As mentioned before, in order to avoid a permanent establishment, the independent agent must not perform activities that fall outside his normal course of business (as a broker or commission agent).

Therefore, the activities in Mexico to be performed by the independent agent must be only supporting or auxiliary ones to the activities of the foreign entity.

¹⁵ Other tax treaties to which Mexico is a party provide similar regulations.

In fact, according to the Treaty, the following activities can be performed without the risk of having a permanent establishment:

- a) The use of facilities solely for the purpose of storage, display, or delivery of goods or merchandise belonging to the entity;
- b) The maintenance of a stock of goods or merchandise belonging to the entity solely for the purpose of storage, display, or delivery;
- c) The maintenance of a stock of goods or merchandise belonging to the entity solely for the purpose of processing by another entity;
- d) The maintenance of a fixed place of business solely for the purpose of purchasing goods or merchandise, or of collecting information, for the entity;
- e) The maintenance of a fixed place of business solely for the purpose of advertising, supplying information, scientific research, or for the preparations relating to the placement of loans, or for similar activities which have a preparatory or auxiliary character, for the entity,
- f) The maintenance of a fixed place of business solely for any combination of the activities mentioned in subparagraphs a) to e) provided that the total activity or the combination is of a preparatory or auxiliary character.

If the independent agent performs activities that are not only preparatory or auxiliary for the entity residing abroad, but also part of the normal activity of the foreign company, Mexican tax authorities may consider that a permanent establishment exists for the resident abroad.

In such cases, it is advisable to open a regular branch or a subsidiary to perform said commercial activity on a regular basis, as a normal taxpayer of the Mexican Treasury.

It is important to consider that having an irregular permanent establishment implies the impossibility of taking normal deductions (costs, purchases, etc.) and thus, the imposition on the income instead of on the profit of the permanent establishment.

2. DISTRIBUTION AGREEMENT.

2.1. *Definition.*

As explained in the Preliminary Considerations of this Article, a distribution agreement is considered an atypical and innominated contract. Therefore, Mexican law does not provide with a definition of such agreement; however doctrine has defined it to be a contract formed when a distributor (concessionary) obligates itself to acquire, commercialise and resell the manufacturer's products, as set forth by the terms of the manufacturer, who in turn shall transfer title to the goods to the

former. The manufacturer has the ability to impose the distributor certain obligations regarding the business organisation in order to qualify as such.

Moreover, the major element of a distribution agreement is that the distributor typically acquires and holds title to the merchandise, for the sole purpose to resell the merchandise at a higher price obtaining a profit from the difference of the retail price and selling price. Since the purpose of the distributor is to obtain a profit, under the Commercial Code, such commercial speculation is considered a commercial activity¹⁶ and therefore regulated and subject to commercial laws in Mexico. Under the Mexican Commercial Code, supplemental authority may be found in the Federal Civil Code.¹⁷

2.2.1. *Formalities.*

A distribution agreement is not subject to any type of legal requirements regarding its legal form. Moreover, if no written distribution agreement is executed between the parties; one simple transaction could be considered a commercial sale, which need not require written evidence.

Furthermore, Mexico follows the UNIDROIT Principles of International Commercial Contracts, which establish the freedom of contract and no formal requirements regarding distribution agreement. As explained above, these agreements are not specifically regulated in the law, therefore, no formal evidence of writing or specific rules apply, other than general principles of contract law, and other default provisions hereof mentioned. Despite the above, one must bear in mind that a distribution agreement may fall within the category of an ‘adhesion agreement’, such standard type agreement require they follow specific rules, such as to be drafted in Spanish and be authorized by the Federal Consumer Protection Agency.

A distribution agreement, transfers title from the manufacture to the distributor and the former may, within the terms set forth, subjects the distributor to comply with certain distribution requirements, i.e. minimum sale, inventory stock, warranty, limit sale price, among others. If these clauses appear within a contractual distribution relationship, certain antitrust rules may apply regarding fixed pricing products or services necessary for the national economy or consumption.¹⁸

These contracts are not officially subject to any registration requirement, unless the contract is to be used as a standard-form or adhesion agreement, which calls for a mandatory registration as provided by the Mexican Federal Consumer Protection Law.¹⁹ Such law requires standard-form agreements be drafted in Spanish and dully registered and authorized by the Federal Consumer Protection Agency.²⁰

¹⁶ Subsection I of Article 75 of the Mexican Commercial Code, (hereinafter as Commercial Code)

¹⁷ Article 2 of the Commercial Code.

¹⁸ Article 7 of the Federal Economic Competition Law, (hereinafter Competition Law)

¹⁹ Articles 85of the Federal Consumer Protection Law, (hereinafter Consumer Protection Law)

²⁰ Article 85 of the Consumer Protection Law.

2.2.2. *Exclusivity.*

Usually a manufacturer or distributor may prearrange and call for an exclusivity clause. This clause may bind the distributor to sell products only from a particular manufacturer; or, on the other hand, grant the exclusive right of the distributor to be the only authorized entity to sell the manufacturer's goods within a given territory and during a certain time frame.

Manufacturers usually grant exclusivity to a distributor in connection to a specific territory and in a given term.

It is important to mention that Mexican Competition Law prohibits any kind of agreement that aims to displace agents from the market, provided that such contract achieves a substantial power within a given market,²¹ and the controlling agent has the ability to unilaterally fix prices in such market.²² Therefore, special care must be taken when adjudicating distribution agreements.

Furthermore, Mexican Consumer Protection Law determines that the Executive Branch is the authority in charge of prefixing prices regarding certain products. Therefore, when drafting and implementing a distribution agreement it is obligatory to follow such rules. The Federal Competition Commission has the authority to sanction any violation to the antitrust laws.²³

A severe violation of the exclusivity clause triggers a rescission action against the breaching party if said party has breached his obligation contained in such clause, and any penalty remedy provided thereof. Yet, when distribution agreements do not provide for any type of remedy in case of exclusivity clause violation, the non-breaching party may file suit for breach of contract and petition the Court to rescind the contract, and seek damages payment caused as a result of the breach.

Typically, distribution contracts prearrange a liquidated damages clause that imposes a penalty on the breaching party in the event of a breach. When drafting such type of clauses, we must consider that Mexican law prohibits that penalty clauses exceed the principal amount of the agreement, as explained before in connection with agency agreements. Additionally, a Mexican Court will not award a claim seeking both the enforcement of a penalty clause and claiming damages against the breaching party.²⁴ Therefore, if the liquidated damages clause has been triggered, the claimant may not file suit for both the liquidated damages clause and payment of damages. Furthermore, a strong burden of proof is imposed to the party seeking a damage award.

2.2.3. *Territory.*

²¹ Article 10 of the Competition Law.

²² Article 13 of the Competition Law.

²³ Article 35 of the Competition Law.

²⁴ Article 1840 of the Civil Code for the Federal District

As to territory, Mexican Law does not establish any limitations regarding these agreements. Almost all general considerations mentioned in the exclusivity area must be taken into account when drafting a distribution agreement, regarding the displacement of certain agents within the territory given in exclusivity to the distributor, as provided by the Mexican Federal Competition Law. Therefore, the analysis of the effects of a distribution agreement must be made in a case-by-case basis.

Any violation exceeding a territory clause may trigger a contract termination clause, as provided for in the agreement and could lead up to the payment of penalty clauses or damages.

2.2.4. *Obligations of supplier.*

Following the general principles of contract law in Mexico, which establish that these types of contracts will be governed by the most similar regulated contract²⁵ and pursuant to the decision issued by the Mexican Supreme Court of Justice,²⁶ which has found authority that the articles regarding a commercial sale set forth in the Commercial Code²⁷ govern certain aspects of the distribution contract, from such authority we must reveal the obligations imposed to the supplier.

a) The most important obligation imposed to a supplier or manufacturer is his obligation to supply a certain amount of tangible goods and sell them to the distributor. This obligation implies by itself two obligations: (1) to deliver the goods, and (2) to transfer title to the goods to the distributor.

A distributor – as an independent salesperson – must have title to the goods in order for him to resell the merchandise to third parties, therefore, the supplier must transfer title to the goods at the time of sale. However, certain suppliers only deliver the tangible goods and transfer title once the distributor has paid-off in full such goods.

Under the Mexican Commercial Code, a sale of goods for commercial purposes, is divided in two categories: (1) sale of known tangible goods,²⁸ and (2) sale of unseen tangible goods.²⁹ Performance of the contract is deemed when: (a) Buyer receives the goods or accepts a partial delivery, or (b) until the buyer inspects and accepts the goods.

Delivery of the goods must be made pursuant to the contractual obligations set forth in the agreement. However, if the contract does not foresee delivery of the goods, the seller must place the goods at buyers' release within 24-hours after performance.³⁰

²⁵ Article 1858 of the Civil Code for the Federal District.

²⁶ Decision by the Supreme Court, *Compraventa de distribución exclusiva, contrato mercantil de. Rescisión.*

²⁷ Articles 371-387 of the Commercial Code.

²⁸ Article 373 of the Commercial Code.

²⁹ Article 374 of the Commercial Code.

³⁰ Article 379 of the Commercial Code and Articles 2142 – 2149 of the Civil Code.

Regarding the transfer of title to the goods, it is often used that the supplier delivers the goods and reserves title of such tangible property until the distributor has paid-off the price of such goods. In these cases, the goods are deemed to be in deposit.

b) The supplier has to warrant and guarantee the distributor of the quality and quantity of the merchandise bought.³¹ Said obligations are imposed to the supplier, since a distributor under Mexican Consumer Protection Law is the responsible party before third party purchasers.³²

Once the buyer accepts the goods he has five days to claim seller for any hidden defects in the goods. Unless otherwise provided for, seller will be obligated before buyer for warranty of title and right of possession.³³

c) It is common practice to insert clauses that bind the supplier to maintain certain prices or grant the distributor a preferential price, collaborate in marketing which benefit distributors', provide technical and administrative assistance for the sale and commercialisation of the products, and must be expressly established in the contract itself.

2.2.5. *Obligations of distributor.*

a) The distributor has an obligation to buy a prearranged amount of goods from the supplier. Typically, a distribution agreement establishes the obligation of the distributor to acquire a minimum number of goods, otherwise known as quota.

b) A distributor has the obligation to pay the supplier for the goods as established in the agreement, or if not provided for, as explained above, the sale is considered to be paid in cash.

Regarding the place and payment date, if not provided for in the contract, the Commercial Code establishes that the sale is considered to be in cash. Furthermore, if the contract is silent as to the place of payment, the Federal Civil Code, as a supplemental law, determines that the place of payment is the place of delivery.³⁴ Regarding the payment time, if the merchandise is delivered, purchaser must pay the price at the time of delivery, nonetheless, if merchandise is not delivered the seller may collect the outstanding debt, thirty days after perfection of the agreement.³⁵

³¹ Article 383 of the Commercial Code.

³² Articles 2, 92 and 93 of the Federal Consumer Protection Law.

³³ Article 384 Commercial Code.

³⁴ Articles 380 of the Commercial Code and 2294 of the Federal Civil Code.

³⁵ Article 2080 of the Federal Civil Code, determines "If the time when payment is to be made has not been determined an obligations to give are concerned, the creditor cannot require payment until after thirty days following a formal demand, made either judicially, or extrajudicially before a Notary Public or before two witnesses..." See Also, Article 2249 of the Federal Civil Code "As a general rule the sale is perfected and mandatory for the parties when they have agreed as to the thing and its price, although the former has not been delivered nor the latter paid." See also, Article 2014 of the Federal Civil Code "In alienations of certain and specific things the transfer of ownership takes place between the contracting parties merely as a result of the contract..."

On the other hand, if there is an outstanding debt, the distributor has the obligation to pay interests on the overdue payment.³⁶ Interests under commercial agreements are regulated in the Mexican Commercial Code at a fixed annual rate of six percent over the outstanding debt.³⁷

c) The distributor must follow to the terms and obligations set forth in the contract, regarding the maximum and minimum resale prices to third parties.

d) A distributor has the obligation to use the trademark as determined in the contract itself. As in the agency agreement, distributors have the obligation to refrain from any trademark alternation.³⁸ Additionally, under the Mexican Intellectual Property Law, distributors may be banned from selling altered trademarked products and may be subject to intellectual property sanctions.³⁹

e) Distributors are subject to provide consumers warranty as provided for in the Mexican Consumers Protection Law. Therefore, they are responsible for any product malfunctions, although, the distributor has the right to revert action against the manufacturer for redress.

f) Further obligations may be provided for in the contract.

g) There are other common obligations established in distribution agreements, which are imposed to the distributor, such as: to comply with marketing programs, inform the supplier the market information, distributors' use of the best efforts and have a minimum stock in the distributors' warehouse.

2.2.6. Term.

A distribution agreement is regularly a long-term relationship between the manufacturer or supplier and the distributor. Mexican law does not have a minimum or maximum term for a distribution agreement.

There are various forms for establishing a term clause. One possibility is to establish that the agreement has an indefinite term, that is, without any term. In these cases, termination may be arranged for as established in the agreement, by merely notification or if no provisions are set forth, termination should be through a notification attested by a Notary Public. Either alternative, shall establish the termination date of the distribution agreement, which shall be within a reasonable period of time.⁴⁰

³⁶ Article 380 of the Commercial Code.

³⁷ Articles 85, 362 and 380 of the Commercial Code.

³⁸ Article 300 of the Commercial Code.

³⁹ Articles 151 – IV, 175, 178 bis 4-II, 178 bis 5-V and 199 bis-VI of the Mexican Intellectual Property Law.

⁴⁰ UNIDROIT Principles Article 5.8.

Other types of term clauses, establish a pre-fixed termination and typically provide a reasonable time upon expiration of the term, in order for the distributor to sell all of the remaining goods, or may intend to sell such goods to the manufacturer for the acquiring price. Additionally, distribution agreements defer automatically the contract for annual periods, and have the ability to terminate as provided for in the agreement or upon prior notification to the other party.

2.2.7. *Indemnification upon termination.*

Mexican law does not provide for indemnification rights upon termination. Nonetheless, parties' to a contract may establish indemnification in case of termination for no just cause. Please refer to section 1.14. of agency agreement.

2.2.8. *Non-competition after termination.*

There are no legal non-compete clauses after termination, however it is common to establish these types of clauses in distribution agreements, in order for the distributor to benefit for prior businesses engaged while using the trade name or trademark of the manufacturer as an authorized distributor. Please refer to section of non-compete clause of the agency agreement section.
