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TV Azteca: A Case Study of Corporate Governance in Mexico

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1. Introduction

As the casual investor will appreciate from a cursory review of the news, corporate governance is a subject of ongoing debate. In the world's most sophisticated capital market, the United States, there continues to be room for improvement. For the serious investor looking overseas, corporate governance is a concern for the same reasons: a lack of transparency and the existence of conflicts of interest between those who control a company and those who should protect shareholders' investments. In Mexico, however, there is additional uncertainty about the rules of the game and opportunities for legal recourse if things go wrong.

This is one of the challenges that Latin American corporations have to overcome to attract capital from the U.S. In Mexico, corporate governance, or the lack thereof, has become a hot topic. Recent developments point to a move toward more transparency and improved shareholder rights, but corporate scandals in Mexico have damaged investors' faith in the game. Recent investigations into the dealings of Ricardo Salinas Pliego, a member of Mexico's billionaires club, underscore the fact that Mexican companies could go further to earn the trust of foreign investors.

This article will use two case studies to highlight the changing nature of corporate governance in Mexico since the advent of the Sarbanes-Oxley Act. The first is the deal between Salinas Pliego's company, TV Azteca, and NBC, one of the leading U.S. broadcast networks. The second is the Securities and Exchange Commission (SEC) investigation of Salinas Pliego in connection with TV Azteca's cell phone unit, Unefon, an investigation that came about due to a provision in Sarbanes-Oxley. This was a case of unprecedented enrichment on the part of insiders in a Mexican company, with Salinas Pliego and a colleague each pocketing \$109 million at the expense of their shareholders.

2. Corporate Governance in Mexico

Corporate governance under Mexican law is the responsibility of one or more directors, who are not necessarily executives of the corporation (Husted and Serrano 2001). Beyond that, corporate governance is essentially a question of self-regulation, with all the shortcomings that implies. Given that an estimated 95 percent of Mexican businesses are family-owned and run,¹ there are serious limitations to this model of corporate governance. TV Azteca is no exception. Salinas Pliego and his family control approximately 59.8 percent of TV Azteca's capital stock (TV Azteca 2004). As a result, Salinas Pliego has a high degree of autonomy.

Even if a board of directors sought to curb the behavior of management, its powers under Mexican law would be limited to dismissing corporate managers and hiring new

¹ "Still keeping it in the family," *The Economist*, March 18, 2004.

ones. Families tend to play an important part in running large companies in Mexico, and the board's role would be negligible if the candidates were all family members. In 1999, a study found that 95 percent of family-controlled companies in Mexico had a family member as their CEO². At Mexico's largest media company, Televisa, for example, the current CEO is Emilio Azcarraga Jean, who was appointed in 1997 following the death of his father, the founder of the company (see exhibit 1). In such a situation, there is bound to be a closer relationship between a company's board, stacked with family members, and its family-controlled management, than between a professional board and its professional managers. These structural conditions mean that the role of the board of directors in Mexico is very limited compared to its role in OECD countries, where there is also a duty to provide advice and input on compensation.

Nevertheless, increases in foreign investment in Mexico and global trends in corporate governance have had an impact. There is a movement to improve corporate governance in Mexico, exemplified by the Code of Best Corporate Practices developed by a group of academics with the blessing of the Mexican Stock Exchange (BMV) in 1999. However, the code is voluntary and most companies can afford to pay lip service to its practices. This is because the majority owners and operators of most Mexican companies are family members, which limits accountability and corporate control at the board level. In the U.S., in contrast, institutional investors hold over 50 percent of corporate equities.

The code recommends, among other things, that at least 20 percent of board members be independent. Another positive development in the composition of boards in recent years is the new right to name a director to a board if a 10 percent stake is held in a Mexican public company (the influence of that seat is another matter). To this point, Salinas Pliego provides another good example. He did follow the code's recommendation and announced an 11-member board for TV Azteca with five independents, up from the two independents who had previously sat on the company's board.³ Salinas Pliego recruited high-profile names such as James R. Jones, the former U.S. ambassador to Mexico; Michael Gearon Jr., executive vice president of American Tower; and Mario Laborin, CEO of Bancomer, as independent board members. Unfortunately, distinguished independent board members are not always made aware of executives' activities, especially when they harm shareholders' interests. In this case, TV Azteca's independent board members were unaware of the deal that made Salinas Pliego the subject of an SEC investigation.

Shareholders can strengthen their shareholder rights when investing in Mexican companies by investing in those with American depository receipts (ADRs). ADRs

² La Porta *et al.*, "Corporate Ownership Around the World," *Journal of Finance*, 1999.

³ Daniel J. McCosh, "Executive Strategies for the Americas," *Latin CEO*, December 1999.

represent shares of a foreign corporation listed on the New York Stock Exchange (NYSE). The SEC's corporate governance and disclosure rules apply to firms with an ADR listing, and the actions of these firms fall under the SEC's jurisdiction.

It was the SEC that pursued the investigation into Salinas Pliego's treatment of minority shareholders in the case of TV Azteca and Unefon. A minority shareholder suit initiated in Mexico before the SEC's investigation had been dropped because of a technicality. No other action was being taken by the Comision Nacional Bancaria y de Valores, the national banking regulator, when the SEC's investigation began.⁴ The SEC's investigation has already led to a curbing of Pliego's control of TV Azteca and serves as a warning to other Mexican businessmen. Investors need to weigh the differences between current disclosure requirements for the SEC and the Mexican Stock Exchange and decide whether they are comfortable with these if they invest in a Mexican company that does not have an ADR listing.

3. Case #1: TV Azteca and NBC (Pre-Sarbanes-Oxley)

In July 1993, Ricardo Salinas Pliego, the scion of a wealthy Mexican industrialist, broke into the broadcast television market with the purchase from the Mexican government of two networks, Canal 7 and Canal 13, for \$643 million. With these acquisitions, TV Azteca was born and became the first direct competition to the incumbent monopolist Televisa, a giant media conglomerate with \$2 billion in revenues in 1994.

Within a year of TV Azteca's formation, Salinas Pliego sought expertise and content from NBC. TV Azteca offered NBC an entry into the regulated Mexican broadcast market on the eve of the North American Free Trade Area agreement (NAFTA), a treaty that was expected to bring Mexico accelerated economic growth. NBC would have found it hard, if not impossible, to reach a similar agreement with Televisa, given its extensive experience in programming (the company began broadcasting in 1952). This goes some way toward explaining why NBC entered into a deal with a company that had yet to report on its first full year of operations. In May 1994, Salinas Pliego struck a deal with NBC to license some programming and receive advisory and other services in exchange for cash and stock options (see exhibit 1 for complete details of the transaction and settlement). This was NBC's first joint venture in Latin America.

By the time NBC sought to exercise its options in 1997, TV Azteca's revenues had grown to \$451 million. It had captured what would be a record audience share for the company of 40 percent, and an initial public offering (IPO) on the New York and Mexican Stock Exchanges was imminent. If NBC had been able to exercise all the options it was

⁴ TV Azteca's 20F for 2003 mentions that it is under investigation by the SEC and that the Comision Nacional Bancaria y de Valores had, at that stage, only requested information about the transaction in question (TV Azteca 2004).

granted under the IPO in August 1997 it would have realized a profit of \$125 million (please see exhibit 1 for analysis of TV Azteca's 20F filing with the SEC for 2003). NBC's total claim against TV Azteca was for \$130.6 million, including the \$5.6 million in cash it was owed for services rendered (see exhibit 1).

TV Azteca responded to NBC's request for the balance of the cash it was owed and the right to exercise its options by moving to cancel its agreements and outstanding financial obligations. TV Azteca filed a request for arbitration with the International Chamber of Commerce, as it was required to do under the terms of their contract, claiming that NBC had not fulfilled its obligations under the agreement.

TV Azteca and NBC settled three years later. After incurring millions of dollars in legal fees, NBC walked away with less than it was entitled to under the terms of their original agreement (see exhibit 1). If NBC, backed by a corporation as influential and well financed as General Electric, had to undergo such an ordeal to force Salinas Pliego to honor his contract, what chance would a less powerful investor have of enforcing his or her contractual rights?

What was behind TV Azteca's actions and how did the settlement come about?

A quick review of Salinas Pliego's business career to date, from his wresting control of the family department store business from his aunt and uncle (who are still seeking compensation) to his current status as the subject of an SEC investigation, offers a possible explanation. Salinas Pliego's business record highlights a man who has made a career by evading prosecution for his actions and taking advantage of the limitations of the legal system and corporate governance in Mexico.

A few examples of Salinas Pliego's abuse of minority shareholders or creditors for personal gain include the following:

- Salinas Pliego moved to rescind TV Azteca's agreement with NBC and by doing so prevented it from taking a 10 percent stake in his company and a seat on the board. Pliego claimed breach of contract to explain his actions but eventually settled. If he had honored the agreement, TV Azteca would have had to pay NBC \$28.1 million. The settlement eventually required TV Azteca to pay NBC \$48.1 million (TV Azteca 2004).
- Salinas Pliego even proved resistant to political pressure. The dispute between NBC and TV Azteca was so acrimonious that at one point it was reported that "an aide in the Clinton White House raised the issue with the office of then-President Ernesto Zedillo of Mexico in 1997 . . . But even after a Mexican government official asked Mr. Salinas Pliego to respect the contract, the media mogul refused . . ."⁵

⁵ David Luhnow, "New Static: A Mexican Media Billionaire Now Faces Investigation in U.S.—Ricardo Salinas Pliego Built Small Retailer Into Empire That Has Many Adversaries," *Wall Street Journal*, February 27, 2004.

- Comerica Bank in Detroit has been trying to collect on a \$3.3 million loan to Salinas Pliego's business Elektra for over a decade, with no clear end in sight. Pliego clearly has no problem with long-running legal disputes.

Given that Salinas Pliego had resisted previous attempts by minority shareholders and creditors to alter his position, what brought TV Azteca back to the negotiating table in February 2000? A case can be made that Salinas Pliego's ambition to enter the U.S. market through TV Azteca gave him a good reason to settle. In the spring of 2000, TV Azteca began discussions with a U.S. partner to launch a local television network using TV Azteca content aimed at U.S. Hispanics. Salinas Pliego probably needed a clean slate if TV Azteca was to invest in the U.S. and enter into another contract with a U.S. partner. Azteca America began operations in the U.S. in July 2001.

4. Case #2: SEC Investigation into Salinas Pliego (Post-Sarbanes-Oxley)

Salinas Pliego and a partner bought debt owed by Unefon, a division of TV Azteca, to Nortel at a discount in June 2003 and sold it back to the company at full price in October 2003. The *New York Times* reported that Salinas Pliego had admitted that he earned \$109 million on the transaction.⁶ Pliego's role was not disclosed to TV Azteca shareholders at the time, and minority shareholders initiated a lawsuit against him. The Mexican authorities later dropped the case because of a technicality. This would most likely have been the end of the matter had the SEC not stepped in. This highlights another reason why investors should be wary of Mexican companies that do not have ADRs.

The SEC had jurisdiction in this case because TV Azteca is traded on the New York Stock Exchange. As such, the SEC had the power to impose fines, penalties or a cease-and-desist order against TV Azteca, Salinas Pliego and other individuals. It could also bar Pliego and others from serving as officers or directors of any company whose securities are sold in the U.S., which would be a real limitation given Azteca America's broadcast operations in the U.S. and Pliego's ambitions for growth in this country.

The Nortel transaction only came to light owing to a provision in the 2002 Sarbanes-Oxley Act that requires a company's outside lawyers to disclose possible violations of securities laws. Akin, Gump, Strauss, Hauer & Feld reported this transaction to the SEC and resigned as TV Azteca's legal counsel. When an internal investigation triggered by the firm's resignation found that Salinas Pliego had benefited from the deal, two of TV Azteca's most prominent independent directors resigned: James R. Jones, the former U.S. ambassador to Mexico, and Gene F. Jankowski, former president of the CBS Broadcast Group.

⁶ Elisabeth Malkin, "As Inquiries Press Ahead, 2 Directors Quit at Azteca," *New York Times*, May 10, 2004.

In response to the SEC's investigation and on the advice of independent Mexican legal counsel, TV Azteca has taken a number of measures to improve transparency and, in effect, reduce Salinas Pliego's power (TV Azteca 2004). A committee unrelated to the existing board will now nominate independent directors and an audit committee of three independent directors will be established to ensure compliance with U.S. securities law, among other things. Perhaps the biggest concessions are the removal of executives close to Pliego from the day-to-day operations of the company and changes to Pliego's existing powers of attorney. Salinas Pliego will no longer be able to act on behalf of TV Azteca in any material transaction or related party transaction without the prior authorization of the board of directors.⁷

5. Implications for the Region and Conclusions

NBC has yet to enter into another joint venture with a partner in Mexico or Latin America. Its experience with TV Azteca may have persuaded the company that the risk of a failed deal was too high, given weak corporate governance in Mexico and the rest of the region. In a broader context, the NBC-TV Azteca case presents an important challenge to Mexico in attracting foreign investment. Unless corporate governance rules such as those enforced by the SEC are enacted for private and public companies, Mexican entrepreneurs and businesses face an additional obstacle in attracting foreign investment. Only improved corporate governance will reduce a foreign investor's risk of a deal's going awry, as happened to NBC.

While there have been many positive developments in corporate governance in Mexico, these cases highlight the risks facing U.S. investors and the weaknesses in corporate governance that Mexican companies must address to attract foreign investment and expertise, especially if they do not have ADRs offering shareholders recourse to the SEC. TV Azteca's actions following the SEC investigation offer an example of measures that should improve protection of shareholders' rights.

Other developments also bode well for foreign investment in Mexico. In March of this year, Televisa reorganized its capital structure to protect the interests of minority shareholders by eliminating the risk of dilution if any large shareholders sell their stakes in a holding company.⁸ The current share structure of the company is as follows: 55.3 percent is held by Emilio Azcarraga Jean, the current CEO; 24.7 percent is held by Inbursa, a Mexican bank owned by Carlos Slim; and 20 percent is held by the Aramburuzabala and Fernandez families. The board of Televisa now has 20 members who are elected proportionally.

⁷ See the subsection "Certain Changes in Management" in TV Azteca's 20F filing with the SEC for 2003 (TV Azteca 2004).

⁸ "Televisa Capitalization increases certainty about company," *El Financiero*, March 2004.

An example of improved corporate governance is the recently floated Grupo Aeroportuario del Sureste, which has emerged as a poster child for good corporate governance in Mexico. With a public float of over 60 percent of its stock, the company's board made a point of rewriting its rules to limit the rights of a major shareholder, the troubled construction giant Tribasa, and naming four independent board members who were elected by minority shareholders.

Ultimately, there is no substitute for careful due diligence. Investors should avoid relying on the protection of regulators or the claims of firms and their leaders to make a sound investment. For instance, an investor visiting TV Azteca's listing page on the NYSE Web site in July 2004 would have seen an article, dated March 3, 2003, entitled, "TV Azteca Receives International Award for Excellence in Corporate Governance" (see exhibit 3).⁹ In 2000, many investors might have found false comfort in that headline. Today, there is a lesson for investors in the fall of Mexico's self-styled model corporate citizen. After Salinas Pliego's highly publicized corporate governance scandals, businesspeople in the region face the challenging task of persuading better-educated investors to trust them.

⁹ See <http://www.nyse.com/events/1047947344408.html>.

Exhibit 1. Timeline of the TV Azteca–NBC Deal and Settlement

May 1994	TZA* agrees to pay NBC \$7 million for program licenses, advisory and other services over three years.
	TZA also gives NBC the right to purchase nonvoting shares equal to or up to 10% of all then fully diluted outstanding shares of TZA post-exercise (the “Warrants”).
	The aggregate Warrant exercise price is \$120 million before June 30, 1994, rising to \$160 million at expiration on May 6, 1997 (the price will rise by 2.75% compounded quarterly).
	NBC has the right, during the 60-day period after the expiration of the option period, to require TZA to purchase any unexercised portion of the Warrants for up to a total of \$25 million.
April 3, 1997	NBC notifies TZA that it will exercise its right to purchase shares of TZA equivalent to 1% of all the fully diluted outstanding shares for \$16 million. Payment is due on May 5, 1997.
	NBC advises TZA that it is required to purchase the unexercised portion of the Warrants for \$22.5 million (\$2.5 million being equivalent to the price NBC would have received had it not exercised its right to purchase 1% of the stock).
	NBC also requests payment of \$5.6 million, the balance of the \$7 million owed by TZA for unpaid programming as of May 6, 1997, plus accrued interest.
	In summary, NBC seeks payment in cash of \$28.1 million and Warrants that would have yielded the company a gain of \$12.5 million given TZA’s market capitalization of \$2.85 billion at its IPO and the exercise price of \$16 million. (NBC would have earned \$40.6 million had TZA complied with the terms of the agreement.)
April 29, 1997	TZA files a request for arbitration with the International Chamber of Commerce (ICC) seeking to rescind its agreements with NBC, including all of its financial and legal obligations as outlined above.
July 29, 1997	NBC counterclaims, requesting the right to exercise its Warrants for the other 9% stake of the fully diluted outstanding TZA capital stock as of May 6, 1997, or receive compensation equivalent to the difference between the fair market value of the underlying stocks and the exercise price.

	Based on the valuation of TZA at IPO, this additional 9% would have had a fair market value of \$256.6 million (9% of the \$2.85 billion valuation at IPO). At the exercise price of \$144 million NBC would have gained \$112.5 million.
	In summary, NBC had a claim to 10% of TZA's stock, which would have had a fair market value of \$285 million. At the exercise price of \$160 million NBC would have gained \$125 million on the transaction. NBC was also owed \$5.6 million in cash. TZA owed NBC a total of \$130.6 million according to the terms of their original agreement.
February 2000	TZA and NBC commence discussions regarding the claims raised in the ICC arbitration.
March 21, 2000	TZA and NBC jointly notify the ICC that settlement discussions are under way and request that the ICC tribunal withhold any decision for a period of 30 days.
April 28, 2000	TZA and NBC settle all claims and terminate the arbitration proceeding before the ICC tribunal with the following outcome: <ul style="list-style-type: none"> • TZA pays NBC \$46.2 million in cash. • NBC pays \$26 million (fair market value) for a 1% stake in TZA.

Source: TV Azteca, 20F filing with the SEC for 2003.

* TZA is the NYSE ticker for TV Azteca.

Exhibit 2. Televisa's 20F Outlining the Roles of Emilio Azcarraga Jean

<u>Name and Date of Birth</u>	<u>Current Position</u>	<u>Business Experience</u>	<u>First Appointed</u>
Emilio Azcarraga Jean (02/21/68)	Chairman of the Board, President and Chief Executive Officer and President of the Executive Committee of Grupo Televisa	Member of the Boards of Teléfonos de México, S.A. de C.V. and Banco Nacional de México, S.A. and Vice Chairman of the Board of Univision	March 1997

Exhibit 3. The Only Article Posted on the NYSE Web Site in Connection with TV Azteca, as of August 2004

03/03/2000

TV Azteca (NYSE-Listed TZA) was selected by the Institutional Shareholders Services (ISS) to receive the ISS Award for Excellence in Corporate Governance 2000. The award was presented at a ceremony in Washington D.C. on February 24, 2000. Institutional Shareholders Services is the world's leading provider of proxy advisory services.

TV Azteca is Mexico's #2 TV broadcaster (behind Grupo Televisa) with one-third of that country's advertising market. Chairman and CEO Ricardo Salinas, whose only previous business experience involved selling household goods, bought two state-owned TV networks in 1993 and lured viewers with aggressive, fast-paced news broadcasts and controversial soap operas. The company broadcasts over 250 Azteca 13 and Azteca 7 stations in Mexico; it also has operations in Costa Rica and El Salvador. Its initial effort to expand into the US through Miami-based Telemundo Group was thwarted when it was outbid by Sony. Salinas and his family own 70% of TV Azteca.

Exhibit 4. *New York Times* Article, May 10, 2004

As Inquiries Press Ahead, 2 Directors Quit at Azteca

By ELISABETH MALKIN

With its chairman under investigation by the Securities and Exchange Commission and Mexican regulators, the No. 2 broadcaster in Mexico, TV Azteca, has announced that two of its independent directors have resigned.

Mr. Salinas acknowledges that he bought debt owed by TV Azteca's cell phone unit, Unefon, at a discount last June and sold it back to the company at full price in October. He and a partner each took in \$109 million from the deal. His role was not disclosed to shareholders of Unefon or TV Azteca at the time.

The company said in a brief statement released late Friday that James R. Jones, a former chairman of the American Stock Exchange and former ambassador to Mexico, and Gene F. Jankowski, a former chairman of the CBS Broadcast Group, had resigned from the board.

Independent directors first learned of the deal in December from TV Azteca's New York lawyers at the time, Akin Gump Strauss Hauer & Feld. The firm withdrew as counsel to TV Azteca, citing a provision of the Sarbanes-Oxley Act of 2002, which requires lawyers to notify directors if they believe a company may have broken securities laws.

Exhibit 5. *New York Times* Article, July 31, 2004

Americas: Mexico: TV Executive Restrained

By ELISABETH MALKIN

The board of Mexico's second-largest broadcaster, TV Azteca, has limited the powers of its chairman, Ricardo Salinas Pliego, who is under investigation by the Securities and Exchange Commission and Mexican authorities. Mr. Salinas admits that he bought discounted debt owed by TV Azteca's cellular telephone unit, Unefon, and sold it back at full price to the company last year. Mr. Salinas and a partner each earned about \$109 million but did not tell the board. The company said Mr. Salinas would no longer be able to make decisions in any material transaction without the board's approval.

References

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TV Azteca. 2004. 20F filing for period ending December 31, 2003.