Alternate Directors are Obsolete and Unnecessary

The figure of alternate director remains legal in Mexican companies; nonetheless, more and more companies opt to reject it, given that it serves no legitimate purpose, is an invitation to bad behavior and its existence can lead to the transfer or sharing of corporate governance duties, among other salient reasons. It is time that this antiquated element of corporate governance is abandoned.

The version of the Code of Best Corporate Governance Practices (Código de Mejores Prácticas de Gobierno Corporativo - CMPGC), issued in 1999, and each revision since, explicitly recommended against the practice of having alternate directors. **Twenty-five years ago, the drafters of the Code viewed the figure of alternate director as of doubtful value:** reflecting doubts about alternate directors' practical contribution to Board effectiveness and legal uncertainty around their duties, responsibilities and accountability.

The figure of alternate director remains legal in Mexican companies; nonetheless, more and more companies opt to do without it. During the Covid pandemic, law and regulation were modernized to facilitate the conduct of Board meetings without the physical presence of all directors.

Today, when directors can efficiently and effectively meet virtually or in hybrid fashion – when circumstances require - there is no justification whatsoever to have alternate directors. **The continued use of the figure of alternate director can only dilute responsibility and accountability** of directors, present opportunities for inappropriate conduct and undermine Board continuity and effectiveness.

This practice should have been discarded in public companies long ago. The Corporate Practices Committees of every Mexican company that still permits the practice of alternate directors should introduce an amendment of the company's charter to eliminate it. The securities exchanges should accelerate the abolition process by amending their listing rules to bar this practice.

The Origins of Alternate Directors

Mexico's General Law of Commercial Companies (Ley General de Sociedades Mercantiles - LGSM) establishes the figure of alternate director. LGSM Article 143 lays out the intended purpose and role of alternate directors as follows:

"In case of the *temporary* absence [emphasis added] of the principal director [*consejero titular*], the alternate director [*suplente*] will assume their functions. When the election of a director has been made without the designation of an alternate director, the Shareholders

Meeting will choose an alternate director to carry out the function of the principal director in their absence."

The LGSM never made designation of alternate directors mandatory. It is clear from the language of the statute and from the history of its use in the nineteenth and twentieth centuries that the figure of alternate director was always intended to help ensure the continuity of the work of the Board in cases of illness or incapacity of some of the principal directors, or when some of them could not be physically present in the meetings.

There may once have been a time when alternate directors served some constructive purpose. Physical presence at Board meetings was required by law and means of travel and communication were not always reliable. In some instances, principal directors who represented the interests of shareholders who resided outside Mexico (or at least outside the city in which the meetings were conducted) valued the option of having an alternate director when the principal director could not physically attend. But this was another era, both technologically and in corporate governance.

For modern public companies, these considerations no longer apply. **Board composition should be robust enough to manage the occasional absence of a director**; principal directors with long-term incapacity should be immediately replaced, and logistical challenges can be managed through proper meeting scheduling, and where appropriate, hybrid, in-person or virtual meetings.

The Risks of Bad Behavior

At this point the reader might be asking: "Alternate directors are antiquated and redundant, but what harm is done by continuing to permit companies to have them if their controllers want them?". The answer is "Plenty".

Legal uncertainty around the duties, responsibilities and accountability of alternate directors (and those of principal directors with respect to their alternates) remains a fundamental problem. **The LGSM establishes the figure of alternate director, but the participation of alternate directors in the Board is not fully regulated** in either the LGSM or the Commercial Code of Mexico City.

Legal lacuna leaves space for interpretation about how principal directors and their alternates should behave and what their respective accountability is to the company and shareholders when an alternate assumes the role of director. At the same time, there is little clarity over what responsibility principal directors have for the actions of their alternates.

A fundamental principle for all Board members is that the fiduciary duties of loyalty and care are responsibilities that may not be delegated. Legal experts frequently reject

the appropriateness and value of alternate directors and specifically note that CMPGC's practice #10 states that the use of alternate directors is unnecessary.

One practical manifestation of the legal uncertainty around alternate directors **is their potential misuse on Board committees**; for example, certain companies have assigned, for practical effects, alternate directors to serve as principal directors on Board committees.

Presumably, such companies do not consider this a prohibited practice and feel comfortable doing so because there is nothing in the LGSM or the Commercial Code that explicitly outlaws it. However, this practice appears completely inconsistent with LGSM Article 143's reference to alternate directors as intended only to fill in for temporarily absent principal directors.

In any case, just as the gaps in the legal framework for alternate directors are large enough for some companies to think they can use such individuals to occupy seats on Board committees, **the absence of legal guidance leaves investors (and directors themselves) uncertain about what standards of fiduciary duty and accountability apply** to the alternate directors.

A further potential consequence of ambiguity around alternate directors is that their presence in Board sessions can result in inefficient meetings. For example, if a company's Board includes eleven principal directors and eleven alternates, and all or most of the alternates attend meetings, such Board is composed, for all practical purposes, of twenty-two directors who can participate. This contradicts the CMPGC's recommended appropriate number of directors (between 3 and 15 Board members), and the general rule of thumb that commercial company Boards with more than 12 members are less effective, potentially unmanageable and dilute accountability and productivity.

The very existence of alternate directors implies that governance duties can in some way be transferred or shared. As noted above, every director's fiduciary duty of loyalty and care are not delegable. Every Board member is obligated to the company and its shareholders to devote sufficient time and effort to effectively carry out their responsibilities. Their full engagement with the company is never optional.

The presence of alternate directors raises the possibility of "tag-team" directors with, in practice, two individuals sharing one seat, with whomever finds it most convenient to attend present at any meeting. This dilutes both the effectiveness of individual directors and muddles accountability, especially considering the patchy legal framework for alternate directors.

And, of course, when the composition of the Board can vary from meeting to meeting depending on whether a principal director or their alternate is in attendance, the continuity

of Board operations - the main reason for which the figure seems to have been created in the first place - is impacted.

A review of experiences of companies in the selection of alternate directors reveals a pattern of common pathologies, all of which undermine rather than contribute to Board effectiveness and efficiency:

- Failure to be strategically recruited. Alternate directors tend to be selected in practice by management and subject to little or no scrutiny by shareholders, since the latter focus on the principal director and do not expect the alternate directors to participate actively.

- Too many insiders. Many alternate directors are selected from among (current or former) executives of the company, adding little to Board diversity and risking conflicts of interest.

- Related consultants. It is common to see former lawyers or accountants of the firm among the alternate directors.

- Family domination. It is also common for alternate directors to be members or associates of the principal shareholder (especially in family businesses), with obvious implications for their independence and objectivity.

- Dominant group. When a company is part of an economic group, alternate directors are frequently selected from the directors, managers and advisors of other group entities, again compromising independence and objectivity.

- Cronyism/Backscratching. Appointment as an independent director can be a mechanism for providing extra compensation to family members, consultants or cronies.

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Virtual and Hybrid Board Meetings

Significant amendments to the LGSM were enacted on October 20, 2023. Section 14 of Article 6 of the LGSM was inserted to explicitly allow shareholders' meetings and Board meetings to be held either in person, virtually or in hybrid fashion through the use of appropriate technology. **Section 14 of Article 6 requires that the technology employed**

permit participation to be simultaneous and equivalent to that of meetings and sessions held in person, to ensure effective discussion and decision-making.

Many - if not most - companies have already amended their charters to conform to the amended law. Necessity being the mother of invention, numerous Boards have become well-practiced and adept at efficiently conducting virtual and hybrid Board meetings in the aftermath of the pandemic.

Like their peers in most markets globally, Mexican firms continue to encourage all Board members to attend as many Board meetings in person as possible. But the **option of virtual and hybrid meetings** means that whenever this is difficult or impossible for a director, they can participate electronically. Given this, **alternate directors simply have no value in this scenario**.

Alternate Directors in Other Markets

In the absence of any compelling reason to adopt or continue the practice of alternative directors, **most equity markets have either never had or have done away with the practice of alternate directors, by law or market practice**. Those markets where alternate directors continue to exist look to be on the path to abolition.

Section 3.5.c of the Brazilian Institute of Corporate Governance's Code of Best Practices states that if a company has alternate directors, they should only be used as permanent replacements for Board members who resign or are removed. Under this regime, **a Brazilian alternate director becomes a pre-elected principal director for the eventually of a director who leaves the Board**, which eliminates any uncertainty around such director's expected role, responsibilities and accountability to the company and shareholders.

India's Company Act of 2013 retained the concept of alternate director. However, it requires that an alternate director can only substitute for a principal director during the latter's absence from India for a period of at least three months. And even though the legal framework around the respective duties, responsibilities and accountability of principal and alternate directors under Indian law is better defined than they are in Mexico**, the practice is increasingly disfavoured**.

In the words of one commentator, the concept of alternate directors "has significantly lost its relevance after CA 2013 coming into effect because holding of Board Meetings through audio-visual means … is recognised under CA 2013".

The Voting Guidelines of Institutional Investor Advisory Services (IiAS), **India's leading proxy advisor, recommend voting against alternate directors.** IiAS excludes the presence of alternates in its calculation of Board attendance statistics:

"IiAS uses attendance level of directors in board/committee/shareholder meetings as a measure of directors' engagement with the company. IiAS believes that companies must refrain from appointing alternate directors who attend meetings on behalf of an elected director. The elected director must use technology to participate in board/committee meetings. Therefore, IiAS will generally recommend voting AGAINST appointment of alternate directors."

It is Time to Abolish the Figure of the Alternate Director

For the reasons just espressed, **it should be apparent** to anyone looking at the current situation objectively that it is time to abolish the figure of alternate director in Mexico. The reasons the drafters of the CMPGC considered alternate directors a bad practice twenty-five years ago are just as relevant today as they were then.

And the excuses for continuing to permit alternate directors are patently unjustified, as technology, regulation and practical experience make remote participation in Board meetings more and more seamless.

The contribution of alternate directors to Board effectiveness and efficiency is nil, the legal and practical ambiguities significant, and the opportunities they present to actually undermine good governance are obvious

It is high time for this antiquated element of Mexican corporate governance to be abolished.

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