Latin America*

Latin American, as a region, continues to struggle with its enormous foreign debt burden. As discussed below, various nations have enacted or further developed legislation governing "debt-equity swaps." In addition, certain measures have been taken to attract private foreign investment and transfers of technology, particularly within the Andean Common Market (that is, Bolivia, Colombia, Ecuador, Peru, and Venezuela). These measures are summarized immediately below. The discussion then turns to legal developments in specific Latin American countries.

I. Andean Common Market

For nearly two decades, the Andean Common Market's rules governing foreign equity investments, loans, and technology agreements were contained in its Commission's Decision No. 24, as amended. The Commission has now replaced Decision No. 24 with Decision No. 220, presumably so as to attract foreign investors, lenders, and suppliers of technology to transact business within the Andean Common Market. Indeed, while Decision No. 24 prohibited foreign investors from acquiring equity interests held by national investors, Decision No. 220 promotes foreign investors by expressly allowing for such equity acquisitions, if permitted under the domestic legislation of the respective member country. Similarly, Decision No. 220 should encourage intergroup transfers of technology, because it empowers the various national authorities to allow royalty payments by local companies to their foreign parent or affiliated companies; in contrast, Decision No. 24 absolutely prohibited such intergroup royalty payments.

In addition, Decision No. 220 codifies and sanctions a number of the largely divergent rules previously enacted or applied de facto by Colombia, Ecuador, Peru, and Venezuela in implementing Decision No. 24, and specifically delegates additional legislative authority to the various member countries. This approach is most evident in connection with the rules on transformations/divestitures, capitalization of royalty payments, limitations on dividend remittances, and election of foreign law and submission to foreign jurisdiction in connection with contractual arrangements.

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A. Transformations/Divestitures

Decision No. 220 requires that a majority foreign-owned company be transformed into a mixed company (i.e., fifty-one percent local ownership with proportionate management control) only if it desires to export its products throughout the Andean Common Market under the then available Andean Common Market trade benefits. A similar rule already existed in Ecuador, Peru, and Venezuela.

Decision No. 220 appears to provide a significant incentive to foreign investors by not limiting foreign equity participations in marketing and various other activities to twenty percent of capital, as was generally the case under Decision No. 24. In fact, however, Decision No. 24 authorized member countries to elect not to apply that highly restrictive rule, so that Decision No. 220 may be viewed simply as an election by the member countries not to limit generally foreign equity participation in marketing such activities.

B. Capitalization Of Royalty Payments

Decision No. 220, which retains the prohibition against contributions to capital in the form of "technology," permits accrued royalties to be capitalized upon payment of applicable taxes. A similar rule already applied in Venezuela.

C. Dividend Remittances

Although Decision No. 220 retains the limitation on yearly dividend remittances to amounts equal to twenty percent of registered investments, it empowers each member country to establish a higher limit at its discretion. Thus, for example, Ecuador may continue to limit generally these annual remittances to thirty percent (forty percent if at least forty percent of annual production is exported), and Venezuela may continue to limit such remittances to twenty percent, plus LIBOR.

D. Foreign Law and Jurisdiction

Decision No. 24 prohibited covenants submitting disputes derived from contracts providing for foreign equity investments or transfers of technology to the jurisdiction of foreign courts for resolution. Based on that rule, various member countries also prohibited a choice of foreign law to govern contractual disputes. Decision No. 220 leaves the matter of governing law in such cases to be legislated by the individual member countries, a choice that may not promote uniformity of legal treatment throughout the Andean Common Market, but that should be greeted favorably by the foreign investor.

II. Argentina

Over the past few months, Argentina has announced and provided the framework for a debt conversion program. The program provides for the conversion into Argentine australs, over a period of five years, of U.S. $1.9 billion of foreign debt of the Argentine Government, its Central Bank, and other elements of its public sector, with the local currency to be applied to investment in the Argentine private sector. While touting simplicity as one of its principal features, the program is quite complicated. A few of its salient features are sketched briefly.

The debt that may be converted includes virtually all foreign currency indebtedness of Argentina's public sector. Such debt may be paid in australs, provided that the austral proceeds are used for the purchase of new equipment and construction of plants and other works. They may not be invested in real estate, acquisition of existing shares of companies, or financial investments. The stated purpose of the program is for the austral proceeds to be used to increase the supply of goods and services in Argentina and to improve its balance of payments.

A party wishing to use the debt conversion program must first present an application which, if approved within the allowed forty-five day period, results in the qualification of an "eligible investment." The application is rather detailed. In general, it must describe the project and the financial plan for the utilization of the funds.

The most significant features of the program involve matching funds and a kind of public bidding. Once a prospective investor has an investment declared eligible, it must participate in an auction, pursuant to which it must offer matching funds in an amount at least equivalent to the amount of the debt to be converted to australs. The matching funds may be in the form of new investment or medium- or long-term loans. Qualifying matching funds are specified. Some items qualify as matching funds without limitation. These include, for example, loans having a minimum term of six years, with four years of grace, and 1987 series Bonex. Other items may be used only to the extent of fifty percent of the total amount of matching funds. These include, for example, certain financing from the International Finance Corporation and the Interamerican Investment Corporation.

The winners of the auction are to be those who offer the greatest proportion of matching funds by comparison with the amount of the debt to be converted. The rules contemplate that a discount offered by the bidder in the future also may be taken into account.

To participate in bidding, the party wishing to take advantage of the debt conversion program must post certain guarantees. Those successful in the auction have the funds resulting from payment in australs of the foreign indebtedness deposited in a frozen account. Amounts received by virtue of the auction, and the matching funds contributed as a part of the process, must not be diverted from their stated purpose for a period of three years. In addition, amounts resulting from the debt conversion invested in Argentine enterprises cannot be repatriated for a period of ten years, and dividends may not be paid on that portion of the capital of the Argentine company for a period of four years.

As indicated above, the program contains some fairly significant restrictions with respect to the use of funds derived from the debt conversion program. In addition, the amount to be converted over five years (less than U.S. $2 billion) is not particularly substantial in light of the overall level of Argentina's foreign indebtedness. Nevertheless, the results under the regulations, in particular those relating to exchange rates, may be such that the program will, after investigation, prove to be quite attractive to those wishing to make investments in Argentina.

III. Brazil

The most recent proposals for a debt-to-equity conversion program were presented by Brazil's Securities and Exchange Commission (CVM) and by Brazil's Finance Minister, Mr. Bresser Fereira. The proposals have four purposes:

1. To allow nonresident corporations to purchase negotiable instruments issued by Brazil's creditor banks secured by their deposits with the Brazilian Central Bank (DFA deposits). Thereafter, such instruments could be redeemed with the Central Bank at face value and the proceeds invested in local companies. The investment would be U.S.-dollar-denominated, and equivalent cruzados would be made available by the Central Bank to the local company where the investment is being made. Upon sale of the negotiable instruments, the selling bank would relinquish an equivalent amount of its deposit(s) with the Central Bank. The Central Bank likely will require the nonresident corporation to present evidence of purchase of and payment for the instruments. If the nonresident buyer/investor purchases the instruments at a discount from the official exchange rate, the Central Bank may request the buyer/investor to make a cash investment in the local company equal to the discount.

2. To create mutual investment funds managed by one or more creditor banks or their Brazilian affiliates. Creditor banks would cancel a portion of the Brazilian debt by issuing and selling fund shares to nonresident investors. Thereupon, the Central Bank would make an equivalent amount in cruzados available to the fund to be invested in the local stock markets or other areas.

3. To allow debts to be converted into equity in joint ventures involving Brazilian companies. The Central Bank has already approved some debt-to-equity conversions of this nature. One that was recently approved involved the Bank of Scotland and the Norwest Bank of Minneapolis, Minnesota. These banks converted $25 million in loans into equity of a Brazilian paper and pulp company at par value. The two banks have committed not to repatriate any capital out of Brazil for a twelve-year period. Dividends are not subject to any restriction.

4. To convert a portion of the Brazilian debt into Brazilian government bonds denominated in U.S. dollars or other hard currencies. The bonds could be redeemed upon their maturity, or traded in the secondary market, or converted into investment capital in Brazilian companies.

Whether and when any of these proposals will be adopted is still uncertain.

IV. Colombia

The most important recent change in Colombian legislation in the international context is a significant liberalization of foreign investment and, to a lesser extent, technology transfer rules. Andean Common Market Decision No. 220, replacing Decision No. 24, as amended, was followed in July by Colombian Presidential Decree 1265 and CONPES Resolution 44.

Foreign government in Colombia still requires prior approval of the National Planning Department, but a new rule requires this department to respond to applications within forty-five days after application materials are completed. If it fails to do so, the application is considered to be approved. The new legislation also explicitly requires that approved foreign investments be registered with the Exchange Office of the Bank of the Republic and gives a more explicit monitoring role to the Superintendency of Companies.

Areas of possible foreign investment have been expanded. First, fewer sectors of economic activity are reserved to Colombian investors. For example, now no special rule applies to so-called "internal commercialization" (*e.g.*, marketing) companies. Second, foreign investors now can acquire shares owned by national investors (which formerly required that the Colombian company be in a state of imminent bankruptcy), provided that a public offering of the shares is made to other Colombian investors. The public offering requirement is subject to some important exceptions, however, including the acquisition of less than ten percent of the outstanding shares of a Colombian company. Third, foreign investment can be in the form of capital increases. An old rule that did not permit the foreign share in a Colombian company to pass twenty percent and forty-nine percent benchmarks has been repealed.

One of the few rules under the new legislation that apparently may be less favorable to foreign investors deals with reinvestment of profits. The automatic reinvestments permitted earlier have been scrapped. Now, excess profits may be reinvested only if (1) the Colombian company invests fifty percent of the reinvestment in IFI bonds (an option available earlier, and generally considered to be unattractive) or (2) the foreign investor matches the amount of reinvestment with new investment from abroad, on a dollar-for-dollar basis.

The annual remittance limit for profits now is generally set at twenty-five percent of the amount of registered investment, but is higher in the case of investments in minerals. With respect to repatriation of invested capital, repatriation now is allowed explicitly in the event of capital reductions, as well as liquidations. In addition, the remittance right now turns upon "internal" sale, rather than sale to "national investors," a change that, depending upon interpretation, may prove to be significant. In any event, the new legislation explicitly denies remittance rights in the event of a Colombian company's redemption of shares held by foreign investors.

Other significant changes relate to so-called "transformation agreements," pursuant to which a Colombian company is to be owned in progressively greater shares by Colombian shareholders. Under the new rules, no transformation agreement is required, even with respect to newly formed companies, if the company is not to take advantage of the Andean Common Market's trade liberalization programs. Specifically, with National Planning Department approval, a foreign investor can own one hundred percent of a Colombian enterprise and maintain that level of ownership. In addition, transformation agreements are considerably more flexible than before, both as to when they can be signed, and the new possibility that once signed they may be cancelled. Finally, the term for transformation now is set at twenty years by Decision No. 220 and the internal implementing Colombian legislation mandates that Colombian authorities grant the maximum term, rather than setting a shorter term in their discretion.

With respect to technology transfers, a contribution of technology in exchange for stock of a company still is not possible. The new rules, however, make it clear that royalties may be capitalized. This change is especially significant because royalties now, with governmental approval, can be paid by a Colombian subsidiary to its foreign parent. In addition, the forty-five day rule mentioned earlier for response to an application also applies to the Royalty Committee.

While the effect of the changes has yet to be seen, it generally seems clear that the rules of the game with respect to investment have been liberalized substantially and those with respect to technology transfer to a lesser degree. The National Planning Department, responsible for the investment aspects, will have greater flexibility than in the past in its attempt to encourage foreign investment. On the other hand, the Royalty Committee has a bit, but not much, more flexibility, but really does not need it in order to continue the rather negative policy Colombia has followed for some time with respect to technology transfers.

V. Mexico

Mexico's latest public sector debt restructuring agreement has expanded the scope of the so-called "debt swap program," successfully implemented by the Mexican Government during the past year. The original program allowed for conversion of Mexican public sector debt (UMS Debt) held by foreign financial institutions into equity interests in Mexican business enterprises. Only foreign investors were permitted to take advantage of the program.

The new version of section 5.11 of this restructured agreement, which regulates the swap mechanism, now permits UMS Debt to be exchanged for (1) stock or equivalent interests in Mexican entities (both public and private, now also including Mexican trusts), (2) other private and public Mexican debt, and (3) investments by Mexican nationals or entities. The use of trusts for equity investments, the debt-for-debt swaps, and the investments by Mexican nationals had not been contemplated by the original program.

Although the original program has never been formally regulated by statute, it has been administered by the Ministry of the Treasury and Public Credit and the National Foreign Investment Commission, pursuant to operating rules articulated by those agencies in their "Operating Manual for the Substitution of Public Debt for Equity." Due to the more recent changes to section 5.11, however, it is widely expected that new rules will have to be issued, although as yet no timetable has been announced.

Pending the issuance of the new rules, the authorities will continue to process debt-for-equity swaps based on the existing rules. Certain applications under the expanded section 5.11 (e.g., Mexican trusts) also may be considered. Those involving debt-for-debt swaps, however, and qualified investments by Mexican investors generally will not be processed until guidelines are established.

A particularly thorny problem that may account for much of the delay in issuing the new rules arises in connection wih the determination of the types of investments that will be allowed to Mexican persons, as well as the mechanisms for channeling such investments. The government must ensure that the proceeds invested by Mexican persons arise from prior "flight" capital to be repatriated, or from profits legitimately earned and maintained abroad, and not from dollars obtained currently on the Mexican free market or in violation of the exchange control rules. At the same time, in the midst of the electoral process, the government does not want to be seen as bestowing special favors upon those holding "flight" capital abroad.

VI. Venezuela

In April of 1987, the Venezuelan Government introduced legislation creating a debt-to-equity conversion program, joining the growing ranks of the Latin American countries (for example, Argentina, Chile, Ecuador, and Mexico) with programs of this kind. With this program, the government hopes to achieve a moderate reduction in Venezuela's substantial foreign debt, while at the same time fomenting additional foreign investment in the private sector. The new legislation is contained in Decree No. 1521, published on April 14, 1987.

Decree No. 1521 offers foreign investors two basic forms of debt-to-equity transactions: the capitalization of foreign debt in the debtor company; and the conversion of public sector foreign debt into equity investment. The decree also provides for the conversion of public sector foreign debt into national investment, but gives an insufficient indication of how such conversion would be carried out.

Capitalization of foreign debt in the debtor company already was an option available to the foreign investor prior to the enactment of Decree No. 1521. The decree largely refers to the preexisting statutory framework contained in articles 63 and 64 of Decree No. 1200, but clarifies that the capitalization of the foreign debt will be computed at the exchange rate established in the applicable exchange agreements between the Finance Ministry and the Central Bank, currently Bs 14.50 to U.S. $1.00. Capitalization of a debt consists of the issuance to the creditor of shares of the debtor in exchange for the cancellation of the debt. The prior approval of the Office of the Superintendent of Foreign Investments (SIEX) is required. That the original creditor (in most cases a foreign bank) be the investor is not required. Thus, a foreign enterprise wishing to acquire stock in a particular Venezuelan company may purchase (presumably at a negotiated discount) from a foreign bank or other creditor a loan or trade credit payable by such company and then capitalize the credit so acquired.

The capitalization format is intended principally for private sector debt, but Decree No. 1521 does not exclude the capitalization of public sector debt. In the latter case, however, the restrictions imposed by the public sector restructuring agreements with respect to repatriation of profits and capital would presumably be taken into account by SIEX in authorizing the capitalization.

The second form of debt-to-equity conversion contemplated by the legislation involves: (1) the purchase by a foreign investor of a public sector foreign credit from a foreign financial institution; (2) the sale of the credit so acquired to the Central Bank of Venezuela in exchange for an equivalent amount of Venezuelan bolivars or, at the Central Bank's option, bolivar-denominated government obligations; and (3) the contribution of the cash or instruments so received (or the product or the sale of such instruments) to the capital of a new or existing Venezuelan company in exchange for shares of the stock of such company. The Venezuelan public sector debt is currently trading at approximately seventy percent of face value. Thus, assuming the Central Bank purchases a credit at face value or at a discount of less than thirty percent of face value, the foreign investor may purchase the bolivars required to carry out its investment at a cheaper rate than it would if it made its investment by a direct contribution of foreign currency. In this regard, government officials have indicated that, at least in the initial stages of the program, the Central Bank will purchase foreign credits at one hundred percent of face value.

Public sector debt conversions require the prior approval of a commission made up of the Ministers of Finance and Development and the President of the Central Bank. The decree provides that the commission may authorize conversions when the proceeds are to be invested in one of a number of priority sectors or activities identified in the decree (for example, agriculture, agroindustry, construction, capital goods production, manufacture of chemical products, electronics, and informatics). The capital invested by means of a public sector debt conversion may not be repatriated during the first five years after the registration of the investment. During the eight years thereafter not more than 12.5 percent of the capital may be exported annually. In addition, during the three years following the investment, profits earned in respect of the investment may not be remitted abroad at a rate in excess of ten percent annually of the invested amount.

The decree does not go into detail with respect to the mechanics of debt capitalizations or conversions. It provides that this aspect will be covered by regulations to be issued by the Finance Ministry. Such regulations have yet to be issued.

The new debt-to-equity conversion program has thus far provoked little serious interest among foreign investors. Many observers believe that a principal reason for the lack of enthusiasm is the current requirement that all foreign investments (whether made under the debt/equity program or not) be converted into Venezuelan currency at a controlled rate of U.S. $1.00 to Bs 14.50, a rate far below the free-market rate of approximately Bs 30 (as of August 1987). Although the current regulations also provide that capital and profits may be remitted abroad at the same Bs 14.50 rate at which the capital is brought in, foreign investors are understandably skeptical that such a favorable rate will be available several years hence, when they want to repatriate their investments.