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Debt-for-Equity Swaps: A Phenomenon in Transition

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I. Introduction

Debt-for-equity swap transactions[1] (swaps) have been touted as the saviour of not only the heavily indebted Latin American countries but also of several multinational and small regional creditor banks.[2] Swaps are also seen as a technique for market penetration by multinational enterprises otherwise excluded from certain industries of debtor countries. In the last few years, the volume of swaps in the world debt-equity market has surged, with an estimated 8 billion dollars spent worldwide in swaps activity for 1988.[3] This was a testimony of the perceived utility of the process by those involved. However, since the inception of swaps, serious questions have emerged regarding their stability, benefits, and true ability to relieve debt. In the forefront of these questions is whether or not swaps undermine Latin American goals of maintaining national control over the economy.

Although developed only within the last couple of years, the swap program in Mexico has already been suspended twice due to alleged

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1. Recent Development, *International Debt: Debt-To-Equity Swaps*, 28 Harv. Int'l L.J. 507, 507 (1987).

> [D]ebt-to-Equity swaps grew out of creditor banks' desires to reduce their exposure to debtor countries, and the perception by these countries that increased foreign direct investment may be beneficial to their economies. In order to rid themselves of undesirable debt, banks sell or trade their debt instruments at substantial discounts. *Id.* at 507-508 (footnotes omitted) [hereinafter Recent Development, *Int'l Debt*].

2. *See generally* Mark, *Debt-Business Boom in Latin America*, Euromoney, Sept. 1987, at 81 [hereinafter Mark]; Osborn, *Can This Dream Come True?*, Euromoney, Sept. 1987, at 74. [hereinafter Osborn]; Ollard, *The Debt Swappers*, Euromoney, Aug. 1986, at 67 [hereinafter Ollard].

3. Truell, *Cutting Losses*, Wall St. J., Sept. 23, 1988, at 10R, col. 1.

adverse economic impacts.[4] In addition, national laws governing swap transactions are in a continuous state of flux in response to lessons learned by debtor nations. These circumstances combine to create an environment of uncertainty in which banks, investors, debtor and creditor nations strive to protect their prospective interests.

Mexico and Brazil have encouraged swaps as a mechanism to help reduce their outstanding national debt.[5] It has been the practice of other debtor developing countries to project the probable impact of their swap transactions by examining the Mexican and Brazilian experiences both in the short and long-run. In view of the fact that Brazil and Mexico have developed different regulatory schemes for swaps and their individual or collective influence on other Latin American countries, a comparison of the swap transactions in the two countries might yield cogent indications of the future of this activity in Latin America.

Given the perceived role of swaps in international finance, foreign investment and reduction of outstanding debt, it is the objective of this comment to critically assess the future of debt-equity swaps. The current suspension of swaps by the Mexican government may suggest significant questions about the future vitality of swap transactions in general. Is the suspension a result of significant costs to the Mexican economy not in any way balanced by the benefits? Is the suspension a necessary step towards a better assessment of the facility, its legal character or the techniques for regulations? On the other hand, the suspensions may well be an historically induced political response to foreign participation in certain industries. Whatever the reasons for the suspension of the swaps, the history of foreign investment policies in Latin America suggests that the swaps are laden with serious stability questions. If the creditor banks are under pressure to reduce their debt-equity ratios in order to minimize the possibility of losses, the swaps may be a trap to the unwary.

These are all important questions which require answers. It is the objective of this comment to examine the extent to which the swap constitutes a stable transaction from the point of view of the creditor banks, the foreign investors, and the governments of both the host and the creditor nations.

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4. Note, *Debt-for-Equity Swaps in Mexico*, 23 Tex. Int'l L.J. 443, 452-55 (1988) [hereinafter Note, *Debt-for-Equity Swaps*].

5. *See generally id. See also* Note, *Debt-for-Equity Swaps, supra* note 4; Cohen & Michaels, *Brazil Plunges Into Debt-Equity Swaps*, Wall St. J., Sept. 9, 1988, at 18, col. 1 [hereinafter Cohen & Michaels].

To achieve this objective, this comment is divided into seven parts. First, it begins by describing the mechanics of a debt-equity swap: how the swap functions; who are the typical parties; what industries are usually involved; and the typical size and frequency of the swap transaction. Second, it examines the evolution of the debt crisis and early responses to that crisis. Third, this comment discusses the interplay of foreign investment policies in Latin America and current swap regulatory trends in Mexico and Brazil. The comment then describes the responses to swap transactions, including the regulations of the United States as well as less formal measures of avoiding problems from swaps. The fifth section follows with a discussion of the costs and benefits of debt-equity swaps to the banks, the investors, and the debtor nations, with an emphasis on implications that the swap may have on control over key economic decisions in debtor nations. The comment closes with a summary and conclusion anticipating potential changes in the environment for debt-equity swap transactions and the implications of current economic and regulatory trends for swap investors and debtor nations.

II. What is a Debt-Equity Swap?

A. *The Mechanics of the Transaction*

Debt-equity swaps[6] are a relatively recent phenomenon which have become extremely popular among Latin American countries as a way of retiring outstanding national debt.[7] Swaps allow creditors of large debtor nations to convert their debt holdings into equity holdings in the debtor country.[8] The basic premise of debt-equity swaps is to retire public debt in a debtor nation by trading that debt for invest-

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6. There are three basic types of debt swaps which occur in the international swap market: debt-for-debt swaps, debt-for-equity swaps, and debt-for-currency swaps. In a debt-for-debt swap, the debt is exchanged for another debt instrument or for some combination of debt and cash; in a debt-for-currency swap, foreign debt is exchanged for either local currency or bonds denominated in local currency; in a debt-for-equity swap, foreign debt is exchanged for equity or shares of stock in a local concern. House Comm. on Banking, Finance, and Urban Affairs, Subcomm. on Int'l Finance, Trade and Monetary Policy, 100th Cong., 2d Sess., Report on an International Debt Management Authority (Report of Patricia Wertman) 89-90 (Comm. Print 1988) [hereinafter House Report on an International Debt Management Authority].

7. Recent Development, *Int'l Debt*, *supra* note 1, at 508. Debt/equity swaps have been an attractive alternative to debt restructuring. *Id.*

8. *Id.* Equity holdings are comprised of shares of stock, or equity in an entity. *Id.* at 507-16.

ment in the capital stock of its companies, either public or private.[9]

There are two basic types of swaps, the indirect swap and the direct swap. In the indirect swap, a third party investor purchases the debt from the bank on the secondary market[10] and then swaps that debt with the debtor nation. For example, an investor might purchase $80 million of debt (on the secondary market) from a bank at half the face value, here $40 million, and subsequently swap the debt with the debtor nation for $60 million in pesos. The pesos are in turn used to purchase equity in a Mexican firm. The investor must, of course, have the potential swap transaction approved by the debtor nation before the transaction begins.[11]

In order to decrease losses on these debts, banks have begun to bypass the investors by participating directly in swap transactions. In a direct swap, the transaction begins when a bank, usually holding a large portfolio of LDC debt,[12] applies to the debtor government[13] for approval of a swap transaction.[14] If approved, the bank is given a discounted amount of local currency which they then must use to purchase shares in a local entity. Here, a bank might exchange $80 million of outstanding Mexican debt holdings for $60 million worth of pesos or peso-denominated bonds from the central bank of the debtor nation.[15] The pesos received must then be used to buy stock holdings in a Mexican enterprise worth $60 million. The $20 million difference represents the "discount rate"[16] charged by the debtor nation.

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9. Pando, *The Mexican Debt Crisis in Perspective: Faulty Legal Structures and Aftershocks*, 23 TEX. INT'L L.J. 171, 218 (1988) [hereinafter Pando].

10. HOUSE REPORT ON AN INTERNATIONAL DEBT MANAGEMENT AUTHORITY, *supra* note 6, at 89. Public and private loans are actively traded and sold on the international secondary market. The secondary market developed after the announcement by Mexico in 1982 that it would suspend payments on its outstanding debt. *Id.* at 80.

11. Recent Development, *Int'l Debt*, *supra* note 1, at 507. This intermediary is usually another bank which acts as a broker in setting up the deal on the secondary loan market. *Id.*

12. An investor diversifies his investments to reduce risk. Webster's defines "portfolio" as: "the securities held by an investor," "the commercial paper held by a financial house (as a bank)." WEBSTER'S NINTH NEW COLLEGIATE DICTIONARY 917 (1983).

13. In Mexico, the government department applied to is the Ministry of Finance and Public Credit. Comment, *Give Me Equity or Give Me Debt; Avoiding A Latin American Debt Revolution*, 10 U. PA. J. INT'L BUS. L. 89, 110 n.158 (1988) [hereinafter Comment, *Give Me Equity*]. In Brazil the applicant goes directly to the Central Bank of Brazil. Baker and McKenzie, *Regional Developments: Latin America*, 22 INT'L LAW. 845, 847 (1988) [hereinafter Baker & McKenzie].

14. Note, *Debt-for-Equity Swaps*, *supra* note 4, at 447-48. In Mexico, the National Commission of Foreign Investment must approve the transaction. *Id.*

15. HOUSE REPORT ON AN INTERNATIONAL DEBT MANAGEMENT AUTHORITY, *supra* note 7, at 90.

16. Although called a discount, in fact, the "discount" represents the amount of reduction of the outstanding debt charged by the debtor nation. This reduction equals a loss which must be written "off" on the bank's books. For a general discussion, *see infra* note 158 and accompanying text.

The discount rate is determined according to the type of venture proposed.[17] The amount of the discount generally depends on whether the investment is in a sector which the government wants to promote.[18] If so, the discount may be as little as 5 or 10 percent.[19] In effect, the government promotes a sector in which it wants to encourage foreign investment, while the bank holding the outstanding debt "writes off" only 5 or 10 percent of the loan amount as a loss. If the investment is in a sector in which local control is preferred, the discount may be as high as 25 percent.[20]

The transaction, on its face, benefits all parties involved. The bank retires a portion of its uncollectible foreign debt and can eventually decrease its loan-loss reserves. The investor obtains equity in an entity in the debtor nation which it may not otherwise be able to finance. The debtor nation fosters direct foreign investment in national enterprises that it wants to encourage and discharges outstanding national debt at a reduced amount.[21] The benefits of the swap, however, may be illusory. Other persistent questions arise regarding the long-term stability of the investment from the viewpoint of the investor, and the effect on the economic freedom of the debtor nation.

B. *The Parties*

Banks, multinational firms, and individuals participate in debt swaps. Banks seek to minimize their risk by diversifying their portfolio holdings in order to spread the risk of possible default. On the other hand, a bank may desire to concentrate its holdings in order to minimize their costs through simplifying administrative burdens and focusing expertise on one debtor nation.[22]

Many of the sellers of Latin American debt are small foreign regional banks with a high percentage of loan-loss reserves, typically 50 percent or more.[23] In selling its loans, these banks are attempting

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17. *See infra* note 158 and accompanying table.

18. A. Balmaseda, D. Brill, and W. Kryzda, Substitution of the Public Debt of the Federal Government of the United Mexican States by Investment 7-8 (May 1987) (unpublished) (available from Goodreich, Riquelme & Associates A.C., Mexico City) [hereinafter Balmaseda].

19. *Id.*

20. *Id.*

21. For example, the bank of the debtor nation would be able to retire $80 million of its external debt for only $60 million. The investor receives $60 million in local currency to be used to buy shares of a local concern.

22. HOUSE REPORT ON AN INTERNATIONAL DEBT MANAGEMENT AUTHORITY, *supra* note 6, at 83.

23. Evans, *New Debts for Old and the Swapper is King*, EUROMONEY, Sept. 1987, at 72, 86 [hereinafter Evans].

to decrease their mandatory loan-loss reserves[24] by disposing of the right to collect on large but risky loans.[25] These regional banks originally became involved in Latin American debt holdings due to the attractive returns available, however, they often did not have the expertise necessary to understand the possible ramifications of this involvement. For instance, the syndicated loan contracts used for these transactions generally contain cross-default clauses.[26] These clauses require that once a default has been declared by one bank, all other outstanding loans to that debtor country are automatically in default.[27] This creates often unexpected controversies with other larger banks who would prefer not to place the debtor nation in default, making it difficult for the small regional bank to accelerate the loans.[28]

Another large group of institutions involved as third party investors in swaps are multinational corporations (MNCs),[29] which may have significant local currency needs for ongoing activities and expansion of foreign subsidiaries. Swap transactions allow MNCs to make equity investments in less developed countries at a lower price by purchasing debts held by banks at a discount rate, and then swapping the discounted debt for equity.[30] This allows the MNC to inject fresh capital[31] into its subsidiaries located in the debtor nation,[32] or

24. Loan-loss reserves refers to a gradual building up of a sum of money set aside to protect the stability of a bank in case of default on debt. Kuczynski, *The Outlook for Latin American Debt*, FOREIGN AFF., 129, 131 (Fall 1987) [hereinafter Kuczynski].

25. Increasing loan-loss reserves results in loss to the bank. When Citicorp increased its loan-loss reserves against Latin American loans by $3 billion, the decision to do so resulted in a $2.6 billion loss to the bank that quarter. JOINT COMM. ON FOREIGN AFFAIRS AND FOREIGN RELATIONS, 100TH CONG., 2D SESS., TWENTY-EIGHTH MEXICO-UNITED STATES INTERPARLIAMENTARY CONFERENCE, 201 (Joint Comm. Print 1988) [hereinafter INTERPARLIAMENTARY CONFERENCE] (report of Glennon J. Harrison and Patricia A. Wertman). As the secondary market price for Latin American loans has decreased, however, banks with Latin American debt holdings, have had to hedge against future losses. As the price decreases on the secondary market, additional increases in Latin American reserves are required. *Id.* at 210.

26. Note, *Exchange Controls and Foreign Loan Defaults: Force Majeure as an Alternative Defense*, 71 IOWA L. REV. 1499 (1986).

27. *Id.*

28. An acceleration clause in a loan contract is one providing for the advancement of the date of payment under specified circumstances. WEBSTER'S THIRD INTERNATIONAL DICTIONARY 10 (16th ed. 1976).

29. Note, *Debt-for-Equity Swaps*, *supra* note 4, at 458.

30. HOUSE REPORT ON AN INTERNATIONAL DEBT MANAGEMENT AUTHORITY, *supra* note 6, at 83.

31. *See infra* notes 262-66 and accompanying text (discussing fresh capital and additionality).

32. Evans, *supra* note 23, at 86. For example, Co. X wants to invest in a new subsidiary in Mexico and to own that subsidiary. Co. X is allowed the right to collect $1 million in Mexican debt on the international secondary loan market at 60% of its face value ($600,000). The particular government discount used in this example is 5%, so the Mexican government will pay the Co. X

to make investments in new areas.[33]

For example, the debt may be bought by a multinational corporation from a bank or through a broker on the secondary market at as much as 50 percent of its face value. The loan is then exchanged with the Central Bank for a minimum of 75 percent of the face value of the debt in pesos.[34] The pesos are then exchanged for shares of stock in businesses within the debtor nation.

Governments tend to exclude nationals from swap activity. For instance, in Brazil, regulations limit participation in swaps to nonresident foreign creditors.[35] This regulation effectively creates tension among nationals who wish to compete in the market, the host country's government, and the foreign investor adding to potential instability. In Mexico, participation has been limited to holders of debt, non resident entities, and individuals.[36] Although Mexico has passed legislation recently to enable Mexican nationals to participate in swap transactions, the regulations governing the procedure for their participation has not yet been placed into effect.

C. *The Investment Industries*

The types of industries involved in swap conversions vary widely with the priorities of the debtor country and with the desires of the investor.[37] Some sectors, however, such as telecommunications and natural resource extraction, remain closed to swap transac-

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subsidiary in Mexico the equivalent of $950,000 in pesos for the debt. Co. X then purchases $950,000 worth of shares in a Mexican company. This produces a savings to Co. X of $350,000, the difference between the amount spent on the secondary market and the amount of pesos allowed for the retirement of the $1 million in Mexican debt. Note, *Debt-for-Equity Swaps*, *supra* note 4, at 457 (describing an example put forth by the Director of Mexico's Foreign Investment Commission, Jaime Alvarez Soberanis).

33. U.S. based Citicorp, which transacts many of the swap deals, has indicated that one of the most important advantages of this type of transaction is that outsiders will probably manage their pesos better than the debtor country did. Ollard, *supra* note 2, at 69.

34. House Report on an International Debt Management Authority, *supra* note 6, at 90.

35. Under Resolution 1460, the only types of debts that qualify for conversion are: (a) foreign debt which originates from a Deposit Facility Agreement executed between the Central Bank of Brazil and non resident creditor banks; (b) debt represented by voluntary deposits made under previous conversion plans under Resolutions 230 and 432; (c) and debt that has yet to mature. Baker & McKenzie, *supra* note 13, at 847.

36. Although originally limited to non resident individuals, amendments to § 5.11 of the New Money Agreement, allows Mexican individuals to participate in debt-equity swaps, thus effectively allowing nationals to compete. Note, *Debt-for-Equity Swaps*, *supra* note 4, at 453-54.

37. Note, *Debt-for-Equity Swaps*, *supra* note 4, at 462. However, as of May 1987, most swaps in Mexico were in the areas of the motor vehicle industry (52%), metal working and mechanical industries (11%), tourism (9%), electronics (5%), chemicals and pharmaceuticals (5%), and agro-industry (3%). *Id.*

tions.[38] Most investment bankers headquartered in the United States execute swap transactions in exchange for equity in foreign banks.[39] This is because of U.S. SEC Regulation K[40] and the familiarity that bankers have with the banking business. On the other hand, due to negative experiences of investments in Latin American banks in the past, some bankers have been surprisingly unwilling to consider investments in foreign banks.[41] They feel more comfortable investing in hotels, fishing fleets, electrical companies, and the like.[42] The question this poses is what effects this expansion into unknown areas may have on the economic stability of the foreign debtor nation.

III. THE EVOLUTION OF THE DEBT CRISIS AND THE DEVELOPMENT OF SWAPS

A. *Patterns of Foreign Investment and the Emergence of a Debt Crisis*

Large debtor nations often face conflicting goals of servicing their debt obligations while trying to stimulate their national econ-

38. *Id.* at 451. For example, petrochemical, mining, electrical, railroad, and telecommunications, all of which were protected against foreign investment under such earlier legislation as the 1973 Foreign Investment Law, and the Andean Pact, are still guarded. Also included in this list of reserved sectors are those that are reserved for 100% Mexican ownership, such as, radio, television, bus and air transports, and gas distribution. *Id.* Although the percentage of foreign investment in some of these industries is restricted, when combined with those industries that allow 100% ownership, it is possible that the cumulative effect will be a majority of foreign shareholders.

39. *See generally*, Evans, *supra* note 23, at 89. Some banks prefer investing in other banks, while others prefer to stay uninvolved in foreign bank holdings and prefer other investment opportunities. *Id.*

40. *Id.* at 86-90. The Securities and Exchange Commission enacted Regulation K, "International Banking Operations," 12 CFR Part 211, to restrict the foreign industries that U.S. banks may invest in. Regulation K limits the amount and types of foreign investments that U.S. banks may engage in by limiting the types of industries that may be invested in. Due to the large amounts involved in swaps, an average of $10 million or more, some bankers feel more comfortable investing in a familiar field. The average size of the debt-equity swap is still unclear. Different institutions have different figures on it. Salomon Brothers has indicated that its average deal is approximately $7 million. Over a two year period Mexico engaged in 23 swap transactions totaling approximately $300 million, indicating that the average size exceeds $10 million. HOUSE REPORT ON AN INTERNATIONAL DEBT MANAGEMENT AUTHORITY, *supra* note 6, at 81 n.167.

41. Evans, *supra* note 23, at 99. One such bank is Morgan Guaranty which has had at least one bad experience investing in a foreign bank and prefers not to repeat it. *Id.*

42. *Id.* at 104. For example, in Mexico, approximately 25% of the swap transactions have occurred in the automobile industry and another 40% in the tourist industry. *Id.* at 109. Citicorp has been planning to invest in a fishing fleet in Chile. Security Pacific Bank bought a Chilean electrical company. Amex announced plans in March of 1987 to swap $100 million in Mexican loans for equity in seven hotels. *Id.*

omy. In Latin American countries, interest payments on outstanding debt consume such a high percentage of export earnings that there is not sufficient profits left to support the costs of manufacturing more exports. The result is that these countries are forced to continually borrow more funds to service the debt of their existing loans, creating a cycle of debt dependency. In order to break this cycle, it is necessary for a country to experience enough economic growth to allow both servicing their debt obligations and recycling money back into the economy.[43]

Latin American nations rely on increased commodity exports to create economic growth.[44] Although exporting manufactured goods may generate a greater revenue of foreign currency, harsh manufacturing standards imposed by developed nations effectively preclude importation of Latin American goods into the developed nations.[45] As economic growth slows worldwide, commodity exporters face an increasingly shrinking market for their goods.[46] Without increased income from exports, there is little hope of obtaining the economic growth necessary for debtor nations to effectively service their existing debts, not to mention building up a broader, more sophisticated manufacturing base.[47]

Latin American countries cannot continue to borrow large sums to service their debts. Instead, these debtor nations must find

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43. Interest due on loans for Latin American countries during 1982-85 was approximately $30 billion a year. This amount represents about 30% of export earnings annually. Another $10 billion a year was added in bond obligations. This represents a net outflow of approximately $20 billion annually in interest payments, exceeding inflow from loans and foreign direct investment. Kuczynski, *supra* note 24, at 140.

44. Most of the Latin American countries, including Mexico, are commodity-producing countries. Mexico's primary commodity is oil the price of which continue to remain depressed. JOINT REPORT ON ECONOMIC DEVELOPMENT IN LATIN AMERICA AND THE DEBT PROBLEM, *infra* note 58, at 26-28 (essay by K. Morr).

45. For a discussion of economic interdependence among nations *see generally*, Yelpaala, *The Lome Conventions and the Political Economy of the African-Caribbean-Pacific Countries: A Critical Analysis of the Trade Provisions* 13 N.Y.U. J. OF INT'L L. AND POLITICS, 807 (1981).

46. Kuczynski, *supra* note 24, at 136. GNP growth has steadily declined since 1950 both in first world countries and in Latin America. In the O.E.C.D., 1950-59 growth stood at 6%; 1960-69 at 5.1%; 1979-79 at 3.2%; and 1980-86 at 2.2%. In Latin America the percentage of GNP growth has similarly declined, from 1950-59 at 5.9% to 1980-86 at 1.8% growth. Merchandise export growth has also declined in the O.E.C.D. countries and in Latin America. In the O.E.C.D. countries, from 1950-59 at 10.3% to from 1980-86 at 3.6%; and in Latin America from 5.6% during 1950-59 to 1.8% in the period 1980-86. This problem for Latin American countries is exacerbated further by the realization that while exports have been declining, the percentage of annual exports that reflect the amount of interest payments on outstanding debt was 40% from 1980-86. *Id.*

47. *Id.* at 90-92. *See also* Hormats, *The World Economy Under Stress*, FOREIGN AFF. 455 (1985).

alternative means.[48] Since neither more borrowing nor more exporting appears to be a reasonable alternative in Latin America,[49] swaps have been utilized to stimulate foreign direct investment, injecting fresh foreign capital into the country, and retire outstanding "public debt" at the same time.[50]

B. *Path to Crisis: The Mexican Example*

The Mexican debt crisis is representative of experiences in other developing countries.[51] Facing increasing financial pressures and decreasing cash reserves, in August of 1982, Mexico announced that it could no longer service its debt obligations and asked for a 90-day extension from its creditors.[52] Mexico suspended all debt payments for a period of three months while it began negotiations for rescheduling the debt payments.[53] Although Mexico had previously had difficulties in meeting its debt obligations,[54] never had so much money and so many creditors been involved.[55]

Years before Mexico announced that it could no longer service its debt obligations, the mechanisms which eventually precipitated the debt crisis were already in place. Legislation allowing the President to obtain loans without legislative approval[56] made it possible to circumvent constitutional restrictions on executive bor-

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48. Conrow, *Structural Reform and the Debt Strategy: The Mexican Case*, 18 CAL. W. INT'L L.J. 21, (1987) [hereinafter Conrow]. Conrow points out that debtor countries must increase their domestic savings and non debt financial flows. *Id.* Conrow further points out that although some foreign financing to supplement savings is necessary to achieve rapid economic growth, it is also necessary to avoid increasing the debt at a pace exceeding the ability of that country to service that debt. *Id.*

49. *Id.*

50. Note, *Debt-for-Equity Swaps*, *supra* note 4, at 444. Section 5.11 of the 1985 Mexican Restructuring Agreement opened the door for debt-equity swaps in Mexico. *Id.*

51. Comment, *Give Me Equity, supra* note 13, at 94 n.38. Most of Latin American outstanding foreign debt is debt owed to banks. *Id.*

52. *Id.* at 94-95. In August of 1982, Mexico's outstanding foreign debt exceeded $80 billion U.S. and 30% of that $80 billion was due to be paid that year. As it had exhausted savings reserves, Mexico notified the IMF, the United States Secretary of the Treasury, and the Chairman of the Federal Reserve Board of its planned moratorium on debt payments. *Id.*

53. *Id.* at 98.

54. *Id.* at 95. In 1976 Mexico faced a similar problem though the ramifications were not as severe. At least one author has pointed out that Latin American countries have borrowed and defaulted periodically since they gained their independence in the 1820's. *Id.* at 95 n.44 (*citing* D. DELAMAIDE, DEBT SHOCK: THE FULL STORY OF THE WORLD CREDIT CRISIS 232-51 (1985)).

55. Comment, *Give Me Equity, supra* note 13, at 89, 95 (1988).

56. Pando, *supra* note 9, at 177-78.

rowing power.[57] Moreover, credit was cheap during the 1970s for many of the Latin American countries.[58] Much of the debt accumulated during this time was borrowed at rates below the rate of inflation.[59] Many of the loans to Mexico, however, used floating interest rates,[60] resulting in Mexican repayment obligations becoming controlled by conditions prevailing in global capital markets. Gradually, the amount of interest paid annually on the public debt came to consume nearly one-half of Mexico's export earnings.[61]

The "public debt"[62] of Mexico is divided between the government debt and that of the *paraestatal* sector.[63] The *paraestatal* sector consists of agencies and departments which the government owns in whole or in part.[64] During the oil boom of the 1970s, the Mexican government allowed many *paraestatales* to borrow inordinate amounts of money on the international market.[65] At that

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57. *Id.* at 175. Article 73-VIII of the Mexican constitution restricts the Executive's power to incur debt. It allows Congress:

> To fix the bases upon which the President may borrow on the credit of the Nation; to approve such loans and to acknowledge and order payment of the national debt. No loan may be affected except for the execution of works which directly produce an increase in public revenues, unless they are undertaken for the purposes of currency regulation, conversion operations or loans contracted for during an emergency declared by the President. . . .

Id.

This provision seems to indicate that some cooperation is necessary between the Congress and the President when taking out loans. However, Pando points out that in reality, the President does not request the approval of Congress before taking out loans. *Id.* at 177.

58. SUBCOMM. ON ECONOMIC GROWTH, TRADE, AND TAXES, 100TH CONG., 1ST SESS., ECONOMIC DEVELOPMENT IN LATIN AMERICA AND THE DEBT PROBLEM 49 (Joint Comm. Print 1987) [hereinafter JOINT REPORT ON ECONOMIC DEVELOPMENT IN LATIN AMERICA AND THE DEBT PROBLEM] (essay by C. Bogdanowicz-Bindert).

59. *Id.* With interest rates negative in real terms, it made sense to borrow heavily. The possibility for repayment was high if the money borrowed was invested into productive sectors. In reality, however, only approximately half of the amount borrowed was ever invested into productive areas. *Id.*

60. Many of these loans were linked to either the London Interbank Offered Rate (LIBOR) or the U.S. Prime rate for the first time. LIBOR is the cost of the funds plus a premium for the credit risk of the borrower. The premium varies according to the credit risk of the borrower involved. R. Weerasinghe, Note on the Eurocurrency Markets, 5-6 (rev. ed. April, 1975) (unpublished paper prepared for class discussion; available from Harvard Business School).

61. From 1980-86, interest payments on outstanding Latin American debt were approximately 40% of export earnings. Kuczynski, *supra* note 24, at 136.

62. Most third world country debt can be separated into public and private debt. Public debt is usually debt incurred by the government itself, while private debt is that debt incurred by corporations borrowing on the international debt market. *See generally* Pando, *supra* note 9, at 182-85.

63. Pando, *supra* note 9, at 183 n.76.

64. *Id.*

65. *Id.* at 184. Although the *paraestatal* sectors are owned in whole or in part by the Mexican government, in reality, they have separate legal personalities. This enabled creditors to consider each *paraestatal* separately to evaluate its viability as a borrower. *Id.*

time, Mexico was exporting large amounts of oil and petroleum products at high prices. Investors perceived Mexican *paraestatales* as a good credit risk and banks were only too willing to lend large amounts.[66] This served to exacerbate the already large Mexican debt.

The other portion of public debt was incurred to develop industrial sectors which would generate manufactured goods for exportation. Increased manufactured exports fuel economic growth by increasing revenues without depleting the finite source of natural resources. Mexico's goal in this increase of production capability was one of self-sufficiency, perceived as necessary to lift Mexico from Third World status.[67]

Mexico's ability to repay loans now depends, in large part, on the international price of its commodity exports, primarily oil.[68] In 1981, global oil prices began to fall along with oil exports.[69] During this period the oil-producing countries, including Mexico, continued to borrow heavily. Banks continued to perceive Mexico as a "good risk" and thus were eager to oblige.[70] Simultaneously, the interest rate on Mexico's floating interest rate loans began to rise.[71]

With double-digit inflation occurring in the United States, in October 1979, the U.S. Federal Reserve Board tightened the growth of the money supply as a remedial measure. As a result, global interest rates rose sharply.[72] Latin American loans with floating interest rates, originally taken out at rates of 4-5 percent, had to

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66. *Id.*

67. The increased manufacturing base that was envisioned never came to pass in Mexico. After funds were loaned to Mexico, too often those funds were invested in other countries. *See infra* note 300 and accompanying text.

68. Tapia, *Mexico's Debt Restructuring: The Evolving Solution*, 23 COLUM. J. TRANSNAT'L L. 1, 2 (1984) [hereinafter Tapia].

69. *Id.* at 3 n.3. During 1981, oil exports dropped from 1.5 billion barrels a day to 1.1 million barrels a day. Major customers, such as France, Japan, and the U.S. deferred orders. At the same time oil prices began to fall. *Id.* Recession hit the industrialized nations at approximately the same time which served to further exacerbate the problem. Other causes can be attributed to the second OPEC oil price hike of 1979-80, decreasing commodity sales, and higher real interest rates. JOINT REPORT ON ECONOMIC DEVELOPMENT IN LATIN AMERICA AND THE DEBT PROBLEM, *supra* note 58, at 26-27 (essay by K. Morr).

70. *Id.* at 49 (essay by Bogdanowicz-Bindert). Although exports had dropped, the level of imports had risen and had not yet tapered off, resulting in a severe trade imbalance which adversely affected Mexico's balance of payments. This further precipitated the debt crisis. Pando, *supra* note 9, at 185.

71. Tapia, *supra* note 68, at 4.

72. JOINT REPORT ON ECONOMIC DEVELOPMENT IN LATIN AMERICA AND THE DEBT PROBLEM, *supra* note 58, at 49 (essay by Bogdanowicz-Bindert). Beginning in 1979, the Federal Reserve Board battled inflation in the U.S. with a tight money supply which sent interest rates soaring. Pando, *supra* note 9, at 186 n.91.

be repayed at rates of 15-20 percent.[73] Inevitably, Mexico turned to short-term private financing to meet its debt payments, creating even more debt.[74] The debt crisis had begun.

C. *The Creditors' Response to the Debt Crisis: Restructuring, the Baker Plan, and the IMF.*

The Third World debt crisis led to a variety of responses.[75] As the United States holds a large proportion of the outstanding Latin American debt, a default by a Latin American country could threaten financial stability in the United States if not the world. The overall economic and political impact cannot be ignored. In order to prevent further instability, the primary response of the creditor nations has been the immediate avoidance of default.

The principal tool used by creditors to avoid default has been the restructuring of debt. "Restructuring debt" involves lengthening the time period over which the debt can be paid while reducing the periodic payment amount.[76] This allows the debtor country an extended period of time to increase domestic savings and accelerate growth in exports.[77] The first restructuring of the Mexican debt was completed in 1983.[78]

Three issues were addressed during the 1983 restructuring negotiations. First, Mexico asked for $5 billion from its commercial bank lenders to contribute to a new money facility[79] which would

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73. Pando, *supra* note 9, at 186.

74. *Id.*

75. These responses included restructuring of existing debt, attempts at the development of structural changes instituted within the debtor countries to create a stronger economic base as well as lending more money to make interest payments on the existing loans. *See infra* notes 76, 85, 92-97 and accompanying text.

76. House Report on an International Debt Management Authority, *supra* note 6, at 84.

77. Joint Report on Economic Development in Latin America and the Debt Problem, *supra* note 58, at 50 (essay by Bogdanowicz-Bindert).

78. Pando, *supra* note 9, at 207. The first restructuring agreement contained a provision that allowed rescheduling of the public debt that was to mature between August 23, 1982, and December 31, 1984. Under this agreement, Mexico was to make quarterly installment payments from 1987-1990 on the debt which was to mature during the 1982-1984 period. It also committed the Mexican government to support the private sector debt crisis. The principle effort in this regard was the creation of the Trust for the Coverage of Foreign Exchange Risks (FICORCA). *Id.* at 207 n.233.

79. Under the agreement, Mexico's lenders granted credits in varying currencies for a total amount of $5 billion. *See Infra* note 173 for definition of credits. The credit amount was to be repaid in thirteen periodic payments. Credits were tied to both fixed and variable rates. The new money facility agreement also provided for choice of forum: New York, High Court of London, courts of the Federal District of Mexico, and jurisdictions where the main offices of each creditor were located. Choice-of-law provisions designated the law of New York, but excluded New York conflicts-of-law provisions. Pando, *supra* note 9, at 200-201.

help Mexico stay current with its interest payments.[80] Banks were reluctant to lend, however, and only did so upon assurances that all of Mexico's lenders would participate and that the new loans have much higher rates than those extended previously.[81] Second, public Mexican debt payments for the next six months were to be rescheduled over an eight year period.[82] This rescheduling was felt essential if Mexico was to continue to meet its debt obligations. Finally, the International Monetary Fund[83] (IMF) was to disburse $3.9 billion over a three year period.[84]

This restructuring was actually short-term in nature as only interest payments were rescheduled, leaving the principal amount to be rescheduled at a later time.[85] Further, it has been argued that restructuring only works well if the global economy is expanding at a rate of 3 percent or more and if industrial countries are open to increased exports from lesser developed countries.[86] With increasing problems of exportation and declining global economy, Mexico's choices did not look good. Since the 1983 restructuring did nothing to alleviate long-term debt, it was inevitable that new approaches would be considered.

1985 proved to be a year of unusual crisis for Mexico. By July, the public sector deficit had exceeded limits imposed for the entire year.[87] During September, earthquakes hit Mexico, ravaging Mexico City.[88] The IMF extended further funding and the creditors agreed

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80. Comment, *Give Me Equity, supra* note 13, at 90.

81. Tapia, *supra* note 68, at 6. Rates for the new money facility were fixed at prime plus 2 1/4% or LIBOR plus 2 1/2% and included a management fee of 1 1/4%. *Id.* at 6 n. 5.

82. Comment, *Give Me Equity, supra* note 13, at 96. A new restructuring and money facility became necessary in 1984 in the amount of $3.8 billion U.S. *Id.* at 96 n. 51.

83. Pando, *supra* note 9, at 193-96. The International Monetary Fund was founded to aid member nations in procuring short-term financing. The role of the IMF has greatly expanded over the years. Although the IMF aids debtor countries in securing loans, thereby alleviating their debt problems, debtor counties have found some of the IMF restrictions and requirements for these loans to be interventionist in nature. IMF assistance is conditioned upon the implementation of certain performance quotas and fiscal policies which focus on medium- and long-range structural changes. It is interesting to note that IMF policies are based on monetarist and Keynesian economic views, which do not experience universal acceptance in Latin America. Developing countries fear that these requirements undermine their sovereignty. This is particularly true with Stand-By Arrangements (SBAs) which are typically used in large debtor nations. With SBAs, the IMF is allowed to dictate the economic policy of the country receiving the funds. *Id.*

84. Comment, *Give Me Equity, supra* note 13, at 96.

85. *See supra* note 80 and accompanying text.

86. JOINT REPORT ON ECONOMIC DEVELOPMENT IN LATIN AMERICA AND THE DEBT PROBLEM, *supra* note 58, at 50 (essay by Bogdanowicz-Bindert).

87. Pando, *supra* note 9, at 216.

88. *Id.*

to reschedule the public sector debt of the United Mexican States, the Department of the Federal Districts, and of thirty *paraestatals*.[89] All of this debt, originally scheduled to mature between 1985 and 1990, was rescheduled to mature between 1986 and 1990.[90] Mexico also agreed to modify existing agreements to reschedule debt maturing between 1982 and 1984, to mature between 1987 and 1990.[91]

In October of 1985, at the IMF joint session, James Baker, then Secretary of the United States Treasury, unveiled the "Baker Plan."[92] The plan attempted to solve the debt problem largely through new lending plans to Latin America.[93] The plan sought three objectives. First, debtor nations were to implement far-reaching structural changes which would enable them to decrease spending. Second, the World Bank and all remaining institutions of multilateral development were to grant credits to finance sectoral/structural changes within the debtor nation. Third, bank loans of $20 billion were to be made available to the main debtors during the three years following.[94] This plan was not fully implemented,[95] however, largely because lending has not reached the $20 billion level projected and the economic growth anticipated has not occurred.[96] Aside from its implementation, the Baker Plan has been criticised as not providing adequate funds to achieve its goals.[97]

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89. *Id.* For a list of those *paraestatal* entities involved *see id.* at 216 n. 274.

90. *Id.*

91. *Id.* at 216-17.

92. JOINT REPORT ON ECONOMIC DEVELOPMENT IN LATIN AMERICA AND THE DEBT PROBLEM, *supra* note 58, at 42 (essay by A. Reifman).

93. *Id.* Under the Baker Plan, it was expected that the development banks such as the World Bank, and the Inter-American Development Bank would provide $9 billion in new loans over a three year period, while the commercial banks were expected to loan an additional $20 billion over a three year period. *Id.*

94. Pando, *supra* note 9, at 217.

95. *Id.*

96. Kuczynski, *supra* note 24, at 135.

97. The funds allotted to Mexico under the plan alone comprise 40% of the funds allotted to all 15 heavily indebted countries for 1987. JOINT REPORT ON ECONOMIC DEVELOPMENT IN LATIN AMERICA AND THE DEBT PROBLEM, *supra* note 58, at 42. (essay by A. Reifman).

On March 10, 1989, United States Treasury Secretary Nicholas Brady announced a new debt-reduction policy for the Third World. The proposed policy favors the forgiveness of Latin American debt as opposed to additional lending. Included in the plan are three types of debt-reduction transactions. The first type involves debt that would be swapped for bonds of lower face value. In the second, the bank debt would be traded for bonds with an equal face value but which carry a lower interest rate. In the third, the bank debt would be traded for part-ownership of local business entities.

Countries such as Mexico and Venezuela, which can show that they are recapturing capital lost due to capital flight would be entitled to special measures of debt-reduction. Among these special measures are the following: the right to use a percentage of their loans to rebuy bank debt or to guarantee bonds that will be swapped for debt at a discount; additional guarantees

On July 22, 1986, the IMF and Mexico came to an agreement for $12 billion in new financing.[98] In this agreement, Mexico succeeded in obtaining loans sufficient to finance Mexico's interest obligations while still allowing the Mexican economy to grow at a 3-4 percent annual rate. Mexico also demanded to be assured that additional funding would be available should the price of petroleum sink further.[99] These concessions are significant as Mexico had been unsuccessful in obtaining identical demands in the past, suggesting increased efforts by the IMF to avoid loan default. Mexico also sought the "write off" of part of its outstanding debt.[100] However, this was denied and Mexico accepted the increased debt amount.[101]

These crises-management solutions are necessarily shortsighted, and the long-term effect of the solutions may be more damaging than the problems which they were intended to remedy. The dependency which debtor nations attempted to avoid has become even more burdensome as the debtor nations continue borrowing more money to pay off existing outstanding loans. The ongoing frustration of inability to expand manufacturing exports has left debtor nations dependent upon their commodity exports which are conditioned upon global prices. The crisis suggests that debt is driving debtor countries into deeper foreign dependency, something Latin American countries always avoided. The ramifications of the crisis and the responses to it not only affect debtor countries, however, but creditor countries, investors, and the stability of foreign investment as well.

III. The Interplay of Foreign Investment With Laws and Regulations Governing Swaps

During the last decade, Latin American countries have experienced increasing foreign investment. Possibility for conflict arises where a debtor nation which is in need of the economic growth that foreign investment may bring, is unwilling to relinquish control over the entities invested in. This conflict exists because generally, along with

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that interest would be paid on loans for which interest or principal had been; Japanese loans to be used to increase reserves or to buy back debt. Mossberg & Truell, *U.S. Strategy on World Debt Faces Hurdles*, Wall Street J., March 13, 1989, at A4, col.1.

98. Bailey, *The Mexican Economy as 1987 Begins*, 18 Cal. W. Int'l L.J. 31 (1987). The IMF agreed to a number of Mexico's demands that it had rejected in the past. This concession on the part of the IMF was due, in part, to pressure from the U.S. Federal Reserve Board which was concerned about the possibility of another Mexican debt default. *Id.*

99. *Id.*

100. *Id.* at 32.

101. *Id.*

foreign investment comes foreign ownership and control. Often the debtor nation is forced to compromise its desire for independence in favor of increasing foreign investment. As swaps entail some compromise between the two goals, it is likely that debtor nations will continue to impose regulations regarding industries eligible for foreign investment, the amount of allowed investment, the control that is relinquished to foreign investors, and the repatriation of capital and profits.

A. *Patterns of Regulation of Foreign Investment in Latin America*

1. *International Foreign Investment Initiatives: The Andean Pact Principles*

In hopes of breaking the cycle of dependency, some Latin American countries agreed in 1969 to form the Andean Pact.[102] The Andean Pact was created to facilitate the goal of breaking economic and financial dependency upon other nations by enabling member nations to plan and develop their own manufacturing sectors.[103] This, in turn, was to facilitate increased manufactured exports, allowing the country to service its debts without stifling economic growth. Although only Bolivia, Chile,[104] Columbia, Ecuador, and Peru entered into the agreement,[105] the impact of the Andean Pact has been felt throughout all Latin America. The impact of the Andean Pact Agreement has been seen in Mexico in the recent past, and is still

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102. The Cartagena Agreement, along with its ancillary rulings and regulations, has become known as the Andean Pact. Kuczynski, *Planned Development in the Andean Group: Industrial Policy and Trade Liberalization*, in THE ANDEAN GROUP: TRADE, INDUSTRY AND FOREIGN INVESTMENT 1 (1973) [hereinafter Kuczynski, *Planned Development*].

103. *Id.* at 2. The Andean Pact's Cartagena Agreement seeks to plan manufacturing in neighboring countries to avoid duplication and to better allocate scarce resources. The Agreement also seeks to liberalize trade within the region, coordinate the external tariffs, and implement joint industrial planning. *Id.* at 4. The most complex of these is joint industrial planning. The list of basic industries sought to be planned include: iron and steel, metallurgy, machine and tools, motor vehicles, farm machinery, food processing, chemicals, petrochemicals, electrical engineering, electronics, and pulp and paper. *Id.* at 12. Provisions are made for the submission of detailed plans, the search for financing, and a time allotment in which to start production. *Id.* at 16.

104. GENERAL ACCOUNTING OFFICE, REPORT TO CONGRESS BY THE COMPTROLLER GENERAL OF THE UNITED STATES, U.S. DIRECT INVESTMENT IN SOUTH AMERICA'S ANDEAN COMMON MARKET at i (1977) [hereinafter COMPTROLLER GENERAL REPORT]. Chile has withdrawn from the Andean Pact, indicating that it cannot adhere to the Andean Pact's restrictive stance on foreign investment. *Id.*

105. Kuczynski, *Planned Development*, *supra* note 102, at 1.

seen in Brazil today. Until 1984, Mexico followed a policy of "Mexicanization" which limited foreign investment, excluded foreign participation in certain industries and limited foreign participation in others.[106] In Brazil, there remains today considerable emphasis on the retention of control over key economic sectors.[107]

One of the principal objectives of the Pact was to develop a common market among its members.[108] This objective works in harmony with another prime concern of the Andean Pact: influencing the course of industrial development in Latin America.[109] The Pact allows Latin American countries to work together toward the common goal of industrial independence by allowing them to better allocate scarce industrial resources.[110]

One of the key concerns of the Pact is the possible negative impact that direct foreign investment may have upon Latin America.[111] Decision 24,[112] ratified on December 31, 1970, outlines many of the basic principles involved in the regulation of foreign capital investments.[113] Decision 24 recognizes that the contribution of foreign

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106. Mexicanization refers to the process whereby Mexican ownership was required to be increased in an entity usually to at least 51%, thereby limiting the maximum allowable amount of foreign ownership to 49%. Maviglia, *Mexico's Guidelines for Foreign Investment: The Selective Promotion of Necessary Industries*, 80 AM. J. INT'L L. 281, 288 n.51 (1986) [hereinafter Maviglia]. Examples of industries where investment was thus restricted to 49% ownership were mining, petrochemicals, railroads, and public utilities. Examples of industries where foreign investment was prohibited were banking, insurance, bonding, and investment businesses. *Id.* at 287 n.42. The 1973 Foreign Investment Law promulgated the above legislation regarding direct investment in Mexico. *Id.* at 290. The 1973 Foreign Investment Law limited foreign participation in the management of a corporation to the proportion of foreign capitalization used in the venture. It also established 49%-51% ownership in favor of Mexican participation as the minimum. *Id.* The policy underlying the 1973 Foreign Investment Law was changed dramatically by the 1984 Guidelines for Foreign Investment, which sought to actively promote foreign investment in selected areas. *Id.* at 294.

107. Business Perspective, *Foreign Investment Climate in Brazil* 10 U. PA. J. OF INT'L BUS. L. 161, 165 (1988) [hereinafter BUSINESS PERSPECTIVE].

108. *Id. See also* Kuczynski, *Planned Development*, *supra* note 102, at 1.

109. Kuczynski, *Planned Development*, *supra* note 103, at 2.
The pact seeks to determine what is to be manufactured, where it is to be manufactured, and how much internal competition will be allowed. *Id.*

110. *Id.* at 3.

111. *See generally* Huelin, *Investment in the Andean Group* in THE ANDEAN GROUP: TRADE, INDUSTRY AND FOREIGN INVESTMENT 20-21 (1973) [hereinafter Huelin].
The Andean Pact Junta, an administrative group, has been vigorous in imposing regulations regarding foreign capital. *Id.* at 19-20. The Junta hands down decisions which become law upon adoption by the Ministerial Commission and ratification by individual member countries. *Id.*

112. *Id.* at 20. Decision 24 was modified by Decision 103 which increased the amount of profits that were allowed to foreign investors. See COMPTROLLER GENERAL REPORT, *supra* note 104, at 14 n.1.

113. Huelin, *supra* note 111, at 20.
The main features of Decision 24 are outlined below:

technology and capital is important to the economic growth of Latin America, but only to the extent that such contribution is effective to the attainment of the goals of self-sufficiency and maintaining national control.[114] Foreign investors are limited to increases in capital and are not allowed to control the entity.[115] The overriding principle involved is that of control.[116] Since foreign investors are allowed to contribute capital but not to gain control, it follows that foreign capital may only be used to acquire non voting stock.[117]

Under Decision 24, host countries reserve the right to exclude foreign investment from public sector industries, especially from the industries of natural resource extraction, public services, and communication.[118] Foreign investment in these areas is felt to defeat the Latin American goal of maintaining control over those sectors which are politically sensitive and which spur economic growth.[119] Decision

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> 1. Host countries reserve the right to exclude foreign investment in specific sectors of the economy, such as extractive industries, public services and socially sensitive activities; and also to exclude specific investments if they seem superfluous or undesirable.
> 2. Foreign capital should, as a general principle, be phased out over given periods, either completely or down to minority holdings. Foreign companies that do not accept the phasing-out principle will not be eligible for the advantages available to national companies, and will be unable to engage in certain activities.
> 3. There shall be no take-overs of national firms by foreign interests, except in special circumstances such as the avoidance of bankruptcy; foreign investors may acquire an interest in national companies only when this represents an increase in capital, and provided it does not mean that they gain control. Phase-out still applies.
> 4. Companies must have free access to foreign technology, capital equipment, raw materials and working capital, all at normal international cost; there may be no agreements binding companies to acquire their needs from specific sources or at inflated costs, and none limiting their right to export their products at any part of the world.
> 5. Foreign capital may be freely repatriated, and profits derived from it may be remitted within certain limits; reinvested profits count as new foreign capital and are subject, as such, to the regulations.

Id. at 21.

114. COMPTROLLER GENERAL REPORT, *supra* note 104, at 40.

See also Huelin, *supra* note 111, at 21, ". . .Foreign investors may acquire an interest in national companies only when this represents an increase in capital, and provided it does not mean that they gain control." *Id.*

115. *Id.* at 21.

116. "Control" is the "application of policies and procedures for directing, regulating and coordinating production, administration and other business activities in a way to achieve the objectives of the enterprise." WEBSTER'S THIRD NEW INTERNATIONAL DICTIONARY 496 (16th ed. 1976).

117. However, not all types of stock have the same rights. Among other differences, common shares have voting rights and preferred shares carry no voting rights.

118. Huelin, *supra* note 111, at 22-23.

119. *Id.* With extraction, the fear is that foreign corporations will be able to accelerate or decelerate investment and production thereby controlling a large sector of Latin American export economy. It is felt that the state should control the disposition of non renewable

24 also limits foreign investment in any one company to 49 percent or less.[120] Take-overs of national firms by foreign interests are prohibited.[121] Moreover, the decision encourages the complete phase-out of foreign investment.[122] This phase-out principle allows host countries to ensure that national investors are allowed to participate.[123]

If the foreign owned shares are subsequently sold to a national investor, the capital may be remitted in its original currency, allowing repatriation of the capital.[124] Decision 24 also provides that a ceiling of 14 percent of the foreign capital employed be imposed on the remittance of profits.[125] The intention was that earnings above that limit be reinvested in a member country.[126] Limitations on remittance are necessary to keep profits within the country for reinvestment.

Decision 24 has since been modified by Decision 46, the Uniform Regime on Multinational Enterprises. Decision 46 allows multinational corporations to participate in the reserved sectors described in Decision 24.[127] Decision 46 thus effectively allows a wider degree of foreign participation than did the original Decision 24.[128] Furthermore, while Decision 24 limited participation to no more than 20 percent foreign shares, Decision 46 raises that limit to 40 percent.

On May 12, 1987, the Andean Pact countries adopted fundamental revisions to the 1969 Cartagena Agreement.[129] The new basic agreement, the Quito Protocol, still requires ratification by the members.[130] However, certain provisions have been adopted by member nations for immediate use; among them are provisions concerning foreign investment in Andean Pact countries.[131] The new Quito Protocol calls for a weakening of common rules on foreign investment such that

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resources. Parallel principles apply to public services, including Mexican banks. Latin Americans greatly fear foreign control of their banks and exclude this sector from foreign investment. With regard to protecting communications, the main concern is keeping politics free from undue foreign influence. *Id.* at 23-24.

120. *Id.* at 23-24.

121. Huelin, *supra* note 111, at 21.

122. *Id.*

123. *Id.* at 23.

124. *Id.* at 27-29. The Decision provides that "foreign investments liquidated by the sale of shares to national investors may be freely remitted in the currency in which they originated. . . ." *Id.* at 27.

125. *Id.* at 27.

126. *Id.* at 28.

127. Huelin, *supra* note 111, at 28.

128. *Id.*

129. *Andean Group Ministers Approve New Rules Diminishing Consensus on Trade*, 4 Int'l Trade Rep. (BNA) 745, (June 3, 1987).

130. *Id.*

131. *Id.*

individual member states will now be allowed to regulate foreign investment within their borders.[132]

However, prohibitions on foreign investment within certain sectors are still in force.[133] Governments of individual countries must decide which sectors are appropriate for foreign investment in accordance with Article 3 of Decision 220, which provides that: "[t]he member countries will not authorize direct foreign investment in activities considered properly managed by local existing companies."[134] Individual members are left to decide what they consider "properly" managed by local existing companies.[135] While this can be interpreted as giving a wide range of control to individual countries, it can also be interpreted as limiting the ability of that country to release control to foreign investors of any company which is properly managed by locals.

While Mexico did not sign the Cartegena Agreement, nevertheless, the economic and political developments occurring in Mexico during the Andean Pact's inception reflect similar concerns and attitudes. The industrial goals remain the same - to develop a sufficient base to achieve economic freedom. Like the other Pact countries, Mexico is striving to export manufactured goods in order to escape reliance on natural resource exportation. Only a few years after the Andean Pact agreement was signed, Mexico enacted the nationalistic 1973 Foreign Investment Law.

2. *National Foreign Investment Laws: The Experience in Mexico*

The 1973 Foreign Investment Law[136] (FIL), enacted to restrict foreign investment in Mexico, limits certain business investments.[137]

132. *Id.* at 746.

133. For example, the industries of telecommunications, natural extraction, banking and insurance remain restricted areas of foreign investment. *See* Huelin, *supra* note 111 and accompanying text.

134. Lindow, *The Andean Pact Relaunched: Implications for the United States; Treaty of Cartagena*, 10 Business America, Information Access Company, U.S. Dept. of Commerce, Oct. 12, 1987 at 12.

135. *Id.*

136. Maviglia, *supra* note 106, at 281. The 1973 Foreign Investment Law is only restrictive with respect to foreign direct investment in Mexico. *Id.* at 290. Articles 2 and 6 of The Foreign Investment Law define foreign investment as that investment made by: foreign corporations, foreign individuals, non-incorporated foreign enterprises, and Mexican entities under foreign

The FIL prohibits investment in certain sectors reserved to the state.[138] While it restricts foreign investment in sectors targeted for private Mexican investors, a limited amount of foreign participation is allowed.[139] In all other sectors, foreign ownership is limited to 49 percent.[140] The FIL also requires an authorization by the Mexican government for any investment which allows a foreign investor to acquire more than 25 percent of the equity, or more than 49 percent of the fixed assets of a Mexican corporate entity.[141] Thus, it can be seen that the 1973 Foreign Investment Law was primarily concerned with the retention of national control over key economic sectors.

On February 16, 1984, Mexico implemented the 1984 Guidelines[142] (Guidelines), a set of policies to be used in combination with the FIL. The Guidelines allow up to 100 percent foreign investment in certain industries not allowed under the FIL.[143] Some of the limitations and goals of the Guidelines can be interpreted as similar to those of the Cartagena Agreement. As in the Cartagena Agreement, the long-term goal of the 1984 Guidelines is to increase exports. The Guidelines and the Cartagena Agreement seek to accomplish this through the transfer of technology from foreign investors to Mexican industry and by encouraging national technological development.[144]

Although the 1973 Foreign Investment Law is a restrictive framework governing all foreign investment in Mexico,[145] in certain industries the Guidelines allow up to 100 percent foreign ownership.[146]

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control or with a majority of foreign capital. However, investments made by foreign individuals living in Mexico as permanent residents are not considered to be foreign. *Id.* at 290 n.67.

137. *Id.* at 420. Limited businesses include: (1) areas such as mining (34%), autos (40%), and all others where foreign investment is limited to 49% and foreign control is limited to the percentage of total ownership; (2) petroleum and natural resource industries, both of which are reserved to state ownership; and (3) communications and transportation, which are reserved for private Mexican investors. *Id.* at 421.

138. *Id.* at 420-21.

139. *Id.* at 421.

140. *Id.*

141. Maviglia, *supra* note 106, at 291.

142. NATIONAL FOREIGN INVESTMENT COMMISSION OF MEXICO, GUIDELINES FOR FOREIGN INVESTMENT AND OBJECTIVES FOR ITS PROMOTION (1984), *reprinted in* Maviglia, *supra* note 106 [hereinafter cited as 1984 Guidelines].

143. Note, *Has Mexico Kept the Promise of 1984? A Look at Foreign Investment Under Mexico's Recent Guidelines*, 23 TEX. INT'L L. J., 417, 418 (1988) [hereinafter Note, *Mexico's Recent Guidelines*].

144. Note, *Mexico's Recent Guidelines, supra* note 138, at 419. *See also* Heulin, *supra* note 112, at 22-23 (outlining Decision 24 involving basic principles in regulating foreign capital investment).

145. Note, *Debt-for-Equity Swaps, supra* note 4, at 445 n.6.

146. The 1984 Guidelines list priority industries that allow 100% foreign investment. The list includes: the production of electric and nonelectric equipment and machinery, electronic

Thus, the Guidelines would seem to mitigate the restrictiveness of the FIL.[147] Nevertheless, the FIL remains as Mexico's basic foreign investment legislation.[148] The 1984 Guidelines are merely regulatory provisions which stem from the FIL.[149] The Guidelines signal a change of attitude in Mexico from a more restrictive investment environment to one that is more open to direct foreign investment.[150] It remains to be seen whether the 1984 Guidelines are only an interim measure allowing 100 percent foreign investment that will soon close, or whether Mexico is permanently abandoning restrictive foreign investment laws.

B. *Regulation of Swap Activities*

The widespread use of debt swap transactions quickly generated regulatory response from the debtor nations. These laws and regulations, imposing a variety of restrictions, have been criticized as unnecessarily restricting investment. Commentators have stated that internal controls and regulations, which operate to prevent the immediate conversion of pesos to dollars, act as a drawback to debt swaps.[151] Because investors can only use pesos, they are forced to purchase locally made goods and equipment which are often inferior to those the investor could have purchased and brought into the debtor country for use. Nevertheless, the substantial government

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equipment and devices, equipment and material for transportation, metal mechanics, the chemical industry, other manufacturing industries, advanced technology, and the hotel industry. Maviglia, *supra* note 107, at 296. For a further breakdown of each industry, *see id.* at 296 nn.101-109.

147. *See generally* Note, *Debt-for-Equity Swaps, supra* note 4, at 445 n.6. (discussing the change in attitude that the 1984 Guidelines seem to represent toward foreign investment in Mexico).

148. The Guidelines do not repeal the 1973 Foreign Investment Law. In fact, the Guidelines do not function as law at all, but rather as a policy decision. *See id.* at 445 n.6.

149. *Id.*

The Foreign Investment Commission has made this point clear.

> While . . . direct foreign investment is welcome, it should be emphasized that the National Development Plan states that the legislation on foreign investments and transfer of technology provides, on the basis of nationalistic principles, an adequate normative framework for a flexible orientation . . . . Consequently, the Federal Government affirms that the law to Promote Mexican Investment and Regulate Foreign Investment does not require modifications, since it adequately covers the field of its regulation and likewise gives flexibility. . . ."

Note, *Mexico's Recent Guidelines, supra* note 138, at 423-24.

150. *Id.* In issuing the 1984 Guidelines, the Foreign Investment Commission was careful to reaffirm that the 1973 Foreign Investment Law was in no way changed or repealed by the issuance of the Guidelines. Thus it would appear that the Mexican government is free to reevaluate its position regarding the desirability of increased foreign investment. *Id.*

151. Ollard, *supra* note 2, at 67, 73.

interests affected by swap transactions have generated the enactment of numerous laws restricting the use of swaps.

1. *The Liberal Swap Program in Mexico*

The Mexican legislative framework for debt swaps had its genesis in Mexico's 1985 Restructuring Agreement.[152] Clause 5.11 of the Restructuring Agreement[153] provided the legal authorization necessary to convert Mexico's public debt into public and private capital investment.[154] Clause 5.11 is not legislation, but rather a part of an agreement between Mexico and its creditors to encourage the development of a swap program in Mexico.[155] In accordance with Clause 5.11, the Ministry of Finance and Public Credit[156] imposes a loss percentage or discount rate on the debt to be swapped. The bank must then reduce the loan repayment amount by this percentage. The discount varies depending upon the industry involved,[157] ranging from 0 percent for industries which the government wishes to promote, to 25 percent for those which are not a government priority.[158]

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152. Note, *Debt-for-Equity Swaps, supra* note 4, at 444.
153. *Id.*
154. *Id. See also* Pando, *supra* note 9, at 219 n.289.
Section 5.11 applies to exchanges of Qualified Capital Stock, Qualified Debt or a Qualified Investment. 5.11 (a) Qualified Capital Stock is defined as "capital stock of any Mexican public sector entity or Mexican private sector company . . . . (i) which is issued in registered, certificated form . . . ." Qualified Debt is defined as "indebtedness of any Mexican public or private sector entity . . . ." "Exchanges of advances for qualified capital stock are subject to all required Mexican governmental authorizations, including authorization by the Ministry of Finance and Public Credit, The National Commission of Foreign Investment and the Ministry of Foreign Relations of the United Mexican states. *Id.*
155. Note, *Debt-for-Equity Swaps, supra* note 4, at 445.
156. *Id.* at 449. The Ministry of Finance and Public Credit represents the government of Mexico as the obligor in all aspects of the debt/equity transaction. *Id.* at 456.
157. Balmaseda, *supra* note 18, at 7-8.
158. Recent Development, *Int'l Debt, supra* note 1, at 511.

Use of Investment	*Discount Percentage*
Companies owned by the Government and which the Government has decided to sell	0
Companies the production of which derived from the new investment is destined to export at least 80%, or small or medium sized companies	5
Companies engaged in the development of activities of prime importance and which generate jobs and foreign currency	8
Companies with minority or no foreign capital that some other benefit to the Mexican economy is produced, such as exportation of 30% of the new production	12

The Mexican government has also published an Operations Manual which is a set of administrative rules to be used in accordance with the 1973 Foreign Investment Law.[159] The Operations Manual gives the Ministry of Finance and Public Credit the power to authorize or deny the use of the swap transaction once an analysis of the risks and benefits of that particular transaction has been made.[160]

To implement the swap, two approvals are required; one from the National Commission of Foreign Investment[161] and the other from the Ministry of Finance and Public Credit. The Commission weighs the costs and benefits of the proposed transaction.[162] The Commission must rule on the proposed swap and issue an opinion within five days of receiving the application.[163]

In a Mexican swap transaction the investor exchanges credits[164] for "Qualified Stock Capital," which is stock in Mexican public-sector entities, subject to certain qualifications.[165] Mexico also limits an

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Reduction of liabilities with domestic suppliers	14
Payment to FICORCA or Mexican government banks for liabilities in Mexican currency	16
Projects that do not represent a special benefit for the economy of the country	25

Balmaseda, *supra* note 19, at 7-8.

Priority is given to debt conversions which benefit Mexico. Examples of activities which are considered beneficial are as follows: any activity which increases exportation, expansion of the productive capacity of subsidiaries, those that transfer advanced technology, those projects in which the degree of domestic integration exceeds the general level of the economic line in question, those projects with 100 percent foreign capital, and small and medium sized companies. *Id.* at 3-4.

159. *Id.* at 447.

It is interesting to note that although swap transactions do not abrogate existing law in Mexico, neither are they indicative of a permanent change in Mexico regarding foreign investment. *Id.* at 446-47. There does not seem to be any broad legislation in Mexico indicating that foreign investment is now favored. The Operations Manual is prepared by the Ministry of Finance and Public Credit and the National Commission of Foreign Investment. Pando, *supra* note 11, at 219.

160. Balmaseda, *supra* note 18, at 2.

161. This is required by General Resolution No. 5 of the *Comision Nacional de Inversiones Extranjeras Diario Oficial*, Dec. 5, 1985. Note, *Debt-for-Equity Swaps, supra* note 4, at 445 n.5. The Commission of Foreign Investment has a duty to enforce Mexico's foreign investment laws. *Id.* at 447.

162. *Id.* Factors taken into consideration by the Commission include: (1) outside sources of resources used in the debt swap; (2) whether the proceeds from the transaction are used to increase productive investment; (3) the degree of inflation caused by the program to date; and (4) that the transaction benefit all parties involved. *Id.*

163. *Id.* at 449. Variations to this basic procedure exist with regard to special circumstances.

164. A credit is a loan in which a group of financial institutions makes funds available on common conditions to a borrower. Goodman, *The Pricing of Syndicated Eurocurrency Credits*, FED. RES. BD. N.Y.Q. REV. 39 (1980).

165. Recent Development, *Int'l Debt, supra* note 1, at 511. There are five conditions which

investor's ability to circumvent currency exchanges and repatriation of capital.[166] Transactions which do not permanently add to Mexico's capital stock are not allowed. An unfortunate corollary of this requirement is to preclude the use of swap transactions to finance working capital.[167]

In the past, swaps in Mexico were limited to investments by foreign entities.[168] Although this restriction has been lifted under Clause 5.11, no legal framework has been included in the Operations Manual, so that in effect, Mexicans are still barred from participation in the program.[169]

As Mexico implemented the first formal swap program, it provided the model from which others have patterned their programs. Mexico opened its doors to swaps in hopes that it would reduce the amount of Mexico's outstanding debt. Although swaps have relieved only a relatively small proportion of this debt,[170] it is hoped that swaps have encouraged additional amounts of foreign investment.

However, Mexico's model has not proven to be perfect. On the contrary, due to its propensity to cause inflation, the swap program has been suspended twice in Mexico.[171] Although the Mexican regulations prohibit the transfer of equity to any Mexican entity or individual for a period of 12 years,[172] the regulations fail to govern the repatriation of profits. Profits, though not guaranteed, are freely remittable to the investor's country once dividends are declared.

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must be met for the stock to be considered Qualified Capital Stock:

> The shares must be issued in the name of the foreign entity, they are not to be transferred to any Mexican citizen or entity for a period of 12 years, they cannot be redeemed on terms which are more favorable to the investor than the terms of credit for which they were exchanged, the shares are not to be guaranteed dividends, and are not to be converted to securities other than other Qualified Capital Stock.

Id. at 511-12. The 12 year prohibition on transferring shares to Mexican entities or individuals is designed to prevent investors from exchanging the stock into pesos and then back into dollars, thus preventing any arbitrage profits. *Id.* at 511 n.38.

166. Note, *Debt-for-Equity Swaps, supra* note 4, at 447.

167. Conrow, *supra* note 48, at 25.

168. *See supra* note 36 and accompanying text.

169. Note, *Debt-for-Equity Swaps, supra* note 4, at 453-54. Although there has been controversy surrounding the allowance of Mexican nationals to participate in swap transactions, it appears that nationals will be allowed to participate in the new swap program of 1988. Some of the arguments against allowing participation of Mexican nationals are that the swap program allows Mexican nationals a discount on domestic investments they would have made anyway. Further, this discount would act as a reward to those same nationals who are guilty of exporting money out of Mexico at the begging of the debt crisis. *Id.* at 453, n.65.

170. By 1987, swaps had provided only $1.1 billion U.S. in debt relief for Mexico. HOUSE REPORT ON AN INTERNATIONAL DEBT MANAGEMENT AUTHORITY, *supra* note 7, at 87. Mexico's outstanding debt at that date stood at $104.4 billion. *Id.* at 85.

171. Note, *Debt-for-Equity Swaps, supra* note 4, at 452.

172. *Id.* at 450.

Furthermore, Mexican regulations allow for the issuance of common voting stock as Qualified Capital Stock, thereby relinquishing control in those entities that are owned by a majority of foreign investors.

In short, although Mexican regulations require the initial investment funds from swaps to remain in the debtor country for a period of time, the profits from these investments can be remitted to the investor's home country. This counteracts the goal of expanding the manufacturing bases necessary to become self-sufficient. Furthermore, while types of industries are limited and various levels of ceilings on foreign ownership are imposed, the shares issued are common stock which carry voting rights. This enables a foreign investor to obtain control over the entity involved. As foreign investors continue to gain control over more and more single entities, the cumulative effect can be that foreign investors achieve majority holdings of Mexican industries.

B. *The Restrictive Brazilian Regulatory Scheme*

In 1984, Brazil imposed severe restrictions on swap transactions by implementing Circular 1125.[173] Issued by the Central Bank, Circular 1125 banned debt swaps that involve third parties[174] and imposed severe restrictions on other debt swap transactions.[175] Swaps could only be implemented if specified conditions were met. First, Circular 1125 limited the parties that could be involved in the swap. The swap was only allowed if the original parties to the debt were involved.[176] This limitation effectively banned third party transactions. The swap transactions were approved by the Central Bank only on a case-by-case basis.[177] The investment had to remain in Brazil until the maturity date of the original loan.[178] The transaction had to be performed by a financial institution.[179] Finally, ownership of the Brazilian entity was not to be transferred to a third party investor.[180] This last restriction prevented an investor from reaping arbitrage profits.[181]

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173. Ashford, *Brazil Plans for State Auctions*, EUROMONEY, Sept. 1987, at 93, 94 [hereinafter Ashford].
174. *Id.*
175. Business Perspective, *Brazil, supra* note 108, at 164.
176. *Id.*
177. *Id.*
178. *Id.*
179. *Id.*
180. Business Perspective, *Brazil, supra* note 107, at 164.
181. Arbitrage is defined as the simultaneous purchase in one market and sale in another of a security or commodity in hope of making a profit on price differences in the different markets. BLACK'S LAW DICTIONARY 95 (5th ed. 1970).

Two subsequent resolutions governing swaps have been enacted in Brazil. The first, Resolution 1416 of the Central Bank of Brazil, went into effect for a period of about two months beginning November 17, 1987.[182] The Resolution required that the Brazilian foreign debt be secured as a prerequisite to its conversion.[183] As the international banking community was opposed to this securitization requirement, Brazil's National Monetary Council approved new swap rules in Resolution 1460.[184] Resolution 1460, approved on February 1, 1988, now regulates swap transactions in Brazil.[185] In an effort to curb the inflationary aspects of swap transactions, under Resolution 1460, the Central Bank retains the power to set ceilings on the amount of debt converted into equity.[186]

Three types of debt qualify for conversion under the new Resolution. The first type is the compulsory U.S. dollar deposit with the Central Bank made under the so-called "Deposit Facility Agreements" (DFA). The deposit is executed between the Central Bank and non resident creditor banks (*i.e.*, "rolled-over" debt).[187] Deposits made under the Deposit Facility Agreements are converted by means of a public auction which fixes the discount in the stock market.[188] After the auction occurs, the cruzado proceeds from the auction are invested in one of three options: 1) capital of new companies; 2) capital of existing companies; or 3) Foreign Capital Conversion Funds.[189]

The second type of debt which qualifies is represented by voluntary deposits with the Central Bank made pursuant to previous resolutions.[190] Finally, the third type of qualifying debt is one which has yet to mature.[191] These second and third types of debt are not

182. Baker & McKenzie, *supra* note 13, at 846-47.

183. *Id.* "Securitization" involves the "issuance of bonds" (vis-a-vis cash) to the foreign creditors holding the debt to be converted into equity. The foreign creditors defer the receipt of the discounted value of their credits. *Id.* at 848. This provision was dropped in Resolution 1460. *Id.* at 848.

184. *Id.* at 846-47.

185. *Id.* at 847.

186. *Id.*

187. Baker & McKenzie, *supra* note 13, at 847.

188. *Id.* There are two types of auctions. One for investments that are to be made in the less developed areas of the country such as the Sudam and Sudene areas; and the other for investment in other areas of the country. *Id.*

189. *Id.* These funds act like mutual funds and are managed by the Brazilian stock market. *Id.* It appears that the government of Brazil prefers the Foreign Capital Conversion Funds because dividends from these funds are subject to a reduced withholding income tax rate. *Id.*

190. These resolutions are Nos. 230 and 432. *Id.*

191. Baker & McKenzie, *supra* note 13, at 847.

converted by auction, but may be converted privately.[192] The discount rate for their conversion is set by the Central Bank.[193]

The regulations governing swap activity currently in place in Brazil promote direct foreign investment without relinquishing control of Brazilian entities. Both Resolutions 1416 and 1460 require that converted proceeds remain in Brazil for a period of at least twelve years.[194] This provision ensures that swap proceeds remain in the economy[195] where they may be used to help fuel economic growth. Both Resolutions mandate that debt may not be converted into equity of companies that have repatriated capital during the three years prior to the swap unless the repatriated amount has returned to Brazil.[196] This provision is aimed at deterring capital flight of the funds involved.[197] Most importantly, both Resolutions mandate that converted debt may not be invested in such a way that companies presently controlled by Brazilian residents would be transferred to non residents.[198] Control is maintained by transferring preferred, non voting stock rather than common stock.[199] This provision is crucial to the maintenance of control over Brazilian entities by Brazilian nationals which in turn allows Brazil to maintain greater control over its economic decisions.[200] Finally, the converted debt invested into the Foreign Capital Conversion Funds is limited to 5 percent of the voting capital or 20 percent of the total capital of the Brazilian company.[201] Under the new conversion plan, the role of brokerages in executing the debt swap transactions will be greatly reduced.[202] In effect, the Central Bank will act as broker.[203]

C. *Mexico and Brazil Compared: Approaches to Regulating Investment and Swap Transactions*

Although Brazil and Mexico have both implemented swap programs, the approach each country has taken in formulating their

192. *Id.*
193. *Id.*
194. *Id.*
195. *Id.*
196. Baker & McKenzie, *supra* note 13, at 847.
197. *See generally* Business Perspective, *Brazil, supra* note 107, at 164. Regulations imposed in Brazil require that the entity acquired through the use of the swap mechanism not be transferred to a third party in order to control problems of capital flight. *Id.*
198. *Id.*
199. *Id.* at 165.
200. *Id.*
201. Baker & McKenzie, *supra* note 13, at 847. Currently, projects applied for in Brazil under the new conversion plan totals $457 million. Ashford, *supra* note 184, at 94.
202. *Id.*
203. *Id.*

program differs not only in the basic structure of the regulations used, but also in what the regulations are meant to encourage or deter.[204] Mexico actively seeks swap transactions and remains receptive to them.[205] Brazil has been much more cautious in its approach to the implementation of a swap program.[206] As a result, Brazil's regulations governing swaps are much more restrictive in nature.[207]

A key difference between the two sets of regulatory systems is how they differ with regard to the relinquishment of control over the business entities involved. Mexico's regulations allow the exchange of common voting shares for retirement of outstanding debt.[208] For those sectors where 100 percent foreign ownership may be obtained through swap activities, those business entities become subject to complete foreign control.[209] Because foreign investors can gain and maintain this control, Mexico's current domestic investment policy appears to be contrary to the goals set out in the Andean Pact.[210] In comparison, Brazil issues non voting preferred shares in their swap transactions.[211] This allows Brazil to maintain control over business entities involved in swap transactions, therefore, the entity remains Brazilian in effect. Brazil's emphasis on maintaining control of their industries is in alliance with the goals set out in the Andean Pact.[212]

It remains to be seen how much change Decision 220 of the Quito Protocol[213] will bring about in foreign investment. Although Decision 220 appears to ease the implementation of debt swap transaction programs,[214] individual sectors may still be reserved for national investment.[215] Decision 220 allows member countries to adopt either a liberal interpretation of its language, enabling a member country to implement a less restrictive swaps program,[216] or a more restrictive

204. *See supra* notes 155-98 and accompanying text.
205. *See supra* notes 155-63 and accompanying text.
206. *See supra* notes 196-202 and accompanying text.
207. *See supra* notes 196-203 and accompanying text. *See also* notes 208-12 and accompanying text.
208. *See supra* note 165 and accompanying text.
209. *See supra* notes 140-43 and accompanying text.
210. This follows as Mexico allows 100% ownership while the Andean Pact stresses national control. *See infra* notes 218-22.
211. Business Perspective, *Brazil*, *supra* note 107, at 165. Brazil uses preferred non voting shares. *Id.*
212. Brazil uses non-voting preferred shares in its swap transactions. *Brazil*, *supra* notes 119-120 (discussing Latin American goal of maintaining control over economic sectors).
213. *See supra* notes 120-35 and accompanying text.
214. *See supra* notes 134-36 and accompanying text.
215. *See supra* note 134 and accompanying text.
216. *See supra* note 135 and accompanying text.

reading of its language, allowing a country to strictly regulate swap activities.[217]

As the Cartagena Agreement[218] is still in effect, and if the 1984 Guidelines[219] have the force of law, a conflict in goals is apparent. This is so as the Cartagena Agreement stresses national control over manufacturing sectors[220] while the Guidelines allow for the loss of such control over these sectors in favor of foreign investment, to encourage economic growth.[221] Thus, if foreign control is found to lead to instability, Mexico may face difficult choices in the years ahead.[222]

IV. Responses to the Swap Market: Investors and Their Home Country Regulations

With the increasing popularity and rapid growth of debt swapping, and the implementation of regulations imposed by debtor countries, investors, banks and their home country governments have reacted with a variety of responses.[223] In some creditor countries, regulations have been adjusted in order to allow enough flexibility in foreign investment laws to encourage swaps without causing instability in the banking and economic systems of the debtor nation.[224] Bankers and investors have scrambled to find the most lucrative avenue available to turn outstanding debt into money.[225] The ramifications of these actions must be considered prior to executing a swap agreement.

A. *Creditor Home Country Regulations: The U.S. Approach*

In response to the looming problem of potential default and its impact on the banking industry and the national economy, the Federal

217. *Id.*
218. The Cartagena Agreement is part of the Andean Pact. *See supra* note 102.
219. *See supra* notes 136-38 and accompanying text.
220. *See supra* notes 117-18, 121-26 and accompanying text.
221. Comment, *Give Me Equity*, *supra* note 13, at 115.
222. It should be noted also, that both the present swaps activity and the Guidelines seem to reflect less concern on the part of Mexico regarding foreign ownership and control than has been evidenced by the Andean Pact and its ancillary rulings. *See supra* notes 114-17 and accompanying text.
223. *See infra* notes 226-45 and accompanying text.
224. *See* notes 222, 226 and accompanying text for an example of US Regulations allowing increased flexibility in debt swaps.
225. *See infra* notes 226-27 and accompanying text.

Reserve Board[226] of the United States has recently enacted liberalized regulations regarding swaps. The new regulations allow banks to hold a greater percentage of shares in non financial foreign companies.[227] Prior to the recent amendment, Regulation K of the Bank Holding Company Act of 1982 limited investments abroad to activities of a banking nature.[228] The amendment allows banks to invest in a maximum of 40 percent of the shares of a private sector foreign company.[229] The amendment further limits prospective transactions by prohibiting U.S. banks from holding more than 25 percent of a private sector, non financial foreign company's voting shares. However, the bank may invest in more than 25 percent as long as that company has a larger shareholder who is unaffiliated with the bank.[230] Although there are exceptions to Regulation K, the amount of the ceiling on share ownership remains limited.[231] The new regulations allow banks to acquire up to 100 percent of any non financial public entity that is being privatized through the use of swaps.[232] In short,

226. The Federal Reserve Board is one of the federal banking regulators along with the Office of the Comptroller of the Currency and the Federal Deposit Insurance Corporation. The Federal Reserve Board examines policies of U.S. bank portfolio diversification to minimize risk both domestically and internationally. The Federal Reserve Board also regulates the investments that U.S. banks make. Lindow, *supra* note 134, at 12.

227. *Announcements*, 74 FED. RES. BULL., 232 (April 1988) [hereinafter *Announcements*].

228. Evans, *supra* note 23, at 86. The Bank Holding Act was enacted under 12 U.S.C. 1842(a), 1843(c)(8), and 1843(c)(14). Regulation K was enacted under C.F.R. §§ 211.3(a), 211.4(c), 211.5(c), and 211.34. Before its amendment, effective February 24, 1988, Regulation K mandated that if a U.S. bank wanted to make an investment in the voting stock of a foreign entity in excess of 50%, that entity had to have at least 95% of its assets involved in permissible activities such as commercial, financial, and leasing operations. *Announcements*, *supra* note 227. *See also* Evans, *supra* note 23, at 86-87. Regulation K further stated that a bank could invest in any type of entity, regardless of its activities, as long as the stock owned by the investing company represented less than 20% of the entity's voting stock. Evans, *supra* note 23, at 87. Before being amended in 1988, the regulation had already allowed banks to: (1) reduce exposure by selling debt to other investors, or (2) take advantage of debt/equity swaps for up to 25% of non-financial companies. *Announcements*, *supra* note 227.

229. *Announcements*, *supra* note 227. Some investor banks in the United States are irritated at the interference to free trade that Regulation K imposes. Evans, *supra* note 23, at 87. One means of avoidance has been through purchasing preferred, non-voting shares of stock rather than common voting shares. *Id.* However, the Federal Reserve has ruled that a U.S. bank may not hold more than 25 percent of a company's shares, although it is a mixture of non-voting and voting stock. *Id.* Brazil is presently issuing non-voting, preferred shares in its debt/equity transactions. Business Perspective, *Brazil*, *supra* note 107, at 165.

230. *Announcements*, *supra* note 227, at 232.

231. Evans, *supra* note 23, at 91. One such exception to regulation K allows the exchange of debt that was previously contracted for equity. However, the equity interest cannot exceed a five year period even though most debt/equity transactions mandate that the investment be held for at least a ten year period. *Id.*

232. *Announcements*, *note* 227. The February 1988 amendment to Regulation K has also lengthened the permissible holding period, allowing the investor to hold the investments made through swaps for a two-year period beyond which full repatriation of investment is restricted by the debtor country up to a maximum of 15 years. *Id.* Once the investment exceeds 1% of the bank's equity capital or $15 million, notice of swap activity must be given to the SEC. *Id.*

while the regulations impose limitations on the amount of foreign ownership, in the case of a swap, they allow up to 100 percent ownership. This provides incentive for banks and investors to utilize swaps to maintain control over foreign investments which are otherwise heavily restricted.

These regulations allow increased investor control over foreign direct investment by broadening the types of investments allowed to include non financial entities. In addition, by allowing up to 100 percent ownership, foreign investors can purchase an entire industry of the debtor country, thereby controlling that industry. Finally, changing the debt from public to private eliminates the pressure on a creditor or its country to use direct political instruments and solutions against a debtor country to cure default.

B. *Swaps as an Alternative to Losses on the Secondary Market*

Further providing incentive for banks to consider swap transactions has been the rapid increase in the discount rate offered to investors of Latin American debt.[233] As banks have grown more anxious about holding large amounts of Latin American loans, they have taken the opportunity to sell them on the secondary market.[234] This means that the number of Latin American loans on the secondary market is increasing. Without a matching increase in demand for these loans, the market becomes one where everyone wants to sell and no one to buy. The price on the market is then forced down, and the banks lose still more money when they eventually sell these loans.[235] Due to the questionable recoverability of these debts, the price on the secondary market has been discounted at a greater percentage than the discount demanded by the debtor nation.[236] Therefore, banks turn to direct swap transactions with the debtor country in order to recover a greater percentage of their loan.

C. *An Increase in Involuntary Lending*

Involuntary lending occurs when a bank is "forced" to loan additional funds to a debtor nation in order to ensure that the debtor

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233. Kuczynski, *supra* note 24, at 134.

234. The secondary market generally consists of private or secondary institutional purchasers who purchase outstanding loans from the banks at a discount. HOUSE REPORT ON AN INTERNATIONAL DEBT MANAGEMENT AUTHORITY, *supra* note 7, at 80.

235. Kuczynski, *supra* note 24, at 134.

236. For example, a $100,000 loan held by the bank may be purchased by a third party for as little as $50,000. By swapping with the debtor nation, even where the discount is at its highest rate of 25%, the bank will receive $75,000 worth of shares.

nation is able to maintain its interest payments on prior loans.[237] Voluntary lending has declined severely since 1984.[238] World Bank President, A.W. Clausen, has warned that commercial lending to large debtor nations could drop by as much as 50 percent during the next decade.[239] An increase in loan-loss reserves represents an expectation that banks may not be able to recover money loaned to large debtor nations.[240] There is speculation that present loan-loss provisions are insufficient at 25-30 percent of the total loans to debtor nations.[241] As fresh capital decreases, banks holding existing notes are "forced" to lend more money to Latin American countries to ensure the viability of their loan repayments.[242]

D. *Investors Fight Back With the "Informal"*

In response to the increased restrictions imposed by both debtor and creditor nations, a new type of swap has emerged in Brazil called an "informal."[243] The informal is basically an unauthorized swap which, so far, has been tolerated by the Central Bank of Brazil[244] ostensibly because of its role in the reduction of debt.[245] The restrictions which a debtor country places on repatriation of capital and profits, on industries that may be invested in, and on the percentage of ownership allowed are circumvented by the use of informals.

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237. Kuczynski, *supra* note 24, at 131.

238. JOINT REPORT ON ECONOMIC DEVELOPMENT IN LATIN AMERICA AND THE DEBT PROBLEM, *supra* note 58, at 41. Since 1984, debt service on private loans has increasingly exceeded the amount borrowed. See Interparliamentary Conference, *supra* note 25, at 220 (table indicating debt flow from 1981-1987).

239. *Id.* at 160.

240. Kuczynski, *supra* note 24, at 132. In May of 1987, Citicorp increased its loan-loss reserves by $3 billion. Chase Manhattan followed suit at $1.6 billion, followed by Bank of America, Chemical Bank, and Manufacturers Hanover each at similar amounts. *Id.*

241. 25%-30% represents the present level of loan-loss reserves after the increases by Citicorp, et al. *Id.* at 134.

242. *See id.* at 131.

243. Cohen & Michaels, *supra* note 5, at 18. For example, where a Brazilian company has $100 million in debt about to mature to a U.S. bank, instead of depositing the cruzado equivalent into the Central Bank as it would have previously done, it pays the cruzado equivalent of $90 million U.S. to an agent. That agent then buys U.S. dollars on the black market obtaining $60 million. The agent then pays the U.S. bank $59 million ($11 million more than it would have gotten on the secondary market at 48-cents-to-the-dollar). *Id.* at col. 1. These unauthorized swaps have converted $2-$3 billion of debt. *Id.*

244. *Id.* The interest in "informals" stems from the fact that the transaction costs less to all parties. The creditor is allowed more than the amount obtained on the secondary market (currently 48-cents-to-the-dollar), and the cost to the debtor is less than it would be if it went through the official channels. *Id.*

245. *Id.* However, recently the Central Bank has tried to impose restrictions that make the transactions more traceable, by mandating that the cruzado payments of maturing debt be deposited into bank accounts. *Id.*

Some of these informals, however, allow investors to make quick profits without creating any productive investment.[246] This occurs through "roundtripping", where an investor exchanges the dollar-denominated debt for local currency at the discounted rate and then exchanges the currency for dollars at the official rate which is higher.[247]

The problem with the informal market is three-fold. First, by allowing repatriation of profits, investors can freely remit profits to their home country,[248] therefore, no fresh capital is generated to fuel economic growth. Second, if voting shares are exchanged instead of the non voting interests required by the Brazilian conversion program, the "informal" facilitates the loss of control over locally owned companies which the government seeks to maintain.[249] Finally, disclosure is difficult to enforce in an informal market, adding to risk for investors in an informal swap.[250] Thus, the existence of the informal market circumvents nationalistic interests of the debtor nation and increases the instability of participating firms.

V. The Costs and Benefits From the Perspective of Debtor Nations, Banks, and Third Party Investors

Since their inception, significant questions have arisen regarding the costs and benefits of swaps. These questions must be addressed if swaps are to continue in the long-term.

A. *The Benefits of Swaps: Both Real and Perceived*

1. *Benefits to the Foreign Investor*

For the foreign multinational investor, the benefits from swap transactions are dependent largely upon the ability to purchase debt at a discount which fluctuates from 40 to 50 percent of the face value.[251] The investor then exchanges the debt for equity in the debtor

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246. Cohen & Michaels, *supra* note 5, at 18.

247. House Report on an International Debt Management Authority, *supra* note 6, at 92.

248. Ollard, *supra* note 2, at 69.

249. Maintenance of control is an important goal under the Andean Pact. Huelin, *supra* note 111. As Brazil exchanges preferred non voting shares in swap transactions, control remains with the original owners. Business Perspective, *Brazil*, *supra* note 107.

250. *See generally* disclosure requirements imposed by Regulation K, *supra* note 232 and accompanying text.

251. Balmesada, *supra* note 18, at 2.

country's industries, subject to the discounts imposed by the debtor nation's government.[252] This allows the multinational investor to make an investment that may otherwise have been prohibitive. The swap is also perceived as useful to the multinational corporation that wishes to inject fresh capital into its subsidiaries located within the debtor nation. However, whether or not this capital is truly "fresh" is questionable.[253]

2. *Benefits to the Banks*

For the banks, the benefit of debt swaps is the chance to recover money from the debtor nation which may otherwise be unrecoverable. Although the bank must write off the discount rate applied in the transaction as a loss, if loan-loss reserves are high enough, the bank's stability is not called into question.[254] When faced with the prospect of default which would threaten the bank's solvency, the bank will usually prefer to use the swap mechanism to relieve it of a portion of its debt holdings even though it must write off a percentage of the debt as a loss in the process.[255]

3. *Benefits to the Debtor Nation*

The obvious benefit of swaps to the debtor country is the retirement of a portion of their outstanding national debt for less than its full amount.[256] This in turn reduces interest payments, leaving the debtor nation needing less foreign capital to service their debts.[257] This would leave the debtor country more money to reinvest in increasing their manufacturing base, thus fueling economic growth. As long as banks and investors are willing to discount the indebtedness in return for shares of foreign companies, this benefit will exist.

Another perceived benefit of the swap transaction is increased foreign investment.[258] Foreign investment is encouraged in Mexico by the 1984 Guidelines[259] in an effort to increase industrial develop-

252. *Id.* at 7-8.
253. *See infra* note 263-265 and accompanying text.
254. Kuczynski, *supra* note 24, at 132.
255. *Id.*
256. Balmaseda, *supra* note 19, at 2. In Mexico the government has been able to convert debts in foreign currency into Mexican pesos. Because Mexico has repeatedly devalued the peso, this allows the government to repay fewer pesos at the maturity dates of the loan. *Id.*
257. Meltzer, *A Way to Difuse the World Bomb*, FORTUNE, Nov. 28, 1983, at 138, 143.
258. Comment, *supra* note 13, at 112.
259. Note, *Mexico's Recent Guidelines*, *supra* note 137, at 423.

ment.[260] Increased foreign investment would seem to be particularly important in light of the disinclination of banks to lend money to Latin American countries.[261] As fresh capital is thought necessary to attain increases in economic growth, if banks lend less fresh capital, swaps provide an alternative.[262]

In determining whether capital is truly fresh, however, one must consider *additionality*.[263] Put simply, the question of *additionality* is whether the "subsidy to direct investment provided as part of a debt/equity swap actually calls forth additional investment," as opposed to investment which would have occurred anyway without the discount.[264] If the investment would have been made without the swap mechanism, the debtor country actually gives up hard currency without reaping a benefit.[265]

One of the factors scrutinized by some debtor nations in the determination of whether to implement a swap transaction is whether the proposed project will transfer technology to the debtor country.[266] This goal is reflected in the Mexican 1984 Guidelines.[267] A consideration in this determination should be the appropriateness of the technology transferred. There are different components of "technology," with "production technology" being the most obvious form.[268] Technology may include project design or even managerial systems.[269] These technologies allow national firms to produce a better or different product or produce the same product more efficiently.[270] In analyzing the costs and benefits of swap transactions in the long-term, governments must seek transactions which will enable a country to meet its appropriate technological development goals.

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260. *Id.* at 425.
261. House Report on An International Debt Management Authority, *supra* note 7, at 90.
262. Voluntary lending has decreased since Mexico's announcement of suspension in 1982. Kuczynski, *supra* note 25, at 130. *See also* Note, *Debt-for-Equity Swaps*, *supra* note 4, at 460.
263. House Report on An International Debt Management Authority, *supra* note 7, at 91.
264. *Id.*
265. *Id.* Brazil has hesitated involving itself in the debt/equity market as it believes that the investments would be made even without the subsidy provided by the swap. Business Perspective, *Brazil*, *supra* note 182, at 164.
266. Note, *Debt for Equity Swaps*, *supra* note 4, at 448.
267. Comment, *Give Me Equity*, *supra* note 13, at 116.
268. Joint Report on Economic Development in Latin America and the Debt Problem, *supra* note 58, at 176 (essay by Kristin Hallberg) Other technologies include enterprise technology, research technology, financial technology and managerial skills. *Id.*
269. *Id.*
270. *Id.*

A third area where the interests of the debtor nation influence swap transactions is the privatization of portions of a nation's public industries.[271] Some countries pursue a policy of privatization in public industries.[272] The debt swap is a particularly effective means of privatization as it serves the collateral function of releasing the nation from its foreign debt.[273] Industries which transfer appropriate technology are likely to remain strong areas of debt swaps.[274] Thus, industries which transfer product technology such as the auto industry are likely to remain active in the swap market. Likely too are industries which the government wishes to privatize. There may be reasons for maintaining government ownership of particular industries in developing countries.[275] For instance, often the infrastructural level is so inferior that if the government does not assume the responsibility for providing services, the private sector can not provide them either.[276] Therefore, the issue of privatization requires more than a cursory glance.

In sum, it appears that benefits to the debtor nation do exist. Swap transactions do retire a portion of a debtor's outstanding debt which lowers that country's interest payments. However, although these transactions result in increased foreign investment, it is possible that many of these investments would have taken place regardless of the presence of the swap mechanism. Swaps also facilitate the goal of privatization. Finally, swap transactions can be used as a vehicle for transferring appropriate technology to a debtor nation which should result in an increase in the debtor country's manufacturing base.

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271. Comment, *Give Me Equity, supra* note 13, at 113 n.175. Privitization is the conversion of ownership of state-owned entities to the private sector. It is believed that privitization increases efficiency by increasing competition. *Id.*

272. *Id.* Privatization has been favored in the past, both by the International Finance Corporation and by the Reagan administration. *Id.* Since the inauguration of President Bush, the new administration has not indicated any change of this policy. However, among individual Latin American nations, there has been extensive debate regarding the wisdom of the sale of national industries. Kuczynski, *supra* note 25, at 138-39.

273. Debt swaps serve to privatize and relieve debt where the exchange involves a public sector entity. Comment, *Give Me Equity, supra* note 13, at 113.

274. *See generally* Maviglia, *supra* note 105, at 296 (one of the most important goals of the 1984 Guidelines is to encourage national technological development through a transfer of technology).

275. Kuczynski, *supra* note 24, at 138.

276. *See id.* at 138.

B. *Costs*

1. *To the Banks/ Foreign Investor*

The financial costs of debt swaps stand to increase due to newly augmented disclosure requirements in investor home countries.[277] One area where this change is evident is in the home country regulation of swap activities by banks. As loan-loss reserves are still considered inadequate at 25 to 30 percent,[278] it is likely that banks will continue to be regulated by their home country. At the same time, however, in recognition of the plight of banks which hold large amounts of foreign debt, the Federal Reserve Board has recently liberalized regulations concerning swap transactions.[279] Despite the trend toward the relaxation of regulations, the Federal Reserve Board is likely to continue to regulate U.S. banks involved in swaps and to call for increased disclosure of swap transactions.[280]

Because the debtor country investment policies are unpredictable, and their implementation is even more problematic, it seems difficult to predict what policies will exist in the future. At present, Mexico is welcoming investors interested in these transactions. However, restrictive foreign investment laws are still in effect in Mexico.[281] Should Mexico decide to change its investment policy, it could do so easily. Swaps are not permitted by law in Mexico as they were not implemented by legislation,[282] but rather, exist at the grace of the Commission of Foreign Investment.[283] Both banks and multinational corporations should also be aware of the possibility of change in investment laws in debtor nations regarding ownership limits and

277. *See supra* note 232.
278. Kuczynski, *supra* note 24, at 134.
279. *See supra* notes 227-32 and accompanying text (Regulation K amendment liberalization).
280. INTERPARLIAMENTARY CONFERENCE, *supra* note 25, at 200 (essay by Wertman). *See also Alternative Policies for Managing the International Debt Crisis*, Hearing before Joint Economic Committee, 99th Cong., 2nd Sess. 14 (1986) (discussing the risks faced by banks holding large amounts of Latin American debt).
281. Note, *Debt-for-Equity Swaps, supra* note 4, at 444-45.
282. *Id.* at 445.
283. *Id.* The Mexican government adopted a swap program based on the 1985 Restructuring Agreement under the auspices of the Ministry of Finance and Public Credit and the National Commission of Foreign Investment. The swap requires an authorization by the National Commission of Foreign Investment in accordance with Resolution 5 of the *Diario Ofical. Id.* at 445 n.5.

eligible industry sectors. For instance, should a particular investor own 60 percent of the stock of a Mexican corporate entity, there are unanswered questions regarding the stability of the investment if the ownership percentage allowed in that investment is reduced. An investor should also be aware of limitations on repatriation of capital and profits. Most debtor nations severely restrict the time period before which an investment may be liquidated and recouped.[284] An investor should be prepared to accept a limitation on the repatriation of profits as well. For example, Andean Pact members limit repatriation of profits to a set percentage.[285] The remainder must be reinvested in the debtor nation.[286] Risks to the investor in Brazil are similar, although Brazil is less receptive to swap transactions in general. An investor in Brazil must be content to receive non voting shares of equity.[287]

2. *Costs to the Debtor Nation*

Unfortunately, while there may be a variety of benefits to the debtor nation arising from swap transactions, there are also numerous problems. One of the disadvantages is the inflationary impact caused by an increase in the money supply.[288] This increase occurs as a natural consequence of the debtor nation printing up additional currency for the redemption of the debt in a swap transaction.[289] As there is no increase in real production, but only in the amount of currency flowing into the market, inflation occurs.[290] There are conflicting opinions regarding the inflation that swap transactions produce. It has been suggested that if the country is illiquid, it would be unwise to repay debts which would create inflationary pressures in the economy.[291] However, some bankers take a different view observing that if the new money injected into the economy, is used to increase productive capacity, inflation will not occur.[292]

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284. *See generally* JOINT REPORT ON ECONOMIC DEVELOPMENT IN LATIN AMERICA AND THE DEBT PROBLEM, *supra* note 58, at 180 (essay by Kristin Hallberg) (discussing various methods used by countries to repatriate capital).

285. *See supra* note 125 and accompanying text.

286. *Id.*

287. *See supra* note 249 and accompanying text re:Brazil using non voting shares.

288. Note, *Mexico's Recent Guidelines*, *supra* note 138, at 439.

289. HOUSE REPORT ON AN INTERNATIONAL DEBT MANAGEMENT AUTHORITY, *supra* note 6, at 92.

290. *Id.*

291. Evans, *supra* note 23, at 94 (citing comments of Dornbusch, Professor of International Economics at Massachusetts Institute of Technology).

292. *Id.*

There has also been concern that swaps help accelerate the growth of a nation's budget deficit.[293] It has been observed that where no swap program is implemented, investment funds come into the country as foreign exchange.[294] With swaps, the funds come in as direct foreign investment rather than as foreign exchange. If investment funds are thus limited, the debtor nation's revenues may decrease.[295] Therefore, a swap program may result in lower foreign reserves, or in a greater need for additional new funds.[296] The purchase of debt by using local currency may increase debt service costs because these processing costs are absorbed by the government of the debtor country.[297] This increases government expenses, creating an obvious adverse impact on the fiscal deficit.[298]

A detrimental outgrowth of swap transactions is that swaps create an incentive for more "capital flight," [299] which continues to plague developing countries.[300] Capital flight occurs when dollars which have been borrowed by debtor countries have been invested outside the country rather than used to increase the productive capacity of the debtor nation.[301]

Another fear of some debtor country officials is the occurrance of roundtripping or the bicycling of funds.[302] Roundtripping occurs when debt is bought by offshore dollars for less than the amount the debtor nation discounts its debt in a debt swap. For example, for $60 million, $100 million worth of Mexican loans can be purchased

293. HOUSE REPORT ON AN INTERNATIONAL DEBT MANAGEMENT AUTHORITY, *supra* note 7, at 92.

294. *Id.* at 91.

295. *Id.*

296. *Id.* at 92.

297. *Id.*

298. HOUSE REPORT ON AN INTERNATIONAL DEBT MANAGEMENT AUTHORITY, *supra* note 6, at 92.

299. Zamora, *Mexico and the Global Financial Market: Capital Flight as a Factor in National Policy Making*, 18 CAL. W. INT'L L. J. 35, 36 (1987) [hereinafter Zamora]. To a large extent, Mexico's external debt was lost to capital flight. Although the exact figure is argued, it is agreed that a large percentage of the dollars borrowed by Mexico were used to finance investments in countries other than Mexico. Capital flight is both difficult to quantify and to define. Economists vary in their definitions from an expansive view of "both reported and unreported acquisition of foreign assets by the nonbank private sector . . . ," to a narrower view of unrecorded capital outflows. *Id.* at 38.

300. Capital flight continues to plague developing nations. *Id.*

301. Zamora, *supra* note 299, at 36. Although estimates of capital flight have varied for the period from 1977-1984, the Central Bank of Mexico indicates that at least $33 billion were lost to capital flight during that same period. Morgan Guaranty Trust estimates that approximately $50 billion were lost to capital flight in Mexico during the period 1977-1987. *Id.* at 39.

302. Evans, *supra* note 23, at 110.

on the secondary market.[303] The bank or multinational could then take advantage of the swap mechanism in place to get $80 million in local currency for the $100 million loans.[304] The local currency could then be used for local investment (which may be promptly sold) or could be exchanged on the black market for dollars and taken out of the country.[305] As a result of roundtripping, currency leaves the country adding to the problem of capital flight.

Another consideration from the debtor nation's perspective is that of loss of ownership. Perhaps the most significant aspect of loss of ownership is the question of control. From the debtor nation's perspective, it may be undesirable for foreign countries to be allowed to buy controlling shares of large industries in the debtor nation.[306] This occurs where the equity shares involved in the swap transaction carry voting rights,[307] since control over key economic decisions concerning that industry may be taken away from the debtor and given to the creditor. The goals of the Andean Pact through the Cartagena Agreement emphasize the desire to maintain control over key manufacturing sectors of the economy.[308] Debt swaps conflict with this desire for control as the swap may create a majority of ownership and control in the foreign investor.

It would appear that the costs to the debtor nation may be high enough to outweigh the potential benefits of swaps. Swap transactions associated with the retirement of public debt increase the money supply in the debtor nation and so are inflationary.[309] Although this inflation can be curbed by setting a cap or ceiling on the amount of swaps that are transacted within a given period,[310] the inflation produced by swaps cannot be eliminated. In countries where the inflation has reached triple digit figures, it hardly seems appropriate to further fire inflation. Furthermore, swap transactions can result in increased costs to debtor nations.[311] This increase in costs can result in one of two ways: either through a decrease in foreign exchange,[312] or through internal processing costs absorbed by the

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303. *Id.*
304. *Id.*
305. *Id.*
306. Wall St. J., Sept. 23, 1988 at, 11R, col. 1.
307. *See supra* notes 196-200 and accompanying text.
308. *Id.*
309. *See* HOUSE REPORT ON AN INTERNATIONAL DEBT MANAGEMENT AUTHORITY, *supra* note 6, at 92.
310. *See Debt-for-Equity Swaps*, *supra* note 4, at 452.
311. *See supra* note 297 and accompanying text.
312. *See supra* notes 295-97 and accompanying text.

debtor nation.[313] Capital flight[314] and roundtripping[315] remain a continuing problem of swap transactions. Finally, swaps may result in a loss of ownership and control in areas of the economy key to economic decisions of the debtor nation.[316]

SUMMARY

In sharp contrast to the Mexican regulatory scheme, Brazil's swap program emphasizes maintenance of Brazilian control over its economic sectors. Brazil continues to achieve this control in its implementation of swap programs by allowing only non voting preferred shares to be exchanged. Current resolutions in effect in Brazil require that "no converted debt be invested in any manner which would transfer control of companies presently controlled by Brazilian residents to nonresidents."[317] Thus, the Brazilian swap program can be seen as in alignment with the goals of the Andean Pact.

Both the Brazilian and Mexican swap programs restrict the repatriation of capital. In Mexico, the entity invested in may not be sold to a Mexican entity or individual; thus, the problem of capital flight is prevented. Brazil maintains a similar restriction on transfer to third parties. Both countries require that converted capital remain within the country for a set number of years. This limits the options open to an investor should the investment prove unprofitable. An investor must wait for at least the specified time period before his capital may be recouped. Although liberalized, some restrictions remain on the industries eligible for investment and the percentage of ownership permitted in these industries. In Mexico, restrictions on permitted areas of investment are expressly imposed by the 1984 Guidelines and effected by the discount rate applied to the proposed project. Latin American debtor nations are not alone in imposing restrictions on Latin American investments.

Regulation K of the Bank Holding Act currently imposes restrictions on U.S. bank holdings in foreign countries both with regard to the type of industry invested in and the shares purchased. However,

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313. *See supra* note 298 and accompanying text.
314. *See supra* notes 299-301 and accompanying text.
315. *See supra* notes 302-304 and accompanying text.
316. Consider the Mexican example where 100% ownership is allowed in some sectors. *See generally* Note, *Mexico's Recent Guidelines, supra* note 138. As Mexico uses common shares in its debt/equity transactions, it follows that ownership and control in those entities is given over to foreign hands.
317. *See supra* note 198 and accompanying text.

Regulation K presently allows up to 100 percent ownership in foreign holdings in the case of a debt swap. This provides an incentive for banks to utilize debt swaps to divest themselves of foreign debt holdings.

In an effort to avoid regulations imposed by debtor nations on repatriation of capital and profits, investors and debtors have begun to engage in the unauthorized "informal" debt swap. Use of the informal swap circumvents regulations and allows investors to freely remit profits and capital to their home country, facilitates loss of control to the debtor nation, and increases the risk involved for both debtor and investor. Thus, it is likely that swap transactions will continue to be highly regulated and that the informal market will be prohibited.

The benefits of swaps are varied. The multinational investor benefits in the utilization of swaps to the extent that an investment may be made at a savings. Further, the multinational corporation may use these savings to inject fresh capital into an already existing subsidiary located in the debtor nation. The primary benefit of the swap transaction to the creditor bank is the opportunity to recover a portion of an otherwise perhaps unrecoverable loan. The primary benefit to the debtor nation is the retirement of a portion of their outstanding debt for less than its face value. This allows the debtor nation to reduce periodic interest payments.

In light of the reduced lending available to Latin American nations, the debt swap is seen to be an important tool in promoting direct foreign investment in Latin America. The question of whether in fact the swap generates additional foreign investment is arguable. If the investment would have been made without utilizing the swap mechanism, the debtor nation is giving up hard currency without reaping a benefit.

Additional possible benefits of the swap mechanism are the transfer of technology and the privatization of publicly held entities. The swap may be used by the debtor nation to import technology appropriate to their needs. Privatization has been sought in Latin American countries to increase competition and efficiency in the marketplace. Swap transactions take the entity out of the hands of the government and place it into private hands thus, facilitating this goal.

The costs associated with swaps, however, should not be ignored. Swap programs are easily terminated[318] and in fact have been sus-

318. *See supra* note 148 and accompanying text (discussing the more restrictive foreign investment laws still in effect in Mexico).

pended twice in Mexico due to their inflationary propensity. Brazil remains less receptive to swap transactions in general. Both banks and third party investors engaging in swap transactions should be aware of the possibility of future changes in attitude in debtor nations regarding foreign investment. Latin America has had a long history of nationalistic regulations concerning foreign investment. It is unlikely that the tolerance of current swap activity represents a permanent change in attitude for Latin America in this regard. It is also possible for investment laws in debtor nations to change ownership limits and eligible industries.

Perhaps the greatest risk to the investor lies in the possible ramifications of the swap to the debtor nation. Use of the swap creates serious problems for the debtor nation involved. The swap remains a highly inflationary mechanism and as a result, ceilings must be imposed on the amount of swap transactions engaged in. The wisdom of creating further inflation in economies which already experience high rates of inflation is questionable both from the debtor nation's perspective and from the perspective of the investor.

Swaps may actually exacerbate the already existing problem of capital flight in Latin America. Where investors and debtors successfully circumvent regulations imposed by debtor nations on the repatriation of capital, the proceeds from debt swaps are often taken out of the country and invested elsewhere. Roundtripping and bicycling of funds allow investors to make quick profits without creating any increase to the debtor nation's capital or manufacturing bases.

The greatest dilemma that swaps present to the debtor nation is that of loss of control over industries in their economy. Brazil has structured their swap program such that they do not encounter this problem. However, the swap program in Mexico allows voting shares of stock to be issued in the swap transaction. The Mexican program also allows up to 100 percent foreign ownership. This may result in a decrease in the ability of the debtor nation to address key economic issues in the future. As control is lost by the debtor nation and disseminated among foreign investors with competing interests, the stability of the base economy is threatened and will most certainly add to the problems faced by both the debtor nation and the foreign investor.

Conclusion

The swap was conceived of as a clever international financial instrument designed to achieve multiple objectives. The primary problem as perceived by both creditor banks and debtor nations was the looming possibility of debtor default. Faced with an ever mounting foreign sovereign debt concentrated substantially in Latin America, creditor banks were confronted with several imponderables. If the sovereign debtor nations defaulted on their loans, the consequences on the global banking industry could be devastating. Default could trigger a run on banks in creditor countries leading to a possible collapse of some of the largest banks in the world leading to political upheaval. Furthermore, because of consistent use of cross-default clauses in bank lending agreements to debtor nations, default on one loan mandates default on all loans which would necessarily imperil the stability of banks worldwide.

Default would prove equally disastrous for those debtor nations which rely on continued lending to both service their debt and recycle funds back into their economies. After such a default, new loans would only be granted at exorbitant interest rates if at all. In light of the adverse reactions of creditors upon payment moratoriums declared by Latin American countries during the early part of this decade, Latin America has come to realize that neither default nor moratoriums are in their best interest. A way had to be found to reduce their outstanding debt.

Because foreclosure on these loans could prove impossible and most certainly would create political chaos, creditor banks have been driven to the swap as an alternative mechanism for divesting themselves of risk-laden Latin American loans. Debtors, too, have anxiously sought for a method of reducing their debt servicing burdens. By reducing the amount of total outstanding debt, swaps have been perceived as one solution to the problem of default. Furthermore, by utilizing the swap mechanism, debtor nations seek to increase foreign investment. Third party investors have taken advantage of the swap to make investments which otherwise could be prohibitive or unavailable. While all parties involved anticipated considerable benefits flowing from swaps, the unforeseen consequences have both hindered their use and created pitfalls for the unwary.

One consequence has been the increasing complexity of the transactions. Not only must the parties be aware of home country regulations, they must also take into consideration regulations imposed by the debtor nation involved. Debtor country regulations are often imposed in a rapid ad hoc manner making it difficult yet crucial to keep abreast of changes. Often, small regional banks have become involved in contractual agreements using unfamiliar provisions such as cross-default clauses. Another potential problem occurs when these banks invest in areas in which they have no expertise. Without careful planning and an intimate knowledge of the transaction to be entered into, the wisdom of the investment should be questioned.

A further consequence of the swap transaction is the tension created between competing goals of debtor nations. The debtor nation is often forced to pit their desire to maintain national control against the need to relieve their debt burden and increase foreign investment. This compels the debtor nation to change their policies in order to accommodate multiple demands of the swaps and their parties.

Ironically, one last consequence of the implementation of swap transactions is the switch in bargaining power. Where originally the creditor set forth the terms of repayment and conditions for new lending, now, the debtor controls. The banks cannot realistically declare default without jeopardizing global economic stability due to the existence of the cross-default clause. Furthermore, political ramifications prevent creditor banks from exerting pressures on the debtor nations. This places the debtor nation in a position to demand what discount rate will be applied and what industries the investor may consider.

As the secondary market matures, it is likely that the price for Latin American loans will rise making the investment less attractive. On the other hand, this rise in price may be indicative of a less risky investment. In that case, although it is probable that the numbers of swap transactions will decrease, the long-term stability of the transaction and its consequent investment will increase. A further influence on the future of the swap transaction is the direction that may be taken by the debtor nation. While it appears that the swap program in Mexico has been suspended due to its inflationary propensity, the underlying concerns of foreign domination and tighter national control may dictate future restrictions and regulations.

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