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Investment Funds and Debt-Equity Swaps: Broadening the Base of a New Financial Tool

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Stephen M. Wallenstein and James R. Silkenat

Abstract

This article first examines the emergence of several new market-oriented mechanisms that could help relieve both the ominous “debt overhang” confronting many developing countries and equally ominous financial exposure of commercial banks. Prominent among these mechanisms are debt-equity swaps (or debt-for-equity conversions), which are examined in this article with a view of assessing their potential impact on the economic outlook for a number of developing countries. Particular emphasis will be placed in this article on the recent establishment of investment funds with debt-equity conversion framework and on the differences between these funds and the more traditional country-fund approach that has been developed in countries like Korea and Thailand.

INVESTMENT FUNDS AND DEBT-EQUITY SWAPS: BROADENING THE BASE OF A NEW FINANCIAL TOOL

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INTRODUCTION

In the face of an aggregate external debt of some US\$1.3 trillion,¹ developing countries are confronted by draconian obstacles to economic development against which the development dilemmas of previous years pale in comparison. As the data in Table 1 suggest, in the 1980s the external debt of developing countries as a whole has increased dramatically, not only in absolute terms, but also as a percentage of Gross National Product ("GNP") and as a percentage of exports. The level of debt-service payments for these countries has risen commensurately. As a result, debtor countries have found it increasingly difficult—in both economic and political terms—to honor interest and principal commitments on existing loans,² while meeting national development program objectives and fulfilling obligations to multilateral lending agencies. The situation has been exacerbated by a significant reduction in new lending to debtor countries by commercial banks.³

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1. WORLD BANK, WORLD DEBT TABLES (1988-89 ed.); see Sloan, *The Third World Debt Crisis: Where We Have Been and Where We Are Going*, WASH. Q., Winter 1988, at 103, 106-07.

2. See *Review of the International Lending Supervision Act of 1983: Hearing Before the Subcomm. on International Finance and Monetary Policy of the Senate Comm. on Banking, Housing, and Urban Affairs*, 99th Cong., 2d Sess. 42 (1986) (statement of Karin Lissakers, Adjunct Professor of International Affairs, Columbia University). Lissakers has noted that "Latin American debtors have paid out more than \$130 billion in interest since the [debt] crisis began, only to find themselves \$50 billion deeper in debt." *Id.* at 44.

3. See L. Clarke, *Promoting Country Funds and Foreign Portfolio Investments*

TABLE 1: Debt Indicators for Developing Countries, 1980-1986
(U.S. \$ billions and percent, when indicated)

Indicator	1980	1981	1982	1983	1984	1985	1986
Current Account Balance							
Total Developing Countries	-69.1	-106.7	-103.0	-57.2	-32.1	-37.4	-35.5
Low-Income Countries	-17.0	-13.9	-8.9	-6.7	-8.1	-25.9	-22.0
Middle-Income Countries	-52.1	-92.8	-94.1	-50.5	-24.0	-11.5	-13.5
Other Indicators							
Ratio of Debt to GNP (%)	20.6	22.4	26.3	31.4	33.0	35.8	35.4
Ratio of Debt to Exports (%)	90.0	98.0	117.6	134.8	121.2	143.7	144.5
Debt Service Ratio (%)	16.0	17.5	20.6	19.4	19.5	21.4	22.3
Ratio of Debt Service to GNP (%)	3.7	4.0	4.6	4.5	4.9	5.3	5.5
Private Debt as Percentage of Total Debt	63.1	64.5	65.0	65.8	65.7	63.9	63.5
Total Debt Outstanding and Disbursed	428.6	490.8	551.1	631.5	673.2	727.7	753.4

Source: WORLD BANK, WORLD DEVELOPMENT REPORT 17, 18 (1987)

Latin American countries owe a significant percentage—approximately one-third—of the total external debt of developing countries. As the information in Table 2 indicates, Argentina, Mexico, Brazil, and Chile together had debt levels close to US\$300 billion at the end of 1987, approximately one-fourth of all developing-country external debt for that year.

The acute difficulties implicit in these levels of debt, resulting as they have in repeated attempts at some resolution of the debt issue (such as cyclical efforts to reschedule and restructure existing debt), have demonstrated the necessity of fashioning a more effective approach to the world debt crisis and the threat it poses to the international economic system. Though such an international approach has not yet materialized, the formalization of the international debt crisis in August 1982⁴ has initiated consideration of a wide range of possible alternative economic and financial responses.⁵

Against this background, several new market-oriented mechanisms have emerged that could help relieve both the ominous "debt overhang" confronting many developing countries and the equally ominous financial exposure of commercial banks. Prominent among these mechanisms are debt-equity swaps (or debt-for-equity conversions), which are examined here with a view to assessing their potential impact on the economic outlook for a number of developing countries. Particular emphasis will be placed in this article on the recent establishment of investment funds within the debt-equity conver-

Through Debt Conversions: The IFC Experience 2 (address presented before the Seminar on Debt/Equity Swaps sponsored by the United Nations Center on Transnational Corporations and the Latin American Economic System, in Caracas, Venezuela, Apr. 27-29, 1988) (available at the *Fordham International Law Journal* office). The participation of commercial banks in loans to developing countries has shifted from a high of some forty percent in 1981 to a present level of less than five percent. *Id.*

4. The announcement by Mexico, in August 1982, that it would withhold payment on its foreign debt and that some US\$4 billion would be needed to satisfy its creditors, coupled with the announcement by Brazil in the same year that it would default on debt repayments, can be taken to mark the beginning of what has come to be called the international debt crisis.

5. See, e.g., Rotberg, *Toward a Solution to the Debt Crisis*, INT'L ECON., May/June 1988, at 42; Robinson, *Seek New Alternatives on Debt*, J. Com., May 5, 1988, at 6A, col. 2; Yemma, *A Reader's Guide to Third-World Debt-Forgiveness Plans*, Christian Sci. Monitor, Mar. 11, 1988, at 13, col. 1; Broad & Cavanagh, *How to Approach Third World Debt*, N.Y. Times, Mar. 3, 1988, at A31, col. 1.

TABLE 2: Debt Indicators for Selected Latin American Countries 1980-1987
(U.S. \$ billions)

Indicator	1980	1981	1982	1983	1984	1985	1986	1987
Total External Debt for Selected Latin American Countries								
Argentina	27.2	35.7	43.6	45.1	46.6	48.1	51.4	54.5
Brazil	62.8	71.9	83.2	91.6	102.2	105.2	110.4	116.9
Chile	11.2	15.5	16.9	17.7	19.2	20.1	20.7	20.5
Mexico	51.4	75.1	89.6	93.1	96.2	97.5	101.0	105.6
Peru	9.6	9.7	11.3	12.2	13.3	13.9	15.0	15.3
Venezuela	—	—	37.6	37.1	35.1	34.3	32.4	32.2
Total	162.2	207.9	282.2	296.8	312.6	319.1	330.9	345.0

Source: Sloan, *The Third World Debt Crisis: Where We Have Been and Where We Are Going*, WASH. Q., Winter 1988, at 103, 107 (quoting World Bank and IMF figures) (1980-86 data); Riding, *Latins Want Bush to Help on Debts*, N.Y. Times, Nov. 29, 1988, at A1, col. 1 (quoting IMF figures) (1987 data).

sion framework and on the differences between these funds and the more traditional country-fund approach that has been developed in countries like Korea and Thailand.

One of the reasons for the resort to new mechanisms like debt-equity swaps and investment funds (in addition to other devices like "exit bonds," "retiming," and "early-bird specials")⁶ has been the simple inability of creditors, debtors, and multilateral financial institutions to agree on any broad-gauge solution or solutions. Whether such schemes amount to more than "band-aids" for the ongoing problem is still an open question—one that is only partially resolved by examining the intricacies and interrelationships of debt-equity swaps and investment funds.

Debt conversion activities can be divided into several broad categories. The most prevalent activity is straight swapping of acquired debt for equity investments in local enterprises, for other sovereign debt, or for local currency. A subset of this kind of activity utilizes pooled investment vehicles, or investment funds, in which a consortia of resident and non-resident banks with the same general objectives pool a portion of their loans to form a "national investment trust." Another strategy involves swapping debt for goods (exports). Certain of these mechanisms, with a specific focus on country fund vehicles, are examined here in terms of legal considerations in the United States and in selected Latin American countries.

I. *INVESTMENT FUNDS FOR DEBT-EQUITY CONVERSIONS: AN OVERVIEW*

A. *General Nature*

The recent emergence of secondary markets for the trade of debt instruments in certain developing countries represents an important means by which more manageable levels of developing-country debt can be obtained. Though the level of

6. In a debt reduction plan involving "exit bonds," banks agree to accept low-interest government guaranteed bonds in exchange for a portion of their existing debt. "Retiming" generally refers to a plan in which banks agree to accept interest once yearly instead of semi-annually, thus reducing the difficulties inherent in managing a debtor country's foreign exchange requirements. The term "early bird special" refers to a plan in which banks that agree early to new loans to a debtor country receive extra fees on their commitment.

trading in these new debt instruments constitutes only a small percentage—at present, less than one percent⁷—of the total external debt accumulated by developing countries, the rate of growth in such markets suggests that the debt-equity approach to confronting the world debt crisis is likely to become increasingly significant.

The concept of “conversion” of debt to equity is a well established financial method of revitalizing bankrupt corporations in the United States⁸ and elsewhere. Likewise, transactions involving the sale of debt from one bank to another (occasionally in bulk) are a well established means of managing portfolios. The application of these procedures to highly-indebted developing countries, however, is much more recent. Within this framework, external debt instruments are converted into local currency or local central bank obligations. Such debt is traded in a secondary market managed by commercial and investment banks based outside the developing countries. This allows the debt to be acquired by banks or other putative investors. The discounts currently available in these secondary markets for selected Latin American countries are set out in Table 3.

For debtor countries, conversions represent, first, a means by which a percentage of overall debt can be retired without the use of limited foreign exchange and, second, a channel through which new investment can be promoted. Chile, which has developed one of the most sophisticated debt-equity mechanisms, has retired from 1985 to the end of 1987 approximately US\$4 billion of its approximately US\$20 billion in foreign debt by utilizing this approach⁹ (see Table 4). The investment provided by debt conversions also presents the potential of an improved outlook for economic growth, higher levels of employment, increased tax revenues, gains in export revenues, and a host of other related fiscal benefits. In addition, debt-equity transactions permit local governments to promote development in geographically- and/or sector-specific areas. For example, Brazil's longstanding tax incentive program, which

7. WORLD BANK, WORLD DEVELOPMENT REPORT 22 (1987).

8. The most prominent recent example of a case of this type involving U.S. government participation was the reorganization of the Chrysler Corporation.

9. See Christian, *Chile's Debt-Swap Plan Cuts Loan by \$4 Billion*, N.Y. Times, July 18, 1988, at D10, col. 5.

TABLE 3: Recent Price Quotes for Debt of Selected Latin American Countries
(U.S. cents on the dollar)

Country	May 1988		12-Month	
	Bid	Ask	High	Low
Argentina	28.0	29.0	60.5	25.0
Bolivia	10.5	12.0	12.0	6.0
Brazil	55.0	56.0	65.5	38.0
Chile	61.0	62.0	72.5	50.0
Mexico	53.5	54.5	59.5	46.5
Nicaragua	2.0	4.0	6.0	2.0
Peru	4.0	9.0	15.0	4.0
Venezuela	55.0	56.0	74.0	49.5

Source: Anders & Truell, *For Investors Who Are Strong of Heart, Third-World Debt Holds Some Allure*, Wall St. J., May 17, 1988, at 41, col. 4 (quoting Bear, Stearns & Co. figures).

TABLE 4: The Effect of Debt-Equity Conversions on Chilean Debt, 1985-January 1987
(U.S. \$ millions)

Debtor	1985	1986	Jan. 1987	Total
Medium and long-term debt	37.0	966.7	249.4	1,587.0
Central Bank	36.9	122.1	140.0	299.0
State Bank	5.7	29.2	8.0	42.9
Public enterprises	9.3	116.4	—	125.7
Private sector with public guarantee (restructuring 1983-1984)	35.6	150.4	30.8	216.8
Private financial sector	126.7	320.0	55.2	504.3
Private company sector	157.2	228.6	13.0	398.8
Short-term debt (private financial sector)	—	1.8	—	1.8
Total Reduction	371.4	968.5	249.4	1,589.0

Source: Rubin, *Chile*, in *GUIDE TO DEBT EQUITY SWAPS* 180 (S. Rubin ed. 1987) (quoting Central Bank of Chile figures).

seeks to augment investment in the northeast region of the country, has been incorporated into Brazil's new debt-equity review and approval authority.¹⁰

Investments in the northeast of Brazil and in other incentive areas of the country are carried out in an auction process separate from investments in the rest of the country. Generally, auction discounts in the incentive area are less than discounts that apply in the free area, resulting, in local terms, in larger foreign capital registration and investment in the incentive area for an equal amount of eligible debt converted.¹¹

From the standpoint of debtor countries, however, there are a number of possible macroeconomic drawbacks to debt-equity conversions. Clearly, the potential exists that the additional local currency necessary to meet debt-equity transactions could lead to monetary growth and inflationary pressures above and beyond the current high levels in Latin America.¹² Apart from the more general and obvious negative effects on the economy, an increase in inflation could run contrary to the rigid monetary supply criteria established by the International Monetary Fund (the "IMF") and other multilateral lending

10. For a discussion of Brazil's recently revitalized debt-equity conversion program, see Truell, *Debt Swaps by Brazilians Draw Interest, but Terms Discourage Some Participants*, Wall St. J., Apr. 26, 1988, at 34, col. 2.

11. Table of Discounts for Brazilian Auction*

<u>1988</u>	<u>Free Area</u>	<u>Incentive Area</u>
March	27.0%	10.5%
April	32.0%	15.0%
May	22.0%	0.5%
June	13.5%	16.0%**
July	27.0%	11.0%
August	29.5%	8.0%
September	34.5%	6.0%
October	38.0%	16.5%
November	50.0%	21.5%
December	49.0%	18.0%

* US\$150 million in debt is offered each month: US\$75 million for the free area and US\$75 million for the incentive area.

** One bidder bid for US\$50 million of the US\$75 million offered in the auction. Information courtesy of Marine Midland Bank, International Department, New York City.

12. For a discussion of the negative factors that may accompany a debt-equity conversion program, see Roberts & Remolona, *Debt Swaps: A Technique in Developing Country Finance*, in GUIDE TO DEBT EQUITY SWAPS 41 (S. Rubin ed. 1987) [hereinafter GUIDE]; Riding, *Deepening Gloom Over Latin Debt*, N.Y. Times, Dec. 28, 1987, at D8, col. 4.

agencies in support of balance-of-payments and other macroeconomic development objectives.¹³ It is important to note, however, in the final analysis, that monetary pressures generated by debt-equity conversions may not differ from the effects of increased foreign direct investment.

The larger Latin American debtor countries have responded to the debt problem with significantly different conversion systems. Brazil has limited the volume of transactions primarily to a monthly auction of the equivalent of US\$150 million in an effort both to gauge the effects of the conversions on the monetary supply and to build a more rationalized national mechanism for the regulation of the conversion process. By contrast, Chile has enacted a system in which the Central Bank issues government bonds instead of pesos, which are traded in the local securities market.¹⁴ The bonds are then traded at a discount because they pay a rate of interest that is slightly less than the "UFR rate."¹⁵ From the standpoint of monetary pressures, money is not created immediately through this system because "new money" is not injected into the economy. The money does, however, go to private investment instead of to the government. There is also the inverse concern in certain Latin American debtor countries (and among some Western critics of the conversion process as well) that debt-equity conversions do not inject "fresh money" into the economies, but merely subsidize investment that would have been made in the absence of the debt-equity mechanism.¹⁶ Such concern has been particularly apparent in Argen-

13. See M. Rodriguez, *Debt Equity Swaps: The Latin American Experience* (address presented before the Conference on Debt-Equity Conversions in Latin America, in Caracas, Venezuela, May 1988) (available at the *Fordham International Law Journal* office). Rodriguez, an influential debt commentator, has noted that "[s]ince the inception of Chile's program in June 1985, Chile's inflation rate has fallen from 33% to 20% even though the volume of swaps each month is equivalent to 10% of its monetary base." *Id.* at 21. He also observed that the effect of debt-equity conversions on inflation varies from country to country, and drew attention to the inflationary pressures experienced by Mexico. *Id.*

14. BANCO CENTRAL DE CHILE, *COMPENDIUM OF RULES ON INTERNATIONAL EXCHANGE*, chs. XVIII-XIX (May 1985) [hereinafter chs. XVIII-XIX]; see *infra* text accompanying notes 38-39.

15. The "UFR rate" (Unidad de Fomento Rato) represents the blended rate of Chilean treasury bonds of different rates.

16. See Bentley, *Debt Conversion in Latin America*, COLUM. J. WORLD BUS., Fall 1986, at 37, 38-40.

tina, where laws governing the debt-equity conversion process require investors to make additional local investments in connection with their debt-equity transactions.¹⁷

For their part, creditors—primarily commercial banks—engage in debt-equity transactions for several reasons. Because the banks, by trading debt, receive a relatively high percentage of their loan repayments in local currency, they are able to replace sovereign debt with high-risk equity assets, instead of selling loans at a more substantial discount in dollar terms. To the extent that countries are behind on interest payments, banks can convert their loans to an investment that offers a potentially greater rate of return through dividends and capital gains.¹⁸ Moreover, banks can either diversify their exposure to a number of countries or concentrate their creditor position in a single debtor country to maximize a comparative advantage, reduce administrative expenses, or implement a longer-range strategy in the local country. Through debt-equity conversions, such banks can then invest in local enterprises by means of direct debt-equity swapping by local debt-equity teams, established typically by larger banks for the purpose of identifying suitable longer-term local investment opportunities, or under a “pooled” venture-capital structure—either off-shore mutual funds or venture-capital fund structures.¹⁹

Certain large commercial banks in the United States were initially reluctant to sell their loans at a discount because of the losses they would be required to show on their respective balance sheets. Another obstacle to their participation in debt-equity conversions had to do with the American Institute of Certified Public Accountants (the “AICPA”) accounting rules. While the banks have been able to maintain the debt on their books at full value (while taking substantial reserves of about thirty percent against their developing-country debt portfolio), the AICPA has held that an equity investment acquired through debt-equity conversions should be reflected at its fair-market value—or at a loss on the full value of the loan.²⁰ De-

17. See *infra* text accompanying notes 28-30.

18. Sloan, *supra* note 1, at 114.

19. See *infra* text accompanying notes 54-74.

20. See *Notice to Practitioners on Accounting for Foreign Loan Swaps*, CPA Letter, May

spite these obstacles, certain major banking institutions have elected recently to set aside certain parts of their third-world loan portfolio for debt-equity swaps. They have done so because of their continuing loan exposure and because of the development of new and more effective debt-equity frameworks in certain developing debtor countries. Larger money-center banks with specialized staffs are able to carry out debt-equity conversion programs themselves. Two notable examples are the US\$3 billion internal fund recently set aside by Citibank for debt-conversions and the US\$1.6 billion internal fund established by Chase Manhattan Bank.²¹

In the final analysis, however, debt-equity transactions represent additional risk to creditors, because the exchange of debt paper for equity investments is subject to a range of additional uncertainties. Investments are linked implicitly with future economic trends and shifts in economic policy as well as with the vagaries of politics and social philosophy in the countries involved. In addition, equity investments are unsecured, there is no agreed return on investment (such as interest), they are subject to the control of majority shareholders, they require supervision and monitoring, and they are ultimately much more time-intensive than is debt management. Likewise, the limited number of investment opportunities in most developing countries brings into question the extent to which the local economies can provide favorable outlets for large debt-equity conversion schemes. Debt-equity conversion programs are currently in place or are under serious consideration in Mexico, Brazil, Chile, Argentina, Uruguay, Jamaica, Costa Rica, the Philippines, Nigeria, Peru, Colombia, and Ecuador.²²

27, 1985, at 3. The practice is based on the procedures employed in the accounting for debt-for-debt transactions. *Id.*

21. Chase Manhattan Bank has already taken steps to convert US\$200 million of its Brazilian debt into shares in Autolatina. Chase did not have to surrender its debt at a discount in this transaction, because the conversion took place under Brazilian regulations that preceded debt auctions that began in Brazil in March 1988. See Barham, *Chase Converts Brazilian Debt*, *Fin. Times*, June 2, 1988, at 23, col. 5. This saved Chase a considerable sum inasmuch as the discount in recent auctions has ranged from 13.5% to 50%. See *supra* note 11.

22. For a brief summary of the debt capitalization programs existing in a number of these countries, see *Capitalisation Programmes: A Survey*, *INT'L FIN. L. REV.*, Jan. 1988, at 38.

1. Volume

Both the expansion of secondary debt markets and the development of relevant national regulations and procedures governing trade have resulted in a steadily increasing volume of debt-related transactions. In 1984, total secondary market transactions in developing-nation debt instruments amounted to some US\$1 billion. The corresponding levels for 1985 and 1986—US\$3 billion and US\$6 billion, respectively²³—reveal increases that may continue as the mechanics of the markets become more highly refined.

Despite the number of countries involved in debt-equity conversion programs, the volume of debt-equity conversions is constrained by considerations pertaining to the economic circumstances of debtor countries and creditor institutions alike. As previously mentioned, the potential inflationary effects of large debt-equity transactions have compelled indebted countries to regulate carefully the amount of their debt sold in secondary markets. Moreover, the opportunity cost to creditors of liquidating a large percentage of their debt paper may include unacceptable financial and political costs. Together, these elements could serve to reduce somewhat the rate of growth of debt-equity transactions that has been prevalent in recent years.

2. Structures

Debt-equity conversions are the outgrowth, at the international level, of longstanding financial practices in the United States and elsewhere regarding failing or bankrupt enterprises. In the aftermath of the 1982 international debt crisis, commercial banks became more active in trading their sovereign debt paper for other national debt in order to diversify their debt portfolios or, conversely, to concentrate their holdings in one or more specific countries. Apart from reasons pertaining to strategic planning and portfolio management, tax considerations may also be a factor in the exchange of sovereign debt.²⁴

23. WORLD DEVELOPMENT REPORT, *supra* note 7, at 22; see Weinert, *Swapping Third World Debt*, FOREIGN POL'Y, Winter 1986-87, at 85, 86.

24. The biggest problem has been the imposition of significant local withholding taxes on dividends and capital gains to be remitted from the developing countries.

In addition, local commercial banks in the debtor countries themselves have been among the creditors involved in debt-for-debt swaps, primarily for the purpose of acquiring their own debt at a discount.

In light of the ominous outlook for global debt trends, the absence of a more direct international approach to the debt crisis, and the acute economic obstacles facing many highly indebted countries, the evolution from debt-for-debt swaps to debt-for-equity conversions may be viewed as more of a necessity than a choice. As with debt-for-debt swaps, debt-for-equity conversions draw from traditional financial procedures in which debt is traded for equity stakes in one or more enterprises. In the case of international debt-equity transactions, however, such procedures are subject to the uncertainties attendant upon the evolving political, legal, and economic frameworks existing in debtor developing states.

Latin American countries were the first of the highly indebted states to implement debt-equity conversions. Brazil and Argentina enacted debt-equity programs in the early 1980s, but due to concerns over possible monetary pressures, competition with foreign direct investment that would occur without debt-equity schemes, and the conversion of local currency to dollars on the black market, these early programs were curtailed until they were reimplemented recently with regulatory changes.²⁵ Chile initiated its system in 1985, when chapters XVIII and XIX were added to the Chilean Central Bank's exchange regulations.²⁶ Mexico's debt-equity conversion program began in 1986.²⁷

Typically, the structure of debt-equity conversions is straightforward in theory and more complex in practice. A foreign investor—generally a foreign company, often acting through a foreign bank—buys discounted local currency in exchange for sovereign debt notes in a secondary market overseen by the central economic authority. Such purchases are often conducted through an auction process in which the terms and volume of transactions are regulated by the local govern-

25. See *infra* text accompanying notes 28-37.

26. See *supra* note 14.

27. Newman, *Trends in the Market for Developing Country Debt and Debt Equity Conversions*, in GUIDE, *supra* note 12, at 10, 12.

ment. The local currency, under conditions, restrictions, and inducements imposed by the respective legal systems, is then used to purchase equity investments in local corporations. In order to foreclose the risk of short-term capital repatriation by the investor, the term of the equity investments generally is mandated to be at least as long as the duration of the original sovereign debt arrangements. Variations on this general theme are numerous.

Participants in debt-equity conversions are not confined to commercial banks holding sovereign debt paper. Debtor countries themselves may elect to purchase their own debt at a discount. Nationals may also purchase debt in an effort to expand investments or to capitalize an ongoing local enterprise. Participants also include multinational corporations seeking to secure an investment position or to expand or increase the capitalization of an existing subsidiary.

B. *Country-by-Country Differences*

Particular attention will be focused in this article on the legal mechanisms governing the emerging debt-equity structures of three of the principal highly-indebted Latin American countries, namely Argentina, Brazil, and Chile. This background is important in understanding and evaluating the potential for investment funds in these and other countries.

1. Argentina

The establishment, in 1984, of a debt-equity conversion system in Argentina was short-lived due primarily to objections arising from "round-tripping,"²⁸ declining foreign direct investment, and potentially negative monetary effects. The reconfigured debt-equity conversion structure that emerged in April 1987, during negotiations with creditor institutions, took these three factors into account by reducing the potential for round-tripping, by restricting the size of the program to US\$1.9 billion over a five-year period, and by mandating a ra-

28. "Round-tripping" refers to the practice of bringing back into a particular country funds that had been effectively transferred abroad as a result of under-invoicing by exporters or over-invoicing by importers. This reintroduction of capital would be done at the more favorable exchange rate usually offered through the debt-conversion process.

tio of thirty to seventy of matching investment, which can be in local currency, to the amount of the converted loan.²⁹ The system differs from its Brazilian and Chilean counterparts in its modest size, which is clearly intended to deflect potential inflationary effects. It also departs from other systems, particularly the experience in Chile, in the extent to which the government assumes a controlling role in the transactions.³⁰

Under the Argentine plan, the Ministry of Economy accepts bids to convert debt held by banks or companies wishing to invest in Argentina. Such companies purchase the debt paper from Argentina's commercial creditors at a substantial discount. Thus, a company wishing to purchase US\$1 million in Argentine debt would pay a commercial bank US\$200,000, reflecting the value of Argentine debt in the secondary market. The company, however, can only acquire local currency at a discount from its official value and must offer the Ministry of Economy such discount as part of the debt-equity swap. The discount offer is included in the company's bid. The Ministry of Economy has set a twenty-five-percent discount as the minimum it will accept. Discounts at the end of 1988, however, reached seventy percent. Thus, the most our hypothetical company would have received at the time would have been US\$300,000 in Argentine currency. Although the Argentine discount seems steep, the scheme remains attractive to foreign investors, because the conversion occurs at the parallel exchange rate, rather than the official commercial rate. Essentially, the result is that investors get US\$300,000 in local currency for the US\$200,000 spent to acquire the debt.

The goal of the Argentine plan is two-fold. Argentina hopes to reduce its debt by US\$1.9 billion over the next four years. As scheduled, the program was intended to cover debts worth US\$300 million by July 1, 1988 (although the target has

29. See *EL DERECHO—LEGISLACIÓN ARGENTINA* [E.D.L.A.] No. 21.382 (subsequently amended by E.D.L.A. No. 22.208); BANCO CENTRAL DE LA REPÚBLICA ARGENTINA, Comunicación "A" 1035 (June 1, 1987); E.D.L.A. Resolución 520 (Ministerio de Economía May 29, 1987); COMUNICADO CONJUNTO DEL MINISTERIO DE ECONOMÍA Y EL BANCO CENTRAL DE LA REPÚBLICA ARGENTINA No. 7691.

30. For a discussion of Argentina's debt-equity conversion program, see Cárdenas, *Argentina's New Debt to Equity Conversion Programme*, *INT'L FIN. L. REV.*, Aug. 1987, at 32; Onetto, *Argentina: Debt Capitalisation and Matching Funds*, *INT'L FIN. L. REV.*, Dec. 1987, at 47; Truell, *Citicorp Plans Debt-for-Equity Swap with Argentina; Restructuring Signed*, *Wall St. J.*, Aug. 24, 1987, at 20, col. 2.

not been reached) and US\$400 million in each of the next four years. Argentina is also using the debt-equity plan as a way of promoting foreign investment. Under the terms of the program, investors can cover up to seventy percent of project costs with funds raised by debt-equity swaps; the remaining thirty percent must be supplied in the form of new funds.

2. Brazil

As the data in Table 2 suggest, at the end of 1987 the total Brazilian external debt approached US\$117 billion and continues to represent a formidable obstacle to economic development.³¹ Brazil, as stated previously, was the first country to enact a debt-equity conversion program as a means of confronting its high levels of sovereign debt. In 1982, the Central Bank offered, under Executive Act No. 1994³² and subsequent amendments, a ten-percent discount on debt-equity conversions. The program was curtailed, however, in November 1984, when the Central Bank sought to limit round-tripping, illegal repatriation of capital by foreign corporations, and reductions in foreign direct investment by adopting Carta Circular No. 1125.³³ As a result of this regulation, the volume of conversions dropped from US\$581 million in 1985 to US\$191 million in 1986.³⁴

The Brazilian debt-equity conversion system was only recently revived when the Central Bank opted, on July 20, 1987, to consider swaps on a case-by-case basis. A new legal framework for conversions, Resolution No. 1416, was introduced by

31. In 1986, when the total Brazilian external debt exceeded US\$110 billion, Brazilian debt of US\$6.4 billion, falling due in 1985, was rolled-over by commercial banks to March 1987. The Paris Club rescheduled another US\$4.1 billion in January 1987. In February 1987, Brazil also announced a moratorium on debt payments, precipitating the severance or restriction of lines of credit by many international creditors. Payment of some debt obligations has resumed. Negotiations are currently underway between commercial banks and Brazil for new loans in the amount of US\$5.2 billion. Rubin, *Brazil*, in GUIDE, *supra* note 12, at 192; see Blustein, *Brazil's High-Stakes Debt Talks: Throwing Good Money After Bad?*, Wash. Post, May 24, 1988, at C1, col. 3.

32. DIÁRIO OFICIAL [D.O.], Ato Executivo No. 1.994 (Braz. Dec. 29, 1982).

33. D.O., Carta Circular No. 1.125 (Braz. Nov. 9, 1984).

34. Rubin, *Brazil*, in GUIDE, *supra* note 12, at 193 (quoting Central Bank figures); see *Debt/Equity Swaps Finally Come of Age*, *Gazeta Mercantil*, Apr. 15, 1988, at 1, col. 2 (int'l weekly ed.).

the Central Bank in November 1987.³⁵ This resolution, which required participants in debt-equity transactions to accede to subsequent modifications in restructuring agreements, met with opposition from the international financial community and was amended as Resolution No. 1460 on February 1, 1988, to exclude the previous modification requirement.³⁶ Pursuant to the current resolution, sovereign debt is auctioned at a ceiling amount and the discount percentage is determined by the auction process. Foreign debt-equity investors investing in stock market funds are prohibited from owning more than five percent of the voting capital or twenty percent of the total capital of any one company. Finally, funds invested in Brazil must remain in the country for a period of twelve years.³⁷

3. Chile

The debt-equity system in Chile, which was inaugurated in May 1985 with the adoption by the Central Bank of two additional chapters—chapters XVIII and XIX—to its regulations governing foreign exchange, is regarded as the most effective of its kind. The program is based on flexibility and emphasizes the role of the private sector in the conduct of debt-equity transactions. It has resulted in the greatest levels of conversion of any debtor state. This more laissez-faire position of the Chilean government has also led to a greater level of participation in the process by Chilean nationals with capital abroad as well as the involvement of creditor institutions.³⁸

Chapter XVIII of the Chilean regulations, directed at effecting repatriation of flight capital of Chilean nationals, provides for the purchase of foreign currency-denominated debt paper from the range of public and private debtors in the country. The investor submits a bid to the Central Bank, which, through a monthly auction process, makes a predeter-

35. BANCO CENTRAL DO BRASIL, Resolução No. 1.416 (Nov. 17, 1987).

36. BANCO CENTRAL DO BRASIL, Resolução No. 1.460 (Feb. 1, 1988).

37. For a discussion of Brazil's debt-equity conversion program, see Ashford, *Brazil Plans for State Auctions*, *EUROMONEY*, Sept. 1987, at 93; Werrett, *Debt-Equity Deal That Cut Through Brazilian Jungle*, *CORP. FIN.*, Sept. 1987, at 89.

38. For a discussion of Chile's debt-equity conversion program, see Marcy, *Chile May Use Copper to Collateralize Debt*, *J. Com.*, May 11, 1988, at 13A, col. 5; Truell, *Chile Pushes Debt-Conversion Program*, *Wall St. J.*, Dec. 9, 1987, at 34, col. 1.

mined amount of debt available for sale. The converted funds are then invested in Chilean enterprises. Conversely, another provision in Chilean law, chapter XIX of the Central Bank regulations,³⁹ which is directed at foreign creditor institutions and other foreign investors, allows for debt conversions through the same auction process. Investors in both instances are required to maintain capital in Chile for a period of ten years and dividends for a period of four years.

C. *Development of an After-Market*

The secondary market in developing-country debt is expected to reach almost US\$30 billion in 1988. There are approximately fifty commercial and investment banks with departments designed to deal in debt-equity conversions and debt swaps, although about eight of these institutions account for more than eighty-five percent of the volume.⁴⁰

Several issues—although relatively few answers—arise with regard to this secondary market. First, there is the question of whether secondary market prices should be used as a measure of the extent to which banks should write down their existing debts. Second, there is the question of the thinness of the market, combined with the width of bid/offer spreads and the perceived unresponsiveness of the market to external events.⁴¹

D. *Morgan/Mexico Program*

Among the more intriguing debt-swap proposals of recent years was the debt-swap plan for Mexico initiated in early 1988

39. The regulations contained in ch. XIX represent an amendment of the basic laws governing debt-equity conversions contained in the Chilean Foreign Investment Statute, Decree Law No. 600 of 1974 (ESTATUTO DE LA INVERSIÓN EXTRANJERA, Decreto Ley No. 600, de 1974) [hereinafter Decree Law No. 600]. The main difference between the two sets of regulations is the extension of the period of repatriation of initial investment and dividends. Compare Decree Law No. 600, tit. II, art. 4, with ch. XIX, *supra* note 14, at § 6(b).

40. See M. Schubert, A Critical Appraisal of the Changing Secondary Market for Discounted Third World Debt 4 (address presented before the Debt-Equity/Swap Market Conference sponsored by the Institute for International Research, in New York City, Oct. 19-20, 1987) (available at the *Fordham International Law Journal* office).

41. For a rigorous economic analysis of the shape and scope of the secondary market, see Laney, *The Secondary Market in Developing Country Debt: Some Observations and Policy Implications*, *ECON. REV.*, July 1987, at 1.

by the Morgan Guaranty Trust Company of New York. Essentially, the plan amounted to giving commercial banks an opportunity to swap a portion of their Mexican loans at a discount, for new marketable Mexican bonds, backed by U.S. Treasury bonds.

Under the plan, the principal on the Mexican bonds that the banks received in exchange for their pre-existing debt was backed by twenty-year, zero-coupon U.S. Treasury bonds, which would be purchased separately by the Mexican government for purposes of this plan and placed in a special escrow arrangement with the Federal Reserve Bank of New York. This portion of the plan was intended to offer banks greater assurance concerning eventual payment of the principal of the bonds. A problem of the program, however, was that while the principal was guaranteed, the interest was not.

While the potential advantages of the plan, both to the commercial banks and to Mexico, were significant, the actual result for Mexico was less meaningful than had been hoped. Rather than the US\$10 billion external debt reduction for Mexico that was anticipated, the actual reduction resulting from the swap was only slightly in excess of US\$1 billion.⁴²

The Morgan/Mexico plan attracted 320 bids from 139 commercial banks covering US\$6.7 billion of debt. Mexico accepted bids from 95 of those banks covering US\$3.67 billion of its US\$53 billion of debt to foreign banks, which was replaced by US\$2.6 billion in bonds. Mexico accepted tenders from banks up to a price of 74.99 cents on the dollar. The average price that Mexico paid for the debt that it accepted was less than 70 cents on the dollar.⁴³

Although the Morgan/Mexico plan did not produce the volume that was envisioned, it is nonetheless likely to result in additional attempts at related forms of debt reduction. An example of this would be the recently announced efforts by the Mexican Finance Ministry to expand on the Morgan Guaranty plan.⁴⁴ One proposed modification of the Morgan plan would improve the security on the bonds by having the government

42. Truell, *Mexico's Plan to Reduce Debt is Short of Goal*, *Wall St. J.*, Mar. 4, 1988, at 3, col. 4.

43. *Id.*

44. See *Mexican Debt: Any Interest*, *THE ECONOMIST*, June 18, 1988, at 78.

offer to deposit one year's interest in an escrow account. This amount would be forfeited if Mexico defaulted on the interest payments on the bonds. If Mexico did pay, the escrow account interest would roll over and guarantee the next year's interest.⁴⁵ The lack of security for interest payments under the original Morgan plan was one of its principal weaknesses.

E. *Legal Considerations*

In the United States, the activities of U.S. banking institutions in debt-equity conversions are governed by three statutory provisions. Section 25 of the Federal Reserve Act⁴⁶ provides for U.S. banking organizations to invest in foreign financial institutions, but requires that other forms of investment in equity securities (except for investments directly in financial institutions), such as those under the debt-equity conversion framework, be held indirectly or by bank holding companies. Additionally, the Federal Reserve Act limits the activities of the foreign company in which investment is placed by U.S. financial institutions to geographic areas located outside the United States, except under circumstances considered to be incidental.⁴⁷ Under section 4(c)(13) of the Bank Holding Company Act,⁴⁸ bank holding companies of U.S. financial institutions are allowed to invest in foreign companies so long as the company's activities are outside the United States and are consistent with the public interest and the purposes of the Act.⁴⁹

This traditional framework was altered to some extent by the amendment, on August 12, 1987, of Regulation K of the Bank Holding Company Act,⁵⁰ which is administered by the U.S. Federal Reserve Board. The amendment of Regulation K was one of several coinciding structural factors that has lent significant momentum to the debt-equity conversion process.

Until August 1987, under Federal Reserve Regulation K, a U.S. banking organization was only allowed to own twenty percent of the shares of non-financial companies abroad, although it could own as much as one-hundred percent of for-

45. *Id.* at 83.

46. 12 U.S.C. §§ 601-604 (1982).

47. 12 U.S.C. § 601.

48. 12 U.S.C. §§ 1841-1850 (1982 & Supp. IV 1986).

49. 12 U.S.C. § 1843(c)(13).

50. 12 C.F.R. pt. 211 (1988).

eign financial companies. As of August 12, 1987, however, the Federal Reserve Board liberalized Regulation K so that U.S. banks could acquire up to one-hundred percent of the shares of a foreign non-financial company under the following circumstances: the shares must be acquired from a foreign government (thus promoting privatization) through the conversion of existing sovereign debt obligations; the country in which the company is located must be a country that has restructured its sovereign debt obligations to foreign creditors since 1980; the ownership interest in the shares being acquired must be divested as soon as practicable and no later than five years from the date of acquisition, unless the Federal Reserve Board extends the time for good cause for up to a total of five additional years; and the investment must be held through a bank holding company.⁵¹

51. The operative amendments to § 211.5 of Regulation K are as follows:

(f) *Investment made through debt-for-equity conversions*—(1) *Permissible Investment*. In addition to an investment that may be made under other provisions of this section, a bank holding company may acquire up to and including 100 percent of the shares of (or other ownership interest in) a foreign company if:

(i) The shares are acquired from the government of an eligible country or from its agencies or instrumentalities;

(ii) The shares are acquired by conversion of sovereign debt obligations of the eligible country either through a direct exchange of debt obligations or a payment for the debt in local currency, the proceeds of which are used to purchase the shares;

(iii) The shares are held by the bank holding company or its subsidiaries, provided however that such shares may not be held by a U.S. insured bank or its subsidiaries;

(iv) The shares are divested within five years of acquisition unless the Board extends such time period for good cause shown but no such extensions may in the aggregate exceed five years; and

(v) An investment shall be made under this paragraph in accordance with the investment procedures of paragraph (c) of this section and shall be subject to paragraphs (b)(3)(i) (A) and (B) of this section.

(2) *Definitions*. For the purpose of this paragraph

(i) An "eligible country" means a country that, since 1980, has restructured its sovereign debt held by foreign creditors; and

(ii) "Investment" shall have the meaning set forth in § 211.2(i) of this part and, for purposes of this paragraph, shall include loans or other extensions of credit by the bank holding company or its affiliates to a company acquired pursuant to this paragraph.

(3) *Conditions*. (i) Any company acquired pursuant to this paragraph shall not bear a name similar to the name of the acquiring bank holding company or any of its affiliates; and

(ii) Neither the bank holding company nor its affiliates shall provide to

One of the keys to this amendment of Regulation K was that it fostered privatization in developing countries. Privatization⁵² is considered by the Federal Reserve to indicate an increased willingness on the part of developing countries to operate business enterprises efficiently and economically and to be sensitive to market forces.

Although the Federal Reserve's recent amendment of Regulation K was consistent with privatization policies generally, there seems to be little economic rationale for limiting the increased swap participation by U.S. banks only to programs in developing countries. It would seem equally as important, and probably even more prudent for U.S. banks, if the new rule encouraged swaps in developed countries as well.

As now implemented, the revised Regulation K only applies to debt-equity swaps in countries that have rescheduled their sovereign debt since 1980. This would include most of the largest debtor countries that have swap programs—such as Mexico, Chile, the Philippines, and Brazil—but would exclude other, more developed, countries where major privatization efforts are well under way.⁵³

II. COMBINING AN INVESTMENT FUND APPROACH WITH DEBT-EQUITY SWAPS

A. Overview of Investment Funds

In pooled investment vehicles, or investment funds, a consortia of resident and non-resident banks pool a portion of their loans to form a "national investment trust." Under this

any company acquired pursuant to this paragraph any confidential business or other information concerning customers that are engaged in the same or related lines of business as the company.

12 C.F.R. § 211.5(f) (1988).

The recent amendment to Regulation K is discussed in some detail in Spencer, *Regulation K Allows 100 Per Cent Ownership*, INT'L FIN. L. REV., Oct. 1987, at 13; Berg, *Banks Generally Praise Fed's Third World Shift*, N.Y. Times, Aug. 14, 1987, at D2, col. 5.

52. See generally, French, *Crash Lesson for Privatisers*, EUROMONEY, Dec. 1987, at 83; *Who's Selling What, and Where?*, EUROMONEY, Dec. 1987, at 89; Watson, *Privatization Trend Grows*, J. Com., Jan. 2, 1987, at 5A, col. 2.

53. Privatization efforts in developed countries have received considerable attention in the press recently. See, e.g., Burns, *Furor Over Air Canada Offering*, N.Y. Times, May 2, 1988, at D8, col. 1; Greenhouse, *France Sees Threat to Share Offerings*, N.Y. Times, Nov. 2, 1987, at D8, col. 1; Brinkley, *Reagan Appoints Privatization Unit*, N.Y. Times, Sept. 4, 1987, at A28, col. 1; Leung, *Privatization Prospects Draw Japanese Investors to Britain*, Asian Wall St. J. Weekly, June 15, 1987, at 25, col. 1.

arrangement, the consortia could take foreign-currency denominated shares in the trust in exchange for their loans. The trust's management would then restructure the loans into what eventually would become a conventional investment trust portfolio of equities and convertible debt. This trust—or investment-fund—concept, which is rapidly evolving in a number of countries, including Brazil, Chile, Mexico, and the Philippines, presents the potential for facilitating the transformation of significant volumes of foreign debt capital into local currency equity equivalents.⁵⁴

Pooled vehicles are funded either by contributions of sovereign external debt or by a combination of such debt and fresh infusions of cash. Current holders of a country's debt would typically exchange their debt for foreign currency-denominated beneficial interests (shares, other units, etc.) in this intermediary vehicle. Once suitable investment opportunities in the local economy are identified, the paper is either redeemed by the central bank in local currency or exchanged for central bank notes that are sold in the local market at a discount. The paper is then used to acquire equity investments in the local economy in the name of the fund.

The emergence of the investment fund mechanism within the debt-equity framework draws upon the experience gained from more traditional portfolio investment vehicles in selected developing countries and from venture capital funds in developed countries. While investment funds may appear to be somewhat similar to smaller U.S.-registered "country funds," there are some significant differences.

The modern country-fund concept essentially began with the Japan Fund more than twenty years ago. The idea was to make available to investors in the United States and Europe the shares of companies in a particular foreign market. Rather than having to invest directly in those shares through a foreign stock exchange, even where local laws allowed, mutual funds were formed in the United States and Europe that would re-

54. See, e.g., D. Gill, *Internationalizing the Nigerian Securities Market* 20-21 (Commemorative Lecture for the Twenty-Fifth Anniversary of the Nigerian Stock Exchange, in Lagos, Nigeria, Nov. 19, 1986) (available at the *Fordham International Law Journal* office) (stressing pooled investment vehicle approach for Nigeria).

ceive funds from Western investors and, in turn, invest such funds in companies in the external market.

Developing countries became the focus of these country funds with the advent of the Mexico Fund in the early 1980s. This has been followed by the Korea Fund, the Thai Fund, the Malaysia Fund (all sponsored in part by International Finance Corporation ("IFC"), an affiliate of the World Bank),⁵⁵ and the Brazil Fund. A more diversified investment strategy is possible through IFC's Emerging Markets Growth Fund—which focuses on eight developing countries, including Thailand, Taiwan, Malaysia, the Philippines, Jordan, and Argentina—or the Templeton Emerging Markets Fund, which was listed on the American Stock Exchange in 1987.⁵⁶

While the investments by these country funds are of a portfolio nature, they still meet ideological resistance from a number of these developing countries. Indeed, in a number of such countries foreign investment is allowed only through such funds. Many countries in this category also place strict limits on repatriation of income, forbid majority ownership by foreigners, and maintain high capital gains taxes.

1. Advantages of Investment Funds

The investment-fund mechanism within the debt-equity framework provides significant advantages to participating creditors. First, more favorable economies of scale are possible by virtue of the typically larger size of investments made available through the funds. Likewise, a diversification of assets offers the possibility of a greater rate of return on investments at a lower level of risk. Small and regional banks also benefit from participation in funds managed by larger credit institutions with the in-house capability to evaluate and manage equity investments in developing countries. It has also been important that emerging capital markets have continued, on average, to perform in a very strong fashion, even considering the impact of the October 1987 stock market crash.⁵⁷

55. For recent commentary on the activities of IFC, see Rowley, *The Future Still Lies With Emerging Markets*, FAR E. ECON. REV., Oct. 22, 1987, at 57; Bovard, *World Bank Unit's Lip Service to Private Sector*, Wall St. J., June 21, 1988, at 38, col. 3; Pearson, *IFC's Largest Issue Yet Meets Strong Reception*, Fin. Times, Mar. 4, 1988, at 22, col. 6.

56. Rowley, *supra* note 55, at 57.

57. It has recently been reported that there are over thirty-five equity markets in

Second, the participation in the funds of international organizations, such as the World Bank group in general and IFC in particular, evidences the World Bank's support for more general, growth-oriented, structural reforms conducive, among other things, to the success of the debt-equity conversion framework. IFC has participated in the design and structuring of four investment funds (in Brazil, Chile, Argentina, and the Philippines).

Third, incentives for banks engaging in a pooled transaction include the management of debt-equity investments (whether venture capital in nature or stock market funds as in Chile) by an active professional institution specializing in the venture-capital business. Such institutions, assuming a high quality of management, not only have a greater familiarity with the local investment environment and regulatory framework, but also can offer priority access to conversion as well as other operational "sweeteners." In some countries, such as Chile, the pooled institution offers direct investment in the secondary market.

2. Disadvantages and Problems to Overcome

The array of complexities associated with the establishment of investment funds is an initial obstacle for the country-fund mechanism. Because they necessarily involve a number of diverse participants and are subject to dynamic in-country environments in which intricate legal, regulatory, administrative, and fiscal frameworks are changing rapidly, investment funds must, at times, successfully negotiate a difficult obstacle course of potential problems.

The quality of fund management is, of course, essential to the success of the endeavor. Equity investments, by their nature, present more risk than debt, because they are subject to a wider range of economic and political uncertainties. Because of these uncertainties, the prospect of sound and active fund management is necessary to induce holders of debt paper, or "first-tier" creditors, to convert their position to "second-

developing countries, with a total market capitalization of US\$180 billion (up from US\$55 billion six years ago). In 1987, eleven emerging markets outperformed the New York Stock Exchange (measured in dollar terms). See, *The Emerging Capital Markets*, Swaps: Newsl. New Fin. Instruments, Feb. 1988, at 1, 4.

tier," or equity investment, risk. For this reason, many existing country-fund structures have instituted regular meetings and related reporting mechanisms so that investors can continually monitor the pulse of their collective investments.

Also, if banks invest directly in developing-country equity, it is easier to avoid substantial write-downs of the debt. When debt is contributed to a fund, however, under current regulations an exchange has taken place, and there is substantial pressure for the banks to write down the debt to its secondary market value immediately.

There is also the more political issue of substantial changes in the foreign ownership position in the debtor states, or what has been referred to as "de-nationalization," brought about by large investment placements made by the investment funds. The potential exists that national sensitivities could arise in the event of large-scale debt-equity conversions administered by an investment fund. The argument would be that the national patrimony was being sold to foreigners, and at a price reflecting continued economic weakness and dependence on the West. Similarly, sensitivities may arise regarding the view that conversions are a substitute, rather than a stimulus, for increased levels of foreign investment. There is also the issue of national investors who might be concerned that the most attractive investment opportunities in their country are being secured by foreign sources at a discount, thus further handicapping local entrepreneurs.

Finally, in a significant number of debtor countries the number of attractive investment opportunities is limited. Owing to the relatively large size of most investment funds, there may be some doubt as to the investment absorption capacity of the debtor economy, especially with regard to more promising investment opportunities.

B. *Structural Considerations*

A number of considerations—including prevailing tax regimes, the specific domicile of the fund, and the nature of its investors—determine the optimal structure of such a fund. Possible structures include (a) a trust, (b) a partnership involving a general partner and limited partners, and (c) an orthodox corporate form or a corporation with two tiers, such as a typi-

cal venture-capital company in the United States, involving a management company and an investment company.

1. Trusts

In order to be transparent for U.S. federal income tax purposes, a trust would have to qualify as a "grantor" or "investment" trust. A grantor trust is essentially a custodial entity in which the trustee holds a pool of assets for beneficiaries (who have undivided interests in the pool) but engages in no active management of the assets. These characteristics appear to be inconsistent with the plan to convert the initial assets of the fund (country debt obligations) into equity and to subsequently manage the portfolio.

2. Partnerships

A limited partnership could be a vehicle for the fund, whereby the fund portfolio could be actively managed by the general partner. However, the principal obstacle to a limited partnership vehicle would be the requirement that the corporate general partner be adequately capitalized: namely, that the net worth of the general partner should be at all times at least ten percent of the total contributions to the partnership, excluding the net worth calculation of the corporate general partner's interest in the partnership.⁵⁸

3. Corporations

The third alternative would be to organize an investment company in the United States. In order to be transparent for U.S. federal income tax purposes, the entity would have to qualify as a Regulated Investment Company ("RIC") under the tax code.⁵⁹ To qualify as a RIC, the fund would have to be registered with the Securities and Exchange Commission (the "SEC") as an investment company and would have to meet three qualifications regarding its income and assets. First, in regard to the "passive" character of its income, the fund is limited by section 851(b)(2) of the Internal Revenue Code, which stipulates the following:

58. *See* Rev. Proc. 72-13.02, 1972-1 C.B. 735.

59. I.R.C. § 851 (1982 & Supp. IV 1986).

[A]t least 90 percent of its gross income is derived from dividends, interest, payments with respect to securities loans (as defined in section 512(a)(5)), and gains from the sale or other disposition of stock or securities (as defined in section 2(a)(36) of the Investment Company Act of 1940, as amended) or foreign currencies, or other income (including but not limited to gains from options, futures, or forward contracts) derived with respect to its business of investing in such stock, securities, or currencies.⁶⁰

The second qualification is that less than thirty percent of its gross income be derived from the sale of securities held for less than three months.⁶¹ Finally, the investment company must meet a set of asset-diversification requirements: the pertinent troublesome diversification limitations, applicable "at the close of each quarter of the taxable year," are (1) the requirement that at least fifty percent of the value of total assets is represented by cash and cash items (including receivables), plus other securities for purposes of this calculation limited in respect to any one issuer to an amount not greater than five percent of the value of total assets⁶² and (2) the requirement that not more than twenty-five percent of the value of its total assets is invested in the securities of any one issuer.⁶³

The qualifications relating to "passive" character and the limits on gross income derived from sale of securities held for less than three months should not be obstacles to the proposal. However, at least during the initial period of operation of the fund, it may be difficult to satisfy the diversification requirements applicable to RICs. For the first year or two of its operation, the fund's assets would consist predominantly of governmental debt obligations, so it would not be diversified.

One approach that appears to be most efficient in this context is the initial organization and operation of the fund as an entity outside the United States in a jurisdiction that imposes only minor, if any, taxes on corporations such as the fund. Although this approach would not achieve tax transparency, the impact of tax at the entity level would be avoided. It may be possible, once a fund's portfolio has been converted out of

60. I.R.C. § 851(b)(2). The emphasized portions represent additions made by § 653(b) of the Tax Reform Act of 1986, Pub. L. No. 99-514, 100 Stat. 2298.

61. I.R.C. § 851(b)(3).

62. I.R.C. § 851(b)(4)(A).

63. I.R.C. § 851(b)(4)(B).

governmental debt obligations, to "convert" the fund to the status of an entity organized in the United States, registered with the SEC as an investment company, and qualifying as a RIC for U.S. tax purposes.⁶⁴

In addition to considerations pertaining to the form of the fund, there are a number of salient factors relevant to the selection of a non-U.S. domicile. The most important characteristic of an appropriate domicile for a fund is a low-tax jurisdiction that would impose no substantial corporate tax on income received by the fund or withholding tax on distributions made by the fund. Similarly, the most appropriate jurisdiction would not have substantial franchise or capital gains taxes on fund shares. To this end, it would be helpful if the jurisdiction had tax treaties with the United States, the United Kingdom, Japan, and other jurisdictions in which putative participating banks are situated. The existence of exchange controls should also be considered when selecting a domicile for the fund.

C. *Role of Developmental Finance Institutions*

In addition to the activities of IFC that have been described above, the Overseas Private Investment Corporation ("OPIC") and the recently established Multilateral Investment Guarantee Agency ("MIGA") of the World Bank group may insure certain investment funds and may serve as an incentive to attract additional participants to debt-equity conversions and investment funds. By guaranteeing or insuring the equity investments being made by U.S. and other investors in developing countries through the debt-equity conversion process, these institutions encourage greater use of this vehicle and help, albeit modestly, in softening the sharper edges of the debt crisis. OPIC is limited to insuring investments by U.S. persons (including corporations), while MIGA, which recently began full-time operations, may guarantee investments made by entities from member countries, including the United States.⁶⁵

64. This is an ideal scenario, but may not be applicable under the legal frameworks of certain debtor countries. Chile, for example, requires that the funds remain in Chilean companies for ten years. See Garcés, *Foreign Debt Conversion in Chile*, in *GUIDE*, *supra* note 12, at 24, 28-29.

65. For an analysis of MIGA's proposed membership and operations, see Shihata, *The Multilateral Investment Guarantee Agency*, 20 *INT'L LAW* 485, 488-89 (1986);

D. *Examples of Investment Funds*

1. Brazil

In Brazil, a new debt-equity investment fund has recently been organized. The fund is known as Equitypar and is organized as a corporation under Brazilian law.

Equitypar has been capitalized through debt-equity conversions in the amount of approximately US\$85 million from foreign sources. Because the application to the Brazilian Central Bank for approval of Equitypar was made prior to July 20, 1987, investors in the company choosing the debt conversion process will benefit from the general rules in effect at that time, including Central Bank Carta Circular No. 1125.⁶⁶ These rules require receipt of one hundred cents in local currency for each dollar converted, full registration of converted amounts of foreign capital for purposes of dividends, and capital repatriation on a one-to-one basis. This fund is for venture capital investments in Brazil.

Other rules for dividend and capital repatriation are (a) remittance of dividends as of year one in line with standard dividend repatriation rules applicable to foreign investments and (b) investors must agree to maintain their capital investment in Brazil for a period of twelve years.

Another such fund, called the Brazil Conversion Fund, has also recently been organized by Morgan Grenfell & Co., in a maximum amount of US\$100 million. Investors in this fund may sell their holdings after twelve years and can repatriate dividends throughout the life of their investment in the fund.⁶⁷

2. Philippines

In the Philippines, Shearson Lehman Hutton and IFC have launched a new equity investment fund called First Philip-

Harris, *World Bank Unveils Investment Risk Plan*, *Fin. Times*, Apr. 13, 1988, at 4, col. 3; Lawrence, *US Joins Agency on LDC Investment*, *J. Com.*, Apr. 13, 1988, at 7A, col. 4; Bovard, *MIGA Could Help to Insure Expropriation*, *Wall St. J.*, Dec. 22, 1987, at 18, col. 3. With regard to OPIC, one of the best treatments is Gilbert & Marra, *Overseas Private Investment Corporation*, in *INTERNATIONAL FINANCIAL LAW: LENDING, CAPITAL TRANSFERS AND INSTITUTIONS* 215 (R. Rendell ed. 1980).

66. See *supra* note 33.

67. See *Morgan Grenfell Sets Up Brazilian Debt-Swap Fund*, *Wall St. J.*, Feb. 2, 1988, at 33, col. 4.

pine Capital Fund L.P. (the "Fund").⁶⁸ The initial capital of the Fund amounted to approximately US\$65 million.⁶⁹

The Fund has been organized as a limited partnership under the laws of Delaware and will be managed by a subsidiary of a U.S. investment banking firm. Initial capital for the Fund has been provided by IFC in the form of cash and by other investors in the form of sovereign debt owed them by the Philippine public sector.⁷⁰

The Fund is intended to assist the Philippine government's debt-equity conversion program by funneling private investment into a broader range of industries than would otherwise have been likely. The Fund itself will invest in a wide range of types of equity and quasi-equity securities of Philippine corporations including common and preferred stock, debentures convertible into common and preferred stock, and shares or debentures having warrants or rights to purchase common or preferred stock attached.

Such investments are expected to include new issues of equity securities of Philippine corporations resulting from privatizations, restructurings, and recapitalizations; new joint-venture companies being established in promising sectors of the economy (particularly the export sector); and new issues of common or preferred stock of existing Philippine companies, including some listed on local stock exchanges. The Fund's ability to invest will be subject to the limitations of the conversion program and the Philippine government's foreign investment regulations, as well as to prudential limits on the types and amounts of individual investments. It is anticipated that the Fund's assets may not be fully invested in equities until approximately three years after establishment of the Fund.

Profits of the Fund will be allocated and distributed to the partners semi-annually, in U.S. dollars, on the following basis: (1) ninety-nine percent to the limited partners and one percent to the general partner, until such time as each limited partner has received the sum of the face value of his capital contribution plus an annual return defined as (a) six-month London

68. Fidler, *Shearson in Philippine Equity Fund Venture*, *Fin. Times*, June 17, 1988, at 28, col. 5.

69. *Id.*

70. *Id.*

Interbank Offered Rate ("LIBOR") as computed successively over the period since the partnership's commencement, plus (b) three percent; (2) subsequently, one-hundred percent to the general partner until its capital account equals twenty-five percent of the partnership's total capital accounts; (3) thereafter, twenty-five percent to the general partner and seventy-five percent to the limited partners.

As an additional attraction for U.S. investors, the partnership interests of eligible investors will be guaranteed against certain political risks by OPIC. Interests in the Fund will be transferable only with the express consent of the general partner and a written opinion of counsel that the transfer would not result in the Fund having to register under the U.S. Investment Company Act of 1940.⁷¹

3. Chile

In Chile, the new debt-equity conversion investment fund is known as The Chile Investment Company S.A. (the "Company"),⁷² a private limited liability company (sociedad anonima cerrada) sponsored by IFC and Midland Bank PLC. The Company was formed under the laws of Chile for a term of twelve years, with the purpose of providing eligible non-Chilean entities with an opportunity to participate in investments in Chilean securities by converting certain debts of the Chilean Central Bank into an equivalent amount of bearer notes, which are in turn used to subscribe to shares of the Company.⁷³

In this case, the Company had an initial capitalization of US\$30 million. Funds of the Company will ultimately be used to purchase shares of Chilean companies, with the following restrictions, among others: (a) the Company may not purchase a security if as a result (i) more than ten percent of the Company's total assets would then be invested in securities issued or guaranteed by a single issuer or (ii) more than twenty-five percent of the Company's total assets would be invested in a single industry; and, (b) the Company may not purchase any security if as a result the Company would then hold more than

71. 15 U.S.C. §§ 80a-1 to -64 (1982 & Supp. IV 1986).

72. Morgan, *Midland/IFC Debt Scheme Seen as a First for Chile*, Reuters, Oct. 9, 1987 (LEXIS, Nexis library, Omni file).

73. Duffy, *Plan Launched by Midland Bank Swaps Chilean Debt for Equity*, Am. Banker, Oct. 13, 1987, at 2, col. 1.

fifteen percent of any class of securities of an issuer.⁷⁴

CONCLUSION

A. *Current Impact of Investment Funds on International Debt-Equity Swaps*

In the context of the substantial levels of sovereign debt carried by the Latin American countries, the emergence of debt-equity conversions must be viewed as a stop-gap measure and not a substitute for the more fundamental international response necessary to eliminate the current debt crisis. The volume of the debt and the complexity of the debt-equity conversion transactions make that result impractical.

In early 1987, Richard S. Weinert, a New York investment banker active in debt-equity swaps, noted that

[t]otal foreign investment in Mexico, for example, is estimated at only \$15 billion, compared with a total debt of some \$100 billion. Even if capitalization schemes were to restore the investment flow to earlier levels, these would amount to only a small fraction of the debt service.⁷⁵

This observation is applicable to the Latin American region as a whole, which at the end of 1985 was estimated to have an aggregate debt level of some US\$368 billion and a corresponding foreign investment level of only US\$60 billion.⁷⁶

The addition of the investment fund feature to this debt conversion framework is likely to magnify its impact and, in a sense, to "wholesale" the idea of debt-equity swaps by turning swaps into a commodity that is available to a broader range of investors, with fewer complications and on a more cost effective basis.

B. *Prospects for the Future*

Although novel and innovative, debt-equity swaps contain a number of troubling and complicated aspects, not the least of which is the sheer amount of time and effort needed to complete a transformation of government debt to private equity

74. Mark, *Foreigners Find Favour and Incentives*, *EUROMONEY*, Jan. 1988, at 64, 68 (Supp. on Global Debt).

75. Weinert, *supra* note 23, at 93.

76. Rodriguez, *supra* note 13, at 14.

investment. This is compounded when systemic changes are contemplated or implemented by a developing country.

Another troubling feature is that there is a limited supply of equity in good companies in these countries that can be swapped effectively. In many of the countries with the largest external debt, the availability of enterprises that can be made profitable, and thus be of interest to developed-country investors or creditors, has already begun to run low. The comparative volume of the debt in these countries limits the possible impact of swaps and investment funds.

An additional problem arising with regard to swaps in particular has to do with the possible inflationary impact of promoting such swaps. In Mexico, where the debt-equity swap program was recently suspended, there has been a distinct inflationary impact on the local economy resulting from the need to print additional pesos to cover converted loans.

Despite these qualms, the advantages inherent in policies promoting swaps and investment funds in most instances appear to outweigh the risks. Debt swaps, along with investment funds, seem to be among the few vehicles that a government can use to revitalize a stagnant economy, to reduce outstanding debt, and to encourage a fresh inflow of capital. Given the lack of other viable policy alternatives, these new techniques should be pushed as far as their intrinsic merits can take them.

The U.S. Treasury, the International Monetary Fund, the World Bank group (in particular, International Finance Corporation) and a significant number of developing countries appear quite enthusiastic about the combination of investment funds and debt-equity swaps. Draft legislation may come before the U.S. House Banking Committee that would establish a new multilateral agency, backed by the IMF and/or the World Bank, which would buy developing-country debt at a discount and resell it.⁷⁷

Proponents of Latin American debt capitalization transactions anticipate that through this mechanism, developing countries will be able to provide incentives for hundreds of millions of dollars of new investment within the next few years. If investments through debt-equity swaps and investment

77. See, e.g., Rowen, *Fresh Ideas for Debt Crisis*, Wash. Post, June 7, 1987, at H1, col. 1.

funds are sufficiently encouraged by regulators here and abroad, and if those investments are properly directed, such transactions may provide a constructive mechanism for the reduction of foreign debt, the recovery of many developing country economies, and a lucrative market for third-party investors. Debt-equity conversion funds are an interesting new tool that could accelerate this process and bring in new players who might not otherwise have participated in the process, such as regional U.S. banks with relatively small exposures in debt or country terms.

Even though they have been of comparatively modest impact in total dollar terms, debt-equity swaps and investment funds can serve as important escape valves for underlying financial pressures. These new tools show that while the international debt crisis may be ongoing, it need not be never-ending.