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Debt Equity Swaps in Developing Countries: Toward a Workable System

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DEBT EQUITY SWAPS IN DEVELOPING COUNTRIES: TOWARD A WORKABLE SYSTEM

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I. Introduction

Throughout the 1960's and 70's, developing countries became increasingly wary of direct foreign investment. In large part, this change resulted from the view that the interests of foreign-controlled multi-national corporations (MNCs) were often inconsistent with the priorities and goals of the host country.[1] Developing countries no longer perceived the presence of an MNC as a positive contribution to economic development.[2] Various groups began to demand that foreign investment be restricted. To maintain political legitimacy and stay afloat amid domestic unrest, host country governments adopted a more critical attitude toward direct foreign investment. This attitude took the form of restrictions on the structure and operations of MNCs, divestitures, and expropriation.[3]

Developing nations, reluctant to forego foreign capital altogether, turned to debt.[4] Bank loans channeled through the public sector were used to establish or expand domestically controlled

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[1] MNCs are often unwilling to invest in key heavy industries or infrastructure where costs are high and rates of return low. *See* Frieden, *Third World Indebted Industrialization: International Finance and State Capitalism in Mexico, Brazil, Algeria, and South Korea*, 35 Int'l Org. 407, 412 (1981).

[2] *See generally*, Oliver, *The Andean Foreign Investment Code: A New Phase in the Quest for a Normative Order as to Direct Foreign Investment*, 66 Am. J. Int'l L. 763 (1972).

[3] Studies indicate that among other factors influencing the probability that a nation will expropriate property is the increase in political unrest within a country. In part this was interpreted to be an effort to maintain power by maintaining legitimacy in the face of domestic protests against MNCs. Jodice, *Sources of Change in Third World Regimes for Foreign Direct Investment, 1968–1976*, 34 Int'l Org. 177 (1980).

[4] Frieden, *supra* note 1, at 412.

enterprises, both private and public.[5] Commercial borrowing became the politically acceptable alternative to direct foreign investment. In Latin America, foreign banks replaced MNCs and intergovernmental aid as the most important source of financing.[6] In turn, heavy borrowings from foreign banks produced serious debt repayment problems for many developing countries.[7] These problems reached crisis proportions when, in 1982, Mexico declared it could no longer meet its current obligations.[8]

In an effort to ease reliance on commercial borrowing, developing countries are once again looking to direct foreign investment as a source of needed capital. The attitude of foreign investors, however, has changed. With a history of host country hostility and instability over the past two decades, investors have grown more cautious. As a result, from 1981 to 1984 the net flow of foreign direct investment to developing countries declined by 26%.[9] Today, potential foreign direct investors require assurances including clear investment guidelines, guarantees of economic obligations, and access to an international body for dispute resolution.

One scheme to promote foreign direct investment that is attracting a great deal of attention from developing countries and investors alike is "debt-equity swaps." Converting debt to equity is similar to the process of reorganizing bankrupt corporations with a view to revitalizing them.[10] In corporate reorganizations, creditors commonly convert part of the debt owed to them into capital stock of the corporation.[11] The result is lower debt and lower interest burdens. If the corporation survives and prospers, the investors may see some return. The Chrysler bailout scheme employed this technique, and lenders eventually benefited.[12]

Developing countries adopt a similar practice by structuring debt-equity swaps. Through debt-equity swaps, developing country debt is converted into foreign equity in a domestic firm. Citicorp's Chairman, John Reed, is optimistic about the future of swaps: "An equity investment is a better asset today in Brazil than a loan to the

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[5] *Id.*

[6] *Id.* at 409.

[7] *See generally*, Lochhead, *Debtors, Bankers in Woeful Chorus*, INSIGHT, Aug. 31, 1987.

[8] *See generally*, Lochhead, *A Debt Cure That Could Kill*, INSIGHT, Aug. 31, 1987, at 17.

[9] Latin American countries which had traditionally attracted the bulk of direct investments were hit especially hard by this development. Voss, *The Multilateral Investment Guarantee Agency: Status, Mandate, Concept, Features, Implications*, 21 J. OF WORLD TRADE L. 5, 8 (1987).

[10] Weinert, *Swapping Third World Debt*, 65 FOREIGN POL'Y, 85, 89 (1986–87).

[11] *Id.*

[12] *Id.*

central bank, where the loan is 20 years, subject to renegotiation at the will of the borrower, at what would appear an ever declining rate."[13]

Debt swaps have been chipping away at developing country debt, but these transactions can only substantially reduce debt over a long period. The few billion dollars' worth of swaps transacted in 1986 is dwarfed by the several hundred billion dollars in total debt that still exists.[14] The fact remains that outstanding debt overwhelms investment possibilities. For example, foreign banks' outstanding loans to Brazil are $67 billion, while the total value of the companies traded on its stock market is only $41 billion.[15] Foreign investors will only be interested in certain investment opportunities and there are a limited amount of businesses that countries will want foreigners to acquire. Similarly, most developing countries will want to restrict foreign investment to enterprises that will bring in foreign exchange earnings or foster import substitutes.

Nevertheless, a beginning has been made. Debt swaps do initiate a restructuring of a nation's balance sheet away from debt. Moreover, they serve as a catalyst to improve a nation's investment climate.[16] This Note analyzes the obstacles that both host country and investor must overcome to take advantage of swap schemes. First, it will discuss what exactly a debt-equity swap is and the advantages and disadvantages that it presents to the host countries. Second, it will discuss the potential risks of private investment in the Latin American context and how these risks can be mitigated through a comprehensive foreign investment scheme such as Mexico's. Finally, it will address the possibility of using an investment insurance program as a complement to swap transactions to attract additional direct foreign investment.

II. Swaps: What They Are, How They Work, and Their Attraction

A typical swap transaction works as follows: an MNC that wants to invest in a country will approach a broker who will purchase that country's debt at a discount from its face value in the secondary market. The MNC will buy the debt and present it to the host

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[13] Lochhead, *Western Money and Holes in the Third World's Pockets*, INSIGHT, Aug. 31, 1987, 12, 14.

[14] Weinert, *supra* note 10, at 93.

[15] Lochhead, *supra* note 13, at 15.

[16] *Id.*

country's government, which will redeem the debt at close to face value in local currency. The company invests the local currency within the country.[17] As such, the swap serves as a vehicle for foreign direct investment.[18] The equity position is held by the original holder of the debt (a bank) or by a foreign MNC.[19]

Developing countries generally structure two types of debt-equity transactions. The first type allows foreign banks to convert some of their own debt into local investments. As a result of a recent debt conversion in Chile, Bankers Trust now owns 40% of Chile's largest pension fund and 96% of its largest life insurance company.[20] Bankers Trust also has a $25 million stake in a Brazilian autoparts maker following a similar transaction.[21]

The second and more common type of transaction gives MNCs a local equity stake, using the secondary market that exists for developing country debt. Fiat, for example, used such a swap scheme to expand its plant in Brazil.[22] It bought Brazilian debt at a steep discount in the secondary market and delivered the debt instrument to the Brazilian central bank.[23] The central bank retired the debt, registered the retired debt as if it were a new investment and gave Fiat the cruzado equivalent of the face value of the debt.[24]

Debt-equity swaps depend on the willingness of developing countries to buy back their debt using local currency, provided that the proceeds are invested in the country.[25] Three countries have had quite active programs allowing conversion of debt into equity: Chile, Mexico, and the Philippines.[26] As of April, 1987, these three alone had authorized swaps of about $1.4 billion of their debt into foreign equity.[27] MNC interest in these schemes stems from the fact that developing country debt has been available in the secondary market at a steep discount to face value. In May, 1987, an MNC could get 42% more Mexican pesos through a swap than by pur-

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[17] Schubert, *Trading Debt for Equity*, THE BANKER, Feb. 1987, at 19.

[18] RICHARD A. DEBS, DAVID L. ROBERTS, ELI M. REMOLONA, FINANCE FOR DEVELOPING COUNTRIES: ALTERNATIVE SOURCES OF FINANCE — DEBT SWAPS 18 (1987).

[19] *Id.*

[20] Lochhead, *supra* note 13, 12, 14.

[21] *Id.*

[22] Weinert, *supra* note 10, at 90.

[23] *Id.* Steep discount means that the debt was bought at a significant reduction from the face value of the debt. This discount reflects the free market's assessment of the true value of the debt.

[24] *Id.*

[25] Debs, *supra* note 18, at 22.

[26] Ollard, *The Debt Swappers*, EUROMONEY, Aug. 1986, 69, 71.

[27] Debs, *supra* note 18, at 22.

chasing pesos at the official exchange rate.[28] Similarly, swapping Chilean debt could get the foreign investor as much as 32% more domestic currency than an ordinary foreign exchange transaction.[29]

MNCs often enter into debt-equity swaps to meet local currency needs of their subsidiaries based in the debtor countries. Rather than adding to the subsidiaries' equity by transferring dollars that will be converted at the official rate, the MNC can enjoy substantial savings by using swaps. Through such swap transactions, for example, Allied-Signal Inc. acquired local currency in Chile, and Chrysler added $100 million into Chrysler de Mexico with money obtained from buying Mexican debt at a steep discount.[30]

Sometimes a bank undertakes the investment directly, bypassing the secondary market and thereby preserving book values for its assets.[31] Citicorp expects to reduce its loans to developing countries by about $5 billion over the next three years through debt-equity swaps and loan sales.[32] Such steps would follow in the wake of Citicorp's mid-May $3 billion increase in loan-loss reserves.[33] Citicorp has approximately 5,000 people stationed in Latin America looking for investment opportunities.[34] Chairman Reed would like the bank to invest $200 million in 1987.[35]

Economists have criticized debt swaps as interfering with traditional economic adjustment policies of developing countries by causing a loss of control over the money supply or the exchange rate.[36] They do help, however, by converting a developing country's foreign debt into obligations with payments that the economy might be better able to handle.[37] Moreover, they could encourage privatization of firms that would otherwise be a burden on the economy.[38]

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[28] Bartlett, *The Citi Squeezes Its Lemons*, BUS. WK., June 15, 1987, at 31.

[29] *Id.*

[30] Truell, *Third World Creditors Give Debt-Equity Swaps a Try*, WALL ST. J., June 11, 1987, at 6, col. 1; Riemer, *A Way to Turn Debt From Burden to Boon*, BUS. WK., Dec. 22, 1987, 25.

[31] Book value is the amount of the debt reflected on a bank's financial statement. For example, $100 in debt would be stated as $100 in assets by the bank. If a bank sells an asset at a value below what it has stated on its financial statement, then the value of the remaining assets is thrown into question.

[32] Truell, *Citicorp Plans to Shed Big Part of Loans to Third World Through Swaps, Sales*, WALL ST. J., May 22, 1987, at 3, col. 2.

[33] Loan-loss reserves are provisions banks make for doubtful loans. Citicorp was the first large bank to set aside from retained earnings a large amount to cover doubtful developing country debt.

[34] Truell, *supra* note 32.

[35] *Id.*

[36] French, *Mexico's Capital Idea*, EUROMONEY, Sept. 1986, 167, 172.

[37] Debs, *supra* note 18, at 27.

[38] *Id.*

The main advantage of debt swaps is that they replace a debt liability that requires immediate service with an equity liability that presumably will better fit the country's ability to pay.[39] The host country's balance of payments may benefit from postponed payments in hard currency.[40] A successful program would have to impose some restrictions on capital repatriation in the first years.[41] Otherwise there would be no advantage to the host country; instead of paying interest to creditors they would be paying dividends to investors. Thus, the swaps that have been made to date have operated within the constraints of the restructuring agreements.[42] Earnings can not be brought back to the home country sooner than the rescheduled debt repayments.[43] Eventually, however, investors expect to remit earnings and assurances would have to be made.[44]

It is not clear whether a growing market for developing country debt swaps will help or hinder the rescheduling process. The key factor is to what degree the swaps will attract foreign equity investment that would not otherwise come in.[45] Without the additional investment, the benefit of substituting foreign equity for external debt is slight.[46] The country could achieve the same ends by earmarking the foreign exchange that was coming in through previously planned investment to retire debt.[47]

Proponents of swaps, including many large money center banks and investment companies, argue that swaps give debtor countries access to badly needed investments in export oriented industries.[48] But opponents say that the money would have come in anyway.[49] They note that companies that already have facilities in debtor countries are the major users of swaps, employing them as a cheap way to expand operations.[50]

Under either view, the advantages of swaps are reduced to the degree of additional investment or "additionality" that is brought

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[39] *Id.* at 32.

[40] *Id.*

[41] *Id.* at 33.

[42] Buchheit, *Converting Sovereign Debt into Equity Investments*, INT'L FIN. L. REV., Sept. 1986, 10, 12.

[43] Schubert, *supra* note 17, at 19.

[44] Debs, *supra* note 18, at 33.

[45] *Id.* at 28.

[46] *Id.*

[47] *Id.*

[48] Marton, *The Debate Over Debt for Equity Swaps*, INSTITUTIONAL INVESTOR, Feb. 1987, 177.

[49] *Id.*

[50] *Id.*

into the host country.[51] If an MNC had already decided to invest before a country had introduced a swap program there would be no additionality. By contrast, there would be additionality if an MNC with no intention to invest responds to a new swap scheme by investing.[52]

Direct swaps into equity by banks seem to hold the most potential for bringing about additionality. Since most banks did not intend to invest directly when they first made the loans to the developing countries, these swaps give them equity positions they would not otherwise hold.[53]

Investment over the long term, however, depends primarily on the expected profitability of business opportunities, which in turn depends on the political and economic climate of the host country. The opportunity of an investor to take advantage of the discounts in the secondary market will certainly induce some additionality, but even more can be induced if the country moves toward liberal investment policies.[54]

III. Major Drawbacks of Swaps

Foreign investors gain from debt swaps because of discounts in the secondary market. By redeeming the discounted debt at face value, the host country is in effect giving a subsidized exchange rate.[55] "In nine out of ten swaps, it is one big rip-off," charges Rudiger Dornbusch, economics professor at MIT.[56] "The investment would have come in anyway, and with a swap the central bank is saddled with paying an unnecessary subsidy to provide the local currency."[57] Bankers do not dismiss the charge but add that an additional $20-30 million is usually tacked on to the investment.[58] A preferential rate for certain capital inflows ultimately penalizes exports, import substitutes, and other sectors that earn or save foreign exchange.[59] Resources that could be invested in those trade

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[51] This term expresses the concept of new investment coming in above and beyond that which was already going to come in and was in response to the swap program.

[52] Debs, *supra* note 18, at 28.

[53] *Id.* at 30.

[54] *Id.* at 31.

[55] *Id.* at 34.

[56] Marton, *supra* note 48, at 177.

[57] *Id.*

[58] *Id.*

[59] Debs, *supra* note 18, at 34.

sectors go elsewhere. Just because investment is coming in does not mean it is good for the country.[60]

Swaps may misallocate resources by earmarking the foreign exchange proceeds of capital inflows for debt retirement.[61] In some situations, there may be better uses for the foreign exchange, for example, to pay for needed imports.[62] If a country is looking for new money from its creditors in the form of debt it appears inconsistent to be repaying debt through the swap market.[63]

Opponents of swaps add that swaps allow foreigners to exchange non-performing debt for control of viable domestic assets at a discount.[64] The Mexican press reacted negatively when foreign creditors gained 45% of the equity in the country's largest conglomerate, Grupo Industrial Alfa, in exchange for $920 million in debt.[65]

The issue of foreign control over assets is not as contentious as that of inflation.[66] Critics point out that local currency created by central banks to purchase the swapped debt only adds to inflationary pressures feared by so many developing countries.[67] Mexico recently suspended its debt-equity swap program, citing concern about the country's accelerating inflation rate.[68]

Another factor that causes concern is that local firms and individuals earning foreign exchange will not want to surrender their foreign currency at official exchange rates when they can use swaps and increase their returns.[69] Local importers will take advantage of the swaps' discounts by over-invoicing, thereby acquiring more foreign exchange from the central bank than they need to meet their trade bills.[70] With the excess foreign exchange, they can buy dis-

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[60] *Id.*

[61] *Id.*

[62] *Id.*

[63] *Id.*

[64] Banks term debt as non-performing when interest payments become past due.

[65] Marton, *supra* note 48, at 177.

[66] Orme, *Swaps Spur Foreign Investment in Mexico,* Fin. Times (London), Jan. 5, 1987, at 18, col. 4.

[67] Fear of inflation is one of the reasons Ecuador has been hesitant to get into the swap market. Whitelaw, *Ecuador Stall on Equity Swaps,* EUROMONEY, Jan. 1987, at 135. "It's [swaps] business for everybody, but it's bad business for the country," charges former Argentine economics minister Roberto Alemann. He also adds there is the question of public spending priorities; the funds could be better spent on other things besides retiring debt-like roads, pensions, and healthcare. Marton, *supra* note 48, at 177.

[68] Truell, *Brazil Sets Up a Plan to Swap Debt for Equity,* WALL ST. J., Nov. 18, 1987, at 29, col. 1.

[69] Debs, *supra* note 18, at 35.

[70] *Id.* Over-invoicing is a scheme used by many importers when access to foreign exchange is restricted. In order for importers to obtain foreign exchange to pay for their goods they

counted debt in the secondary market and swap it for local currency.[71] This "round-tripping" uses up official exchange reserves.[72] The government loses reserves with the capital flight but gains no reserves on the return trip, since returning capital is used to retire debt.[73] Foreign firms that would not otherwise remit their earnings may be tempted to do so. They can convert their profits into foreign exchange at the central bank and then take advantage of the preferential rates by bringing it back through swaps.[74]

To protect against the depletion of reserves from the danger of round-tripping, the government must tighten exchange and capital controls.[75] Unfortunately, these very controls can weaken the attractiveness of the country to additional investment.[76]

Some critics attack the entire notion of direct foreign investment as a long term answer to growth in the developing countries, and thus the idea of swaps too. As a development strategy, direct investment overlooks the fact that Japan and other postwar success stories pursued opposite strategies. They drastically limited foreign participation in their economies, promoted domestic savings and import substitution, and only gradually liberalized once their domestic entrepreneurs were strong enough to compete.[77]

Despite the disadvantages of swap programs, Latin American countries are going forward with them and investors are looking for new opportunities.[78] The key to their success is to attract new investment or additionality. This is often difficult since investors fear asset expropriation.

IV. Difficulties in Attracting New Investors: The Specter of Expropriation

Investment disputes have been significant, especially in connection with Latin America. From the conflict with Mexico over

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present an invoice to the central bank who in turn gives them the required foreign exchange to make the purchase. Over-invoicing inflates the importers' foreign exchange needs beyond the cost of the goods purchased.

[71] *Id.*

[72] The term derives from the way the foreign exchange goes out of the country purely to come back again in the form of a swap.

[73] *Id.*

[74] *Id.*

[75] *Id.*

[76] *Id.* at 36.

[77] Kuttner, *Third World Debt: A Flawed Solution,* BUS. WK., Jan. 19, 1987, at 18.

[78] *See, e.g.,* Truell, *supra* note 68, at 29.

U.S.-national ownership of petroleum rights in the 1920's and 30's, to the nationalizations of the Kennecott and Anaconda copper mines in Chile by Allende in 1970-71, U.S. relations with Latin America have been fraught with conflict over the private property rights of U.S. investors.[79] One count by the U.S. Department of State found 87 purported instances of expropriating acts during a two year period in the early 1970's.[80] Nevertheless, no system has yet to emerge by which those conflicts are remitted to juridical determination.[81]

Capital-exporting countries have argued that investment conflicts such as alleged expropriation should be removed to international adjudication.[82] The developing world, however, has been slow to embrace the proposal that disputes between two nations be resolved by an international authority.[83] Latin America's response to proposals for international dispute resolution has not been warm and is deeply rooted in the Calvo doctrine.[84] The Calvo doctrine has two main themes: (1) strict nonintervention by foreign powers in what is held to be the responsibility of the host country to adjudicate rights concerning resources within their borders and compensation for expropriation; and (2) absolute subjection of foreigners to the laws and juridical regimes of the host countries.[85] The Calvo doctrine has been embraced throughout Latin America.[86]

Latin America's attempts to legislate the Calvo doctrine globally met with success in the United Nations' endorsement of the Charter of Economic Rights and Duties of States (CERDS).[87] Article 2 of the Charter substantially restated Calvo. Paragraph One of the Article

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[79] Rogers, *Of Missionaries, Fanatics, and Lawyers: Some Thoughts on Investment Disputes in the Americas,* 72 AM. J. INT'L L. 1–2 (1978).

[80] Ganz, *The Marcona Settlement: New Forms of Negotiation and Compensation for Nationalized Property,* 71 AM. J. INT'L L. 474 n.2 (1977).

[81] Rogers, *supra* note, 79 at 2.

[82] *Id.*

[83] *Id.*

[84] For a general discussion of the Calvo Doctrine *see* Szasz, *The Investment Disputes Convention and Latin America,* 11 VA. J. INT'L L., 256, 260–62 (1971).

[85] Rogers, *supra* note 79, at 3.

[86] Szasz, *supra* note 84, at 261 n. 24. Calvo clauses appear in a variety of Latin American constitutions and conventions. *See, e.g.,* VENEZ. CONST. art. XXI para. 1 (1947): Aliens in Venezuela have, without prejudice to what is provided in international conventions, the duties and rights that this Constitution and the laws grant to them; but neither the one nor the other may be greater than those of Venezuelans. The foreigner, in essence, is bound by local rule, even if that rule is a violation of international law.

[87] Charter of Economic Rights and Duties of States, G.A. Res. 3281, 29 U.N. GAOR Supp. (No. 31) at 50, U.N. Doc. A/9631 (1974).

provided that each state shall freely exercise full sovereignty over all its wealth, natural resources, and economic activities.[88] Even more Calvo-like are paragraphs 2(2)(a) and 2(2)(c). Paragraph 2(2)(a) stated: "[Each state has the right to] regulate and exercise authority over foreign investment within its national jurisdiction in accordance with its laws and regulations and in conformity with its national objectives and priorities. No state shall be compelled to grant preferential treatment to foreign investment."[89]

Paragraph 2(2)(c) recognizes the right of states to "nationalize, expropriate or transfer ownership of foreign property."[90] Compensation for property taken is to be determined under the standard of the nationalizing state.[91] Furthermore, any controversy over compensation is to be settled in the courts of the nationalizing state under the state's domestic laws.[92]

The main problem with the Charter was that it ignored international law's role in resolving disputes.[93] Nothing in the Charter would constrain a state from adopting an arbitrary standard for compensation, or discourage biased administration of compensation laws by local courts.[94] But these reservations failed to persuade the developing nations which overwhelmingly supported the Charter.[95]

CERDS is in stark contrast to the traditional rule of international law which recognizes the rights of sovereign nations to expropriate property for a public purpose only upon prompt, adequate, and effective compensation.[96] The traditional rule was restated in 1962 in the United Nations General Assembly Resolution 1803.[97] Doubts about the general acceptance of the traditional rule,

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[88] *Id.* at 52.

[89] *Id.*

[90] *Id.*

[91] *Id.*

[92] *Id.*

[93] Rogers, *supra* note 79, at 6.

[94] *Id.*

[95] *Id.*, The vote was 124 to 6 with 10 abstentions. The "no" votes were all cast by capital exporters — U.S., Belgium, Denmark, Germany, Luxembourg, and the U.K.

[96] Restatement (second) of Foreign Relations Law of the United States (1965). For a good analysis of CERDS in the context of the general assault on foreign protection, see Lillich, *The Diplomatic Protection of Nationals Abroad; an Elementary Principle of International Law Under Attack*, 69 AM. J. INT'L L 359 (1975).

[97] G.A. Res. 1803 (xvii), 17 U.N. GAOR Supp. (No.17) at 15, U.N. Doc. A/5217 (1962). The Resolution states in part: In such cases [expropriation] the owner shall be paid an appropriate compensation, in accordance with the rules in force in the state taking such measures in the exercise of its sovereignty and in accordance with international law. . . . settlement of the dispute should be made through arbitration or international adjudication.

however, arose soon thereafter when, in 1963 the U.S. Supreme Court stated "[t]here are few if any issues in international law today on which opinion seems to be so divided as the limitations on a state's power to expropriate property of aliens."[98] This division of opinion stems in part from the fact that many developing countries believe that the traditional rules of international law were not formulated with their consent and therefore they are not bound by them.[99] According to the traditional view, a state may not impose the same standards on aliens that it imposes on nationals if such treatment would fall below the internationally accepted minimum standard.[100]

This view is not shared by those countries that subscribe to the Calvo doctrine.[101] National control of the economy is considered a sovereign right. Requiring adherence to a minimum standard of protection for aliens infringes on the state's regulation of its own economy.[102]

The Charter's rejection of both the obligation to compensate and the rules providing a minimum standard of protection for aliens is a resounding rejection of the traditional rule. Though *The Third Restatement of Foreign Relations Law of the United States* (the "Restatement") substantially restates the traditional principles of international law on expropriation,[103] the Comments point out that the "prompt, adequate, and effective" standard is a U.S. position.[104] The Reporters declare that the principles of full compensation were settled law "[e]arly in this century" implying they are not settled law today.[105] The Reporters favor the traditional rule but admit the evidence is not conclusive.

> There have been numerous settlements by aliens or their governments with expropriating states, but these do not provide persuasive evidence as to what the parties to the settlement

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[98] Banco Nacional de Cuba v. Sabbatino, 376 U.S. 398, 428–29 (1964). This case dealt with Cuban expropriation of an American commodity broker's assets in Cuba. The Court reversed the lower court decision and held that the act of state doctrine proscribes a challenge to the validity of the Cuban expropriation.

[99] *Id.* at 430.

[100] B. Wortley, Expropriation in Public International Law, 117 (1959).

[101] Among the countries that subscribe to the Calvo doctrine are Brazil, Argentina, and Mexico.

[102] Wortley, *supra* note 100, at 126–28.

[103] Rest. 3rd, Restatement of the Foreign Relations Law of the United States Sec. 712, 713 hereinafter, Restatement.

[104] Restatement Sec. 712 comment c.

[105] Restatement Sec. 712, Reporters' note 1.

> believed the relevant law to be. Such settlements are often made for political or larger economic reasons, and it is uncertain whether the expropriating state is paying with a sense of international legal obligation to compensate . . . .[106]

There are thus two conflicting views of international law concerning a state's responsibility for injury to aliens. The question of which rule prevails is unresolved.

The Charter received the assent of the developing nations but not that of the developed countries. Because so many developing countries have rejected the traditional rule, it arguably is no longer a settled principle of international law. This disagreement among states has resulted in a situation where there is "no international law regarding compensation for expropriation."[107]

V. Mexico: A Model for Foreign Investment

In this atmosphere of uncertainty as to foreign investors' rights and remedies, the host country governments and investors must work together to facilitate debt-equity swaps. An established program is needed which will address the desire for direct investment to offset the debt and at the same time recognize the need to maintain control over economic development. If the investment is perceived as too great, the host country may be forced to expropriate for nationalistic and political reasons. The best approach is to establish a legal and regulatory framework that will promote foreign direct investment through swaps without threatening the integrity of the host country. The Mexican National Development Plan (NDP), presented by President de la Madrid on May 31, 1983, is such an approach.[108]

The NDP is a 430 page document containing the political and economic policies that govern the Mexican state in very detailed form.[109] With the support of NDP guidelines, the Executive Secre-

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[106] *Id.*

[107] Note, *Creating a Framework for the Re-Introduction of International Law to Controversies Over Compensation for Expropriation of Foreign Investments*, 9 Syr. J. Int'l L. & Com., 163, 174 (1982).

[108] Trevino, *Mexico: The Present Status of Legislation and Government Policies on Direct Foreign Investments*, 18 Int'l Law. 297, 301 (1984).

[109] The investment provisions of the NDP may be summarized as follows:

(A) Foreign investment will be treated as complementary to Mexican investment.

(B) Foreign capital will not be permitted to acquire efficient, already established companies or dominate priority branches of industry.

(C) Foreign investment acquisitions or majority participation in already established Mexican

tary of the National Commission on Foreign Investment (NCFI) has made various policy statements to the effect that foreign investments may be a factor in solving Mexico's economic crisis.[110] Nevertheless, Mexico is not willing to receive foreign investment in an indiscriminate manner.[111]

The Law on Foreign Investment (LFI) controls the extent to which foreign investors may participate in certain Mexican investment opportunities.[112] For example, 34% of special mining concessions, 49% of ordinary mining concessions, and 40% of secondary petrochemical operations and autoparts manufacturing, are the maximum percentages of foreign investment allowed in those respective areas.[113] For other economic areas, 49% is the general rule, though the NCFI has the power to approve applications for majority ownership on a case-by-case basis if it deems the investment to be in the interest of the Mexican economy.[114]

In accordance with the LFI, the NCFI determines whether the foreign investment is acceptable for the country, and the requirements that must be fulfilled.[115] To meet these requirements the investment should be complementary to Mexican investment, oriented to the priority sectors, able to generate new sources of employment, able to make an adequate technological contribution, and an effective form of import substitution.[116]

Debt-equity swaps are approved on a case-by-case basis by the Mexican Finance Ministry (Hacienda) in conjunction with the

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companies may be authorized in exceptional cases where there is a significant contribution in technology, trade balance, or increased Mexican content in product manufacturing.
(D) The following criteria will be adopted and sought in selectively promoting and screening foreign investments:

1. effective substitution of imports;
2. a good or even better balance of payments;
3. international competitiveness of goods produced; and
4. actual transfer of modern technology and managerial abilities.

(E) The administrative process for authorization of investment will be streamlined.
(F) A more flexible treatment of small and medium sized foreign investors will be established to allow their capital contributions to flow more easily to the agricultural and consumer goods sectors. Trevino, *supra* note 98, at 300.

[110] *Id.* at 301.

[111] *Id.*

[112] *Id.* Its complete title is the "Law to Promote Mexican Investment and Regulate Foreign Investment" of Feb. 16, 1973, in force since May 8, 1973.

[113] *Id.*

[114] French, *supra* note 36, at 168; Maviglia, *Mexico's Guidelines for Foreign Investment: The Selective Promotion of Necessary Industries*, 80 AM. J. INT'L L. 281, 292 (1986).

[115] Trevino, *supra* note 108, at 301.

[116] *Id.*

NCFI.[117] The Mexican government usually redeems debts at less than face value.[118] The size of the discount depends on the type of investment applied for and can vary from 0% for participation in state enterprises, and 25% for projects that do not generate foreign exchange and are not a priority.[119]

Having an investment scheme that protects the country from too much foreign investment is a step in the right direction. If the restrictions are tight enough, foreign investment that does come in will probably not be a threat or act as a catalyst in ousting the sitting government.

An example of a foreign investment scheme that has met with great success is the Maquiladora program.[120] Typically, a Maquiladora exports raw materials and equipment to a Mexican assembly operation, which assembles or processes these materials and then reimports the finished product to the U.S. for sale.[121] Mexico benefits from the maquiladora industry in a number of ways. The industry provides training and employment in economically depressed border areas. Export earnings are increased and technology transfer is accomplished.[122] In July, 1986, 896 plants were operating, employing an estimated 255,000 Mexicans.[123]

An investment scheme that protects the host from an overabundance of foreign investment is but one factor in the success of a swap program. The concept of additionality is the other key. If no additional investment comes into a country through a swap program, then the program is a failure. Private investors invest to make profits and not for reasons of benevolence. Thus, if they make profits they expect to keep them; if they acquire property they expect to keep it. A major deterrent to the flow of investment, especially in Latin America, has been the threat of expropriation. The investor must receive assurance that his investment is safe; an investment scheme alone is usually not enough.

A foreign investment program such as Mexico's assures the Mexican people that foreign investment will proceed in concert with

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[117] Buchheit, *supra* note 42, at 13.

[118] Ollard, *supra* note 26, at 69.

[119] This method helps the government steer the investment in the direction it wants.

[120] Tarbox, *An Investor's Introduction to Mexico's Maquiladora Program*, 22 TEX. INT'L L. J. 109, 110 (1986). Generally this term refers to an offshore assembly operation involved in export-manufacturing processing, for example auto-parts.

[121] *Id.*

[122] *Id.*

[123] *Id.*

the development goals of the country. However, investment guidelines such as Mexico's may not persuade foreign investors to come forward without additional guarantees. The specter of expropriation still deters potential investors. The presence of a final ingredient, a multilateral guarantee agency, is important to debt-equity swap planning.

VI. Toward Attracting Additionality: The Role of MIGA

One plan that will protect foreign investors will probably begin early next year under the auspices of the World Bank.[124] Called the Multilateral Investment Guarantee Agency (MIGA), it will become effective as soon as five more developed countries ratify its convention.[125]

MIGA is an international and broader variant of systems that exist in most developed countries for providing political risk insurance. It goes further than many national plans that deny coverage to host countries that have to reschedule their debt, or the Overseas Private Investment Corporation (OPIC) which often fails to match investor needs.[126] Investment guarantees extended by home countries or agencies to their nationals reinforce the traditional perception that investment protection serves only the interest of the home country. As an international institution, MIGA can plausibly be concerned with the interests of both home and host countries. MIGA's role is to minimize perceived non-commercial risk as a barrier to the flow of capital to developing countries.[127] The ultimate objective is to facilitate consideration of investments in developing countries on the same footing as investments in developed countries.[128] For example, MIGA will not just insure against expropriation, but also against "creeping expropriation."[129] MIGA defines creeping expropriation as a series of host country measures that in aggregate are expropriatory, like a combination of new taxes, and state-led wage increases that would make a project unprofitable.[130]

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[124] Voss, *supra* note 9, at 6.

[125] Lewis, *New Plan Aims to Lessen Political Risk in Lending*, INT'L HERALD TRIBUNE, Sept. 28, 1987, at 8, col. 5.

[126] Voss, *supra* note 9, at 13 n.33.

[127] *Id.* at 8.

[128] *Id.*

[129] Lewis, *supra* note 125, at 8.

[130] OPIC, for one, does not insure against "creeping expropriation." Shanks, *Insuring Investments and Loans Against Currency Inconvertability, Expropriation, and Political Violence*, 9 HASTINGS INT'L & COM. L. REV. 417, 425 (1986).

MIGA's coverage will be limited to new investments.[131] This limitation preserves MIGA's underwriting capacity for investments that might not proceed without guarantee protection.[132] Thus, MIGA is specifically geared to produce additionality in direct foreign investment.

MIGA should be especially attractive to those Latin American countries, such as Calvo supporters, that regard international arbitration as an impermissible external interference in their internal affairs. In the event of a dispute MIGA could invoke the rights of the investors against the host country by subrogation, and has indicated openness to alternative dispute settlement procedures.[133] Unfortunately, as of June, 1987, Chile and Columbia are the only large Latin American countries to have signed the MIGA convention.[134]

MIGA alone is not the answer to attracting the additional investment needed to make a swap program successful. However, with the use of MIGA in conjunction with a comprehensive foreign investment policy such as Mexico's, host countries could begin encouraging debt-equity swaps in larger numbers.

VII. Conclusion

Debt-equity swaps are no panacea to the international debt crisis. They have many drawbacks and their modest size will never have a large impact on the overall debt picture. However, swaps are a market mechanism that is here to stay. Banks perceive them as a valid way to reduce some of their value impaired assets. Developing countries see them as an avenue for bringing in direct investment which will contribute to additional foreign exchange earnings.

Investors and host countries must work together to make the most of the swaps' limited use. The host country must recognize that additionality is an important factor for any swap program to make sense. It must balance this desire against the equally strong desire to remain independent from foreign economic control. An investment program similar to Mexico's will allay opposition group fears and will reduce the likelihood of expropriation of foreign owned property.

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[131] Voss, *supra* note 9, at 11.
[132] *Id.* at 11.
[133] *Id.* at 16.
[134] *Id.* at 6 n.4.

Investors will perceive strong investment policies as a positive factor but will require further assurances to commit amounts that make swaps worthwhile for host countries. MIGA can play an important role in allaying investors' fears by providing insurance against expropriation. Therefore, it is in the developing countries' best interest to become a member of MIGA. Their traditional dislike for multilateral agencies that require international arbitration is not necessarily part of MIGA which is open to alternative forms of dispute resolution. There is no rational reason to reject its convention.

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