The International Lawyer

Summer 1989 • Volume 23 • Number 2

A Quarterly Publication of the Section of International Law and Practice/ABA

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Brazil's Debt to Equity Swap Program**

On February 1, 1988, the Central Bank of Brazil (BACEN) enacted Resolution 1.460.[1] Resolution 1.460 establishes a scenario conducive to conversion of debt into foreign capital investments in Brazil through the adoption of liberal regulations.[2] The main purposes of Resolution 1.460 were to encourage new foreign investments in Brazil and at the same time, reduce the burden of the country's foreign currency denominated debt in the overall performance of the Brazilian economy.

Brazilian residents, acting through foreign subsidiaries, and multinational corporations are likely to take most advantage from the new rules. Original lenders probably will not participate in the process as investors in the early phases of the project. Many of these original lenders, in fact, are renegotiating their Brazilian foreign debt holdings in order to reduce their exposure to the current Brazilian economic and financial crisis. Furthermore, home country

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The author is grateful for the valuable comments of Messrs. Donald T. Fox, G. Hallett Denton, W. Wilder Knight III, and Ms. Linda S. Foreman, and for the research assistance of Mr. Eduardo Braga Tavares Paes.

**The Editorial Reviewer for this article was Linda S. Foreman.

1. Rules and Regulations for the Conversion of Debt into Equity—Rio Stock Exchange—April 1988. A resolution is a regulatory administrative act from a high official of the Executive Branch of the Brazilian Government consisting of an order or command to subordinates on how to apply a specific legal rule contained in a statute. The content of the resolution must stay within the scope of the statute to which it refers.

2. Despite the new regulations, a request for conversion filed with BACEN prior to July 20, 1987, still would be governed by BACEN Circular Letter 1.125 (Nov. 9, 1984). The request had to be confirmed by April 16, 1988, so as to allow BACEN to evaluate the request by May 1, 1988. Funds would be released based on the chronological order of presentation of the conversion requests and would be subject to a monthly ceiling. Resolution 1.460, art. 20, *as modified by* BACEN Resolution 1.466 (Mar. 1, 1988). BACEN/International Affairs Area—Foreign Investments in Brazil—Legislation (Firce).

statutes and regulations may make it unattractive for foreign banks to hold equity investments abroad (i.e., the limitations imposed by the U.S. Bank Holding Company Act; also, U.K. banks must count equity investments one for one against capital). As the Brazilian conversion plan succeeds, however, banks may start swapping their debt into equity as an alternative way of recouping their credits. The Brazilian conversion plan may give banks the possibility of a higher yield through remittance of dividends as well as an earlier payment of their credits through their sale abroad or a future remittance of principal. Banks also may benefit indirectly from debt conversions in the event of a future restructuring of the Brazilian foreign debt, as did the commercial bank creditors that converted part of their credits into equity investments up to the base date of March 31, 1987. Banks will be able to reduce their base figures accordingly for purposes of their participation with 11.4 percent of specified Brazilian foreign debt as called for by the agreement for restructuring approximately U.S. $61 billion of Brazil's medium- and long-term foreign currency debt among Brazil and its commercial bank creditors (the Refinancing Agreement), first announced on June 22, 1988.[3]

This article discusses the regulations applicable to debt to equity conversions in Brazil. It first discusses some relevant provisions regulating foreign investments in Brazil and then analyzes the structure of Resolution 1.460. Finally, this article briefly touches on some aspects of the debt to equity conversion programs of other countries in Latin America and demonstrates that Brazil's new debt to equity swap program is one of the most advanced in the region.

I. Previous Experience

Brazil has used the debt to equity conversion process since 1975 with varying degrees of success. At the end of the last decade, foreign investors rarely used the mechanism of debt conversion to invest in Brazil. During 1981 only U.S. $1.8 million worth of debt was converted in Brazil. Interest in debt conversions surged, however, after the 1982 debt crisis. Due to Brazil's inability to repay the principal of its foreign currency denominated debt, foreign investors and lenders thought it best to make use of the then-existing favorable debt conversion regulations to recoup their investments in whole or in part. Foreign investors swapped their credits at a discount, but registered the proceeds from the conversion with BACEN based on the entire value converted. Furthermore, a credit of 10 percent of the amount swapped was offered the foreign investors.

3. The framework established by Resolution 1.460 is complemented by subsequent regulations issued by BACEN and by the Refinancing Agreement. The Refinancing Agreement provides, among other things, for the possibility of investments in new money bonds in the amount of up to U.S. $1 billion, which may be converted into equity under the rules of Resolution 1.460. Eligible creditor banks will be entitled to convert part of their commitment to equity investments at face value; no discount will be applied and investors need not go through the auction procedure. There will be a limit of U.S. $50 million per month for a period of three years. Such period will start to run twelve months after the number of creditors necessary for the Refinancing Agreement to become effective is reached.

Consequently, debt conversions increased to U.S. $745.6 million in 1984. Debt conversion dropped off shortly thereafter, however, when the Brazilian Government revised certain of the more favorable provisions regulating debt conversion.

Informal debt to equity conversions have long been made in Brazil, with most cases involving unmatured debt not deposited with BACEN. For instance, a foreign creditor would assign its credit to its Brazilian subsidiary, local companies, or subsidiaries of multinational companies. At the maturity date, the Brazilian borrower would liquidate its obligation in local currency with the new creditor. The original foreign investor would recoup part of its investments upon receipt from the assignee company of hard currency from a foreign account, although at a discount. The foreign investor might also profit by means of dividend remittances or the sale abroad of the whole subsidiary. Informal conversions were not abolished by Resolution 1.460.

II. Basic Regulatory Aspects of Foreign Investments in Brazil

Foreign capital investments in Brazil are regulated primarily by Law No. 4.131, dated September 3, 1962. Pursuant to Law 4.131, the term "foreign capital" includes (i) money, machines, and equipment directed to the production of goods or services brought into Brazil without any initial expenditure in foreign currency on the part of the individual or entity receiving such equipments and (ii) financial or monetary resources (including credit rights) brought into the country to be used in economic activities. In both cases, the foreign capital must belong to individuals or legal entities residing, domiciled, or headquartered abroad.[4]

Foreign capital investment must be registered with BACEN within thirty days of its entry into Brazil for purposes of repatriation. BACEN then issues a corresponding certificate of registration.[5] Registration of the foreign capital will be effected in the currency of the country where the investment originates. In case of reinvestment of profits, the registration will be simultaneously in Brazilian currency and in the currency of the country where the profits would have been remitted.[6]

A. Profit and Dividend Remittance

Profits and dividends yielded by a foreign capital investment that has been registered with BACEN may be freely remitted to the investor abroad.[7] Profits must be evidenced in a balance sheet, prepared in accordance with applicable

4. Law 4.131, art. 1. BACEN/International Affairs Area—Foreign Investments in Brazil—Legislation (Firce); Brazilian Capital Markets Legislation—Comissao de Valores Mobiliarios—1987, at 7.

5. *Id.* arts. 3 and 5.

6. *Id.* art. 4. The amount of profits in Brazilian currency will be converted into foreign currency at the average rate of exchange in effect at the time of the reinvestment.

7. In the event of a serious imbalance in the balance of payments or if such an imbalance is imminently foreseeable, foreign capital remittances may be restricted. Law 4.131, art. 28.

regulations and generally accepted accounting principles, and their distribution must be based on the decision of the appropriate administrative body.[8] Remittance of profits, however, may be restricted, as in the case of profits generated by investments made in companies producing goods or rendering services deemed superfluous.[9] In such cases, remittance may not exceed 8 percent of the registered foreign capital in each fiscal year.

Brazilian tax law acts as the sole deterrent to unlimited remittance of profits abroad by imposing different withholding rates on such remittances. The basic withholding rate is 25 percent of the amount being remitted if the average amount of all remittances made in a period of three consecutive years has not exceeded 12 percent per year of the registered foreign capital, including actual reinvestments.[10] If, however, the country to which profits or dividends are being remitted has entered into an agreement with Brazil to avoid double taxation, the applicable withholding rate will be the one stipulated to in the agreement (usually between 10 percent and 15 percent).[11]

When the amount being remitted increases to more than 12 percent of the registered foreign capital, a supplementary income tax will be levied. If the remittance amounts to more than 12 percent but less than 15 percent of the registered foreign capital, the tax rate jumps to 40 percent of the amount being remitted. If the remittance amounts to 15 percent to 25 percent of the registered foreign capital, the tax rate increases to 50 percent. The highest rate, 60 percent, is applicable to remittances exceeding 25 percent of the registered foreign capital.[12]

BACEN Resolution No. 1.289, of March 20, 1987, partially modified this tax withholding structure. It introduced new mechanisms for investments in the

8. BACEN Circular Letter No. 298, art. 6(a) (Dec. 29, 1978). A circular letter is an administrative act that disciplines the conduct of public servants and the Administration in general and is intended to express the Administration's position on a specific subject. BACEN/International Affairs Area—Foreign Investments in Brazil—Legislation (Firce).

9. Decree No. 55,762, art. 11 (Feb. 12, 1965). Goods and services of superfluous consumption are defined by Executive decree, after the advice of the National Economic Council. BACEN/International Affairs Area—Foreign Investments in Brazil—Legislation (Firce).

10. Law 4390, art. 2 (Aug. 29, 1964); Decree 85.450 (Dec. 4, 1980).

11. Brazil has entered into special treaties with many countries in order to avoid double taxation. The rate applicable to remittance of profits and dividends generally is 15 percent, as in the case of the treaties with Austria and Portugal Convention on Double Taxation and Income, May 24, 1975, Brazil-Austria, Decree 78.107 (July 22, 1976), regulated by Portaria 470/76 (Brazil); Convention on Double Taxation and Income, Apr. 22, 1971, Brazil-Austria, Decree 69.393 (Oct. 21, 1971), together with Portaria 181/73, (Brazil), 834 U.N.T.S. 3, respectively. Such rates may go as low as 10 percent (Agreement on Double Taxation on Income and Capital, June 27, 1975, Brazil-West Germany, Decree 76.988 (Jan. 6, 1976), regulated by Portaria 43/76 (Brazil), 1016 U.N.T.S. 1873) and as high as 25 percent (Convention on Double Taxation of Income, Feb. 16, 1972, Brazil-Finland, Decree 73.496 (Jan. 17, 1974), promulgated by Portaria 223/74 (Brazil) 923 U.N.T.S.).

12. Law 4.131, art. 43, *as modified by* Executive Act 2.073, (Dec. 20, 1983) and regulated by SRF Normative Instruction 134 (Dec. 13, 1984). The SRF corresponds to the United States Internal Revenue Service.

Brazilian securities market, and specifically in the Investment Fund—Foreign Capital (the Investment Funds).[13] Pursuant to Resolution 1.289, revenues, dividends, and bonuses generated by such investments and distributed to quotaholders (or shareholders) who are resident, domiciled, or with head offices abroad would be subject to withholding tax at the general flat rate of 15 percent.[14]

B. Capital Repatriation

As a general rule, there is no limit on the repatriation of foreign capital invested in Brazil, which has been duly registered with BACEN, including reinvestments of profits generated by such capital. Remittance abroad of amounts exceeding the total investment registered with BACEN depends on prior approval by BACEN and the payment of the applicable taxes. If BACEN approves such remittance, it will issue a certificate of authorization to the investor.

III. Structure of Resolution 1.460

The provisions of Resolution 1.460 substantially liberalize the structure of debt to equity conversion in Brazil. Article 1 expressly provides for the conversion of assigned credits.[15] This provision permits investments by nonfinancial institutions, with the direct effect being to allow a larger number of investors to take advantage of the debt to equity conversion program as a means to invest in Brazil. Resolution 1.460 also makes it possible to convert both principal and interest.[16] Although not specifically stated, the interest to be converted includes, but is not limited to, the interest accrued during the period of the moratorium declared by the Brazilian Government in February 1987.[17]

Resolution 1.460 further stipulates that neither the original creditor nor the assignee of a credit is required to advance or invest new money simultaneously

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13. The Investment Funds are a special kind of legal entity with an authorized capital divided in quotas (or shares) and incorporated with the purpose of investing in the Brazilian securities market. Quotaholders of the Investment Funds must be individuals or legal entities resident, domiciled, or with head offices outside of Brazil. The incorporation of an Investment Fund depends on prior approval of the Brazilian Securities and Exchange Commission-CVM (ch. I, arts. 1 and 2 of the Regulation attached as Exhibit I to Res. 1.289). BACEN/International Affairs Area—Foreign Investments in Brazil—Legislation (Firce); Brazilian Capital Markets Legislation—Comissao de Valores Mobiliarios—1987, at 136.

14. Article 40 of the regulation attached as Exhibit I to Res. 1.289. Article 42 of Exhibit I provides for a decrease in the withholding income tax rate according to the length of time the investment is kept in Brazil, as follows:

- more than six and up to seven years, 12 percent;
- more than seven and up to eight years, 10 percent; and
- more than eight years, 8 percent.

15. Resolution 1.460, art. 1, sole paragraph.

16. *Id.* art 1.

17. The effect of such provision is to transform the moratorium into a default.

with the conversion of their credit (matching funds). This is in stark contrast to other countries' conversion programs, such as that enacted in Argentina.[18]

Resolution 1.460 also includes a number of restrictive provisions. First, investments resulting from the conversion process may not be repatriated for a minimum period of twelve years from the date of entry of the capital into Brazil.[19] Any capital repatriation by legal entities with existing foreign capital participation and making use of the debt conversion program will require a prior deposit with BACEN of an amount equal to the investment resulting from such debt conversion. Dividends, however, may be freely remitted, subject to the usual withholding taxes.[20] Second, investments resulting from the converted funds may not result in the transfer of control of Brazilian corporations to individuals or legal entities domiciled abroad.[21] Third, a conversion will not be allowed if the potential investor or person with whom such investor has a control relationship[22] has effected remittances abroad, by means of capital return or gains, during thirty-six months preceding the date of submission of application for conversion, unless a corresponding amount is reinvested in the country.[23] Finally, Resolution 1.460 prohibits conversion of funds when the investor is guaranteed a fixed return or repayment of the investment. As a result investment of converted funds in treasury bonds and other risk-free investments is not allowed.[24]

Depending on whether the debt being converted is considered a private or public debt,[25] Resolution 1.460 makes it possible to convert foreign credits covered by Brazilian foreign debt restructuring agreements into investments in

18. As in Brazil, the structure for the conversion of the public external debt of Argentina, regulated by Communicate "A" 1109 of the Central Bank of the Republic of Argentina, provided that a program of investment of the funds to be converted had to be previously approved by the competent authorities. In contrast with the Brazilian program, the Argentinian regulations provided that the proceeds from the conversion of debt into equity would cover a maximum of 70 percent of the total cost of the approved project, except in the case of foreign equipments. The interested investor would then provide matching funds equaling a minimum of 30 percent of the total cost of the project.

19. Resolution 1.460, art. 12.

20. *Id.* arts. 13 and 14.

21. *Id.* art. 16.

22. Persons with decision-making control over the investor, or controlled by the investor in the same way.

23. Resolution 1.460, art. 17 and sole paragraph.

24. *Id.* art. 15.

25. As defined by *id.* art. 5, public sector debt is the indebtedness registered with BACEN in the name of the following public sector entities:

(a) the Federal, State and Municipal Governments (political subdivisions of Brazil)
(b) the Federal Territories (a political subdivision of Brazil)
(c) the Federal District (capital of the country and also a political subdivision of Brazil)
(d) the respective Agencies (Autarquias) of (a), (b) and (c) above, Public Companies, Mixed Capital Companies, Foundations, and companies controlled directly or indirectly by such entities.

Conversely, private sector debt is the indebtedness registered with BACEN in the name of legal entities not listed above. Resolution 1.460, art. 7.

the private and public sectors of the Brazilian economy. Medium- and long-term foreign debt registered with BACEN in the name of public sector entities may be converted only into public sector investments. On the other hand, private sector liabilities registered with BACEN may be converted into investments in the private sector, the public sector, or in investment funds specifically devised to receive funds originating from conversion of foreign debt. Under Resolution 1.460, the following debts are eligible from conversion: (1) Compulsory U.S. dollar deposits with BACEN made under ''Deposit Facility Agreements'' (DFAs) entered into by nonresident creditor banks.[26] The amount paid by the borrowers still must be deposited in one of the special accounts with BACEN either by virtue of one of the provisions in the DFAs or a unilateral decision of the Brazilian authorities blocking the release of otherwise freely remittable funds (i.e., the 1987 moratorium); (2) Debt represented by voluntary deposits with BACEN made pursuant to BACEN Resolutions 230 and 432 (currency hedging); and (3) Loan agreements yet to mature.[27]

A. Private Sector Debt

1. *Compulsory Deposits with BACEN*

The following rules apply to the conversion of matured liabilities deposited with BACEN into investments in the private sector:

(a) Before the auction: Investors interested in converting foreign currency denominated credits into new cruzados must participate, through a Brazilian brokerage house, in auctions organized by BACEN that will take place in one of the stock exchanges in Brazil.[28] The auctions will involve a total of approximately U.S. $25 billion of overdue foreign debt already deposited at BACEN. BACEN will periodically set ceilings on the amount of foreign currency being converted.[29] The ceiling will be divided into two special

26. According to the structure of the rescheduling of Brazilian foreign debt, amounts owed by Brazilian borrowers to foreign creditors must be paid to BACEN in new cruzados at the official rate of exchange in effect at the date of deposit. The borrower will be discharged from its obligation upon deposit of such amount with BACEN. The actual payment to foreign creditors will be made by BACEN out of the country's reserves. This scheme allows interesting situations to occur, such as the case when the private sector is financially healthy and capable of meeting its foreign currency denominated obligations, which are not paid to the foreign creditors as a result of the near bankrupt state of the country's public sector. This system of foreign debt restructuring is not common in other Latin American countries.

27. Resolution 1.460, art. 1.

28. *Id.* art. 2; BACEN Circular 1.302, # 2 (Mar. 18, 1988); Agreement among BACEN, Rio de Janeiro Stock Exchange, Sao Paulo Stock Exchange and Comissao de Valores Mobiliarios (SEC) (Mar. 18, 1988). Rules and Regulations for the Conversion of Debt into Equity—Rio Stock Exchange, April 1988.

29. Resolution 1.460, art. 2, § 1. This ceiling has been widely criticized. BACEN officials justify the ceiling as necessary to control the impact on the parallel and official foreign exchange rates and to prevent sweeping inflationary consequences. This reasoning, however, is inappropriate for direct investment of cruzados in the Brazilian securities market, since these transactions are merely

categories: 50 percent of the ceiling must be directed to investments in areas considered less developed in Brazil, identified by Resolution 1.460 as the North, the Northeast, the State of Espirito Santo, and the region known as Vale do Jequitinhonha.[30] The other 50 percent of the ceiling may either be directed to any other area in Brazil not included in the above list, or, at the investor's discretion, be invested fully in the less developed areas mentioned above.[31]

(b) During the auction: The right to convert credits into cruzados will be awarded to the investor offering the best bid, i.e., the investor who accepts the fewest new cruzados per dollar.[32] For example, if two creditors each bid a credit of U.S. $100 million, the creditor who accepts the new cruzado equivalent to U.S. $60 million will be awarded the right to convert its credits ahead of the creditor who only accepts the new cruzado equivalent of U.S. $80 million. The certificate of registration issued by BACEN corresponding to the converted funds will reflect such discount.[33]

(c) After the auction: Within two banking days of the auction, winners of the auction or the beneficiaries of the investment must authorize BACEN to block the deposits being converted and deduct the applicable discount.[34] They must also provide BACEN, within ten banking days of the auction, with the documents necessary for it to examine the conversion request.[35] Failure to comply with these requirements will automatically disqualify the conversion request.[36]

In the event BACEN rejects either the conversion request itself (due to the existence of rules incompatible with the proposed project) or the area to which the investment is directed, necessary steps will be taken to unblock funds and cancel debited discounts.[37]

(d) Direction of investments: If BACEN does not oppose the proposed investment plan, the amounts to be converted must be invested either in new projects, in the expansion of existing enterprises, or in the Brazilian securities market through the subscription of shares or quotas of Conversion Funds—

paper for paper swaps. Any other investment, though, would put into circulation cruzados that were previously withdrawn from the market and would cause an inflationary surge.

30. *Id.* § 2.

31. *Id.* § 1.

32. Regulations attached to Circular 1.302, # I.

33. The discount applied will constitute a loss to the investor and a gain to Brazil, which will write off its foreign debt the face value of the credit converted.

34. Circular 1.302, # 6(a).

35. *Id.* # 6(b).

36. *Id.* # 7.

37. *Id.* # 8. The wording of Circular No. 1.302 allows the conclusion that the merit of the investment will not be subject to analysis by BACEN. The issues to be reviewed encompass solely the compatibility of the proposed project with the applicable regulations and the area to which the investment is being directed. BACEN may not reject an investment project based on the quality of the investment being made. However, a proposed investment plan may be rejected based on the concept of risky investment. Resolution 1.460, art. 15.

Foreign Capital (the Conversion Funds).[38] Conversion proceeds may not be used to purchase outstanding shares or quotas of such funds.[39] The Conversion Funds may not maintain more than 5 percent of the voting capital or 20 percent of the total capital of any one company listed in the Brazilian securities market. Furthermore, shares of a Conversion Fund must be nominative and their transfer will be subject to regulations to be issued by the Brazilian Securities and Exchange Commission (CVM). The Conversion Funds, however, provide the foreign creditor with an opportunity to recoup in whole or in part the discount to the face value of the credit converted by investing the converted funds in a professionally managed portfolio of securities that is bound to reflect the growth and development of the Brazilian economy.

2. *Voluntary Deposits with BACEN*

Conversions of funds represented by voluntary deposits with BACEN of private sector debt for investment in the private sector will not follow the auction procedure. Requests for conversion of private sector debt will be evaluated by BACEN in chronological order of presentation (queues) and subject to a ceiling to be fixed by BACEN.[40] Proceeds from the conversion may be directed to investments in general, in new or existing companies, or in the subscription or purchase of outstanding shares of quotas of Conversion Funds.[41]

3. *Unmatured Debt*

Unmatured private sector debt may be freely converted and invested in the private sector. Conversion of unmatured debt is not subject to the auction procedure, ceilings, or queues of requests. The converted funds may be invested

38. Resolution 1.460, arts. 7, 11. Similar to the Investment Funds, the Conversion Funds are a special kind of legal entity with an authorized capital divided in quotas (or shares) and incorporated with the purpose of investing in the Brazilian securities market. Quotaholders of the Conversion Funds also must be individuals or legal entities resident, domiciled, or with head offices outside of Brazil. As in the case of Investment Funds, the incorporation of a Conversion Fund depends on prior approval of the Brazilian Securities and Exchange Commission CVM.

The main difference between the two funds is the source of the capital being invested. Investments in the Conversion Funds must originate from the conversion of foreign currency denominated Brazilian private sector debt, while investments in the Investment Funds must be new investments; in other words, Investment Funds may only accept ''fresh'' or ''new'' money.

Although both the Investment Funds and the Conversion Funds share some characteristics, the former are subject to a more liberal set of regulations than the latter. For instance, the Investment Funds enjoy tax advantages not available to the Conversion Funds, which are subject to the fiscal rules of Law 4.131. Furthermore, the minimum term of permanency in Brazil of an investment (and capital gains) in the Investment Funds is ninety days, while an investor in the Conversion Funds will have to wait twelve years before being able to repatriate the investment.

39. *Id.* art. 4.

40. *Id.* art. 8. The discount to be applied to the conversion will be equal to the average discount of the previous auctions. It will constitute a gain to Brazil and a partial loss to the investor as far as repatriation of investment is concerned.

41. *Id.* arts. 7, 11.

in the same activities as the funds resulting from the conversion of voluntary deposits with BACEN.

For both voluntary deposits with BACEN of private sector debt and unmatured private sector debt, the foreign investor will be credited in new cruzados with the full amount of its holdings and the Brazilian company receiving the investment will write on its books the value corresponding to 100 percent of such investment. BACEN, however, will issue a certificate of registration reflecting the applicable discount for each transaction.[42] The balance will constitute "tainted capital" and may not be repatriated as foreign capital investment or remitted as profits.[43] The balance may, however, be capitalized by the recipient of the investment. Private sector debt also may be invested in the public sector in accordance with the rules applicable to conversion of public sector debt.[44]

B. Public Sector Debt

The Brazilian Government has a special interest in reducing the burden of its public sector debt. As such, public sector debt is subject to more liberal conversion rules, including the absence of auctions.[45] Funds deriving from conversion of public sector debt must, however, be invested in the public sector only. As in the case of both private sector debt voluntarily deposited with BACEN and private unmatured debt, new cruzados proceeds resulting from the conversion of public sector debt will correspond to the face value of the debt converted. The investor will be credited in new cruzados with 100 percent of its holdings. The certificate of registration corresponding to such investments will reflect the discount applied by BACEN to the face value of the debt converted. The discount will be determined according to the discounts applied in previous auctions.[46] The amount in cruzados corresponding to the discount applied by BACEN also will constitute tainted capital and may not be repatriated as foreign capital investment or dividends.[47] It may, however, be capitalized.

1. *Public Sector Borrowers—Political Subdivisions of Brazil*

If the borrower is a public sector entity,[48] the proceeds from the conversion must be invested in public sector entities.[49] Resolution 1.460 specifically provides that the proceeds of conversion of debt of one of the political subdivisions of Brazil[50] must be used to pay outstanding public sector foreign currency debt.[51]

42. *Id.* art. 10.
43. *Id.*; the sole paragraph refers to "national" capital.
44. *Id.* art. 7.
45. Instead, public sector debt conversion requests will be submitted directly to BACEN.
46. Resolution 1.460, art. 10.
47. *See supra* note 43.
48. *See supra* note 25.
49. Resolution 1.460, art. 5.
50. *See supra* note 25.
51. Resolution 1.460, art. 5 and sole paragraph.

2. *Voluntary Deposits with BACEN*

Conversion proceeds may be used to pay existing public sector foreign currency debt if the borrower is not a political subdivision of Brazil and if the debt subject to conversion has been voluntarily deposited by the borrower with BACEN. Debt voluntarily deposited with BACEN may be converted into another kind of investment in the public sector if the investor so prefers.[52] The request for conversion will be evaluated by BACEN in chronological order of presentation and a discount will be applied.[53] The converted funds may be invested in public sector companies and used at the discretion of the company receiving the investment.[54]

3. *Unmatured Debt*

Public sector debt may be converted into investments in public sector companies and used in any kind of investment if the borrower is not a political subdivision of Brazil and if the debt being converted has not been voluntarily deposited by the borrower with BACEN.[55]

All requests for conversion of foreign debt into public sector investments must have the prior approval of the State Companies Ministry (SEST) and the Treasury Ministry.[56] Once the request has been approved by SEST and BACEN, the amount in new cruzados corresponding to the face value of the debt will be released to the investor.

IV. Comparable Debt Conversion Programs

Brazil's new debt to equity swap program, undoubtedly, is one of the most advanced in Latin America. Brazilian authorities were able to observe debt conversion programs adopted by other Latin American countries and combine the best features of each of these programs in order to create a body of simple and straightforward rules that avoids certain of the problems experienced by these other countries.

For example, the Mexican conversion program, suspended in 1987, mandated negotiations between the prospective investor and the Mexican Government to determine the discount applicable to each conversion. Rather than working together, the parties to the negotiations (the prospective investor, the recipient of the investment, and government officials) often ended up on opposite sides of the

52. *Id.* art. 8.

53. The discount will be stipulated by BACEN according to the discounts applied in previous auctions. *Id.* art. 10.

54. *Id.* arts. 5, 8.

55. *Id.* art. 8.

56. At this time, the merit of the proposed plan of investment is bound to be evaluated, contrary to what happens with investment in the private sector.

table. Furthermore, the Mexican Finance Minister engaged in thorough analysis of each conversion request and could refuse to grant approval to projects considered inadequate to promote new investments. The high level of interference and discretion on the part of government officials led to situations in which an investment project was rejected or approved based on the criteria adopted by the government official in charge of reviewing that specific project.

The Brazilian program avoids both situations to a great extent. First, the prospective investor in the private sector will not have to negotiate with government officials to obtain approval of an investment project. Second, this same investor will have to deal with other prospective investors only when conversion occurs through the auction system. In nonauction conversion cases, the investor merely will submit its conversion request to BACEN officials, who have limited authority to review the request.[57]

The Brazilian debt to equity conversion program also differs from the guidelines for conversion of debt into equity in Chile regulated by Chapter XIX of the Central Bank of Chile Compendium of Rules on International Exchange. In contrast to private sector debt conversions in the Brazilian program (especially the auction procedure), investments regulated by Chapter XIX depend on prior approval of the Central Bank of Chile.[58] BACEN's discretionary analysis of conversion projects for investment in the public sector, however, is justified by the nature of the investments, where the appropriateness of an investment will depend on the Federal Government's specific policy on the area to which such investment is directed.

A key reason for the wide acceptance by foreign investors of the Brazilian conversion program is the absence of a provision requiring the foreign investor to invest new money in Brazil (matching funds) together with the converted funds. In many cases, the foreign investor is not willing to run a risk with new investments at full value in addition to the investment through the debt-

57. *See supra* note 37.

58. *Id.* Chapter XIX allows a foreign investor holder of specific Chilean foreign currency-denominated credit to transform such credit into pesos or peso-denominated obligations and invest such pesos in Chile. Remittance abroad of capital and profits is authorized, although subject to restrictions. Such restrictions range from the possibility of Chilean's Central Bank requiring that part of the investment be made in freely convertible foreign exchange to limitations on dividend remittance abroad. Under the Brazilian debt conversion program, remittance of dividends is still governed by the more liberal provisions of Law 4.131, outlined at the beginning of this article. The framework for the Chilean debt capitalization program also includes Chapter XVIII of Chile's Central Bank Compendium of Rules on International Exchange (Chapter XVIII) and Decree Law 600/74 (DL 600). Chapter XVIII allows the conversion of foreign currency-denominated Chilean debt into a peso-denominated obligation that need not be used for investment purposes and contains no provision for remittance abroad; no authorization from the Chilean Central Bank is necessary for the investment but, as in the auction system of the Brazilian program, there is a limitation on the amount to be converted. DL 600 contains provisions similar to those found in Chapter XIX, but with the additional restriction that investments may only be effected in the debtor's own capital.

conversion, which usually requires an actual foreign currency investment lower than the face value of the debt.

The absence of a requirement for matching funds in the text of Resolution 1.460 met with some criticism in Brazil. Critics asserted that the conversion plan would discourage new investments in Brazil in that investors would prefer to go through the conversion program rather than make new investments in the country. For this reason the critics advocated a provision requiring matching funds.

The Brazilian authorities, however, opted for keeping any requirement for matching funds out of Resolution 1.460. They had the opportunity to observe the low acceptance of the Argentinian debt conversion plan due, in great part, to the requirement that an investor contribute thirty dollars of new money for every seventy dollars converted.

Furthermore, Brazilian authorities already had ways of attracting new investors. Other legislation regulating "fresh" foreign investment in Brazil, such as Resolution 1.289, which regulates the Investment Funds, is much more liberal than Resolution 1.460 itself. A differentiated method of taxation, more beneficial to "fresh money" capital investments (such as reduced withholding tax rates), represents another benefit not available to investments through debt to equity conversions. In any case, the mere development of a market demand for conversion of discounted foreign currency-denominated Brazilian debt would create an environment conducive to potential foreign investors. Also, direct domestic investment on the part of the government and the recipient of such investments would naturally increase as a result of savings on such foreign currency debt payment and inflow of fresh capital or forgiveness of a debt, respectively.

V. Conclusion

A major cause of the current debt crisis being experienced by many Latin American debtor countries are the internal economic policies adopted by such countries during the past two decades.[59] Debtor countries have begun to alter these policies in an effort to regain economic and political stability. Their success will depend on how efficiently these new economic policies are carried out. A well devised and implemented economic policy "could play an important role in the long term process of shifting a broad range of the world's manufacturing activities to developing countries."[60]

Brazil has been striving to solve its debt problem or at least to ease the burden of its debt on the overall performance of its economy. Different policies have

59. A. KALETSKY, THE COST OF DEFAULT 59 (1985).
60. *Id.* IMF, WORLD ECONOMIC OUTLOOK, Apr. 1984, at 76.

been tried, but most of them proved insufficient to eliminate or reduce the debt problem. Resolution 1.460, however, is an exception to Brazil's prior failures to deal with its debt situation. Resolution 1.460 proved to be a valuable tool to both Brazil and its foreign creditors in intelligently and efficiently easing the debt burden while providing for new resources to finance the growth of the Brazilian economy.

The new debt conversion program brought about by Resolution 1.460 was first tested in March 1988, when investors snapped up the entire U.S. $150 million auctioned at the Rio de Janeiro Stock Exchange. The average discount for the U.S. $75 million to be directed to more indigent areas was 10.5 percent. The remaining U.S. $75 million was auctioned with a 27 percent average discount.[61]

Several auctions have taken place in various stock exchanges in Brazil since March 1988. Nonauction conversions have been used largely by foreign investors and even the volume of informal conversions surged during the year. An aggregate of approximately $6 billion was written off from the Brazilian foreign debt through the debt conversion process during 1988 alone.[62]

The entire Brazilian debt to equity conversion program, however, has not been fully tested. The provisions regarding debt to equity conversion contained in the Refinancing Agreement have yet to prove that they meet the needs and expectations of the Brazilian Government and foreign creditors.

In order to maintain (and even increase) the benefits to the Brazilian economy in general deriving from debt to equity conversion, appropriate steps must be taken to assure continuous access by foreign creditors and Brazilian companies to the framework established by Resolution 1.460.[63] Brazilian authorities will have to devise a schedule for conversion of debt into equity that is satisfactory to

61. In view of the success of the debt to equity conversion program, the Brazilian private sector and some federal government officials already have started discussing the appropriateness of a debt for goods swap program, whereby an existing Brazilian private sector foreign debt would be paid by the receipt by the creditor of goods produced in Brazil. This proposal has met with the acceptance of a wide portion of the business sector as it would provide for the productive use of a presently idle capacity of the Brazilian industrial sector. Critics of such arrangement assert, however, that the production of goods would be shifted from the traditional export activity, with the consequent generation of resources to the delivery of goods against a merely accounting benefit, since no real income would actually be received. Critics claim this would affect the country's balance of payments and might lead to a new borrowing phase, which certainly would annul any benefit obtainable through the debt for goods swap. This criticism is not fully accurate. The debt for goods swap program would make use of an unexplored productive capacity and, hence, no shift of production orientation would occur. Once the economic situation normalizes, with the consequent surge in demand for industrial productivity, the debt for goods swap would no longer be convenient. The reduction of the foreign debt obtainable through such a program would then be accomplished by payment with resources originating from a trade surplus.

62. Resolution 1.460 swaps amounted to approximately U.S. $3.6 billion; informal swaps amounted to approximately U.S. $2.5 billion.

63. The Brazilian debt to equity conversion program in general and specifically the structure of Resolution 1.460 may be subject to accommodate the sometimes conflicting interests of Brazil and its foreign creditors.

the foreign creditors, but does not cause internal political disturbances by contributing to the widespread foreign influence on the Brazilian economy. Brazilian authorities must keep in mind that the benefits obtainable through a debt to equity conversion program and more specifically through the mechanisms of Resolution 1.460 may be annulled if the internal policy atmosphere is not favorable to foreign investment inflows, a situation that would seriously hamper the efforts of the Brazilian Government and foreign creditors to find a definitive solution to the debt problem. For the sake of Brazil and of its creditors, may they all make the concessions needed to avoid collision.[64]

64. THE ECONOMIST, Apr. 25, 1987, at 26 (Survey Brazil).