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SPECIAL FEATURES

LDC DEBT REDUCTION TECHNIQUES: DEBT-EQUITY AND DEBT COLLATERALIZATION TRANSACTIONS—LEGAL AND ACCOUNTING IMPLICATIONS FOR U.S. BANKS

ANDREW C. QUALE, JR.*

I. INTRODUCTION

In spite of intense efforts on the part of developing nations, commercial banks, multilateral financial institutions, the United States, and other governments over the past seven years, the international debt crisis persists with few signs of amelioration. Since the crisis erupted in 1982, total external indebtedness of the developing countries has increased from \$831 billion to an estimated \$1,320 billion in 1988.¹ The total external debt of the highly indebted countries (Argentina, Bolivia, Brazil, Chile, Colombia, Costa Rica, Côte d'Ivoire, Ecuador, Jamaica, Mexico, Morocco, Nigeria, Peru, Philippines, Uruguay, Venezuela, and Yugoslavia) amounted to \$529 billion at the end of 1988.² Per capita income of

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1. WORLD BANK, WORLD BANK TABLES x (1988-89).

2. *Id.* at xvii.

the highly indebted developing countries has fallen as much as five percent per year during the 1980s, despite six years of economic expansion in the industrial countries.³ Net financial transfers to the highly indebted countries, *i.e.*, the excess of new loans over debt service payments, was an estimated negative eleven billion dollars in 1987.⁴ Not surprisingly, social and political turmoil in these countries is increasing, as evidenced by the riots in Caracas in February of 1989 and in Argentina in May of 1989.

Ironically, although the United States has been experiencing a period of sustained domestic economic growth, it has become, in recent years, the world's largest debtor nation. At the end of 1987, the net international investment position of the United States was a negative \$400 billion, as compared to a positive \$260 billion for Japan and \$165 billion for Germany. By the end of 1988, U.S.' debt to the rest of the world had swelled an additional forty percent to \$532.5 billion.⁵ Some of the capital flowing into the United States is coming, of course, from the developing nations. In 1987, for the first time in fifty years, foreigners earned more in 1987 on their investments in the United States than Americans earned on their investments abroad. In brief, the Third World has sunk deeper into debt, per capita income has declined and developing countries that should be importing capital to fuel their economic growth are exporting it to the developed nations.

Fortunately, during this same period, U.S. commercial banks have substantially increased their capital and dramatically increased their loan-loss reserves. Thus, they are now in a much better position to absorb the losses that may result from their Less Developed Countries (LDC) loans. As a result, after years of tedious debt reschedulings and forced new money exercises, the commercial banks have now moved beyond the "muddling through" stage and have begun to actively manage and reduce their debt portfolios.

Instead of passively holding on to their debt for what could be forever, banks have begun to pursue aggressively various alternatives in the management of such debt by: 1) selling debt in the

3. WORLD BANK, WORLD BANK ATLAS 6-9 (1988).

4. See DEP'T OF TREASURY, FIRST REPORT TO THE CONGRESS CONCERNING WORLD BANK STRATEGY AND LENDING PROGRAMS IN DEBTOR COUNTRIES 18 (Mar. 1989).

5. Mossberg, *New 'One-Worlders' are Conservatives*, Wall St. J., Apr. 3, 1989, at A1, col. 5; Wessel, *U.S. Debt to Rest of World Increased by Forty Percent to \$532.5 Billion Last Year*, Wall St. J., June 30, 1989, at A2, col. 3.

secondary market at increasingly greater discounts; 2) swapping debt of one sovereign nation for that of another in order to concentrate their debt in those countries with which they feel most comfortable; 3) converting debt into equity investments in the debtor nations; and 4) exchanging debt for securitized and/or collateralized debentures or other debt instruments.

Many of the money-center banks generally have been less willing and able than regional banks to sell or trade their LDC debt due to their relatively weaker capital positions and greater desire to maintain a long-term financing role in the debtor nations. Straight debt sales or debt swaps, both of which will result in substantial losses to a bank, are, accordingly, less attractive to money-center banks than to regional and foreign banks. By contrast, conversion of debt to equity interests may be more attractive to money-center banks than to regional banks because such conversions usually involve less of an accounting loss, require a long-term interest or commitment to the developing country, and necessitate a continued presence in the developing country which most regional and foreign banks lack. Thus, in terms of their goals, the banks tend to fall into two general categories. One group of banks is prepared to cash out its loan positions and take whatever losses may result. The other group is more inclined to convert some of its debt into equity or other debt instruments that may provide a more profitable and flexible long-term investment than existing debt and may not involve a substantial and immediate accounting loss.

The primary goal of the debtor nations is to reduce the amount of principal and/or the rate of interest payable on their debt so that their remaining debt can be serviced under reasonably normal circumstances without an excessively adverse effect on economic growth. The amount of reduction of principal and/or interest rates necessary to accomplish this objective will vary greatly depending upon each country's particular circumstances. No single scheme for debt relief, if available to banks on a voluntary basis, would be sufficient to enable the debtor nations to meet their interest obligations comfortably. Nonetheless, significant debt relief can be accomplished through a combination of debt-equity conversions, debt-forgiveness arrangements similar to the recent Mexican debt exchange offer (the "Mexican Debt Exchange" or "Exchange"), debt buy-backs, and reductions in the rate of interest payable on the country's debt.

The quickest and most efficient way of achieving meaningful debt relief is to enable the debtor nations to capture, to the fullest extent possible, the discount at which their debt is selling in the secondary market. Such discount ranges from ninety-four percent for Peru, down to about thirty-five to forty percent for Chile and Colombia, the better credit risks in Latin America today.⁶ If banks are willing (as many have been) to sell their LDC debt at the substantial discounts prevailing in the secondary market, debtor nations should be encouraged to acquire their own debt, thereby cancelling and eliminating the accompanying debt service obligations. Debt-equity conversions and exchanges similar to the Mexican Debt Exchange are also designed in part to enable debtor nations to capture some of this discount for their own benefit.

The U.S. debt policy announced by Secretary of the Treasury Nicholas Brady, on March 10, 1989, recognized publicly, for the first time, the U.S. Government's belief that debt reduction (*i.e.*, forgiveness of part of the principal on the LDC debt) is essential to the solution of the debt problem.⁷ To implement the debt reduction proposal, Secretary Brady encouraged the debtor nations and their creditor banks to undertake several types of transactions: 1) debt buy-backs; 2) exchanges of old debt for new longer-term collateralized debt instruments; and 3) debt-equity conversions.

To facilitate such transactions, Secretary Brady called on commercial banks to waive the sharing and mandatory prepayment provisions and negative pledge clauses of existing loan agreements. Sharing and mandatory prepayment provisions prohibit debtors from treating one creditor in preference to other creditors. Such provisions may limit the debtors' ability to negotiate debt reduction transactions with individual creditors and thus inhibit the structuring of such transactions. Negative pledge clauses generally limit the debtors' freedom to grant collateral security with respect to existing or new loans. These clauses may limit the debtor nations' ability to obtain new money from lenders through loans (if such loans cannot be obtained on an unsecured basis). They may also limit the debtor nations' ability to exchange portions of old debt for new debt which is secured by collateral. Representatives of the commercial banks apparently advised the U.S. Treasury Department of their reluctance to waive such important protective

6. *LDC Debt News*, Am. Banker, Apr. 10, 1990, at 16, col. 1.

7. Fried & Trezise, *Third World Debt: Phase Three Begins*, BROOKINGS REV. 25-28 (Fall 1989).

clauses under their loan agreements. The U.S. Treasury subsequently indicated that debt reduction techniques of the type contemplated under the Brady Plan can be implemented without the necessity of obtaining waivers of protective clauses.

Secretary Brady also proposed that the World Bank and International Monetary Fund (IMF) dedicate a portion of their policy based loans to replenish the reserves used by debtor nations to reduce their debt burden. With such reserves, the debtor nations can buy back their debt and finance the purchase of collateral to secure new collateralized debt instruments issued in exchange for old debt. Secretary Brady also suggested that the World Bank and IMF could provide additional financial support to collateralize a portion of the debtor countries' interest payments on new debt issued in debt reduction transactions.

Both the World Bank and IMF responded positively to Secretary Brady's proposal. The IMF's Executive Board decided that approximately twenty-five percent of a country's access to IMF resources, under an extended or standby arrangement, can be set aside to support operations involving principal reduction, such as debt buy-backs or exchanges.⁸ In addition, the IMF may approve additional funding, on a case by case basis, of up to forty percent of a member's quota. This funding must serve as interest support in connection with debt or debt service reduction operations where such support would be decisive in facilitating further cost-effective operations and in catalyzing other resources in support of the operations.⁹ Such approvals have already been given to Costa Rica, the Philippines, and Mexico. The World Bank has decided to allow certain countries, on a case by case basis, to use up to twenty-five percent of their three year economic adjustment loans for the purpose of reducing payments of principal and interest on such debt.¹⁰ It should be noted, however, that both the World Bank and IMF have expressed resistance to proposals that they directly guarantee new instruments created as the result of debt reduction schemes.

The commercial banks have not responded as positively to the Brady Plan as had been hoped. However, some progress has been made. After months of bitter negotiations between Mexico and its

8. *Executive Board Adopts Guidelines for Role of Fund in Debt Strategy*, IMF SURV., May 29, 1989, at 172.

9. *Id.*

10. Truell, *World Bank Sets Rules for Role in Debt Strategy*, Wall St. J., June 2, 1989, at A12, col. 6.

commercial bank lenders, a debt reduction agreement was signed by these parties on February 5, 1990. This accord (the "Brady Mexican Debt Accord"), the first major agreement under the Brady Plan, reduces Mexico's \$48.5 billion medium-term commercial debt by approximately seven billion dollars of principal. It also saves Mexico about \$1.4 billion in annual interest payments and brings in \$1.2 billion in annual new loans during 1990-92. The debt package provides for debt reduction through two different options whereby bank creditors can exchange existing debt for new thirty year bonds. Under one option, new bonds will be issued in exchange for existing debt at a thirty-five percent discount and will pay an interest rate of LIBOR plus thirteen-sixteenths percent. Under a second option, new bonds will be issued in exchange for existing debt at face value but the new bonds will bear interest at a lower, fixed annual interest rate of 6.25 percent. For banks choosing to accept reduced principal or interest, the bonds are collateralized by U.S. Treasury zeros. Special funds from the World Bank, the IMF, the Japanese Government, as well as a commitment from Mexico will guarantee the payment of the principal of the new bonds plus eighteen months of interest. These measures will improve the credit quality of the bonds. As of February 1990 bank creditors holding approximately forty-one percent of the debt (or about \$19.9 billion) which submitted bids for the new bonds opted for the discount bonds while bank creditors holding forty-nine percent of the debt (or about \$23.8 billion) opted for the par value bonds.

In addition, Venezuela recently reached a preliminary agreement with its bank creditors regarding the basic terms of a debt reduction proposal. The proposal covers approximately twenty billion dollars in outstanding loans and offers bank creditors numerous debt reduction options. The first option allows banks to exchange their existing debt for new thirty year bonds at a thirty percent discount. The bonds will bear interest at LIBOR plus thirteen-sixteenths percent. The second option allows bank creditors to exchange their existing debt for new thirty year bonds with an equivalent face value but which would bear interest at a lower, fixed annual rate of 6.75 percent. Principal payments under both types of bonds would be collateralized by U.S. Treasury zero-coupon obligations. Fourteen months of interest payments would be secured by a cash collateral account established by the Venezuelan Government. Under both options the Venezuelan Government would guarantee to make additional payments to the bondholders

after six years if oil prices rise beyond a designated level. Such guarantees of additional payments would be issued in the form of certificates and would trade separately for the debt reduction bonds. Under a third option, Venezuela would offer to buy back existing debt at a discount to be set by the Venezuelan government. Such discount is expected to be approximately sixty to sixty-five percent.

The agreement also contains a temporary interest reduction option under which bank creditors would receive a seventeen year bond bearing interest at a rate of five percent in the first two years, six percent in the next two years and seven percent in the fifth year. For the remaining twelve year life of the bonds, the interest rate on the bonds would be LIBOR plus seven-eighths percent. A collateral account sufficient to cover interest payments for twelve months would be provided by the Venezuelan Government during the five year interest reduction period. All of the above programs will be enhanced by funds provided by the IMF, the World Bank, the Republic of Venezuela, and other official sources.

The Philippines has also reached a debt reduction accord with its bank creditors. Under the agreement, the Philippines will buy back at a fifty percent discount \$1.3 billion of the \$1.8 billion bank debt which was tendered to it. In addition, under the plan the Philippines will receive approximately \$600 million in new money.

Finally, Costa Rica is close to consummating a debt reduction scheme with its bank creditors.¹¹ Under the proposed Costa Rican transaction, bank creditors will be asked to offer up to sixty percent of their outstanding debt for repurchase by the Costa Rican Government at a price of approximately \$.16 on the dollar. The banks would receive a twenty year 6.25 percent par bond for the remaining forty percent of their respective debt. Such bonds would allow Costa Rica a ten year grace period on interest. Twelve to eighteen months of the interest but none of the principal would be collateralized. In addition, Costa Rica would make a twenty percent down payment on its interest arrears and would offer fifteen year bonds paying interest of LIBOR plus thirteen-sixteenths percent for the remaining amount of its interest arrears. Three years of interest payments on such bonds would be collateralized. The proposal also provides for an option for banks which offer less than sixty percent of their outstanding debt pursuant to the transaction.

11. See *Brady Plan Progress Report*, INT'L ECON., Feb./Mar. 1990, at 76.

In such a scenario, the banks would receive twenty-five year, 6.25 percent par bonds which would not be collateralized and which would allow Costa Rica a fifteen year grace period on interest payments. Costa Rica would offer the same terms as above with respect to its interest arrears in such scenario except that none of the interest on the interest arrears bonds would be collateralized.

Despite some success, commercial banks and debtor nations have found it difficult to reach a consensus on the level of discount. This may be due in part to their failure to develop structured transactions that maximize the advantages which may be available under applicable tax and accounting regulations. It may also be attributed to the inherent difficulty of the creditor banks to reach an agreement through their steering committees on a single solution which is acceptable to all creditors. A more practical solution would be to permit the market place to develop a number of separate solutions which may be better tailored to meet the needs of different groups of creditors. This paper will analyze, *inter alia*, some of the legal and accounting implications of two of the more innovative approaches to reducing the LDC debt, debt-equity conversions and debt exchanges involving new collateralized bonds. The author hopes that this analysis will assist the debtor nations and their creditors in developing mutually beneficial approaches to achieving substantial debt reduction.

II. DEBT-EQUITY CONVERSIONS

A. *The Structure of a Debt-Equity Conversion*

The simplest, most straightforward debt-equity conversion occurs when a creditor of a company exchanges or converts the debt which is owed to it by the company for an equity interest in the company. Such conversions are not common because they require that the creditor have an interest in acquiring equity in its debtor. Thus, this kind of conversion will likely occur only where a foreign parent of a local subsidiary is seeking to capitalize the loans which it has made to the subsidiary.

Debt-equity conversions are more likely to occur as a two- or three-part transaction. First, a foreign creditor bank holding public sector debt sells the debt to the Central Bank of the debtor country for a local currency equivalent in an amount equal to the face value of the external debt, or at some pre-established discount.

The creditor bank then takes the local currency and uses it to acquire an equity interest in a company in the debtor country. This is essentially the operation undertaken by Bankers Trust when it converted approximately sixty million dollars of Chilean public sector debt (consisting partially of debt which Bankers held in its portfolio and partially of debt which it purchased from other lenders) into shares of a Chilean pension fund and an affiliated insurance company. Chase Manhattan (Chase) also engaged in a debt-equity transaction pursuant to which it obtained a non-voting equity stake in Autolatina, a Brazilian car manufacturer operated as a joint venture between Volkswagen and Ford. Chase swapped \$200 million of Brazilian bank debt, previously acquired on the secondary market for other purposes, in exchange for its equity share in Autolatina.

Some bank lenders may not be interested in converting the debt they hold into equity and, indeed, may be prohibited from doing so by applicable banking regulations. A three-step transaction involving a multinational corporation may instead be effected. The foreign creditor bank initially sells public sector (or possibly even private sector) debt to a multinational company, usually at a significant discount (depending upon the particular country involved). The multinational corporation subsequently exchanges, usually with the debtor nation's central bank, the dollar denominated debt for local currency equal in amount to the face value of the debt exchanged, or at a fixed or auction-determined discount. Finally, the multinational company invests the local currency in a domestic company, which may well be its own subsidiary.

B. United States Banking Laws and Regulations Affecting Debt-Equity Conversions

A U.S. banking organization's acquisition of an equity interest in a foreign company through a debt-equity conversion or otherwise may be subject to the Federal Reserve Act ("FRA"),¹² the Bank Holding Company Act ("BHCA"),¹³ and Regulations K¹⁴ and Y¹⁵ of the Board of Governors of the Federal Reserve System (the "Board"). Pursuant to Section 25 of the FRA, a member bank may

12. 12 U.S.C. §§ 611-631 (1988).

13. *Id.* §§ 1841-1850.

14. 12 C.F.R. §§ 211.1-211.45 (1988).

15. *Id.* §§ 225.1-225.43.

invest directly in Edge Act Corporations¹⁶ and Agreement Corporations.¹⁷ Since a member bank generally may not directly own equity investments in foreign corporations, the acquisition of stock by a U.S. banking organization usually must be effected through such Edge Act or Agreement Corporations or through one bank's holding company ("BHC").

Section 4(c)(13) of the BHCA permits BHCs to acquire shares of any foreign company that:

does no business in the United States except as an incident to its international or foreign business, if the Board by regulation or order determines that, under the circumstances and subject to the conditions set forth in the regulation or order, the exemption would not be substantially at variance with the purposes of [the BHCA] and would be in the public interest.¹⁸

Section 25(a) of the FRA authorizes Edge Act Corporations to engage in activities overseas which the Board considers to be usual in connection with the business of banking in foreign countries.¹⁹ Edge Act Corporations may also, with the consent of and subject to the regulations of the Board, own shares of any foreign company provided that such company is "not engaged in the general business of buying or selling goods . . . in the United States and [is] not transacting any business in the United States except such as in the judgment of the Board . . . may be incidental to its international or foreign business. . . ."²⁰

The Board has issued extensive regulations implementing the foregoing provisions of the FRA and the BHCA in Regulation K.²¹ Since Regulation K governs most debt-equity conversions, the following is a detailed description of its pertinent provisions.

In addition to Section 4(c)(13), several other provisions of the BHCA may be relevant to the acquisition of an equity interest in a foreign company. Section 4(c)(6) of the BHCA permits a BHC to hold no more than five percent of the outstanding voting stock of any company, irrespective of the nature of its business and where it engages in such business.²² Additionally, Section 4(c)(7) permits

16. 12 U.S.C. § 615(c) (1980).

17. *Id.* § 601.

18. *Id.* § 1843.

19. *Id.* §§ 611-631.

20. *Id.* § 615(c).

21. 12 C.F.R. § 211.5 (1988).

22. 12 U.S.C. § 1843(c)(6) (1988).

a BHC to hold shares (without any percentage limitation) of an investment company, provided that such company is engaged only in the business of investing in securities, and that it does not hold more than five percent of the outstanding voting stock of any company.²³

Finally, a U.S. banking organization may acquire an equity interest in a company without limitation as to the nature of the business of such company or the percentage of voting stock being acquired, if such acquisition is necessary to prevent a loss on a "debt previously contracted" ("dpc"). This exception to the general limits on the acquisition by banking organizations of equity interests in companies is found in the National Bank Act,²⁴ the FRA with respect to Edge Act corporations,²⁵ the BHCA,²⁶ Regulations K²⁷ and Y,²⁸ and various state banking laws.

C. Regulation K

On February 18, 1988, the Board announced a major liberalization of Regulation K. This change was designed to facilitate equity investments by U.S. banks in foreign countries through the use of debt-equity conversions.²⁹ This amendment expanded the scope of an August 1987 amendment to Regulation K³⁰ which permitted banks, through debt-equity swaps, to own up to one hundred percent of nonfinancial companies acquired from the government of a heavily indebted developing country. But the prior liberalization, which permitted banks to buy privatized companies, had been widely criticized as being of limited use and perhaps even misguided in its ultimate effect. The new amendment extends the authority, already generally available to banks under Regulation K, to make certain equity investments through debt-equity conversions.

23. *Id.* § 1843(c)(7).

24. *Id.* §§ 21-216.

25. *Id.* § 615(c).

26. *Id.* § 1843(c)(2).

27. 12 C.F.R. § 211.5(e) (1988).

28. *Id.* § 225.12(b).

29. 12 C.F.R. § 211.5(f) (1987), amended by 53 Fed. Reg. 5,363 (1988).

30. 12 C.F.R. § 211.5(f) (1986), amended by 52 Fed. Reg. 30,914 (1987).

1. General Equity Investment Authority

Regulation K sets forth the Board's long-standing policy regarding foreign investments made by BHCs, member banks, and Edge Act and Agreement corporations (which are collectively defined in Regulation K, and will be referred to hereinafter, as "Investors"). Pursuant to the BHCA and the Edge Act, such foreign investment should be limited primarily to organizations whose activities are "confined to those of a banking or financial nature and those that are necessary to carry on such activities."³¹

2. "Permissible Activities"

Regulation K sets forth a list of those activities which are considered "usual in connection with the transaction of banking or other financial operations abroad,"³² and which are considered to be "permissible activities."³³ These include:

- 1) commercial and other banking activities;
- 2) commercial and consumer finance;
- 3) lease financing;
- 4) providing investment, financial or economic advisory services;
- 5) data processing;
- 6) managing a mutual fund which does not exercise managerial control over the firms in which it invests;
- 7) management consulting;
- 8) underwriting or distributing securities outside the United States; and
- 9) activities which the Board has determined to be closely related to banking under Section 4(c)(8) of the BHCA.

In addition to these listed permissible activities, the Board, upon application by an Investor, may approve other activities. It will approve them if it finds that they are banking or financial in nature, or if it finds that other financial institutions in the foreign country in question engage in such activities. The Board will also

31. *Id.* § 211.5 (a).

32. *Id.*

33. *Id.*

approve activities of an Investor if it determines that for competitive reasons Investors should also be permitted to engage in such activities.

3. Eligible Investment Levels or Categories

An Investor may acquire up to one hundred percent of the voting stock of a foreign company provided that ninety-five percent or more of its activities are listed as permissible activities or have been specifically determined to be permissible by the Board. An Investor may also acquire lesser amounts of voting stock in a company even though the company engages, to a significant extent, in non-permissible activities. More specifically, under Regulation K, an Investor may:

- 1) acquire more than fifty percent of the voting stock of a foreign entity or acquire control of such entity (a "subsidiary" investment), provided that at least ninety-five percent of such entity's assets or revenues relate to permissible activities that are enumerated in Regulation K or have been determined by the Board to be permissible;

- 2) acquire twenty percent or more of the voting stock of a foreign entity but not a controlling interest (a "joint venture" investment), provided that at least ninety percent of the assets or revenues of such company relate to permissible activities;

- 3) acquire less than twenty percent of a foreign entity (a "portfolio investment") irrespective of what activities the company engages in, provided that the aggregate amount of all such portfolio investments by the Investor does not exceed the Investor's capital plus surplus.

4. Requirement of Divestiture

An Investor is required to divest an investment (unless the Board authorizes retention) if the company in which the investment is made: 1) engages in the general business of selling goods, wares, merchandise, or commodities in the United States; 2) engages directly or indirectly in other business in the United States that would not be permitted to an Edge Act Corporation; or 3) engages in impermissible activities to an extent not permitted by the regulations. Thus, in addition to making sure that the company in which an Investor seeks to invest fits within one of the

eligible investment categories, an Investor must also make sure that such company's activities in the United States are narrowly circumscribed.

Even if a foreign company's activities in the United States exceed such limits so that investment in such company would not be permitted under Regulation K, an Investor can always hold up to five percent of the voting stock of such company pursuant to Section 4(c)(6) of the BHCA regardless of its activities.

5. Notice and Consent Requirements

Depending upon the magnitude and nature of the proposed investment, an Investor's acquisition will be subject to the Board's general consent, its prior notice or specific consent procedure. Assuming that an Investor's proposed investment fits within one of the eligible investment categories described above, no prior notice of the proposed investment need be given to the Board if the investment in the entity does not exceed the lesser of fifteen million dollars or five percent of the bank's capital plus surplus.

An investment that fits within one of the three investment categories (subsidiary, joint venture or portfolio), but exceeds the level permitted for general consent, may be made pursuant to the prior notice procedure. Under this procedure, the Investor must give the Board forty-five days prior notice of its intention to make such an investment, during which time the Board may state its objection.

An Investor must seek the specific consent of the Board if its proposed acquisition does not come within the general consent or prior notice provisions. Consent is essentially required where an Investor seeks to acquire more than a portfolio investment in a company whose activities are not included within the Board's list of permissible activities.

D. The February 1988 Amendment

The February 1988 amendment liberalized the authority of BHCs to make equity investments in developing countries through debt-equity conversions by: 1) increasing the amount of equity ownership a BHC may have in a nonfinancial company; 2) permitting the BHC to provide loans, in addition to equity, to such company; 3) extending the time period during which the equity invest-

ment may be retained by the BHC; and 4) liberalizing the general consent procedures.

1. Permissible Equity Investments

In addition to the investments permitted under other provisions of Regulation K, a BHC may now make the following equity investments through a debt-equity conversion:

1) up to one hundred percent of the shares of any foreign company, if the shares are acquired from the government of the country, its agencies or instrumentalities (*i.e.*, a privatization of a public sector company), and

2) up to forty percent of the shares of any private sector company, subject to the following conditions: a) the BHC may acquire more than twenty-five percent of the voting shares of such company only if another shareholder or control group of shareholders not affiliated with the BHC owns a larger block of voting shares of such company; and b) the BHC may not have a greater representation on the board of directors or management committees of the foreign company than is proportional to the shares it holds in such company.

By permitting a BHC to own up to twenty-five (and under certain circumstances up to forty) percent of the voting shares of the foreign company, the Board enabled BHCs to maintain not only portfolio, but "operational" investments in private sector nonfinancial companies. The Board believes that BHCs will be able to have an important voice in the management of the companies through proportionate, non-controlling representation on the companies' boards of directors. The Board feels that a BHC should be able to protect its investment in a nonfinancial company without having sole operational control over the company—a control which a BHC is ill-equipped to exercise. Also, possession of twenty percent or more of the shares of nonfinancial companies will allow BHCs to use consolidation or equity accounting, as opposed to cost accounting, with respect to such investments.

2. Permissible Debt Financing

If a BHC acquires twenty percent or more of the voting shares of a nonfinancial, private sector company, it will not be permitted to extend loans or other forms of financing to the same company in

excess of fifty percent of the total loans or extensions of credit to that company.

3. Permissible Holding Period

BHCs will be permitted to retain investments made pursuant to debt-equity conversions for a period of two years beyond the end of any reparation restriction period established by the host country but in no event for more than fifteen years. This holding period will apply to investments in both public and private sector companies. Its imposition reflects the Board's view that investments of twenty percent or more in the voting stock of nonfinancial companies should be temporary. It also upholds the Board's general objective of maintaining the separation between banking and commerce. The divestment requirement at the end of the holding period is not applicable, however, to investments otherwise permissible under Regulation K, even if such investments resulted from debt-equity conversions.

4. General Consent Procedures

The Board grants a general consent to investments made pursuant to the February 1988 amendment if the total amount invested does not exceed the greater of fifteen million dollars or one percent of the equity of the BHC. Prior notice to, or the specific consent of, the Board is required: 1) if a country's debt-equity conversion program requires the BHC to invest new money after converting debt obligations to equity; 2) if the amount of such new money exceeds fifteen million dollars; or 3) if the investment is to be made through an insured bank or its subsidiary.

5. Investments to be Held Through the Holding Company

Debt-for-equity investments in nonfinancial companies must be held through a BHC and not directly by a bank or a subsidiary of a bank. The Board sought to protect banks from the potential risks of investments in commercial and industrial companies, and has made it clear that the federal safety net does not apply to non-banking activities. The Board is willing, however, to grant exceptions to this general requirement on a case by case basis if the bank can demonstrate that there is a special reason (*e.g.*, local legal requirements) why it, rather than a BHC, must hold the invest-

ment in the nonfinancial company.

6. Private Sector Debt Not Eligible for Debt-Equity Conversion

Despite some sentiment to the contrary, the Board has limited application of the liberalized investment rules to equity investments made through the conversion of sovereign debt, thus excluding the swapping of private sector debt. In support of its position, the Board noted that a bank can already convert private sector debt to an equity investment through the use of the "debt previously contracted" exception, whereas, according to the Board, sovereign debt is not eligible for such conversion.

7. Some Observations on the February 1988 Amendment

Although the February 1988 amendment provides a useful liberalization of Regulation K, the ability of banks to undertake debt-equity conversions has not been significantly enhanced. BHCs may now own up to twenty-five percent of the voting stock of a nonfinancial company (or up to forty percent if another stockholder holds a larger block), whereas previously the BHCs were limited to less than twenty percent. The power to acquire this relatively small additional amount of voting stock has been coupled with limitations on the permissible holding period of the investment, the amount of debt financing that may also be provided, the manner in which the investment may be held, and the type of debt that is eligible for conversion.

The Board, in its August 1987 amendment, permitted BHCs to acquire one hundred percent of a public sector company pursuant to a debt-equity conversion. Since public sector companies are more likely to be poorly managed than private sector companies, the acquisition of a one hundred percent interest in a private sector company would present less commercial risk to a BHC than a public sector company and should, *a fortiori*, also be permitted. Such treatment would be consistent with the purpose of the "dpc" exception described below, namely, to enable a bank to exchange debt for an equity interest, without a limit on the percentage of voting stock, if the bank believes such exchange is a reasonable step toward collecting on its loan. The "dpc" exception is a very limited but well-established departure from the general principle of the separation of banking and commerce. Therefore, the Board would have ample precedent for permitting BHCs to acquire up to

one hundred percent of private sector as well as public sector companies.

E. Other Legal Bases for Holding an Equity Investment in Foreign Companies

Assuming that an Investor cannot make an investment eligible under the investment categories of the newly amended Regulation K, it can nonetheless rely on several alternative legal bases to acquire equity in a foreign company. The most flexible of these is the "dpc" exception. This permits an Investor to acquire an equity investment in exchange for a "debt previously contracted." Of more limited use to an Investor are the two exceptions to the general prohibitions of the BHCA that permit an Investor to acquire directly, or indirectly through an investment company, up to five percent of the voting stock of a company.

1. The "Debt Previously Contracted" Exception

The "dpc" exception permits a banking organization to avoid limitations otherwise imposed by banking laws by acquiring up to one hundred percent of the voting stock of a company in exchange for a "debt previously contracted." The "dpc" exceptions are found in Regulation K, the BHCA, Regulation Y, the FRA, and in state law.

2. Regulation K

Pursuant to the "dpc" exception set forth in Section 211.5(e) of Regulation K, equity interests acquired in exchange for "debts previously contracted" are not subject to the limitations of Regulation K, provided that: 1) such equity is acquired in order to "prevent a loss on a debt previously contracted in good faith"; and 2) such equity interests are disposed of no later than two years after their acquisition, unless the Board authorizes retention for a longer period.

The "dpc" exceptions set forth in the BHCA and Regulation Y are very similar to that of Regulation K except that they permit the Board to authorize the BHC to retain conversion generated shares for a maximum period of five years, whereas Regulation K contains no such absolute limit. By means of the "dpc" exception, an Investor may acquire an unlimited amount of the voting stock

of a foreign company, irrespective of whether such company engages in non-"permissible" activities such as manufacturing, mining or tourism.

Whether the "dpc" exception is available depends upon the facts of a particular case. Generally, this provision has been used to permit an Investor's conversion of debt into equity of the same debtor, or into the equity which served as collateral for the debt in question. Regulation K, however, does not on its face preclude a conversion into equity of a third party. Nonetheless, some members of the Board have apparently taken a somewhat restrictive view of the "dpc" exception. They suggest that it may not be used to acquire equity in exchange for the debt of a sovereign nation. Their reasoning appears to be twofold. First, the "dpc" exception should be limited to debtors that are bankrupt or have been declared in default. Although some debtor nations may be in arrears on their obligations, they have not been declared in default. Therefore, the debtor nations' situation should not be considered so serious so as to justify "dpc" treatment. Second, some members of the Board's staff have expressed concern as to whether the remainder of a banking organization's debt portfolio of a particular debtor country should be written down if part of it has been converted to equity "in order to prevent a loss."

The language of Regulation K, however, does not necessarily compel such a restrictive interpretation. If a banking organization were to sell a particular loan in the secondary market or swap it for the debt of another Third World debtor it would incur a loss which, depending on the discount at which such debt is selling, may be substantial irrespective of whether the debtor was bankrupt or had been declared in default. Moreover, if the banking organization were to incur a loss on the transaction, it would not necessarily be required to write down the rest of its portfolio of such debt. Thus, by effecting a conversion of debt to an equity investment, a banking organization not only might be able to "prevent a loss," but would also not necessarily have to write down any remaining debt of the same debtor held in its portfolio.

3. The National Bank Act

Even if the Board will not permit a BHC to undertake a debt-equity conversion pursuant to the "dpc" exception, the bank itself may be able to effect such a transaction directly. Ordinarily, debt-

equity conversions are effected either at the holding company level, *i.e.*, by the BHC itself, or by a non-bank subsidiary of the BHC. If, however, the debt is held by the bank and is converted by it, then, in the case of a national bank, the National Bank Act and the regulations of the Office of Comptroller of the Currency ("OCC") will apply and, in the case of a state bank, state laws and regulations will apply. The OCC has interpreted the "incidental powers" clause³⁴ of the National Bank Act to permit debt for equity exchanges if the bank believes in good faith that such an exchange is a reasonable and appropriate step toward collecting a bank's loans.³⁵ The OCC has also found that a national bank's power to hold real property received in satisfaction of a "debt previously contracted" enables it to convert debt for equity where the equity in question is in a real estate holding company.³⁶ The OCC is apparently prepared to give considerable weight to a bank's determination that the debt for equity exchange is reasonably necessary to salvage the bank's assets.

The OCC's interpretation of the National Bank Act as permitting "dpc" transactions is elaborated upon in two recent "No Objection" letters issued in 1987³⁷ and 1988.³⁸ The former involved an investment in a Mexican holding company whose sole asset was a Mexican hotel and, the latter involved an investment in a Chilean insurance company.

If a national bank undertakes a "dpc" transaction pursuant to its inherent powers under the National Bank Act, neither approval nor a "No Objection" letter is required from the OCC. Nevertheless, the interpretation set forth in the "No Objection" letter can provide useful guidance to banks making equity investments relying on such powers.

4. New York State Banking Law

Under New York law, a bank "may invest in, and have and exercise all rights of ownership with respect to, so much of the capital stock of any other corporation as may be specifically author-

34. 12 U.S.C. § 24 (1988).

35. *Id.*

36. *Id.* § 29.

37. No Objection Letter No. 87-10, Fed. Banking L. Rep. (CCH) ¶ 84,039 (Nov. 27, 1987).

38. No Objection Letter No. 88-7, Fed. Banking L. Rep. (CCH) ¶ 84,047 (May 20, 1988).

ized by the laws of [New York] or by resolution of the banking board upon a three-fifths vote of all its members.”³⁹ Additionally,

a bank or trust company may acquire stock in settlement or reduction, or a loan, or advance or credit or in exchange for an investment previously made in good faith and in the ordinary course of business, where the acquisition of stock is necessary in order to minimize or avoid a loss in connection with any such loan, advance or credit or investment previously made in good faith.⁴⁰

The New York State Banking Department takes a flexible attitude in permitting the acquisition of stock for a debt previously contracted. If the bank reasonably believes that the acquisition of equity in exchange for debt is necessary in order to minimize or avoid a loss in connection with a loan, and the transaction is not a subterfuge, the Banking Department will not object.

5. Section 4(c)(6) of the BHCA

Assuming a banking organization cannot effect a debt-equity conversion in reliance either upon Regulation K (because the target company is engaged in more than incidental business activities in the United States) or on the “dpc” exception, it still will be permitted to acquire up to five percent of the voting stock of any company, pursuant to Section 4(c)(6) of the BHCA. This exception is self-executing and accordingly requires no prior notice to, or consent by, the Board. The exception is available irrespective of the nature of the business in which the company is engaged or the extent of its activities in the United States. Such investments, however, are required to be passive and may not involve active participation by an Investor in the management of the company.

6. Effecting Debt-Equity Conversions Through Investment Companies

Section 4(c)(7) of the BHCA permits a BHC to hold up to one hundred percent of the shares of an investment company which is not engaged in any business other than investing in securities, provided that such securities do not represent more than five percent

39. N.Y. Banking Law § 97(5) (McKinney Supp. 1990).

40. *Id.*

of the outstanding voting stock of any company. No comparable provision is contained in Regulation K, and the Board has not been called upon to determine what rules would pertain to a BHC's acquisition of shares in an investment company which invests solely in foreign equity securities.

Since a BHC may acquire up to twenty-five (and under certain circumstances up to forty) percent of the voting shares of a nonfinancial company, presumably a BHC could acquire shares in an investment company which holds an equivalent percentage amount of voting stock of a company. Open to question is whether a BHC may hold up to twenty-five (or forty) percent of the shares of an investment company which, in turn, holds any amount of the voting stock of a company. The Board's adverse reaction to such a proposal, and variations thereof, may depend upon the extent to which the BHC has excessive operational control over the company in which the investment company is investing. The Board may be more receptive to a proposal where through the use of the investment company vehicle, the BHC is indirectly investing in the target company with one or more substantial joint venture partners which can bring managerial and/or technical expertise to the investment.

F. U.S. Accounting Treatment of Debt-Equity Conversions

1. Debt-Equity Swaps

In view of the partial liberalization of Regulation K, perhaps the most significant U.S. regulatory obstacle to debt-equity conversion is U.S. accounting treatment. The proper accounting treatment for a debt-equity conversion has been the subject of considerable uncertainty and controversy. Recently, however, the Accounting Standards Executive Committee ("AcSEC") of the American Institute of Certified Public Accountants ("AICPA") and the AICPA Banking Committee reached substantial agreement on the appropriate treatment and released AcSEC Practice Bulletin No. 4 dealing with "Accounting for Foreign Debt-Equity Swaps."⁴¹

Under the AcSEC Bulletin, a debt-equity swap will be treated as an exchange transaction of a monetary asset for a nonmonetary

41. ACCOUNTING STANDARDS EXECUTIVE COMMITTEE AND COMMITTEE ON BANKING, AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS, PRAC. BULL. No. 4 (May 1988).

asset, the latter reflected at its "fair value" on the books of the bank or BHC as of the date the transaction is agreed to by both parties. The AcSEC Bulletin states that to determine "fair value," one should consider the fair value of the consideration given up, *i.e.*, the old debt, as well as the fair value of the assets received, *i.e.*, the equity investment. This is especially true if the value of the consideration given up is not readily determinable or may not be a good indicator of the value received. The AICPA notes that since the secondary market for debt of financially troubled countries is thin, that market may not be the best indicator of the value of the equity investment received. Therefore, the AICPA committees concluded that to determine the fair value of the equity received in a debt-equity conversion, both the secondary market price of the debt given up and the fair value of the equity investment received should be considered. According to the AICPA, the following factors must be considered in determining current fair value:

- 1) similar transactions for cash;
- 2) estimated cash flows from the equity investment received;
- 3) market value, if any, of similar equity investments; and
- 4) restrictions, if any, affecting payment of dividends, sale of the investment or repatriation of capital.

If the fair value of the equity investment received is less than the book value of the debt, the resulting loss should be recognized and charged to the allowance for loan losses. The recorded loss should include any discounts from the official exchange rate that are imposed as a transaction fee. All other fees relating to the debt-equity conversion should be charged to expenses, rather than capitalized.

Will the recognition of a loss in a debt-equity conversion contaminate the remainder of a bank's loan portfolio with respect to that debtor or country? The AcSEC Bulletin does not require that the remainder of the bank's debt be written down to the same value. The AICPA notes, however, that in accordance with Generally Accepted Accounting Principles (GAAP), a financial institution's loan portfolio should be carried at amortized historical cost less loan write-offs and the allowance for loan losses, provided that the institution has the ability and intent to hold the loans until their maturity. Thus, the bank need not mark down such debt to its "fair value" simply because of a debt-equity conversion. Loan

write-offs and loan loss allowances must be taken based on management's judgment of the ultimate collectibility of the loans in the normal course of business. The recognition of a loss on a debt-equity conversion should be a factor considered by management in its periodic assessment of the adequacy of its allowance for loan losses. If, however, management demonstrates its intention to dispose of loans prior to maturity, the loan should be carried at cost or fair value, whichever is lower. Thus, the recognition of a loss on a debt-equity conversion will not require a bank to write down the remainder of its loans to the same borrower, but should be taken into account by the bank in determining the adequacy of its allowance for loan losses.

In practice, will this proposed treatment require a significant write-down of the value of the equity asset received? If the "fair value" of such equity must take into account the secondary market value of the debt given up, as well as the U.S. dollar value of a local currency-denominated equity interest which is not readily convertible into hard currency, the write-down will likely involve a significant loss. Thus, for an equity investment in Mexico, acquired in exchange for debt selling at approximately forty percent of par, the loss might well be twenty-five to forty-five percent. If such losses ensue, some banks may be discouraged from undertaking debt-equity conversions until their reserves are adequate to absorb such losses. Even then, they may prefer to hold on to a debt or, alternatively, to sell it, realize the loss and eliminate the worry involved in their exposure to the developing country in question.

2. Debt-for-Debt Swaps

The market among banks for debt-for-debt swaps was severely dampened by both the AICPA's "Notice to Practitioners" of May 1985⁴² and the OCC Banking Circular 200 ("OCC Circular"),⁴³ which provided that a swap of loans owed by different debtors represented an exchange of monetary assets that should be accounted for at fair value. The OCC Circular further stated that, for loan swaps involving loans to debtors in foreign countries which are currently experiencing financial difficulties "[i]t is presumed the esti-

42. AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS, NOTICE TO PRACTITIONERS (May 1985).

43. Accounting Guidelines for Bank Loans, 4 Fed. Banking L. Rep. (CCH) ¶ 51,145 (May 22, 1985).

mated fair value would be less than the respective fair value of the loans and other consideration [given up]. Assuming the general presumption is not overcome, this would result in a loss on the swap."

Now that many banks have established substantial reserves for their Third World debt and have indicated a willingness to realize losses in dealing with such debt, there will likely be more debt-for-debt swapping. If, however, the banks would realize an equivalent loss in the swap as in an actual sale of the debt, they may prefer to sell, rather than swap, their debt.

III. SOME SUGGESTIONS FOR STRUCTURING EQUITY INVESTMENTS

To avoid some of the limitations on acquiring voting stock of nonfinancial entities placed upon U.S. banks by Regulation K and the BHCA and the restrictions imposed by certain debtor nations on foreign investment generally, investors may need to consider some creative structuring techniques. Additionally, banks which convert their debt with equity investments will want to protect themselves not only from the vagaries of the profitability of such investments, but also from the risk of devaluation of the local currency. To reduce these risks a bank might concentrate on investments that have a high foreign exchange earning capacity, such as the manufacture of exports and tourist resorts. Another option might be to obtain insurance, if available, from the Overseas Private Investment Corporation and the Multilateral Investment Guarantee Agency (especially for inconvertibility risks).

Such risks, as well as the limitations on acquiring voting stock imposed by Regulation K and the BHCA, may be alleviated by the acquisition of a non-voting preferred stock, which has attributes similar to those of debt, and the adoption of one or more of the following "bells and whistles":

- 1) the dividends on the preferred stock could be cumulative and mandatorily payable as soon as the venture has sufficient profits;
- 2) a sinking fund arrangement could be established into which funds would be deposited for subsequent use in paying dividends on, and ultimately redeeming, the preferred stock;
- 3) the issuer of the preferred stock could be an entity within an affiliated group. The group would be structured so that, even if

the overall venture were not profitable, the particular entity issuing the preferred stock could be the beneficiary of special contractual arrangements. These arrangements would assure the entity sufficient profitability to service the dividends due on such stock;

4) to protect against the devaluation of the local currency, the dividend and redemption payments might be adjusted or indexed so as to reflect inflation or changes in exchange rates. Alternatively, the preferred stock could have a bonus dividend which would compensate for losses due to devaluation. Whether any of such arrangements will work in a particular country will depend upon local laws, the regulations applicable to debt-equity conversions, and regulations affecting remittances of foreign exchange with respect to dividends.

BHCs are generally limited by U.S. regulations to ownership of up to twenty-five (and under certain circumstances up to forty) percent of a company's voting stock (assuming the investments are not banking or financial in nature or are not necessary to prevent a loss on a debt previously contracted, in which case more voting stock may be acquired). Therefore, BHCs are logical minority partners for U.S. and other industrial companies which desire to establish or expand an operation in one of the debtor countries. By selling a minority equity interest to a bank, an industrial company can obtain outside financing in local currency (which may be otherwise difficult) at a relatively reasonable cost. By so doing, the industrial company can also share the equity risks of investment with a minority partner with whom they feel comfortable. At the same time, the bank will feel comfortable being a minority partner of an industrial company that has operational control over the business and with which it may well have an existing customer relationship in the United States.

IV. LDC DEBT EXCHANGE AND COLLATERALIZATION SCHEMES: THE MEXICAN DEBT EXCHANGE AND SIMILAR DEBT REDUCTION PROPOSALS

Proposals to turn part of the LDC debt into tradeable securities on a securities exchange, rather than merely in the informal secondary market for LDC debt, have been fantasized about for several years by investment and commercial bankers, and their lawyers and accountants. Schemes have frequently included credit enhancement devices, such as guarantees by multilateral financial

institutions or collateral consisting of U.S. Treasury obligations. The goal has been to create a new instrument which, fulfilling the alchemist's dream, has a value in the market place exceeding the cost or value of its constituent components. The Mexican Debt Exchange, although not the only such scheme to see the light of day, is certainly the most ambitious and noteworthy to date and will be analyzed below. Other debt exchange proposals, which have avoided some of the problems encountered in the Mexican Debt Exchange, are also described below. Most of these proposals are confidential and, therefore, are not appropriate for explicit discussion in this paper. Nonetheless, some of the tax and accounting considerations that may be relevant to these proposals will be discussed in the following sections.

A. The Basic Outline of the Mexican Debt Exchange

Pursuant to an Invitation for Bids,⁴⁴ Mexico, on January 18, 1988, offered to exchange a new issue of Mexican Collateralized Floating Rate Bonds Due 2008 ("Bonds"), which are denominated in U.S. dollars, pay interest at a floating rate and mature in twenty years, in exchange for certain existing obligations of Mexico outstanding under its Restructure and New Money agreements. The Bonds were to be secured, as to principal only, by non-interest bearing U.S. Treasury obligations ("Zeroes"), which were to be purchased by Mexico, using its own reserves. The Zeroes were to be pledged to holders of the Bonds and have a maturity date and principal amount payable at maturity to match the maturity date and principal amount of the Bonds. In the event of a default under the Bonds, a bondholder would not have access to the Zeroes until the originally scheduled maturity date. At such time, the proceeds of the Zeroes would be available to pay the principal of the Bonds at maturity.

Banks desiring to exchange their existing debt for Bonds were invited to submit bids, on a voluntary basis, to the exchange agent, Morgan Guaranty Trust Company of New York (Morgan Guaranty). In its bids, each bank was asked to specify the principal

44. Invitation from Gustavo Petrocelli, Minister of Finance and Public Credit of the United Mexican States, to the Banks Party to Mexico's Public Sector Restructure and New Restructure Agreements and 1983 and 1984 New Money Agreements, to Exchange Existing Indebtedness for United Mexican States Collateralized Floating Rate Bonds Due 2008 (Jan. 18, 1988).

amount of eligible existing Mexican debt obligations (the "Eligible Debt") the bank was willing to tender and the principal dollar amount of Bonds the bank would accept in exchange for such Eligible Debt. For example, a bank could state in its bid that it was willing to tender ten million dollars of Eligible Debt and would accept in exchange therefor Bonds with a principal dollar amount of seven million dollars, thereby indicating its willingness to accept a discount of thirty percent.

To enhance their attractiveness to the banks and, ultimately, to third parties, the Bonds had the following features:

- 1) the Bonds would pay interest at a margin of one and five-eighths percent above LIBOR, which was double the margin of thirteen-sixteenths percent currently being paid by Mexico on the Eligible Debt;

- 2) the Bonds would be listed on the Luxembourg stock exchange;

- 3) the Bonds, according to Mexico, would not be subject to future restructurings or reschedulings which might otherwise apply to its Eligible Debt; and

- 4) also, neither the Bonds nor the Eligible Debt given in exchange would be considered part of any base amount for purposes of future requests by Mexico for new money.

B. Consents and Waivers

In order to issue the Bonds, it was deemed necessary for Mexico to obtain a waiver of the negative pledge provisions under its outstanding credit agreements and, in the case of one credit agreement that did not permit an exchange offer, even if unsecured, the waiver of the mandatory prepayment and sharing provisions. In addition, it was necessary for Mexico to collateralize certain outstanding publicly-held bond issues since it was not practicable to obtain a waiver of the negative pledge provisions relating to such issues.

C. The Results of the Bid

Mexico and Morgan Guaranty had publicly stated they expected up to twenty billion dollars of Eligible Debt would be tendered and, projecting that the banks would tender at a forty to

fifty percent discount, the total amount of new bonds to be issued was predicted to be as high as ten billion dollars. The results of the auction were much less dramatic. Over six billion dollars of Eligible Debt were tendered, but Mexico accepted only those obligations tendered at an exchange ratio of 74.99 percent or less. As a result, Mexico accepted \$3.67 billion of debt to be exchanged for \$2.56 billion of Bonds. Thus, the average exchange ratio of the accepted bids was 69.77 percent. Upon completion of the exchange, Mexico succeeded in reducing its outstanding indebtedness by \$1.1 billion, an amount substantially lower than the reduction of ten billion dollars originally envisioned. Although the results seem disappointing in light of such expectations, the transaction was considered a moderate success, not only because it reduced Mexico's debt by \$1.1 billion, but also because it showed that debt securitization and collateralization schemes can play a significant role in the management and reduction of LDC debt.

D. Accounting Treatment of the Mexican Debt Exchange

Perhaps the two most important issues confronting the banks in evaluating the Mexican Debt Exchange were the accounting treatment of the exchange and the value that the marketplace put on the Bonds. The Exchange raised three principal accounting issues.

1. Accounting Treatment of the Exchange Itself

Price Waterhouse rendered an opinion to Morgan Guaranty on the appropriate accounting treatment for the transaction, concluding that the exchange of Eligible Debt for the Bonds should be treated as an exchange of monetary assets.⁴⁵ As a result, a bank would recognize an accounting loss or gain equal to the difference between the value of the Eligible Debt carried on its books prior to the transaction and the "fair value"⁴⁶ of the Bonds received in exchange. Such a loss should generally be recorded as a charge to the allowance for loan losses. The amount of the loss is affected not only by the discount factor at which a bank exchanges its Eligible

45. *Id.* app. III, Letter from Price Waterhouse.

46. "Fair value" is normally equal to market value if a broad based, active market exists. Since it might take some time for such a market for the Bonds to develop, banks might need to use other appropriate valuation techniques, such as a discounted cash flow analysis, to determine fair value.

Debt for the Bonds, but also by the amount by which the fair value of the Bonds received exceeds the face value of such Bonds.

Some accountants have argued that the Mexican Debt Exchange could be treated not as an exchange of monetary assets with the bonds being registered in the books at "fair value," but rather as part of a troubled debt restructuring pursuant to Financial Accounting Standards No. 15, "Accounting by Debtors and Creditors for Troubled Restructurings" ("FAS No. 15").⁴⁷ If the exchange of Bonds for Eligible Debt were considered a restructuring of the Eligible Debt, FAS No. 15 would not require a bank to write down the value of its restructured loan unless the amount of the loan on its books exceeded the total future cash receipts, including both principal and interest, to be received by the bank pursuant to the restructured terms of the debt. Since the total payments of principal plus interest over the twenty year life of the Bonds would clearly exceed the recorded value of the Eligible Debt on the books of the banks prior to the exchange, the bank would not be required to recognize a loss.

2. Accounting Treatment of Debt Tendered but Not Accepted by Mexico

Under GAAP, a bank should carry a loan if the bank has the intent and ability to hold it until maturity at its historical cost, less the allowance for loan losses. If, however, management clearly demonstrates its intent to dispose of a loan or a group of loans prior to maturity, then such loans should be carried at cost or market value, whichever is lower. Price Waterhouse viewed the Mexican Debt Exchange as a unique opportunity. As such, it concluded that if management does not have a present intent to dispose of the Eligible Debt other than through the tender offer, the mere act of tendering Eligible Debt, which is subsequently not accepted by Mexico, does not necessarily constitute a clear intention to dispose of such loans prior to maturity.

However, the staff of the Securities and Exchange Commission (SEC) took a contrary view in its Staff Accounting Bulletin No. 75 ("SAB No. 75").⁴⁸ SAB No. 75 states:

47. FINANCIAL ACCOUNTING STANDARDS BOARD, ACCOUNTING STANDARDS ORIGINAL PRO-
NOUNCEMENTS 169 (McGraw-Hill ed. 1986-1987).

48. 53 Fed. Reg. 865 (1988) (to be codified at 17 C.F.R. pt. 211).

The tender of the existing loans is an event that must be given accounting recognition either (i) by writing the loans down to the price at which the bank has agreed to accept Bonds in the tender (tender price) or (ii) by increasing, as necessary, the allowance for loan losses to an amount sufficient to result in a net carrying value of the loans tendered that equals the tender price.

3. Treatment of Debt Not Tendered to Mexico

Price Waterhouse opined that even though a bank exchanges part of its Eligible Debt for Bonds and recognizes a loss on the exchange, the accounting treatment of the bank's untendered Eligible Debt should not change solely because a portion of the bank's Eligible Debt was exchanged, so long as the bank has the ability and intent to hold the remaining loans to maturity. SAB No. 75 points out, however, that pursuant to Statement of Financial Accounting Standards No. 5, "Accounting for Contingencies," management has a continuing responsibility to assess the adequacy of the allowance for loan losses relative to untendered Mexican debt. This insures that such allowance is adequate to provide for losses due to ultimate collectibility, including anticipated losses from the sale, swap or other exchange of loans.

4. Securities Laws Aspects

The Bonds were issued in registered definitive form. They were not registered under U.S. securities laws, but were sold to U.S. citizens pursuant to a private placement, with appropriate legends and restrictions on transfer. Bonds issued outside the United States to non-U.S. citizens are prohibited from being sold within the United States or to U.S. citizens for a period of ninety days after issuance. The Bonds to be issued to non-U.S. citizens were initially represented by a single, temporary global bond. Individual Bonds were to be issued to non-U.S. citizens ninety days after the closing date for the transaction, upon appropriate anti-flowback certifications by such persons.

5. FAS No. 15

As noted above, the Mexican Debt Exchange could have been treated as a "troubled restructuring" pursuant to FAS No. 15

thereby avoiding the necessity of the banks' recognizing a current accounting loss. FAS No. 15 might also be used to reduce the accounting losses on other debt reduction transactions. Under FAS No. 15, if a bank restructures a debt owed to it by a debtor, a bank does not have to account for a loss at the time the exchange occurs, as long as the total future cash receipts, including principal and interest, to be received by a bank under the terms of the new debt are at least equal to the amount of the loan recorded on the bank's books. The bank must write down a loss at the time of the exchange only if the total aggregate amount to be received under the terms of the new debt is less than the recorded book value of the old debt.

Thus, FAS No. 15 can provide an accounting incentive for commercial banks to enter into debt restructurings with debtor nations, since it effectively allows them to defer the losses associated with a restructuring. For example, a bank might exchange debt of a debtor nation for which it has a book value of one hundred for new debt that has a par value of sixty-five, a term of six years and bears interest of ten percent per year. Such exchange could be treated as a FAS No. 15 restructuring and the bank would incur no accounting loss on the exchange since the total sum of principal and interest payments would exceed the original book value of the loan.

Nevertheless, some U.S. banks are hesitant to take advantage of the benefits offered by FAS No. 15. The banks fear that although they may not have to currently write down the loss resulting from the debt rescheduling, the use of FAS No. 15 in conjunction with reschedulings may provide a negative signal to the market. In addition, some accountants have criticized FAS No. 15 on the grounds that the present value of the new asset received in exchange for the old has decreased and, therefore, the creditor should be forced to currently realize the loss, rather than defer it as FAS No. 15 allows.

E. Some Observations on the Mexican Debt Exchange and Suggestions for Similar Transactions

The Mexican Debt Exchange deserves genuine recognition for blazing a new trail in the quest for solutions to the debt crisis. A number of criticisms and comments have, however, been put forth which should be taken into consideration and evaluated in struc-

turing other debt reduction transactions:

1) The fact that Mexico itself had to purchase with its own reserves the Zeroes to collateralize the Bonds renders the scheme impracticable for most developing countries that have limited reserves.

2) The requirement by the SEC in SAB No. 75 that Eligible Debt tendered but not accepted by Mexico be written down to the tender price, or that sufficient loan-loss reserves be maintained to reflect a carrying value of such debt equal to the tender price, discouraged some banks from participating in the tender. Nevertheless, it is possible to structure debt reduction transactions to avoid the adverse accounting consequences of such a tender.

3) The transaction could have been structured to qualify as FAS No. 15 troubled debt restructuring, thereby avoiding the immediate financial accounting loss suffered by banks participating in the exchange.

4) Mexico was unrealistic in anticipating that banks would tender their Eligible Debt at a discount which, when combined with the market discount of the Bonds when issued, would result in an overall discount in excess of that at which the Eligible Debt was trading in the secondary market.

5) The interest payable on the Bonds was purely a Mexican credit risk, depressing the anticipated market price at which the Bonds would trade. Some credit enhancement, such as a one year rolling forward guaranty or collateral arrangement, might have been desirable to support Mexico's interest obligation.

With the financial and credit enhancement support apparently forthcoming from the World Bank and the IMF, it is expected that new debt securitization and collateralization schemes will be developed based in part on credit support from such institutions. In addition, by taking advantage of FAS No. 15 and by carefully structuring debt reduction transactions, both the banks and the debtor nations should be able to reach agreement on mutually beneficial transactions.

F. U.S. Accounting Treatment of Debt Exchanges Under the Brady Plan

1. FAS No. 15

In connection with the negotiations of various debt reduction

agreements under the Brady Plan, the Securities and Exchange Commission issued an analysis of proposed debt restructuring transactions where banks would exchange existing debt for either a new debt instrument at a discount and a market rate of interest or a new debt instrument with the same face amount but a below market rate of interest.⁴⁹ The analysis assumed that under the proposed transactions a) the quality of the restructured loans would be enhanced, b) the principal of the new instruments would be due in thirty years, and c) the funds for the collateral and support arrangements would come from non-bank sources. The analysis stated that both of the above transactions "must be accounted for as 'troubled debt restructurings'"⁵⁰ because they involve concessions granted in a negotiated transaction where the same debtor/creditor relationship survives and where such concessions are granted due to the financial difficulties of the debtor. Therefore, the analysis concluded, such transactions should be accounted for under the rules of FAS No. 15 and the banks would not have to recognize a loss assuming that the requirements of FAS No. 15 are met.

2. Loan Loss Reserves

In order to provide an incentive to banks to provide new money to LDC debtors, the Federal Reserve Board recently announced that no reserves will be required against new loans made in the context of the Brady Plan. At this time it is still too early to assess how significant an impact this will have on the U.S. creditor banks' willingness to provide new money to LDC debtors.

G. U.S. Tax Treatment of Debt Reduction Transactions

Since the 1986 Tax Reform Act repealed Internal Revenue Code Section 166(c),⁵¹ voluntary loan loss reserves are generally not deductible. The commercial banks may only take a deduction for the losses associated with their loans upon the actual realization of the loss, that is when the debt has actually been exchanged or sold for a loss. Whether or not the current tax law provides an incentive or deterrence for banks to enter into debt reduction

49. SECURITIES AND EXCHANGE COMMISSION, ACCOUNTING AND DISCLOSURE ISSUES INVOLVED IN LDC DEBT RESTRUCTURINGS, STAFF MEMORANDUM (July 14, 1989).

50. *Id.* at 2.

51. See 26 U.S.C. § 166(c) (1982) (repealed 1986).

schemes is unclear. Some bankers have argued that if loan loss reserves were deductible, banks would more readily accept the devaluation of assets that usually accompanies debt reduction deals. Other bankers have argued, however, that because the current tax law only allows a deduction upon the actual sale or exchange of debt, the law provides an incentive for banks to actually consummate a debt reduction transaction.

On May 22, 1989, the Internal Revenue Service issued Notice 89-58 dealing with the allocation and apportionment of loan losses suffered by U.S. banks.⁵² This notice has encountered great opposition from U.S. banks. Notice 89-58 states that U.S. banks must apportion their loan losses between U.S. and foreign source interest income according to the tax book value asset method described in Section 1.861-9T(g) of the Internal Revenue Regulations (*i.e.*, a bank must apportion its losses with respect to such loans between foreign and U.S. income according to its ratio of foreign assets (loans) to its overall assets (loans)).⁵³ The effect of this notice is that since foreign loan losses are linked to foreign income in a strictly proportional method, the U.S. tax credits which the banks can effectively use as the result of paying foreign taxes on their foreign source interest income may be substantially reduced. Under Section 901 of the Internal Revenue Code, when a U.S. bank pays a foreign tax on its foreign source income, it receives a tax credit that it may apply against its U.S. income tax.⁵⁴ If the tax rate of the foreign country is higher than the U.S. tax rate, as is often the case, the greater the amount of taxes that the bank pays in the foreign country and applies as tax credits for U.S. tax purposes, the lower the bank's overall tax burden will be. The banks can only use tax credits, however, up to an amount equal to their foreign source income divided by their total income multiplied by their U.S. taxes for that year.⁵⁵

Before Notice 89-58, U.S. banks allocated substantial amounts of their foreign loan losses to U.S. source income, so that their foreign source income was higher. Thus, the cap on the banks' tax credits for U.S. income tax purposes was also higher. As a result of Notice 89-58, U.S. banks are now restricted in their ability to allocate loan losses to U.S. source income and thus are limited in their

52. I.R.S. Notice 89-58, 1989 C.B. 699.

53. Treas. Reg. §1.861-9T(g) (1989).

54. 26 U.S.C. § 901 (1988).

55. *Id.* § 904(a).

ability to use increased foreign tax credits. This limitation may therefore remove an incentive for U.S. banks to enter into debt reduction schemes because large amounts of the losses resulting from such schemes will be forced to be allocated to foreign sources. Thus, not only may the banks realize financial losses as a result of entering into debt reduction schemes but, due to Notice 89-58, U.S. banks may also lose a substantial part of the tax benefits associated with the utilization of foreign tax credits.

V. CONCLUSION

As a result of having substantially increased their capital and loan loss reserves during recent years, the commercial bank creditors are in a much better position to absorb the losses inherent in their LDC loan portfolios and, therefore, to aggressively manage such portfolios. Thus, the banks are much freer to engage in debt/equity conversions and debt securitization and collateralization schemes similar to the Mexican Debt Exchange.

The Brady Plan has provided further encouragement to such schemes as a means of effecting substantial LDC debt reduction. The World Bank, the IMF, and Japan have also pledged their direct financial assistance to help finance debt reduction schemes.

The degree of flexibility and the objectives of the banks in dealing with their LDC debt portfolios differ greatly. Perhaps it is unwise and impractical to seek an essentially single, common approach for all the banks to substantial debt reduction. Instead, if the bank steering committees and the debtor nations cannot reach a prompt agreement on an overall approach, perhaps such committees should let the market place develop a number of specific transactions or schemes to deal with the particular needs of individual banks and debtor nations. The development of innovative debt reduction schemes will require a careful blending and balancing of the regulatory, accounting and tax environments affecting the creditor banks with the cash flow and economic limitations of the debtor nations.

The recent liberalization of Regulation K by the Federal Reserve Board has alleviated, to a certain extent, one of the regulatory hurdles to debt-equity conversions. Although debt-equity programs have recently been curtailed in a number of countries, debt-equity conversions can be a powerful tool not only in reducing the LDC debt burden, as Chile has demonstrated, but also as serving

as an engine of growth in encouraging new capital investment. Similarly, debt securitization and collateralization schemes can be quite effective in reducing LDC debt burden while giving the banks, especially those seeking an exit vehicle from LDC lending, flexibility in determining whether to retain or liquidate their LDC debt.

None of these techniques or others currently being developed, standing alone, can be viewed as a "solution" to the LDC debt problem. But, taken together and if not unduly restricted by government regulations, accounting rules and loan agreement provisions, they can produce a significant reduction in the debt burden to levels that the principal debtor nations should be able to manage comfortably. Hopefully, the U.S. Government, other OECD governments, the World Bank, and the IMF can work together to help the LDC nations and the commercial banks achieve substantial debt reduction through debt-equity conversions, debt securitization and collateralization schemes, and other innovative transactions.