

LATIN AMERICAN

Law & Business Report



Volume 13, Number 02

February 28, 2005

HIGHLIGHTS

Success for Argentina's Debt Swap

Despite harsh criticism by bondholders, most creditors held their noses and took the Argentine government's offer of a 70% haircut. Many foreign creditors rushed to accept the terms at the last minute. **Page 3**

Brazil Strengthens Investor Rights

Many Brazilian companies for the last 60 years have been controlled by a single family. A new Corporation Law and other changes hold the hope that minority shareholders, including foreign investors, will be treated more fairly. A special interview examines the legislative and regulatory improvements in corporate governance in Brazil, and notes the practical effects of the changes. **Page 4**

Why Due Diligence Fails to Uncover Problems in Latin American Companies

This article looks at the reasons for the failings, and notes how the process can be improved so that unpleasant surprises—after the merger is complete—can be avoided. **Page 5**

Will Bolivia's Anti-Corruption Bill Help?

An anti-corruption bill is presently winding its way through the Bolivian congress. If passed, the law will be directed at wrongdoing at all levels of government. **Page 7**

Taking Advantage of Brazil's New Public-Private Partnership Law

Two articles examine the fine print of the PPP law, including drafting requirements and the all-important issue of assigning assumptions of various risks. **Pages 9 and 10**

Will Brazil Adopt More Realistic Thresholds for M&A Reviews?

A draft law in the Brazilian congress would change the merger review system to provide approvals—or denials—of M&As in a more timely manner, and raise the thresholds that would trigger review. **Page 11**

Will Fenix Project Be the Model for Opening Mexico's Oil & Gas Sector?

The Mexican government is trying a new approach to entice foreign investment in the one sector of the petrochemical industry where private participation is permitted. New rules permit private companies to operate without PEMEX participation. **Page 22**

CONTENTS

Argentina

Argentina's Debt Exchange. By Walter Molano (BCP Securities) p. 3

Argentina Labor Leaders Discuss Wage Accord with Kirchner. By Michael Casey (Dow Jones) p. 6

Bolivia

Bolivian Anti-Corruption Laws. By Antonio Sanjines (C.R. & F. Rojas - Abogados) p. 7

Brazil

Improved Protections for Foreign Investors in Brazil; New Laws, Policies, Encourage Better Corporate Governance, Creditor and Shareholder Rights. An Interview with Aldo Musacchio (Harvard Business School) p. 4

Why a PPP and Not an Ordinary Concession? By João Marcelo Gonçalves Pacheco (Pinheiro Neto Advogados) p. 9

Extraordinary Risk Allocation in PPPs. By Fernando S. Marcato and Paulo Henrique Spirandeli Dantas (Pinheiro Neto Advogados) p. 10

Brazil: Possible New Merger Control System. By Ricardo Inglez de Souza (Demarest e Almeida) p. 11

Recent Antitrust Developments. By Priscila Castello Branco and Paula Azevêdo (Trench, Rossi e Watanabe Advogados) p. 13

Brazil's Economy Sees Record Growth and Higher Interest Rates. By Edwin Taylor p. 14

Contents Continued on Page 2

Contents Continued from Page 1

Mexico

Non-Basic Petrochemical Industry Faces Challenges in Mexico. By Jorge Valadez (Squire, Sanders & Dempsey) p. 22

New Laws to Broaden Liability of Mexican State to Private Parties. By Jorge Jiménez (López Velarde, Heftye y Soria) p. 24

Mexico Seen Needing \$10 Billion a Year to Develop Deep Water Oil. By Amy Guthrie (Dow Jones)..... p. 25

Regional

Lessons Learned from Due Diligence in Latin America. By Maria Gabriela Sosa and Gonzalo Pacanins (BG Consulting, Inc.) p. 5

Venezuela

New Foreign Exchange Rule Could Restrict Exports in Bolívars. By Luis Ernesto Andueza and Rubén Eduardo Luján (Despacho de Abogados Miembros de Macleod Dixon) p. 27

Venezuela's New Consumer Protection Law. By Maria Eugenia Salazar (Baker & McKenzie) p. 28

Venezuelan Legal and Business Developments. By Vera De Brito de Gyarfás (Travieso Evans Arria Rengel & Paz) p. 32



Publisher: Gary A. Brown, Esq.
Managing Editor: Scott P. Studebaker, Esq.

Published by WorldTrade Executive, Inc.
Tel: 978-287-0301; Fax: 978-287-0302
www.wtexec.com

Assistant Editor: Edie Creter **Special Interviews: Scott Studebaker**
Feature Writers: **Production Assistance: Edie Creter**
Judy Kuan, Petra Halsema **Marketing: Jon Martel**

ADVISORY BOARD

Frederick R. Anderson
 Cadwalader, Wickersham & Taft

Patricia Lopez Aufranc
 Marval, O'Farrell & Mairal
 (Buenos Aires)

Ariel Bentata
 Ruden, McClosky, Smith, Schuster &
 Russell, P.A.

Nicolas Borda B.
 Borda y Quintana, S.C. Abogados
 (Mexico City)

Laurence E. Cranch
 Rogers & Wells

William E. Decker
 PricewaterhouseCoopers

Stuart Dye
 Holland & Knight

David G. Ellsworth
 Baker & McKenzie

Thomas Benes Felsberg
 Felsberg e Associados, Advogados
 (São Paulo)

Georges Charles Fischer
 Fischer & Forster
 (São Paulo)

Isabel C. Franco
 Demarest e Almeida
 (New York and São Paulo)

Sergio J. Galvis
 Sullivan & Cromwell

Steven D. Guynn
 Jones Day

William Hinman
 Simpson Thacher & Bartlett LLP

Salvador J. Juncadella
 Morgan, Lewis & Bockius LLP

Hugo Cuesta Leño
 Cuesta Campos y Asociados
 (Guadalajara)

Timothy J. McCarthy
 Hughes, Hubbard & Reed

Thomas P. McDermott
 TPM Associates

Antonio Mendes
 Pinheiro Neto-Advogados
 (São Paulo)

John H. Morton
 formerly Hale and Dorr

Edmundo Nejm
 Linklaters & Alliance
 (São Paulo)

Uriel Federico O'Farrell
 Estudio O'Farrell Abogados
 (Buenos Aires)

Juan Francisco Pardini
 Pardini & Asociados
 (Panama City)

Reinaldo Pascual
 Kilpatrick Stockton LLP

Robert J. Radway
 Vector International

Keith S. Rosenn
 University of Miami
 School of Law

Eduardo Salomão
 Levy & Salomão
 (São Paulo)

M. Stuart Sutherland
 Troutman Sanders LLP

Miguel A. Valdes
 Machado & Associates, LLC
 (São Paulo)

Carl Valenstein
 Arent, Fox, Kintner,
 Plotkin & Kahn

Juliana L.B. Viegas
 Trench, Rossi e Watanabe
 (São Paulo)

Laurence P. Wiener
 Negri & Teixeira Abogados
 (Buenos Aires)

Lessons Learned from Due Diligence in Latin America

by Maria Gabriela Sosa and Gonzalo Pacanins

[Editor's Note: This article reviews some of the most common pitfalls of due diligence examinations of companies in Latin America. A future article will focus on the difficulties often found when evaluating the competitiveness of the target company in the local market.]

Unfortunately, the following example is all too common. A medium sized manufacturing company headquartered in Michigan has decided to enter the Brazilian market by acquiring a São Paulo manufacturer of metal fasteners. The usual cadre of lawyers, accountants, and in-house staff spend months reviewing the target company, and issue a favorable report at the conclusion of their due diligence survey. The papers are signed, and company management is pleased with the outcome.

However, since finalizing the deal, positive forecasts and indications of compatibility have been dashed by surprises about the acquired firm. A closer look reveals that plant assets were overvalued in the financial statements. Six months after the acquisition, operations were halted due to a government crackdown on permit compliance. Costs are steady, but revenues have fallen precipitously.

While many in management will be asking how did it all go so wrong, so soon, for our purposes, the question should be, could the results have been predicted? Many times, the answer is simply "yes."

In this example, and in many real life cases (the example was a composite of several real life cases), the problem lies largely with the due diligence process. Many mergers and acquisitions with companies in Latin America and the Caribbean (LAC) have fallen short of expectations for reasons that have much to do with the failure of the due diligence process to take note of relevant information and to relay this information to management. The failure in part lies with the types of people who are often chosen to perform due diligence and in part with structural limitations that frequently characterize due diligence in Latin America. This article attempts to both point out the areas where due diligence

Maria Gabriela Sosa (mariasosa@bg-consulting.com) is Vice President of BG Consulting, Inc., a consulting firm specializing in developing business in emerging markets. Gonzalo Pacanins is a M&A specialist, former CFO and CEO of various AES companies in Latin America.

has failed, and to note how the procedure can be remedied to deliver accurate information about target companies in Latin America or the Caribbean.

Look at Yourself First—and Differently

Typically an acquiring firm directs most of its due diligence energies on an examination of the target company. However, a deal's success is equally dependent on an accurate assessment of the acquiring firm's internal position and how this position will change when analyzed outside its home environment and confronted with different competitors. The buyer must identify its own strengths and define its plan for growth for any new acquisitions.

Special consideration must be paid to the target's market. What can be considered a powerful strength in the U.S. may not necessarily be one in LAC. Knowledge of the region is required. For example, the acquiring company might assume its innovative worker-training and

Since finalizing the deal, positive forecasts and indications of compatibility have been dashed by surprises about the acquired firm.

compensation program, which has allowed it to retain skilled employees and beat competitors on turnover costs, would provide the same advantage in international markets. However, labor laws in LAC might transform those benefits into burdens that seriously impair the company's competitiveness.

There are countless instances by which a firm can incorrectly evaluate its competitive position by failing to account for differences in international markets. On the positive side, the greater the extent to which the new environment is accounted for, the more accurate a due diligence will be.

By evaluating itself in an international context, a company will be able to better define the desired characteristics of an acquisition target. Furthermore, a firm's accurate understanding of its competitive position abroad

Continued on page 25

Mexico Seen Needing \$10 Billion a Year to Develop Deep Water Oil

by Amy Guthrie

VERACRUZ (Dow Jones) Mexico's efforts to tap deep water oil reserves will likely require about \$200 billion in investment over 20 years, a BP Plc (BP) official said February 21.

"How much is needed depends on the requirements of Mexico going forward in production," said Chris Sladen, vice president of exploration and production for BP Mexico.

Speaking at an event sponsored by Mexican state oil monopoly Petroleos Mexicanos (PEMEX), Sladen said other companies have been extremely successful in reaching deep water reserves on the U.S. side of the Gulf of Mexico, and that those efforts have been collaborative.

Sladen and other representatives of multinational oil companies say a joint effort is the best way for Pemex to successfully harvest deep water crude deposits.

Changes to Energy Laws Necessary

Pemex reckons it has about 45 billion barrels of oil below deep water in the Gulf, but officials have said they will need to form alliances with other companies to acquire the technology and experience necessary to explore and exploit the resource.

That requires legal changes in Mexico, where energy

laws prohibit Pemex from granting oil and gas concessions or forming upstream joint ventures.

Given the high financial stakes of the deep water project, the format of the multiple service contracts Pemex has awarded to produce natural gas from proven reserves wouldn't offer the same sort of rewards in deep water. A joint venture might be necessary to guarantee returns on investment for multinationals.

"We have to talk to the oil companies to see how they want to do it. There's no perfect scheme," said Rafael Bracho, deputy head of finance at Pemex.

Last November, Pemex struck oil at a depth of 680 meters. Pemex contracted Diamond Offshore Drilling (DO) to drill that well.

By bringing several multinationals to the deep water project, Pemex can tap into the best and brightest of the industry, private sector experts say.

"If you look at the U.S. Gulf, it's all provided by private contracts. There's a learning curve in deep water," said Andrew Gould, chief executive of oil services company Schlumberger Ltd. (SLB).

By bringing several multinationals to the deep water project, Pemex can tap into the best and brightest of the industry, private sector experts say.

"We've had a lot of discussions with Pemex. There's a lot of opportunity for us to work together. Geology doesn't know country borders," said Lew Watts, senior vice president of innovation and marketing for Houston-based services company Halliburton (HAL). □

Due Diligence (from page 5)

will allow for greater ability to identify red flags (signs of caution) and deal breakers during the deal structuring process. Armed with a well thought out and clearly defined set of answers to "what if" issues that may come up in the due diligence process, a firm improves its negotiating position. It knows that it's OK to walk away if the deal-breaker condition cannot be resolved.

Common Mistakes in Due Diligence in LAC Companies

Mistake #1: The Wrong Due Diligence Team

Frequently investors start off at a disadvantage in the due diligence process by lining up the wrong team, or similarly, in not using the best players at the right times. Due diligence assessments are often conducted by business developers, lawyers, and accountants—in some

cases separately—while technical personnel, uniquely qualified to value many of a firm's fixed assets, are scarcely utilized—and often only during the final stages of a due diligence. Such a lack of technical expertise often means that problems with sophisticated machinery or other equipment may go unnoticed until after the deal has been signed. By including technical experts in the due diligence process from the beginning, a buyer can obtain a more accurate picture of a target's assets.

Just as technical experts can spot problems with sophisticated machine tools, experts who understand both the buyer's industry and local business conditions need to be called in to assess the investment climate. As the acquiring firm's management is interested in instances where the target's activities deviate from what is typical in its home country, the team must also understand the buyer's business environment. While having a bi-cultural assessment team does not require that each team mem-

Continued on page 26

Due Diligence (from page 25)

ber understands both contexts, it does compel a team to contain experts from both business environments and be sufficiently integrated to allow information exchange between team members from the distinct cultures. A LAC expert with no knowledge of the local environment of the buyer will probably not detect which situations could be harmful or not convenient for the buyer. LAC experts could consider something normal that the buyer could deem absurd or unacceptable.

Such problems persist even when due diligence is conducted by large international firms with offices located near the target firm. Often in such cases, information gathering is done entirely by the international office. The information is then passed to the home office where the evaluation is completed and presented to the client. In such cases, the home office's absence during the information collection process leaves room for errors. Taking again the example of equipment maintenance, an international assessment team that is inexperienced with the lower standards of the buyer's business environment might report equipment had been well maintained (based on maintenance records at the target company) when a lower evaluation would be more accurate to the reader of the report in the home office. The result is an overstating of the value of the equipment.

Mistake #2: The Due Diligence Checklist—The First Two Seconds of a Two-Hour Movie

Due diligence has become largely standardized. As a result it does not allow for flexible interpretations and ignores many of the factors critical to a sound investment evaluation. Each buyer and each target is different. Thus, each due diligence needs to be customized to the parties involved and to the particular conditions of the target's market. The following are factors about which those performing due diligence in LAC should take particular care:

Accounting practices: Understanding differences in countries' accounting practices, not just principles, is crucial to properly valuing a firm. Generally, LAC companies are more inclined than U.S. firms to adopt creative accounting practices. Although creative accounting is certainly not unique to Latin America, unstable economies and changing tax regimes promote ambiguity and lack of consistency in accounting. As a result, many different interpretations of the GAAP, not necessarily based on the same standards used in the U.S., may coexist in the company's accounting system.

Ownership and control: Firm ownership in LAC tends to be concentrated around individuals and families. This situation is not always bad, but caution is recommended since corporate governance rules are less stringent in most LAC countries. Quite commonly the owners have special ways of milking cash from the

company. Thus, it is important to understand how the owner makes money as well as how the company makes money.

Internal auditors: Commercial laws are outdated in most of the LAC countries. There are few restrictions on who can be an internal auditor of a company. Consequently, it is not unusual for shareholders or the friends and family of shareholders to conduct internal audits. These audits should be given little value in a due diligence.

External auditors: External audits are often conducted by firms with conflicts of interest. Frequently, external auditors are simultaneously financial advisors or lawyers for the companies they audit. They may have been involved in many "creative" accounting and tax solu-

Unstable economies and changing tax regimes promote ambiguity and lack of consistency in accounting.

tions, which will not be revealed in company reports. While such conflicts of interest are not exclusive to LAC, weak enforcement and outdated legal codes increase their prevalence in the region. When issues of conflict of interest related to auditing show up in the due diligence, the buyer should see them as red flags. In such circumstances, the auditor should be viewed as more of an interested party than an objective evaluator.

Boards of directors: Likewise, conflicts of interest by company board directors in LAC are common. In many companies the boards of directors are largely made up of members of the owner's family, business partners or friends. According to a recent USAID study in Central America, boards of directors tended to vote as management wished. Such conflicts of interest could likely remain an issue if the previous owner retains some control of the company. To make matters more complicated, board members are frequently well connected and useful in facilitating a firm's relations with the government or other third parties. The "connections" of some board members should be considered when considering their removal after an acquisition.

Real estate: Special attention must be paid to real estate titles. In many LAC countries, registration procedures make proof of title difficult and time consuming. In addition, ownership of important assets may be questioned due to multiple titles, zoning, squatter rights, and risk of *de facto* expropriation. It is also important to note that in some countries (e.g., Guatemala), foreigners may not acquire land in some parts of the country. Litigation over real estate in the wake of acquisitions in Latin America has been all too common, and usually with poor results for the corporate buyer. □

VENEZUELA

~~Legislation Update~~ (from page 35)

The Ministry of Infrastructure through the National Civil Aviation Institute issued partial Regulations on the General Conditions of Air Transport specifically related to the compensation and aid to passengers in the case of unjustified rejection of boarding, cancellation or delay of flights. The National Civil Aviation Institute also published the fees to be charged by such institute for the services it offers and adjusted the aviation fees to be paid by airplanes that fly over or land in Venezuela. The Administrative Rulings containing such norms were all published in the Official Gazette of December 6, 2004.

The Ministry of Production and Commerce announced that all administrative procedures that had been suspended in November due to the fire in Parque Central where its offices were located are now resumed as of January 12, 2005. This Resolution was published in the Official Gazette of January 13, 2005.

The Ministry of Production and Commerce created the Electronic Registry of Consultants which will be managed by the National Autonomous Service of Normalization, Quality, Metering and Technical Regulations

(Servicio Autónomo Nacional de Normalización, Calidad, Metrología y Reglamentos Técnicos— SENCAMER). When public entities contract consultants, they must necessarily request from the consultant (individual or company) the valid certificate of Electronic Registry of Consultants.

The Ministries of Defense and Infrastructure prohibited the use of civil airplanes in La Carlota military base in Caracas. The owners of airplanes have a period of 60 days as from December 15, 2004 (date of publication of the Resolution in the Official Gazette), to remove said airplanes from the military base.

The National Assembly declared the public use of VENEPAL, a paper manufacturing company that went bankrupt and whose facilities were taken over by its employees. Now, by means of the State intervention and employee management, VENEPAL will be re-launched as a state owned company INVEPAL, S.A., as per Presidential Decree No. 3449, published in the Official Gazette of December 31, 2004.

The Venezuelan Presidential Commission for the Peaceful Use of Space was created via Presidential Decree No. 3389, published in the Official Gazette of December 28, 2004. □

Fastest Way to Order: Fax Us Today (978) 287-0302 or Call (978) 287-0301

YES, sign me up risk-free for **Latin American Law and Business Report** today. I understand I may cancel within 60 days for a full refund.

1 Year/12 issues – \$893 (\$943 outside U.S.)

Name _____

Company _____

Title _____

Address _____

City _____

State/Prov. _____

Country _____

Zip/Mail Code _____

Phone _____

Fax _____

Email _____

Billing Info: Company Check (US funds only)

Bill me

Charge my card:

Visa MasterCard Diners Card AmEx

Card # _____

Expires _____

Signature _____

NO-RISK GUARANTEE

If you are dissatisfied with **Latin American Law and Business Report** at any time in the first two months, we will cancel your subscription and refund your payment in full.

Checks/money orders payable in \$U.S. only to **WorldTrade Executive, Inc.**

WorldTrade Executive, Inc • P.O. Box 761 • Concord, MA 01742 USA • Phone: (978) 287-0301

• Fax: (978) 287-0302 • Email: info@wtexec.com • Web: www.wtexec.com