

LATIN AMERICAN

Law & Business Report



Volume 13, Number 03

March 31, 2005

HIGHLIGHTS

Opening for Foreign Investors in Mexico's Existing Oil Fields

Mexico's state oil monopoly, Pemex, is opening some parts of the oil sector to private—and foreign—participation. Under a new contract scheme, Pemex will pay bonuses to producers in mature onshore fields when they meet quotas. Page 3

Analysis of the Fine Print of Brazil's New PPP Law

A special report on Brazil's newly enacted public-private partnership program examines the contractual requirements, guarantees, special payment funds, and other details of the program. Page 10

A Closer Look at the Protections and Procedure under Brazil's New Bankruptcy Law

In a welcome change from the previous bankruptcy law, the new law provides real safeguards for secured creditors, and secured property. Page 4

The Reasons for Argentina's Economic Recovery

The biggest surprise to the Argentine financial meltdown was the speed and strength of the economic recovery. Much of the credit should go to one of the understated assets of Argentina: its large pool of highly skilled workers. Page 5

Tax Planning for Foreign Investors in Argentine Real Estate

Several different structures are examined that permit foreign companies to minimize the tax effects of investments in commercial real estate projects. Page 6

It's Official: Brazil's Economy Surged in 2004

Brazil's economy grew by over 5 percent last year, but ever higher interest rates by an inflation-focused Central Bank threaten a continuation of the growth. Page 10

Complying with Mexico's National Registry Requirements

Foreign investors must register and file periodically with the Mexican Registry for Foreign Investments. The agency has published new rules to make the process less bureaucratic. Page 18

Evaluating the Value of Latin American Firms

Standard due diligence often fails to provide an accurate value of Latin American companies for the medium term. This article looks at the reasons why, and discusses some factors that need to be included in the due diligence report. Page 21

CONTENTS

Argentina

Argentina: Miracle on the Pampas. By Walter Molano (BCP Securities) p. 5

Real Estate Investments in Argentina Directed from a Foreign Company; "Doing Business" Requirements and Tax Planning. By Matias Grinberg (Severgnini, Robiola, Grinberg & Larrechea) p. 6

Brazil

The New Brazilian Bankruptcy Law and Offshore Loan and Leasing Transactions. By Marcello Portes da Silveira Lobo (Pinheiro Neto Advogados) p. 4

Brazil Says "No Thanks" to Extension of IMF Loan. By Scott P. Studebaker p. 8

Brazil's E&P Rounds Validated by Highest Court. By Glenn Faass (Macleod Dixon Consultores em Direito Estrangeiro), Elisa Sesana and Roberto Carneiro (Carneiro e Sesana Advogados) p. 9

Government Allies in Congress Retreat on Tax Hike Bill. By Gerald Jeffris (Dow Jones) p. 9

The Brazilian Public-Private Partnership Program. By Walter Douglas Stuber (Stuber-Advogados Associados) p. 10

Contents Continued on Page 2

Contents Continued from Page 1

Brazil, continued

Higher Interest Rates Put Growth at Risk.
By Edwin Taylor p. 11

Mexico

Pemex Opens Door—Slightly—to Private Contractors. By Jorge Jimenez (López Velarde, Heftye y Soria) p. 3

National Registry for Foreign Investments. By Alejandro Faya-Rodríguez (Iberoamericana University and Mexican Ministry of Economy) p. 18

Peru

Peru to Give Telefonica Merger Verdict in April.
By Robert Kozak (Dow Jones) p. 20

Regional

Lessons Learned from Due Diligence in Latin America: Going Beyond Conventional Wisdom.
By Maria Gabriela Sosa (BG Consulting, Inc.) and Gonzalo Pacanins p. 21

Will Latin America Get More Attention in Bush's Second Term? By Sidney Weintraub (Center for Strategic and International Studies) p. 23

Venezuela

Venezuelan Legal and Business Developments.
By Vera De Brito de Gyarfas (Travieso Evans Arria Rengel & Paz) p. 26

Business Assets Tax Abrogated. By Ronald Evans (Baker & McKenzie) p. 28

VAT Withholding. By Carlos Fernandez Smith and Mauricio Posadas (Despacho de Abogados Miembros de Macleod Dixon) p. 29

LATIN AMERICAN
Law & Business Report



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
Feature Writers:
Judy Kuan, Petra Halsema

Special Interviews: Scott Studebaker
Production Assistance: Jon Martel
Marketing: Jen Baker

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 Leaña
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 & Teijeiro Abogados
(Buenos Aires)

Lessons Learned from Due Diligence in Latin America: Going Beyond Conventional Wisdom

by Maria Gabriela Sosa and Gonzalo Pacanins

[Part 1 of this multiple-part series (*LALBR*, February 28, 2005, p. 5) examined the initial phase of the due diligence process, and the need to assess the buying company's advantages in relation to the market of the target company. Part 1 also examined the common mistakes of assembling a due diligence team, and suggested some novel criteria for analyzing Latin American businesses.

This second article in the series discusses the methods for evaluating the target company and the local business environment. It suggests that some factors often ignored in the due diligence process should be given more attention.]

The Importance of Context

A potential acquisition or strategic partner in Latin America must be assessed in context. Exogenous risks such as expropriations, conflict, and litigation are more likely in certain countries and, if accounted for, will enhance the value of a due diligence examination. An evaluation is insufficient if the target firm is located in a country where conflict is eminent or expropriations are common. An evaluation is insufficient if it is based solely on financial, management and potential legal liabilities. An evaluation is insufficient if it fails to provide a complete picture of the target. Using local sources to gather information, while important in some aspects of due diligence, often results in neglecting exogenous risks that are considered part of business-as-usual to local lawyers or industry specialists.

Regulatory or de facto expropriations are an important non-commercial risk to consider when entering Latin America. Such expropriations, sometimes referred to as creeping expropriations, gradually reduce a property's value by restricting its use or increasing its tax burden, eventually leaving the property useless.

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

Non-Commercial Risks

While North American managers entering Latin America commonly have a good grasp of the venture's commercial risks, they commonly underestimate the importance of non-commercial risks in the target country. Expropriation, rapid currency devaluation, and war can destroy a business, often faster than commercial factors, and should be considered carefully before entering a country. While it is often more difficult to quantify non-commercial risks than commercial ones, certain variables provide investors with a better idea of these factors. A starting point for evaluating a country's regulatory, judicial and political climates can be obtained using indicators from the World Bank, Heritage Foundation and Transparency International.

Various types of non-commercial risk insurance and guarantees offered by private financial institutions, the U.S. government-affiliated Overseas Private Investment Corporation and World Bank-affiliated Multilateral Investment Guarantee Agency can mitigate non-commercial risks or assist in securing lending for risky projects

U.S. companies are under greater pressure to demonstrate transparency and compliance, not only in foreign operations but in the operations of their foreign service providers.

abroad. But they usually guarantee against a portion of the risk, as opposed to the entire amount of risk.

When assessing the risk associated with a potential target's country of origin, it is also important to look at the country's participation in international treaties. In particular, bilateral investment treaties (BITs) and the investment chapters of free trade agreements (FTAs) protect investors from signatory states against irregular expropriations, unfair treatment such as lack of due process of law and the imposition of unfair regulations such as restrictions on repatriation of profits or dividends. These treaties typically contain an arbitration provision whereby the investor is entitled to initiate international arbitration against a state said to be in violation of the treaty. Through this, foreign investors can circumvent weak domestic legal systems. If the state has not consented to arbitration, the investor may be able to stipulate ad-hoc consent during negotiations.

A diligent investor should first look at a country's overall legal and political climate to determine whether non-commercial risk is high. Once these issues are understood, the investor needs to determine whether the country has committed to treaties that regulate its con-

Continued on page 22

Lessons Learned (from page 21)

duct towards foreign investments. BITs, investment chapters of FTAs, are common in Latin America, however these safeguards frequently remain unknown to international investors.

Latin American countries have signed more than 400 BITs. Argentina has BITs with the U.S., China and almost all Latin American countries. Peru and Colombia have signed similar agreements with many Latin American countries and a chapter will be included in the pending FTA with the U.S. Trinidad and Tobago signed similar agreements with China and the U.S.

Regulatory Framework

Latin American countries tend to have complex regulatory frameworks, and company compliance is often costly. The vagueness and frequent changes of Latin

The various permits and approvals necessary for operating a business are important to consider when assessing a target.

America regulatory codes make compliance with regulation a factor necessary in due diligence.

Local Taxes

Often a company will forecast its tax burden in a target market, on projected liability for national taxes, while local taxes may be ignored. National and local taxes frequently overlap in Latin America and the national government's monitoring of the behavior of municipalities is frequently lax. The relevant local government might increase tax rates immediately after an investment has been established or impose other cost burdens or restrictions on a foreign firm. As local courts tend to move slowly, firms can be left defenseless against such actions for long periods.

Tax Compliance

Complicated tax codes and layered bureaucracies make tax compliance expensive in Latin America. The high cost associated with tax compliance is illustrated by the large informal economies present in the region, as small firms often evade taxes. Because large firms frequently use loopholes to reduce tax payments, medium-sized firms are often saddled with the highest effective tax rate.

Treaties to avoid double taxation (double tax treaties) can reduce the compliance costs associated with national taxes in two countries. Besides providing a sim-

plified code, these treaties often lower tax rates, especially for withholding tax, and may include provisions that eliminate taxes on dividends. Unfortunately, few Latin America countries have signed double tax treaties. So far, only Mexico, Venezuela, Argentina and Trinidad and Tobago have signed these agreements with the U.S. Brazil and Venezuela have double tax treaties with China. However, because double tax treaties often precede a FTA, Peru, Colombia, Ecuador, Chile, and the Central American countries, through CAFTA may soon enter into such agreements with the U.S.

Administrative Barriers

The various permits and approvals necessary for operating a business are important to consider when assessing a target. While these administrative barriers are a burden to business in general, in Latin America they are particularly cumbersome to foreign investors. While local firms may have informal means of expediting these processes, foreign firms often lack such connections.

U.S. companies are under greater pressure to demonstrate transparency and compliance, not only in foreign operations but in the operations of their foreign service providers. Additionally, U.S. firms, or those listed on American exchanges should note the effect that Sarbanes-Oxley requirements will have on international operations. Informal accounting practices in the region make the application of Sarbanes-Oxley standards difficult.

Some aspects of Sarbanes-Oxley compliance will prove particularly difficult, such as reports on internal controls from service providers. On the other hand, European companies, which are not currently required to record the same information from their service providers as U.S. companies, will enjoy a temporary advantage in control costs. Reporting, monitoring, and compliance are, and will continue to be, critical factors when evaluating Latin American operations. While resistance to Sarbanes-Oxley requirements should be expected in Latin America, as in the U.S., increased confidence in reporting will eventually sway detractors to adopt the changes.

Competitive Environment

The competitiveness of the business environment should also be considered when assessing a deal in Latin America. Many industries are dominated by a single local firm and antitrust agencies or industry-specific regulators often lack the power or political strength to ensure true competition. Regulation has been weak over energy, transportation, financial services and telecommunications industries. While, in theory, state-owned monopolies have been largely eliminated, these entities, now privately owned, frequently hold entrenched positions. While formal relationships with government have generally been eliminated, informal ties to important regu-

Continued on page 23

Lessons Learned (from page 22)

lators and politicians support these firms' position. Such relationships should be examined carefully as part of the due diligence process.

For example, entering the Mexican telecom market requires an understanding of Telmex and its relationship with the government. In other markets such as Peru, Bolivia, and Venezuela, the telecom infrastructure is owned by the incumbent, which hinders entry of new competitors to the market. On average, five years after privatization, the incumbent still holds market share of greater than 45 percent. While laws may force incumbents to share infrastructure, cozy relationships between regulators and incumbents make foreign entry more difficult.

Culture

Cultural considerations should be assessed when

performing due diligence on Latin American firms. To ignore cultural considerations when performing due diligence essentially assumes that either the cost of adopting a business model to fit a culture or adopting a culture to fit a business model is zero; neither assumption is correct.

Companies need to be aware of local "business codes," which can determine the appropriate manner of working with local governments, consumers, suppliers, and employees. The acquirer should assess the discrepancy between the two cultures to determine whether the cost associated with cultural adjustment will be relatively high or low. Such a comparison also provides valuable information regarding appropriate post-merger actions to reduce cultural-related friction. Large cultural gaps between firms will tend to make a merger more risky, as the possibility of losing key staff, witnessing a drop in employee motivation, and even sabotage is greater when business cultures are dissimilar. □

In My View

~~Will Latin America Get More Attention in Bush's Second Term?~~

~~by Sidney Weintraub~~

~~This is the season for Latinophiles to urge the U.S. administration to give greater attention to its relations with Latin America and the Caribbean. As one such report put it, "...in recent years, the United States and Latin America have increasingly been pursuing different agendas and growing apart in many ways."¹ Something similar is said every four years, but U.S. attention to its own hemisphere generally languishes compared with the priority given to other regions. There have been occasional exceptions, such as Franklin Delano Roosevelt's Good Neighbor Policy and John F. Kennedy's Alliance~~

~~Sidney Weintraub holds the William E. Simon Chair in Political Economy at the Center for Strategic and International Studies, Washington, DC. He is author of *Development and Democracy in the Southern Cone: Imperatives for U.S. Policy in South America* (CSIS, 2000). He was deputy assistant secretary of state for international finance and development from 1969 to 1974 and assistant administrator of the U.S. Agency for International Development in 1975.~~

~~for Progress but these rare moments of constructive attention reverted after a few years to the normal pattern of neglect.~~

~~Another kind of exception to the general pattern of neglect arises periodically when country leaders pursue anti-U.S. policies, particularly from the left. The United States exerted great effort, including invasions,~~

~~**U.S. relations with the hemisphere must be pursued on all these issues, but priorities have to be established if anything is to be accomplished.**~~

~~over the past half century to replace regimes in Caribbean and Central American countries, even to the extent of violating U.S. laws during the Iran-Contra period. But even this attention dissipated after the immediate mission was accomplished. The shift in U.S. policy from attention to indifference is well captured~~

Continued on page 24