CB 1111: THE DEBT TO EQUITY CONVERSION PROGRAM

NOEL OSTREA*

SYNOPSIS

Debt to Equity Conversion is a program envisioned by the Government whereby certain external debts of a Philippine Public Sector Borrower or a Philippine Private Sector Borrower are redeemed in connection with a conversion transaction.[1]

It has come to the attention of the Philippine Government that external debt obligations are being traded in the secondary market. If an investor purchases an interest in such an obligation and the obligor-debtoi is able to redeem the debt for the Peso equivalent of the amount of the obligation, this permits the investor to obtain Pesos. Afterward, the Peso proceeds of the transaction may be invested in a Philippine Enterprise only in the form of an equity investment. The government intends to utilize this transaction in order to encourage investors to make long-term equity investments in the Philippines. However, in order to ensure that the conversion transaction is not undertaken in order for the investor to obtain investments at a discount at the expense of the government, certain restrictions have been placed on the repatriation and remittance of the capital portion of the investment as well as dividends flowing therefrom.

At present, Philippine Public Sector Debts are not being encouraged for entry into the program because of the inflationary effects arising from their redemption.

The study of this law serves as an illustration of a novel form of *dacion*, and prepares the law student or practitioner for a better understanding of the merger or acquisition that may result from the inability of a highly leveraged corporation to pay its debt.

*Bachelor of Laws, 1989, Associate Professor in Economics, De La Salle University; Managing Editor, Ateneo Law Bulletin, 1989,

[1] The debt-equity swap program had been successfully experimented with by such governments as that of Chile. Under such a program, an investor not only purchases a debtor nation's foreign loan for the local currency that it then uses to buy a stake in a company in the debtor nation, but such investor may also use it to convert foreign debt to domestic debt. Rave Jr., James L., "Chile Shrinks Loan Size with Debt Swaps". *Washington Post*, August 24, 1986, page 43.

Introduction

An often cited aphorism of Justice Oliver Wendell Holmes is "Good cases make bad law." Sterling examples abound in our literature, among them, the celebrated constitutional cases such as *Sanidad v. Comelec,* and *Garcia-Padilla v. Enrile,* to name but two. Turning the proposition around, there are also several laws relevant to corporate law practice which are not as controversial, but are convoluted nevertheless. The study of this law serves as an illustration of a novel form of *dacion,* and prepares the law student or practitioner for a better understanding of the merger or acquisition that may result from the inability of a highly leveraged corporation to pay its debt.

By means of this article, I hope to provide the reader with a guide to the Central Bank Debt-to-Equity Conversion Program. For its fuller understanding, I have situated the circular within its proper economic context.

History and Practice

In 1986, the Monetary Board of the Philippines signed Central Bank Circular No. 1111 into law, otherwise known as the Philippine Debt-to-Equity Conversion Program.[2] At the time, it was conceived as one of the ways of reducing our huge debt burden[3], which is now estimated at $28.25 billion. As of November 40, 1988, the total Philippine debt converted into equity in local projects has totalled $584.5 M. This represents 202 transactions that have actually been closed, out of 350 applications approved by the Central Bank, representing $1.24 B. The total amount approved may be broken down as follows:

$459.9 M	as prepayment of CB obligations,
$ 8.8 M	as public sector debt,
$ 92.5 M	as other private sector debt, and
$ 23.13 M	as fresh investment.[4]

[2] The Debt-to-Equity Conversion Program will be discussed within the framework of the Revised Central Bank. Circular 1111 dated October 20, 1987, pursuant to Monetary Board Resolution 1024 dated October 19, 1987, as this is the most recent version of the law as of this writing.

[3] By no means is CB 1111 the only circular dealing with our foreign debt. There is a companion circular, CB 1188 signed on August 19, 1988 which superseded CB1076. This circular helps private corporate sector borrowers pay their foreign loan obligations by restructuring them thru the CB's Private, Debt Restructuring and Repayment Corporation (PDRRC). Since under this circular, only restructuring is involved, and no increases in money supply, this circular seems to be preferred.

[4] Business World, 27 December 1988.

By nationality, the largest group of investors are Filipinos, with 132 applications approved. Among foreigners, Hong-Kong Chinese are next with 43 applications approved with a total value of $140.8 M, followed by the Americans, with 41 applications approved worth $206.1 M.

Although the impact on the total Philippine external debt is rather small, to the businessman in the field, the program represents a forum for potential investment. This program is not limited merely to the Philippines, but likewise exists in other debt-strapped countries of the world, such as Mexico, Brazil, and Valenzuela. Because of this, it would be useful, as future practitioners of law, to acquaint ourselves with the diffcrent features of our own debt-equity program with an eye towards acquiring legal expertise in a field of corporate law.

Purpose and Intent of CB 1111

The best way to understand any law is to understand the purpose for which the law was created, and the situation for which it was envisioned. CB Circular 1111 was created for the purpose of converting debt into equity, i.e., to take the promissory notes of creditors of a local corporate entity and to translate these promissory notes into shares of stock or some other evidence of ownership in a Philippine corporation. What complicates the matter is the situation within which most of these debts were incurred, the fact that, because of our efforts to source foreign investment during the Marcos years, many of these debts are actually foreign debts owed to transnational banks.[7] Thus, in a purely corporate situation, elements of conflicts-of-law have been introduced. Fortunately for the purposes of our discussion, it appears to be an unspoken but reliable premise that the law on the series of transactions that will arise out of a debt-to-equity swap is the law of the parties according to the terms and conditions that they agree upon, as evidenced by separate contracts.[8] As such, the rule-of-thumb against stipulations *contra bonus mores* shall apply, taking into account the *lex situs,* which in

[5] "Equity conversion totals hit $1.24 B," *Bulletin Today*, January 3, 1989.

[6] A circular validly issued by the Central Bank has the force and effect of law. (Banco Filipino Savings Association v. Navarro, 152 SCRA 346; Pascual v. Commissioner of Customs, 4 SCRA 1020.) However, they [administrative circulars] must be published to be binding (People v. Que Po Lay, 94 PR 640.)

[7] It must be noted however that "crony capitalism" caused substantial loans to be incurred, especially during the period 1981-1986, that were not strictly in accordance with sound financial practice. This accounts for the fact that public sector debt comprises roughly 80% of our total foreign debt. Of this, about the same percentage is composed of the bad debts of both the PNB and DBP assumed by the government.

[8] The law of the parties is premised on the fact that both parties are capacitated

this case is usually the Philippines.

Another aspect of the transaction that must be considered is the mechanism called secondary market, by which these promissory notes are sold to investors. In practice, banks that wish to pre-terminate their indebtedness in a corporation make these debt instruments available at a discount,[9] in view of its termination before maturity, or because internal difficulties of the debtor corporation or country make it difficult to say when repayment will take place, if at all.[10] A discussion of the secondary market is outside the scope of this article and will not be addressed any further. Let is suffice that this will be within the competence of the banker who is undertaking to purchase the debt instrument in favor of the investor.

By way of further explanation, let us examine the language of the law:

> Debt to Equity Conversion is a program envisioned by the Government whereby certain external debts of a Philippine Public Sector Borrower or a Philippine Private Sector Borrower are redeemed in connection with a conversion transaction.
>
> Background to the Program. It has come to the attention of the Philippine Government that Philippine external debt obligations owed to commercial banks or financial institutions are being traded in the secondary market. If an investor purchases an interest in such an obligation and the obligor is able to redeem the debt for the Peso equivalent of the face amount of the obligation, this permits the investor to obtain Pesos. It is the intention of the

to enter into transactions based on their own national laws. Consequently, the validity of the agreements they enter into will be governed by the following:

a) for formal validity:
lex loci celebrationis, which is common in the Philippines, due to convenience.

b) for intrinsic validity:
the proper law of the contract, the *lex contractus.* This refers to the *lex loci voluntatis* or the *lex loci intentionis.* (Paras, Conflict of Laws, 1984, 405.)

[9] Philippine Public Sector Debt is being sold at a 55% discount, while Philippine Private Sector Papers are being discounted at rates between 20% to 30% depending on the stability of the corporation which incurred the debt. *Business World,* "Discount rate for RP debt paper now 55%," February 16, 1989.

[10] This is nothing more than the subrogation of the creditor, which does not require the consent of the debtor.

Government to utilize the opportunity presented by this type of transaction in order to encourage investors (both Philippine and non-Philippine) to make long-term equity investments in Philippine enterprises. An important ancillary benefit for the Philippines resulting from the discharge of foreign currency denominated debt through the payment of pesos, is a reduction in the aggregate external debt stock of the country. Such reductions alleviate the demands placed on the country's foreign exchange reserves by the need to make current debt service payments on existing foreign currency indebtedness. Section 5.11 of each Restructuring Agreement signed by a Philippine Public Sector Borrower, Section 2.04 of the Trade Facility and Section 5.11 of the New Money Agreement permit (with the consent of the Central Bank and the Republic of the Philippines) the discharge of any credit covered by any of such Agreements through the payment of an equivalent amount of Pesos. External debt obligations of a Philippine Private Sector Borrower may be redeemed for Pesos for conversion into equity investments if such borrower is permitted by the relevant loan agreement to discharge its external debt obligations in Pesos, or the creditor otherwise consents to this arrangement.[11]

Components of the Program

It becomes clear that the government, aside from seeking to reduce its foreign debt, also seeks to encourage investment to enter the country through this debt-to-equity program. This arises from the nature of the transaction as a conversion transaction. An investor wishing to purchase debt paper, otherwise known as Central Bank Credit Schedules, will usually bring in his currency in the form of dollars since the dollar is the most acceptable form of currency that exists. Upon the purchase of debt paper from a transnational bank at a discounted rate, he now presents this same debt paper to the Central Bank for payment. The Central Bank then pays him the full face value of the note, although it pays him in the local currency, Pesos. The investor thus stands to gain immediately from the Peso transaction because he gains the difference in the rate for which he bought the note and the value of the note in pesos for which it was fully paid. This now represent Peso proceeds, which the investor in turn is required to reinvest, under the law, as equity in a Philippine enterprise. Broken down, the debt-to-equity swap thus involves three transactions:

First. The purchase of debt paper at a discounted rate. This is a sales transaction.

[11] Section 2, CB Circular 1111 as amended.

its
try
ns-
ebt
ing
ble
ns-
to
ace
in-
he
of
ro-
as
ius

les

Second. The redemption of such debt paper in pesos by either a private commercial bank or by the Central Bank from the investor.

Third. The investment of the Peso proceeds in a local firm in the form of equity.

Although the Central Bank is not actually involved in the first transaction, it can be intimately involved with the second and third transactions. The effect of having the Central Bank redeem its own debt paper with regard to the Philippine public sector debt results in the release of an increased amount of pesos into the local money supply. If unchecked, a rapidly growing money supply could induce a chain of spending expenditures which would outstrip the capacity of an industry to produce the goods demanded, leading to demand-pull inflations.[12] A delicate balance must thus be maintained, inasmuch as the Central Bank must fulfill its twin functions of encouraging investment through the program while curbing inflation.[13] Also, the Central Bank must screen the investments in line with public policy,[14] to ensure the benefit to the country that should result from the proposed investment. Together, these twin factors explain why the pace of processing applications is not as rapid as one might have hoped.[15]

Sources of Debt Paper

As a point of information, to whom are we indebted? This question is essential if we are to discover which banks might be offering debt paper for sale at discounted prices.

Among multilateral organizations, the International Bank for Reconstruction and Development (IBRD), the International Monetary Fund (IMF), and the Asian Development Bank (ADB) are the major creditors, extending loans of 8.16%, 4.7%, and 3.32% respectively, of the total debt. On the bilateral level, Japan and the United States continue to be our biggest creditors. This includes the Export-Import Bank of the US and Japan, as well as the

[12] Stephen M. Goldfeld and Lester V. Chandler, *The Economics of Money and Banking*, 8th ed., 412.

[13] Power of the Central Bank, Sec. 64, as amended by Presidential Decree No. 72.

[14] This is reflected in Sec. 2, CB 1111 as amended, with reference to Schedules 2 and 3 of the same law.

[15] "Becuase many of the smaller banks are no longer interested in lending more money to the Philippines, they have been trying to dispose of their debt paper. Unfortunately, there is currently little demand for the paper due to a CB move initiated last year which limited the processing of public sector debt under the debt-to-equity conversion program." "Debt Paper . . ." *Business World*, February 16, 1989.

Ministry of Trade and Industry of Japan.[16] In short, our biggest creditors are Japan and the United States. Some of the top Japanese banks in the country at this time are:

Name	Outstanding Debt (in US $ Million)
Bank of Tokyo, Ltd.	448.13
Fuji Bank Ltd., Tokyo	226.87
Tokai Bank (Nagoya)	177.45
Kitsui Bank Ltd., Tokyo	138.01
Taiyo Koge Bank Ltd. (Kobe)	80.77[17]

Objectives of the Program

As we mentioned earlier, the Program was designed primarily to ease our external debt burden, but there are other objectives as well. These are:

1. to stimulate long-term equity investments in the Philippines by both foreign investors and Filipinos.
2. To encourage the repatriation of foreign currency holdings of Philippine residents held abroad to the Philippines for the purpose of capitalizing equity investments in this country.
3. to provide for additional incentives for investment in designated sectors of the Philippine economy that require prompt revitalization.[18]

Key Concepts

In order to expand our discussion, let us detail some of the more important points of the Program:

[16] Joel Tanchuco and Marinelle O. Santos, "Monitoring the External Sector: First Half of 1987," *The De La Salle University Business and Economics Review*. 1st issue.

[17] These loan figures are as of December 1987 according to the February 8, 1988 issue of the *Philippine Daily Inquirer*. Mitsubishi Trust in DRQ Corporation Tokyo and Danwa Bank Ltd. (Osaka) with loan exposures of $85.30 M and $46.84 M respectively are supposed to have representative offices in the Philippines, but this could not be confirmed. The rankings of the different Japanese banks come from *Fortune*, "The Top 500 Corporations in the World."

[18] Sec. 2, CB 1111 as revised.

1. Convertible Debt.

   This refers to any domestic corporation with a redeemable exteınal debt, further classified as follows:

   a. It is covered by a Restructuring Agreement;[19]
   b. It is owed by a Philippine Private Sector Borrower, provided that the existing credit instrument relating to such debt permits the prepayment or repayment of such obligation through the delivery of an equivalent amount of Pesos, or the appropriate creditor consents thereto;
   c. It consists of credits covered by the trade facility;
   d. It consists of advances outstanding under the New Money Agreement;
   e. Other debt obligations on such terms and subject to such conditions as may be approved in each case by the Monetary Board.[20]

2. Eligible Investors.

   This refers to any person, natural or juridical, regardless of residence, domicile, or, if juridical, regardless of the place of incorporation. Groups of investors may act through a nominee or agent in filing applications for approval of a Conversion Transaction.[21]

3. Permissible Investments.

   This refers to equity investments in a Philippine Enterprise that are either preferred under Schedule 2 or fall under Schedule 3. Preferred investments under Schedule 2 stand a better chance of being approved first.

   Essentially, preferred investments refer to the following areas of economic activity:

[19] This is nothing more than a novation of the contract of indebtedness between the creditor bank and the Philippine Government under CB Circular 1188. In practice, this may be compared to a suspension of payments, where, instead of a debtor, it is the country wnich defers the payment of its debts, since it foresees the impossibility of paying them all when they fall due.

[20] Sec. 4, in connection with Schedule 1, CB 1111 as revised.

[21] Ibid., Sec. 5. Note that in the introduction to this article, despite the avowed preference that this law has for Filipino investors, several groups of investors that have

a. exports;[22]
b. technical, professional or other services rendered outside the Philippines paid for in foreign currency;
c. banking;
d. non-performing government assets under the government's privatization program (APT):
e. the production of agricultural goods and related services, regardless of whether or not it is intended for export;
f. health care facilities or services;
g. low and middle income housing projects;
h. construction or maintenance of educational facilities.
i. an investment in a priority area of investment as defined in the Investment Priorities Plan in effect at the time such investment is made.

Schedule 3 investments, for their part, refer to investments not falling under the above enumeration.

4. Excluded investments.

This refers to the: prepayment in Pesos of Convertible Debt of a Philippine Private Sector Borrower, which prepayment would not require an extension of credit or release of funds from the Central Bank, and the investment of the proceeds thereof shall not be covered by this Circular; *provided* that the investor undertakes in writing to the Central Bank that no capital portion of the investment and no dividends or income in respect thereof shall be repatriated or remitted outside of the Philippines.[23]

Factors Considered in Evaluating an Application to Undertake a Conversion Transaction

After determining the eligibility of the proposed area of investment, the

availed of this program were mentioned.

[22] This is provided that the Philippine enterprise would qualify as an export-oriented firm within the meaning of CB Memorandum to Authorized Agent Banks dated Feb. 21, 1979, or, is certified such by another agency of the Phil. government, and the Monetary Board recognizes such a certification.

[23] Sec. 11, CB 1111, as revised.

next consideration of an investor is to increase the likelihood that an application for a debt-to-equity swap will be favorably approved. The test that the Monetary Board applies in evaluating an applicant involves the use of the Peso proceeds of the conversion transaction. Where the peso investment is "likely to make a direct or discernable contribution toward the revitalization of the Philippine economy," the chances are increased that the application will be approved, and vice versa. In more practical terms, this refers to investments that either increase the efficiency or capacity of the investee corporation.[24] Another factor weighing in favor of the application would be the extent of funding the proposed investment based on the redemption of the Convertible Debt of a Philippine Public Sector Borrower other than the Central Bank, where no release of funds from the Central Bank will be required,[25] since, as previously mentioned, the release of funds from the Central Bank is inflationary.

Procedure

For your guidance, the procedure for filing an application with the Central Bank under the Program may be broken down as follows:

1. A Filipino corporation that is willing to accept investment under the debt-to-equity swap must be located. More often than not, the difficulty of this step is obviated by the fact that the investor merely wishes to augment his investment in an existing enterprise.

2. An Application form for the Conversion Transaction must be filed with the Debt Restructuring Office of the Central Bank, along with the non-refundable P10,000 application fee.

[24] *Ibid.*, Sec. 9. By way of contrast, the investments that would not have such a direct and desirable effect on the revitalization of the economy would be as follows:

1. the purchase of existing assets or shares of a Philippine Enterprise without an infusion of new capital or expansion of productive capacity;
2. portfolio investments;
3. increases in working capital; and
4. the repayment of the Peso indebtedness of the Philippine Enterprises other than such payments to the government, the CB, or a government owned or controlled entity.

[25] Sec. 10, CB 1111, as revised.

The Monetary Board shall approve the application within 45 days from the completion of the application. If the application is denied, the investor may submit another application.[26]

3. If the application is approved, the investor has 60 days to close the transaction unless the Central Bank grants an extension of this period.[27]

The transaction is closed by obtaining a debt instrument from the secondary market. This is done by calling any one of the creditor banks, and contacting either their Merchant Banking, Investment, or Treasury Departments or their counterparts. Subsequently, negotiations are entered into for the sale of the debt instrument. The instruments are usually sold to thc investors at discounted rates. For instance, an instrument discounted 60% is an instrument for which the investor only has to pay 60 cents for every dollar of face value. Thus for instance, a promissory note with a face value of $100,000 discounted 60% would be sold for $60,000.

The debt paper is presented for prepayment to the obligor.[28]

In the case of Philippine Public Sector Borrowers, the note is presented to the Central Bank, which pays the note on behalf of the agency involved.

In the case of Philippine Private Sector Borrowers, a private commercial bank or the Central Bank can pay the note by drawing down on the foreign exchange reserves of the country.

After prepayment, the Central Bank deducts a Conversion Fee. Given a value of 20% as the fee charged, which is the maximum amount chargeable under Schedule 2,[29] this trans-

[26] *Ibid.*, Sec. 28.
[27] *Ibid.*, Sec. 29.
[28] *Ibid.*, Sec. 30.
[29] Under Schedules 4 and 5 of CB 1111 as revised, the Conversion Fee is a func-

lates into 20 cents profit per dollar of face value for the investor, which the investor now holds in peso form. This Conversion Fee may be reduced by funding a portion of the investment with dollars purchased from the Central Bank at the prevailing rate of exchange. In our previous example of a note with a face value of 100,000 dollars which was sold for 60,000 dollars, this 100,00 dollars will now be paid in Pesos by the Central Bank at the rate of exchange prevailing on the closing date of the redemption, the exchange rate should be P25: $1, then the $100,000 face value of the note is "deemed redenominated into its peso equivalent" which is P2.5 million.

The 20 cents profit per dollar shall be computed by taking the P2.5 million pesos received minus the peso cost of the $60,000 negotiated price for the note, P1.5 million. This leaves ₱1 million as the peso profit, or a dollar profit of $20,000.

5. Within five days, the investor should invest the proceeds of the Conversion Transaction as equity investment in a Philippine Enterprise.[30]

The term Philippine Enterprise can refer to either a stock or non-stock corporation. In the case of stock companies, the investment may be made in common shares, subject to certain restrictions on guaranteed dividends, or in preferred

tion of the amount of investment funded by additional pesos purchased from the Central Bank at the prevailing exchange rate, as follows:

Minimum Percentage of Fresh Money Funding	Fee under Sch. 2	Fee under Sch. 3
60%	0	0
50%	0	8.0%
40%	6.7%	13.5%
30%	11.5%	17.5%
20%	15.1%	20.0%
10%	18.0%	22.5%
0	20%	24%

[30] Sec. 31, CB 1111, as revised.

shares. In the case of non-stock companies, such an investment must be evidenced by an ownership interest in the Philippine Enterprise concerned.

In either case, a restrictive legend will be prominently marked on each paper evidencing ownership.[31]

In case of non-Philippine investors, however, such transactions will be subject to any generally applicable restrictions on foreign ownership in enterprises located in the Philippines.[32]

[31] *Ibid*, Sec. 8., The legend stating:

> This instrument was issued in connection with a [Schedule 2 Investment]. [Schedule 3 Investment] made in accordance with Central Bank Circular No. 1111, dated August 4, 1986, as revised (the "Circular"). The repayment and repatriation of the capital portion of the investment evidenced by this instrument, and the payment and remittance of dividends or current income in respect of such investment, are subject to certain restrictions as set out in the Circular. and the owner of this instrument is subject to certain sporting and certification requirements as set out in the Circular."

[32] *Ibid*., Sec. 7. Some of the restrictions scattered throughout our laws are as follows:

A. Constitutional Restrictions

1.	Mass Media	100% Filipino owned
2.	Public Utilities	–do–
3.	Retail Trade	–do–
4.	Security/Watchman Agency	–do–
5.	Pawnshop	70% Filipino owned
6.	Exploitation of natural resources	60% Filipino owned
7.	Institutions for education, except those established by religious orders, mission boards, or other charitable institutions.	60% Filipino owned
8.	Investment Company	Filipino majority

B. Restrictions in the Omnibus Investments Code

Non-pioneer enterprises either producing 50% of their products for export, an

Within ten (10) days from the closing of the transaction, the post-closing notification should be sent to the Debt Restructuring Office of the Central Bank[33] containing among others:

a. a letter-advice from the Board of Investments approving the investment involved if required under the Omnibus Investments Code;

b. a certification under oath by the corporate secretary of the Philippine Enterprise as to the number of shares, per value, class and serial number(s) of the covering stock certificates issued or any other documentary evidence of the investor's ownership interest, a xerox copy of which should be attached;

c. the capital structure of the Philippine Enterprise before and after the infusion of the equity investment, indicating the total amounts and percentages of equity ownership by nationality;

d. such other information or documents as may be required by the Debt Restructuring Office.[34]

7. Within 10 days following each anniversary of the closing date of a Conversion Transaction during a period in which restrictions on capital or dividends are applicable to such investments, the investor shall submit to the Debt Restructuring Office (DRO) annual compliance certificates indicating the amount of capital and dividends paid over the preceding twelve months.[35]

For verifying the use of the Peso proceeds, the investor shall

existing producer for export, engaged or proposing to engage in the sale of exports, engaged in the sale of motion or TV pictures, or engaged in technical, professional, or other services, should all be 60% Filipino-owned.

C. Nationalization Laws

If listed therein	60% Filipino owned

[33] Sec. 34, CB 1111 as revised.

[34] *Ibid.*, Exhibit B. giving the form for a post-closing notification.

[35] *Ibid.*, Sec. 35.

cause the Philippine Enterprise to submit periodic reports and supporting papers and to permit the periodic inspection of its premises or of its records.[36]

Restrictions on Peso Proceeds

After the law has ensured that investment will take place in a sector favorable for economic development, it must now take steps to safeguard this investment by ensuring that the investment was not merely simulated. This is necessary in order to prevent the loss of needed capital from productive investment. Hence it may be noted that the last two steps of the procedure previously cited deals with the need to verify the use of the Peso proceeds.

To ensure the integrity of the pesos invested, the law has placed certain restrictions on the capital invested as well as on the dividends paid out of such investment. These restrictions vary with respect to the nature of the investment, i.e., whether or not the investment is a Schedule 2 investment or a Schedule 3 investment.

The restrictions as to Capital invested, in tabular form, are as follows:

	Schedule 2	Schedule 3
No repayment	within the 1st 3 years	within the 1st 5 years
Partial repayment	20% within 4th-8th yrs.	20% within 6th-19th yrs.

In addition, it is provided that any unused portion of the amount permitted to be repaid in any such year may be repaid in subsequent years.[37]

Restrictions as to Dividends:

Under both schedules, dividends are allowed to be paid out of the profits of the Philippine Enterprise where an investment was made, provided that no guaranteed dividends or a similar arrangement that is not linked to profits, may be implemented.[38] This is again a safeguard against the undue liquidation of the investment. However, please note that, with regard to

[36] *Ibid.*, Sec. 36.

[37] *Ibid.*, Sec. 12, 14.

[38] *Ibid.*, Sec. 13, 15.

Schedule 3 investments, no dividends may be paid within the first four years after the investment is made.[39]

Additional restrictions likewise exist with respect to the remittance and repatriation of the principal invested, dividends paid, and profits made from subsequent sales. All transactions for the repatriation or remittance of the capital portion of an investment and the profits[40] thereon shall require the prior approval of the Debt Restructuring Office. Furthermore, distinctions must be made between resident investors, non-resident investors, and non-resident buyers. A non-resident buyer may be defined as a non-resident who purchases an investment registered under this Circular with pesos derived from the sale of foreign exchange either to the Central Bank or to a Philippine commercial bank at prevailing exchange rates.[41]

Resident investors are not allowed to remit or repatriate the capital portion of an investment or dividends received thereof,[42] as opposed to non-resident investors who are allowed to do so subject to applicable witholding taxes, if any.[43] However, if a non-resident investor should sell his investment to a non-resident, after a period not less than two years after investment,[44] then the sale must be funded by foreign exchange.[45] The remittance of the profits arising from such a sale will be governed by the restrictions prescribed by this Circular for investments made, herein above-cited.[46] The repatriation of similar profits by non-resident buyers, on the other hand, will be governed by CB Circular 1028, as is in force at such time.[47]

Liquidation of Investment

As all good things come to an end, so too do investments. For a myriad

[39] *Ibid.*, Sec. 15.

[40] Although the use of the word "profits" here is a bit ambiguous, the intent of the law seems to be to refer to dividends only. However, I see no reason why the screening of profits cannot extend to profits derived from subsequent sales of investment, based on the principle that the spirit of the law must prevail over its letter.

[41] Sec. 19, CB 1111, as revised. It seems this clause was intended to prevent the depletion of local capital in the primary market by foreclosing the possibility of using local loans to fund subsequent sales.

[42] *Ibid.*, Sec. 16.

[43] *Ibid.*, Sec. 17.

[44] *Ibid.*, Sec. 22.

[45] That is, using pesos derived from the sale of foreign exchange either to the Central Bank or to a Philippine commercial bank at prevailing exchange rates.

[46] *Ibid.*, Sec. 18.

[47] *Ibid.*, Sec. 19 [CB Circular 1028 is entitled "Consolidated Foreign Exchange Regulations on Non Trade Transactions." Made effective on October 15, 1984, it was subsequently amended on January 3, 1986 by CB Circular 1088.]

of reasons, the investor may terminate his involvement, either through voluntary sale, or through the liquidation of the Philippine Enterprise.

Under the first mode, the buyer is deemed simply to have been subrogated to the rights of the investor, so that all that the law requires after the transfer of the evidences of ownership to the buyer is that the buyer submit a certificate to the Debt Restructuring Office setting forth the following:

1. That the purchaser understands that the repayment or repatriation of the capital and dividends of the investnent is subject to the original restrictions set forth in CB 1111; and
2. That the purchaser agrees to assume all the obligations of the original investor as set forth in CB 1111, including periodic reporting and the submission of annual certificates.[48]

On the other hand, under the second mode, the capital investment shall have been repaid. However, in relation to the restrictions on capital repayment, the portion paid may exceed the amount allowed to be paid for that year under the law. In such a case, the investor has the option of reinvesting such an excess either under the Debt-to-Equity Conversion Program, or in non-transferrable Peso-denominated Central Bank debt instruments until the owner of the investment can reinvest such an excess amount in an approved equity investment.

If the excessis reinvested under this Program and if the original investment was a Schedule 2 investment, then the investment of the excess must likewise be in a Schedule 2 investment; and the date of the original investment shall be deemed the date of the investment of the excess. However, if the excess is reinvested in Central Bank debt instruments, then the payment of the principal or interest on such investment shall be subject to the restrictions which applied to the original investment.[49] Thus, if an excess of P50,000 was reinvested in Central Bank debt instruments due to the liquidation of an original Schedule 2 investment of P100,000 in a Philippine Enterprise after three years, then the repayment of the principal or interest on the P50,000 cannot exceed 20% of the new investment, or not more than P10,000 per year.

This situation might also arise out of a voluntary sale where the seller

[48] *Ibid.*, Sec. 22.

[49] *Ibid.*, Sec. 21.

is a non-resident and the Purchaser is either a Philippine resident or a non-resident.[50] In such a case, the same rules are applicable.

Effect on the Country's Balance of Payments[51]

Clearly the Program as conceived would reduce our level of external debt. However, as regards our Balance of Payment,[52] the effect could be beneficial or detrimental depending on the type of debt retired under the program, as well as the residence of the investor. We shall consider two classes of debt: private sector debts excluding the banking sector, and public sector debt assumed by the Central Bank.

Private Sector Debts Excluding the Banking Sector

If the debt is private, and the investor is a resident, which appears to be the prevailing situation, then the transaction would be recorded as a loan outflow with a corresponding decline in the foreign assets of the commercial banking system, a below-the-line transaction. This would result in a negative effect on our Balance of Payments.

On the other hand, should the investor be foreign, then this would be recorded as a loan outflow with a corresponding inflow of direct investment. The net effect on the Balance of Payments in this case would therefore be nil.

In case the debt should be redeemed by a private commercial bank, then there would be a loan outflow and a corresponding decrease in the foreign assets of the commercial banking system. This would result in the overall deterioration of our Balance of Payments. If the debt paper is subse-

[50] *Ibid.*, Sec. 22 Please refer to the text on non-resident buyers prefacing footnote no. 41.

[51] The following discussion is due solely to the efforts of Mr. Angelo A. Unite, who was the Vice-Chairman of the De La Salle Economics Department during my tenure there. I am very grateful that he allowed me access to some of his materials on the subject.

[52] A country's Balance of Payments table is designed to summarize a nation's transactions with the rest of the world, with respect to flows of goods and services, flows of international grants and loans, and changes in the foreign reserves of the country and other short-term claims as a result of trade and capital inflows and outflows. (Michael P. Todaro, *Economic Development in the Third World,* 2nd ed., 1981, 365.) In general, a favorable Balance of Payments position is preferred, because it indicates that foreign capital is being obtained at a faster rate than it is consumed, creating therefore, a larger capital base in conjunction with local capital with which to fund domestic economic development.

quently sold to a local investor, then, because this transaction is purely domestic, the effect on the Balance of Payments situation would remain negative. However, if the debt paper is sold to a foreign investor, then there would eventually be a net positive impact on the the Balance of Payments due to the inflow of investment coupled with an increase in the foreign assets of the commercial banking system.

When a resident investor purchases debt paper at a discount, a loan outflow is recorded based on the face value of the debt instrument, while the discounted amount of purchase would be reflected as a decrease in the foreign assets of a domestic commercial bank. The differential would be recorded as investment earnings in the non-merchandise account. Under conditions where this debt instrument is subsequently resold, if the purchaser is a resident, then there will be no effect on the Balance of Payments, this being a purely a domestic transaction.

If however, the purchaser is a foreigner, then there would be an inflow of direct investment equal to the face value of the note, and a corresponding investment expense equal to the differential. The net impact on the Balance of Payments in this case would therefore be positive.

Public Sector Debts Assumed by the Central Bank

Under this category, when a monetary debt assumed by the Central Bank is converted into equity by a resident investor, there would be a decline in the Central Bank's foreign liabilities matched by a decline in the commercial banking system's foreign assets. Thus, there would be no change in the country's Balance of Payments. The effect would be the same even if the liability was non-monetary.

However, when a monetary debt assumed by the Central Bank is converted into equity by a foreign investor, there would be a positive impact on the country's Balance of Payments. There would be an inflow of direct investment coupled with a reduction of the Bank's foreign liabilities.

On the other hand, if a non-monetary debt was converted into equity by a non-resident investor, then there would be a loan outflow since non-merchandise liabilities are still reflected "above the line." This would be matched, however, by an increase in direct investment. Thus, the effect on the Balance of Payments would be nil.

Conclusion

After a little more than two years of existence, the Debt-to-Equity Conversion Program has managed to retire 2% of our foreign debt, amounting to $584.5 million, as against a 3.7% increase in our foreign debt from $27.205

billion in 1986 when this Administration took office. Its overall effect on the Balance of Payments position of the country appears to be in the negative, considering that 79% of these conversion transactions were Central Bank obligations that were, presumably, retired to a large extent by Filipinos. In addition, this category of obligation causes inflationary pressure locally due to the increase in the money supply, and draws down on our international reserves, exacerbating our short-term financing problems. A financing gap of $8.4 B is expected over the next few years, if the country is to achieve its targeted growth rate of 6.5% per year.[53]

On the plus side, it cannot be denied that our foreign debt situation would have been worse without the program, and that the estimated $23.14 million in fresh money is better than no money at all.

It would seem therefore, that the program, in terms of its avowed objectives, has indeed reduced our foreign debt and encouraged foreign investment to flow in, but the aggregate amounts are much less than we would have hoped. Therefore, we can only look to the future, and we find that secondary market prices for Third World loans have slumped to record lows because of an overabundant supply of discounted loans and a dwindling demand.[54] However, the recent signing of the IMF letter-of-intent coupled with expected inflationary pressures resulting from an increase in the minimum wage as well as structural shortages in the economy will no doubt cause the Central Bank to further limit the availments under this program.

Since our foreign debt is not likely to dwindle significantly in the near future, it appears that this law and similar schemes such as debt-for-nature schemes, the recent bond-for-debt swap concluded under the recently renegotiated Military Bases Agreement, and, most recently, the French or Japanese proposal for reducing our foreign debt[55] should provide enough lucrative legal tangles for practitioners in the medium and even the long term.

[53] Reuben Lim, "Debt Negotiation will Adopt Tougher Stance," *Business World*, September 21, 1988.

[54] "Third World Debt Prices Fall as Swaps Lose Appeal," *Business World*, November 10, 1988.

[55] "The idea is to try to establish a trust to be funded by a Special Drawing Right allocation which would be used as collateral for commercial debt-swap schemes . . . . The Japanese proposal is almost the same except that the origin of the funds for the trust will come from the Japanese recycling program, distinct from the SDR issue allocation (ed.)." Finance Undersecretary Ernest Leung, quoted in "$335 M Due From Loans." Angelina Sy Tan, *Business World*, January 3, 1989.