LEGAL PROBLEMS OF INVESTMENT IN THE ANDEAN COMMON MARKET†

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I. Introduction

The concept of Latin American integration is by no means new. Ever since Simon Bolivar graced this planet, Pan-Americanists have dreamed of a united continent, though it is only recently that Latin American economists and developmental nationalists tempered the theoretical nature of Pan-Americanism with pragmatism and cold economic logic.

This pragmatism and logic led in 1960 to the formation of the Latin American Free Trade Association (LAFTA), composed of the countries of South America and Mexico. LAFTA's purpose was to bring into being within twelve years a free trade area for a majority of the products originating within its jurisdictional boundaries. LAFTA has not lived up to its potential, however, because of the tendency of the more industrialized members of the group, for example, Brazil and Mexico, to benefit from a free trade regime at the expense of the less developed members.

LAFTA's disappointing progress spurred the formation of the Andean Common Market (ANCOM), which was formally created in May, 1969, by the Agreement of Cartagena. The original members of ANCOM were Colombia, Chile, Peru, Ecuador, and Bolivia, with Venezuela effectively joining on January 1, 1974. Unlike LAFTA's integration philosophy which regards economic interdependence as a *sine qua non* of central planning, ANCOM's philosophy is predicated on the belief that central planning is a precondition of balanced trade and equitable growth.

II. The Development of a Common Regime

Pursuant to Article 27 of the Agreement of Cartagena, the ANCOM countries agreed to take the necessary steps for implementing a common regime of treatment of foreign capital and of trademarks, patents, licenses, and royalties. Adopted as Decision 24 of ANCOM's governing body, the Commission of the Cartagena Agreement, the Common Regime became effective on June 30, 1971.

The principal purposes of the Regime are:

(a) to exclude foreign investment from key sectors of ANCOM's economy;

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(b) to limit foreign participation in local companies to a minority position; and

(c) to diminish reliance on foreign technology while enhancing the development of local technology.

In furtherance of these objectives, the Regime set minimum restrictive standards for the treatment of foreign investments in ANCOM. Each member country is expressly allowed to impose even harsher restrictions on foreign investments than those set by the Regime.

The Regime applies to all investors who are not nationals of the member countries and to new as well as to existing investments. The Regime's regulatory scheme depends upon several important classifications of persons. For example, enterprises are classified as national (more than 80 percent of the capital owned by national investors), mixed (51 to 80 percent of the capital owned by national investors), and foreign (less than 51 percent of the capital owned by national investors). The Regime requires that the crucial percentages be reflected, in the opinion of the competent member countries, in the "technical, financial, administrative, and commercial management of the enterprise." In other words, there is a substance versus form test which precludes minority control by contract arrangements with national majorities.

National investors include individuals, national nonprofit entities, and other national enterprises as defined above, as well as foreign nationals with more than one year of consecutive residence in a member country, who renounce the right to repatriate invested capital and to transfer earnings abroad. "Foreign investor" is defined as the owner of a direct foreign investment. Direct foreign investment includes: (a) convertible currency capital contributions from abroad and belonging to foreign individuals or enterprises, (b) other capital and tangible assets, (c) investments in local currency from funds which are entitled to be transferred abroad, and (d) reinvestments effected in accordance with the Regime.

The Regime contains numerous restrictions which directly affect foreign investment in ANCOM, for example:

(a) Required prior authorization from and registration with the competent national authority of the recipient country of all new foreign investments.[1] The criteria for the approval of the new foreign investment are that the investment (i) fits into the development priorities of the recipient country, (ii) is not directed to activity adequately covered by existing industry, (iii) does not take over shares, participations, or rights owned by national investors,[2] and (iv) is not in a sector closed to foreign investors.[3] New

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1. This includes all foreign investments effected after January 1, 1974.
2. Unless special considerations such as imminent bankruptcy are present or unless waived by the recipient country.
3. Such as public services, insurance, commercial banking, and other financial institutions, domestic transportation, advertising, radio and television, newspapers, magazines, and domestic marketing of products of any kind.

foreign investment may be made in national or mixed enterprises provided there is a corresponding increase of capital and the recipient company maintains at least the characteristics of a mixed company. Thus, new foreign investment is permitted to change specified national companies to mixed companies.

(b) Required prior authorization from the competent national authority for the sale of shares, participations, or rights from one foreign investor to another.

(c) Limitation on the annual repatriation of profits of up to 20 percent of the direct foreign investment providing the remittor has obtained prior approval from the competent national authority of the recipient country. Individual member countries are allowed to approve higher profit remittance levels.

(d) Required prior authorization from and registration with the competent national authority of the recipient country for reinvestments of annual net profits, except that member countries may dispense with the authorization requirement for reinvestments not exceeding 7 percent of the capital of the enterprise.

(e) Mandatory divestment of specified foreign enterprises in key sectors of the market in existence as of January 1, 1974. These include enterprises engaged in the domestic wholesale and retail trade, the communications industry, and domestic transportation. Other foreign enterprises in existence as of January 1, 1974 are allowed to continue indefinitely without divestment, provided they are willing to forego tariff reductions and other ANCOM privileges afforded to their local competitors. However, the right of the Commission and of each ANCOM country to impose additional mandatory divestment rules is expressly reserved.

(f) Mandatory divestment of foreign enterprises established after January 1, 1974. Foreign investors must divest up to 51 percent of their equity ownership and a proportionate percentage of the management. There are two exceptions to this last rule: (i) new foreign investments in the mineral, pipeline, and forestry sectors, which are specifically regulated, and (ii) new foreign investments in enterprises which export at least 80 percent of their total production to countries outside of ANCOM.

(g) Limitation on access to local credit markets by foreign enterprises to short term and medium term (up to three years) credit in accordance with the rules issued by the competent national authority of the recipient country.

(h) Required prior authorization from and registration with the competent national authority of the recipient country of borrowings from abroad. This authority may also set the maximum borrowing limits.

(i) Restriction to a maximum of three percentage points above the prime rate prevailing in the lending country, on the annual effective interest rate[4] payable by a foreign enterprise to its foreign parent or affiliate.

Similarly, the Regime contains numerous restrictions with respect to the licensing of technology. In this regard, the Regime requires that all patent and trademark licenses as well as technical assistance agreements must be registered with the competent national authority of the recipient country, which can oppose the proposed transfer. Whether the transfer will be approved will depend on the effective contribution to the recipient country of the technology transferred. The Regime further stipulates that specified clauses in technology transfer agreements will *not* be permitted. These clauses include:

(i) clauses which obligate the recipient of the technology either to acquire capital goods, intermediate products, raw materials, and other technologies from a specific source, or to permanently employ personnel indicated by the supplier of the technology. In exceptional cases, the recipient country may accept clauses of this nature for acquisition of capital goods, intermediate products, or raw materials, provided that their price corresponds to current levels in the international market;

(ii) clauses pursuant to which the enterprise selling the technology reserves the right to fix the sale or resale prices of the products manufactured on the basis of the technology;

(iii) clauses restricting the volume and structure of production;

(iv) clauses prohibiting the use of competitive technologies;

(v) clauses requiring full or partial purchase options in favor of the supplier;

(vi) clauses which obligate the purchaser of technology to transfer to the supplier the inventions or improvements that may be obtained through the use of the technology;

(vii) clauses requiring payment of royalties to the owners of patents for patents which are not used; and

(viii) other clauses of equivalent effect.

The Regime further establishes the rule that "save in exceptional cases, duly appraised by the competent authority of the recipient country, no clauses shall be accepted in which exportation of the products manufactured on the basis of the technology is prohibited or limited in any way."

A perusal of the prohibitions contained in the Regime with respect to technology licensing reveals several things. First, the prohibitions listed are similar to those contained in Mexican and Argentine laws and regulations.

Second, although antitrust legislation in Latin America is, at best, practically non-existent, the prohibitions listed could be viewed as a form of patent antitrust rules by a United States antitrust lawyer. A comparison of Regime prohibitions in this area to patent licensing clauses that are violative of the United States antitrust laws will reveal a number of in-

4. In other words, interest plus commissions and other related expenses.

stances of similarity between the two.

Third, the Regime also prohibits the remittance of patent and trademark royalties and technical assistance fees from a foreign enterprise to its parent or affiliate, and provides that such royalties and fees are not deductible for local tax purposes. This provision coincides with recent regulations in other Latin American countries which have increased the tax burden on foreign technology transfers.

III. The Implementation of the Regime

Although the final aim of the Agreement of Cartegena was that there should be uniform application and interpretation of the Regime throughout all the member countries, this goal has not been achieved. By the time the Regime was approved, the relative homogeneity of the political and economic outlooks that prevailed in the countries during the negotiations for the establishment of ANCOM had been altered by changes in government. Subsequent to the adoption of the Regime, the member countries pursued dissimilar policies in implementing it, making the situation facing foreign investors in some ways more unstable and confusing than before the approval of the Regime. This lack of uniformity is generally based on the fact that the ANCOM Commission does not have the power to make decisions with the force of law in member countries; thus, the Commission often faces a difficult road in gaining enactment of its decisions as legislation within each member country.

Thus, implementation of the Regime in the member countries has varied from benign neglect (in the case of Bolivia) to vigorous and stringent application (in the case of Peru and Venezuela). The Regime's restrictions[5] often make it difficult, if not impossible, for the less industrialized members (Bolivia and Ecuador) to attract the new foreign investment that they will need to participate meaningfully in the integration program. An example of this dissimilar implementation is the preface to the Bolivian Decree incorporating the Regime into its national law. The preface notes that the Regime is in conflict with previously established Bolivian priorities for foreign investment and states that certain adjustments will havė to be made in the application of the Regime in Bolivia. In particular, the preface notes the problems that may be caused by the requirement of divestment for specified new enterprises, including those that wish to market their products only in Bolivia, and indicates that the Bolivian Government does not intend to enforce the divestment requirement for such enterprises. Ecuador has also done little more than routinely enact the Regime and has indicated that, as a relatively less developed country, it should not have to meet deadlines stricter than those of any of the other member countries

5. Particularly restrictions in the limitations on profit remittances which recently have been increased from 14 to 20 percent of the direct foreign investment.

in divesting foreign ownership of enterprises. In this regard, the limitation on annual profit remittance to 20 percent of the direct foreign investment, one of the more restrictive provisions under the Regime from the standpoint of the foreign investor, is of little consequence in Ecuador due to Ecuador's freely convertible exchange system which, as a practical matter, makes the limitation difficult to enforce.

By contrast, Peru and Venezuela have pursued vigorously the implementation of most of the Regime's provisions. Peru has gone beyond the concept of divestment to that of national ownership, and has developed foreign investment regulations which grant a major role for the state and for the industrial communities of workers in the ownership and control of industries. Naturally, this policy has proven somewhat troublesome to foreign investors. Venezuela, in turn, has implemented the Regime with little of the flexibility announced by President Carlos Andres Perez on April 29, 1974. Venezuela has elected not to apply exemptions under the Regime to the area of exploration and exploitation of gas, minerals, and related sectors. In addition, foreign enterprises in television and radio, public services, internal transport, internal marketing of goods and services except those produced in Venezuela, Spanish language periodicals, and professional services, have been required to divest at least 80 percent of their shares to national investors within three years from the implementation of the regulations.[6]

Given the ambiguity of the Regime and the difference in its implementation by the member countries, a foreign investor might indeed reconsider his interest in investing in ANCOM countries and choose to remain at home. The situation, however, is not all that difficult to cope with. First of all, recent events indicate that discord among the member countries will bring about a trend, even if temporary, to liberalize specified restrictions imposed by the Regime and, perhaps, to limit the implementation or enforcement of the restrictions which remain. Recent events which evidence this shift of policy include Chile's formal withdrawal from ANCOM on October 30 of last year, the agreement by the remaining member countries to liberalize the profit remittance limitations from 14 to 20 percent and to allow an increase from 5 to 7 percent in the permitted annual rate of automatic reinvestment, and the lowering of the Common External Tariff for most products. At least partially as a result of this liberalization trend, United States exports to ANCOM countries are expected to rise to $4.91 billion in 1977 from an estimated $4.34 billion in 1976.

Hopefully this trend will encourage the foreign investor to continue with his investment. It is clear, however, particularly in light of past differences in the implementation of the Regime among the member countries, that a thorough analysis of the local law is crucial if not essential. For example, one may find that a method available under the local law of

6. Recently, however, some of these requirements were somewhat modified.

one member country to avoid the mandatory divestment requirements is the setting up of a local branch. The Regime and related ANCOM Decisions and Regulations do not expressly require divestment of the enterprise setting up the branch. However, some countries such as Colombia, which interpret the Regime more strictly, will either infer a prohibition of branch establishment in the language of the Regime or at least make branch establistment practically difficult by delaying necessary bureaucratic approvals. Others, such as Ecuador, permit branches of foreign companies but only for temporary periods, for a specific project, and in areas which are not off-limits to branches.

Similarly, the licensor of technology might consider operating through a distributorship agreement or through a technical services agreement. Such forms minimize the effect of some of the Regime's provisions which require prior authorization and registration, or which prohibit specified clauses in licensing agreements. These forms may also serve to avoid high taxes imposed on royalty payments.

To gain a thorough understanding of the local law, a United States investor should request his lawyer to research the foreign law in such secondary source materials as are available to the lawyer. Then the lawyer should have his conclusions confirmed or corrected by local counsel in the country where the investment is to be effected. Careful choosing and efficient use of foreign counsel is crucial. The task is made especially difficult because, at least in the example of the United States investor investing in ANCOM countries, the lawyers' minds have been formed in different linguistic and cultural milieux. The culture of the United States lawyer, for example, is Anglo-Saxon; he thinks inductively, from the ground up. The mind of the Peruvian, Colombian, or Venezuelan lawyer, on the other hand, moves deductively from theory to practice. Authority emanates from powerful institutions like family, church, and state downwards to the individual. Effective communication, therefore, is essential to achieve a thorough understanding of the local law. Its importance cannot be understated.

Questions and Answers

Question: Is the profit remittance limitation similar to the restriction against Subpart F income?

Answer: Subpart F is something totally different. It is a section of the United States Internal Revenue Code which severely restricts deferral of United States tax through the use of foreign tax havens. Subpart F causes "passive" income, such as dividends, derived by a tax haven subsidiary to be taxed currently to the United States shareholder. The profit remittance limitation, on the other hand, limits the amount of income a foreign company can remit from the member country where such company is operating. The limitation is not the equivalent of a tax. The effect of the profit remittance limitation is to insure that most of the profits made by foreign investors in ANCOM countries remain in such countries. Since the foreign enterprises are generally not going to leave their profits in the bank but rather rechannel them into other local investments, the remittance limitation is an effective way to develop local economies.

Question: What is the reinvestment restriction?

Answer: The first requirement is that of registering the initial investment. In addition to that, there are restrictions applicable to the reinvestment of profits made from the original investment. Although there are no prohibitions on the reinvestment of profits, there are limitations on the amount of unauthorized reinvestment which can be used to increase the amount of registered capital, which is used as a basis to calculate profit remittances. For example, assume a foreign investor invests $1,000,000 and makes a profit of $250,000 the first year. He will be allowed to remit only $200,000 and will have $50,000 left for reinvestment. He can then reinvest up to 7 percent of the capital which means that he can reinvest up to $70,000; thus, he can use the $50,000 to increase his registered capital to $1,050,000. This assumes, of course, that all necessary authorizations are obtained. Now assume that the foreign investor has $200,000 in excess profits which he cannot remit. He will be allowed to increase his registered capital only to $1,070,000. As a practical matter, the remaining $130,000 can be reinvested but cannot be used as a future basis for profit remittances. It should be noted that remittance relates to profits, which is a different concept from repatriation. Repatriation refers to the return of the investment.

The Regime attempts to minimize situations where foreigners invest in member countries only to take back their investments, leaving such countries without capital or natural resources. These countries will not allow foreigners to do this anymore, and in furtherance of their new objectives they have changed the rules of the game.