

Infrastructure boom

Ricardo M Arango and Rodrigo Cardoze of Arias
Fábrega & Fábrega present a primer to lenders
financing energy and other infrastructure projects in
Panama

Many significant energy and other infrastructure projects have been financed in Panama in recent years. The energy industry continues its rapid growth in the country. Generadora Pedregalito, one of the largest hydroelectric projects currently developed by Panamanian investors, is closing on a \$60 million public bond issuance in the Panamanian Stock Exchange. Dating back to 2002, Fortuna, Panama's largest electricity generating company and a subsidiary of Enel, issued \$170 million 10.125% secured notes due 2013. Similarly, in 2006, its main competitor, AES Panama, issued \$300 million 6.35% senior notes due 2016 to refinance existing obligations.

In 2007, AES Changuinola entered into a syndicated loan to finance the construction of a new 223MW hydroelectric facility. In 2007, Bahía Las Minas Corp, the largest thermal generation company in Panama and a subsidiary of Suez Energy, issued \$175 million multi-series senior secured notes to finance a coal conversion project. In 2006, Elektra Noreste, the second largest electricity distribution company in the country, issued \$100 million 7.6% senior notes due 2021. In addition, there have been multiple financings for run of the river hydroelectric projects, such as the \$7.5 million financing of the Macano hydroelectric project and the engineering, procurement and construction (EPC) contract with Constructora Norberto Odebrecht for the construction of the Dos Mares hydroelectric project.

Companies operating in other industries have also financed substantial infrastructure projects in recent years. In the mining industry, a group of banks led a \$45 million prepaid forward gold purchase agreement financing for Petaquilla Minerals, a Canadian-owned mining company established in Panama. In the telecommunications industry, in 2008 Digicel borrowed \$170 million to finance the deployment of its new cellular network; and the Brazilian construction company Odebrecht, financed the construction of Panama City's landmark \$183 million coastal highway (Cinta Costera) with a non-recourse collection rights purchase facility, and also financed the construction of the \$165 million Madden-Colon toll-road with a government-guaranteed syndicated loan to a special purpose construction and operation trust. Furthermore, in 2010, Odebrecht financed additional works related to the design and construction of Cinta Costera through a \$17.5 million non-recourse collection rights purchase facility.

In 2007, the Panama Canal Railway Company, operator of a 47-mile railway running adjacent to the Panama Canal and linking the Pacific and Atlantic coasts of Panama, issued \$100 million senior secured notes due 2026. In 2005, ICA Panama raised \$150 million by securitising toll-road receivables of the South Corridor; and the government of Panama financed the \$70 million expansion project of Tocumen Airport with a syndicated loan.

Arias Fábrega & Fábrega acted as counsel to the arrangers, underwriters, lenders, borrowers and issuers in all of the abovementioned infrastructure projects. Some of these transactions were structured as simple syndicated loans or unsecured senior notes. Others involved complex instruments with highly structured collateral packages.

Non-recourse collection rights purchase facilities

As mentioned above, Odebrecht, financed the construction of Panama City's Cinta Costera with a non-recourse collection rights purchase facility granted by a syndicate of lenders. Under this innovative financing structure, the lenders purchased at discount credits (collection rights) payable to the contractor by the government under the construction contract evidenced in documents named partial payment account certificates (*cuentas de pago parcial*). Each partial account payment certificate stated the specific amount payable to the contractor or its assignees as a result of works performed by

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the contractor and approved by the government during a certain period and such certificate, once issued, constituted an irrevocable payment obligation of the Republic of Panama independent from the construction contract itself. The success of the Cinta Costera financing has paved the way for this non-recourse collection rights structure to be used again; it is being considered as an alternative financing structure for several of the Panama's infrastructure projects.

Concession agreement

Most infrastructure projects in Panama are operated under concession agreements granted to private companies by the government. Generally speaking, concession agreements are of two types: (i) concession agreements enacted by special legislation (*contratos-ley*); or (ii) ordinary concession agreements granted by government agencies under the regulatory framework applicable to the energy, telecommunication, port, toll-road, mining and oil industries and the general public contracts law.

The largest infrastructure projects in Panama, such as Texaco's former refinery, Petaquilla's copper mine, the Balboa, Cristobal and Manzanillo container ports, and the Panama Canal railway have all been awarded under special legislation. The advantage of concession agreements enacted by special legislation is that the terms of the concession can be tailor-made to the specific requirements of the project. For lenders, this may include, among others, specific recognition of step-in rights in the event of default, tax relief on withholding and stamp taxes and more certainty with respect to the creation and enforcement of security interests.

Government control and termination rights

Infrastructure projects in Panama usually involve investments in regulated industries. Such is the case with the energy, telecommunication, port, toll-road, mining, petroleum storage, transportation and refining industries. Lenders must be aware that the government of Panama and its regulatory agencies exercise substantial influence on companies operating in these industries.

Lenders must be particularly aware of the government's right to terminate concession agreements. By law, the government of Panama always reserves the right to unilaterally terminate a concession agreement for reasons of public interest (*rescate administrativo*) and payment of fair compensation. The details of what constitutes public interest, what is fair compensation and which process is

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to be followed change, to some extent, from concession agreement to concession agreement.

In addition, the government of Panama also reserves the right to terminate a concession agreement in a case of breach of the terms of the concession by the concessionaire and in the event of the insolvency or bankruptcy of the concessionaire. As in the case of the unilateral termination of a concession, the details of what constitutes a breach of contract, what compensation, if any, is due to the concessionaire, and which process is to be followed also change, to some extent, from concession agreement to concession agreement.

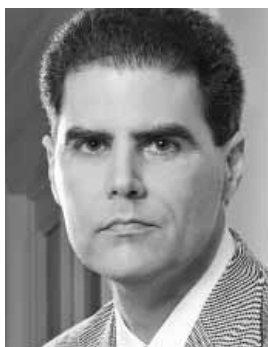
As the concession agreement is in most cases the most important asset of the concessionaire, lenders must take care to understand the circumstances under which the concession can be terminated and the way in which termination payments are calculated and paid. It is critical that whatever termination payment the concessionaire is entitled to receive, whether in the case of the unilateral termination of the concession for reasons of public interest or in the case of termination because of a breach of the terms of the concession, be assigned to the lenders. Consents, filings and proper formalities must be secured and followed for the assignment of these termination payments to be valid and enforceable against the government and to be excluded from the bankruptcy of the concessionaire and beyond the reach of other creditors.

Some concessions, such as ICA's South Corridor, Petaquilla's copper mine and the Panama Canal Railway's railroad, have granted lenders limited rights to step-in, operate the concession, cure defaults and identify potential purchasers for the concession before the government terminates the concession. However, the general legal framework applicable to most concessions does not contemplate step-in rights in favour of lenders. In infrastructure projects whose size and nature require step-in rights, concessionaires should seek a concession agreement enacted by special legislation.

Lenders should also review the good standing of the concession and the concessionaire, as the government generally reserves substantial rights to audit performance of the concessionaire under the concession agreement and violations of such terms may result in causes of termination.

Collateral package

The financing of most of the infrastructure projects in Panama has included a comprehensive and complex secu-



About the author

Ricardo M Arango is a partner of Arias Fábrega & Fábrega. With deep marketplace experience and sophisticated industry knowledge, he has effectively assisted leading multinational and Panamanian companies in financing their infrastructure projects in Panama. From simple government supply contracts to developing intricate financial structures for complex concession agreements and public contracts, he has been instrumental in creating many financial structures that are now commonly used in Panama. Arango has a Master of Laws from Yale Law School, a Master of Laws from Harvard Law School and a Bachelor of Laws from the University of Panama. He has been endorsed as a leading banking and finance lawyer in Panama by top international publications.

Contact information

Ricardo M Arango
Arias Fábrega & Fábrega

Plaza 2000, 16th Floor, 50th St
P.O. Box 0816-01098
Panama, Republic of Panama

t: +507 205 7000
f: +507 205 7001/02
e: rarango@arifa.com
w: www.arifa.com

urity interest package. Security packages have ordinarily included a combination of a mortgage or an assignment of the concession agreement: an assignment of concession termination payments, a pledge of the stock of the concessionaire, a pledge or similar security interest on collection, capex and debt service reserve accounts, a mortgage on real property, a chattel mortgage on movable assets, an assignment of insurance payments, an assignment of accounts receivable and an assignment of material contracts, such as power purchase agreements. Although, in general terms, Panamanian law favours the creation, perfection and enforcement of these security interests, lenders should be aware of certain limitations.

Concession agreement

Generally speaking, infrastructure concession agreements can be mortgaged under Panamanian law. Prior consent from the government is in most cases necessary to create a valid mortgage on a concession. In addition, the filing of a mortgage agreement with the Public Registry is required for the validity and perfection of the mortgage. Although a properly constituted mortgage will grant the mortgagee a first priority security interest on the concession agreement, lenders should be aware that foreclosure of the concession must be carried out through judicial proceedings and, before the concession can be transferred upon foreclosure, the government must approve the new concessionaire. Thus, lenders can expect the foreclosure of a concession mortgage to be a lengthy process that will involve substantial government participation. The mortgage of the concession agreement must be governed by Panamanian law. Regarding hydroelectric plants, concessions to use water resources in Panama are granted by the Panamanian Environmental Agency. At the moment, this agency is of the view that concessions for the use of water resources are not transferable.

Shares of stock of the concessionaire

Shares of stock of Panamanian companies can easily be pledged. Pledging shares of stock usually only requires the execution of a pledge agreement, the delivery of the share certificates with blank stock powers to the pledgee and an annotation of the

pledge on the company's stock register. No further filing is required for the perfection of a stock pledge. Nonetheless, lenders must be aware that the legal framework applicable to most infrastructure concessions requires prior consent from the government in order to create a valid pledge on the shares of a concessionaire.

A properly constituted pledge will grant the pledgee a first priority security interest in the stock of the concessionaire. As opposed to a concession mortgage, the foreclosure of a pledge on the shares of the concessionaire need not be carried out through judicial proceedings. The shares can be disposed of through private or public sales. However, as in the case with the foreclosure of a concession mortgage, the legal framework applicable to most infrastructure concessions requires that the new owner of the shares be approved by the government before foreclosure. One issue that frequently comes up in connection with concession agreements is whether pledging the stock of the parent company of the concessionaire also requires the consent of the government.

The legal framework applicable to most concessions and most concession agreements is silent on this point. However, as the government grants infrastructure concessions while taking into consideration the qualifications and financial strength of the sponsoring shareholders, it is generally advisable to obtain the consent of the government to pledge the stock of the parent company if the transfer of the stock would result in a change of control of the concessionaire or a change of its operating partner. Nevertheless, there seems to be at this time no unified criteria among regulatory agencies regarding the treatment of changes of control. The issue needs to be reviewed on a case-by-case basis.

Collection and debt service reserve accounts

The pledging of collection accounts, capex payment accounts, debt service reserve accounts and other similar accounts is possible in Panama. If the accounts are with a bank in Panama, the security interest must be governed by Panamanian law and can take the form of a pledge of the bank account. Pledging the account requires that a pledge agreement be executed and that the pledgee takes

control of the bank account and its funds. Control of the account is critical for the perfection of the security interest. This is regularly achieved through control provisions in the pledge agreement and by making the bank where the account is located a party to this agreement.

Another possible structure is to set up a trust and open the bank account in the name of a collateral trustee for the benefit of the lenders. If the accounts are not located in Panama, it is advisable that the security interest be governed by the law of the jurisdiction where the account is located.

Real estate and chattel property

Real property, both land and improvements, owned by concessionaires can generally be mortgaged to secured lenders. A valid and perfected first priority mortgage can be established on real property by executing and filing a mortgage agreement with the Public Registry. Foreclosure of a real estate mortgage can only be carried out through judicial proceedings. Consent from the government is generally not required to either create or foreclose a mortgage on real property of the concessionaire if the real property is not considered by applicable laws and the concession agreement to be an essential asset for the operation of the concession.

Where the property is considered to be an essential asset of the concession, such as the dams, tunnels and powerhouses of hydroelectric plants, the legal framework applicable to most concessions requires consent from the government to create and foreclose a mortgage on those assets. A security interest on machinery, equipment and other movable assets can be created by way of a chattel mortgage. A valid and perfected first priority chattel mortgage can be established by executing and filing a chattel mortgage agreement with the Public Registry. As is the case with a mortgage on real property, foreclosure of a chattel mortgage can only be carried out through judicial proceedings, and government consent for the creation and foreclosure of the chattel property would generally be required if the assets are essential to the concession. Chattel mortgages can only be established for four years, but this period can be extended.

When using this type of security interest, the non-extension of the chattel mortgage before its



About the author

Rodrigo Cardoze is a senior associate of the firm. He has been responsible for structuring and documenting numerous types of financings in key cross-border transactions in which the firm has participated in recent years. Cardoze has a Juris Doctor from Washington University School of Law, and a Bachelor of Arts from Duke University.

Contact information

Rodrigo Cardoze
Arias Fábrega & Fábrega

Plaza 2000, 16th Floor, 50th St
P.O. Box 0816-01098
Panama, Republic of Panama

t: +507 205 7000
f: +507 205 7001/02
e: rcardoze@arifa.com
w: www.arifa.com

termination should be included as an event of default in the loan agreement or the indenture. Both real property mortgages and chattel mortgages may cause significant filing fees. Recording fees are charged on the aggregate principal amount of the secured obligations as stated in the mortgage agreement.

Where the fair market value of the real property or the chattel property is significantly lower than the principal amount of the secured obligations, the mortgage agreement can be drafted to secure only the value of the collateral to minimise filing fees. Another issue frequently faced by lenders and concessionaires is the inclusion of new assets to, and the release of damaged, depreciated, lost or sold assets from, the mortgage. Mortgage agreements typically provide for periodic reviews for the inclusion and release of assets.

Material contracts

Creating a security interest on contracts is more difficult under Panamanian law. An assignment of a contract under Panamanian law transfers the rights and obligations of the assignor to the contract and is not simply a way of creating a security interest. In addition, unless the contract so provides, the consent of the other party to a contract is expressly required for the valid assignment of the contract. In some transactions, material contracts (such as power purchase agreements) have been assigned subject to conditions (such as a default under the loan agreement or the indenture).

However, this conditional assignment may be challenged and even undone in the event of the bankruptcy of the concessionaire. For these reasons, where possible, security interests over material contracts should be created and perfected under foreign laws that recognise the assignment as a way of creating a security interest. If a valid and perfected security interest under a foreign law is created on these contracts, Panamanian law should recognise it.

Finally, the legal framework applicable to some concessions requires that certain material contracts be filed and/or approved by the regulatory agency. In these cases, the creation of a security interest and the assignment of these contracts may require notice and/or approval from the government.

Taxation

Under current tax laws and regulations, interest paid by a concessionaire on loans or debt instruments, the proceeds of which are used by the concessionaire in its operations in Panama, is considered Panama-sourced income and is taxable in Panama. Some concession agreements enacted by special legislation and certain toll-road concession agreements have exemption from tax interest payments to foreign lenders and foreign note holders. Such is the case with Panama Port's container terminal and Petaquilla's copper mine concessions.

However, in the absence of such special exemptions, as a general rule, when a foreign lender (a lender that does not have a tax domicile in Panama) lends money to a borrower in Panama, and the borrower is either a taxpayer (earns Panama-taxable income) or uses the proceeds of the loan for a business purpose in Panama, any interest paid by the borrower to the foreign lender is deemed to be Panama-sourced income and is subject to withholding. The borrower must withhold income tax at the applicable rate (which for corporations is 25%) on 50% of the interest amount paid to the foreign lender – an effective withholding rate of 12.5%.

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However, as mentioned, there are exemptions that apply to borrowers on specific industries.

For instance, loans made by a foreign bank to a local bank are not subject to withholding. Furthermore, the corporate tax rate varies depending on the industry. For instance, the corporate tax rate for banks is 30%. Accordingly, since local banks are subject to a 30% rate, the applicable withholding rate to foreign banks is 15%. The payment of additional amounts and gross-up provisions for the benefit of foreign lenders and note holders is common and enforceable in Panama.

To avoid the concessionaire having to pay additional amounts on account of withholding taxes, a structure has been developed to register debt instruments with the Panamanian Securities Commission and to offer them simultaneously on the Panama Stock Exchange and the international markets. This structure makes use of the tax exemption accorded by law to debt instruments listed on the Panama Stock Exchange and allows concessionaires to issue and sell 144-A Reg S notes to foreign note holders without having to pay additional amounts on account of withholding taxes.

This structure, pioneered by the \$170 million Fortuna notes offer, has been successfully used in the \$150 million ICA Corredor Sur notes offer, the \$300 million AES Panama notes offer, the \$100 million Elektra Noreste notes offer and the \$220 million Trump Ocean Club notes offer. Another benefit of this structure is that it exempts the indenture, the underwriting agreement, the security agreements and all related agreements from stamp taxes in Panama.

Choice of law and jurisdiction

The choice of a foreign law as the governing law of a loan agreement or an indenture is valid under Panamanian law and it should be recognised and enforced by the courts of Panama. Nevertheless, lenders must be aware that although the loan or notes may be subject to a foreign law, the concession agreement and the security interest agreements that relate to assets located in Panama, such as mortgages on real property and pledges over bank accounts with banks located in Panama, will remain subject to Panamanian law.

The submission by the concessionaire to the jurisdiction of foreign courts and the appointment of an agent in a foreign jurisdiction to accept service of process in respect of proceedings before such courts are valid stipulations under Panamanian law. However, lenders must be aware that any dispute relating to the concession agreement, unless the government has consented to arbitration, will be heard in the courts of Panama and the foreclosure of any security interest that requires judicial proceedings, such as foreclosure of a concession mortgage or a real property or chattel mortgage, will also be enforced in the courts of Panama.

Significant infrastructure projects are either already being worked on or are being considered in Panama. These projects include the development of the Petaquilla copper mine, Panama's largest copper deposit, further expansions of Tocumen Airport, the financing of new hydroelectric facilities, the expansion of national ports, the construction of new hospitals, the re-organisation of the Panamanian roads and highways and the financing of a new metro for Panama City. It is certain that some of the legal issues discussed here will be relevant to these new projects.